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Operating Risks and the Increasing Indebtedness of Hungarian Local Governments

Audit experiences of the State Audit Office of Hungary

SUMMARY: In 2011, the State Audit Office started the system-level audit of local governments. Based on risk analysis, the first round of audits covered the 19 counties, the 23 towns with county rank as well as the capital; of the 304 towns auditors checked 63 through on-the-spot checks of local governments selected through representative sampling. The financial equilibrium of Hungarian local governments obviously deteriorated between 2007 and 2010; financial risks increased and debt – particularly foreign currency debt – rose rapidly. The majority of local governments are unable to put up sufficient collateral to cover their debt service obligations. Banking exposure increased, and overdue debts rose sharply. The fact that business associations under the majority ownership of local governments also accumulated significant debts is also a serious problem. Paradoxically, the financial situation of local governments was adversely affected by the intensive investment activity related to EU tenders, as they were financed by loans, and the local governments do not have the necessary funds to cover their operating costs and to repay these loans.[1]

KEYWORDS: local government financial management, debt, EU tenders
JEL CODES: H63, H70, H71, H72, H83

The increasingly apparent financial management difficulties of local governments, the sharp rise in cash deficit and indebtedness clearly indicate that the financial status of the local governmental sector must be kept under control. The fact that in 2010 it was the deficit in the local governmental sector that dragged down public finance deficit figures, measured as a percentage of the GDP, showed particularly clearly the significance of these difficulties to the national economy [Ministry for National Economy (2011)].

Though the State Audit Office has a general mandate to audit the utilisation of public funds and public assets,[2] neither the previous, nor the current SAO Act requires that local government reports and final accounts be audited comprehensively. Accordingly, the SAO previously only audited the financial management of counties, towns with county rank and Budapest districts on a regular basis, namely spread across a four-year cycle. These were the only reports that were made public; the others, the audits of close to 3 100 local governments were incidental and not public. In 2011, the management of the SAO decided to audit, over the course of four years, compliance with the relevant legislation at all local governments. In the interest of improving efficiency the SAO switched to risk-based selection for this group of audits,[3] which ensures that the auditors' conduct their audits in order of priority of where an audit is truly required.

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Based on our risk analysis, the first round of audits covered 19 counties, 23 towns with county rank as well as Budapest. These reports were completed and published in 2011.[4] Concurrently, last September we also began to audit the financial status of the local governments of towns. The SAO selected 63 local governments for on-the-spot checks.[5] These were selected by the audit institution from the 304 Hungarian towns using representative sampling.[6] In 2012 the auditing of local governments in villages also commenced, albeit only as a pilot. In the spring, eight pilot reports were drawn up in order for the SAO to be able to commence – utilising the experiences gained here – the auditing of hundreds of villages. The purpose of these pilot audits for the SAO was to identify areas of risk, to develop and test methodologies and to assess the resource and time requirements of audits. The trial audits are in line with the SAO's strategic objective, namely to improve audit efficiency through the development and reinforcement of the planning process. In the case of villages, the audit primarily covers the development and operation of the internal control system, as in smaller villages the risks associated with the regulation of internal controls, risk analysis, the exercise of financial management powers as well as internal audits are higher than usual. For years the State Audit Office has placed special emphasis on the evaluation of the internal auditing systems of local governments. *Tamás Sepsey* (2011) points out some very important lessons in connection with the above. According to Mr Sepsey the local government internal audits fail to methodically assess and improve the effectiveness of the risk management and controlling procedures of local government. This is in part due to the contradictions of applicable acts of legislation, and in part due to the misapplication of internal audits and the misinterpretation of their role.

What is the magnitude of the problem of the indebtedness of mid-level local governments and town local governments? According to the data of the National Bank of Hungary, at the end of last year Hungary's gross consolidated public debt, calculated on the basis of EU methodology, amounted to HUF 21 749 billion. At the same time, the debt portfolio of local governments was around HUF 1 200 billion,[7] i.e. barely more than a twentieth of the total public debt. We must emphasise this because it clearly shows that in comparison with central government, the local governments providing the majority of public services have managed their finances in a relatively responsible and balanced fashion. The problem is that debts increase quickly and have today reached a size that could cause grave problems at the local level.

THE EXPERIENCES OF THE AUDITS PERFORMED BY AUDIT INSTITUTIONS

The financial equilibrium of Hungarian local governments obviously deteriorated between 2007 and 2010, and financial risks increased over the same period. The balance of the current budget has been declining steadily since 2008, dropping from HUF 172 billion in 2007 to HUF 76 billion in 2010. The decrease of budget funds impacted all types of local government, and in the case of mid-level local governments the drop in tax and levy revenues made the situation even worse. Between 2007 and 2010, in absolute terms the revenues of county local governments dropped by 16.9 per cent; while the 6.1 per cent increase in the aggregate revenues of the Municipality of Budapest and the local governments of towns and towns with county rank also dropped in real terms *(see Chart 1)*.

The supplementary subsidies serving to maintain the viability of local governments failed to improve long-term financial equilibrium, and in some cases they did not help create an equilibrium in the short-term either. It is an indication of the financing difficulties of the local government sector that in 2010, of 304 town local governments 51 received ÖNHIKI subsidies, while in 2011 this number was 156.[8]

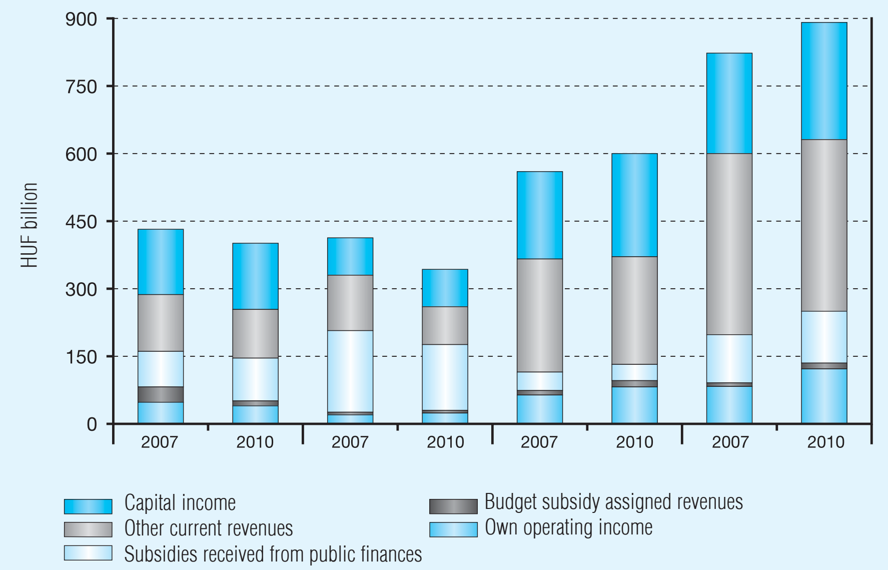
Serious problem: the majority of local governments – in particular county local governments – are unable to come up with the necessary funds in their current budget to cover their debt service obligations. In the absence of a capital surplus this led to a rise in the indebtedness of these local governments. It is a harmful process that the liquid loans taken out to finance the difference between the time required to collect trade receivables and pay trade payables were used, in many places, to finance long-term operating and capital deficits. The majority of local governments favoured taking out overdrafts and liquid loans as the borrowing limit did not apply to these and interest conditions were also favourable. This, however, increased the banking exposure of local governments. Due to insufficient funds on the date of the maturity of these loans, it became common practice to renew these loans annually, mostly out of necessity and in increasing loan amounts.

The borrowing limit of local governments was included in the Act on Local Governments when it was amended in 1995, based on which the per annum debt liabilities of local govern-

Chart 1

CHANGES IN THE REVENUES OF THE LOCAL GOVERNMENT SECTOR

(2007–2010)



	Budapest		Counties		Towns with county rank		Towns	
	2007	2010	2007	2010	2007	2010	2007	2010
Own operating income	145	147	83	83	194	229	223	260
Budget subsidy, assigned revenues	126	108	123	84	251	239	402	381
Subsidies received from public finances	79	95	181	146	41	36	107	115
Other current revenues	134	11	6	6	10	14	8	13
Capital income	48	40	20	24	64	82	83	122

ments may not exceed 70 per cent of the own revenues of the local government minus its short-term liabilities. In connection with this, *Gál* (2011) established that Hungarian practice followed the "market regulated" model, the essence of which was that taking out external funds was first and foremost determined by money and capital market processes and mechanisms. In practice, however, this mechanism did not operate the way it was supposed due to a number of factors; therefore, Hungarian regulation also generated unintended consequences.

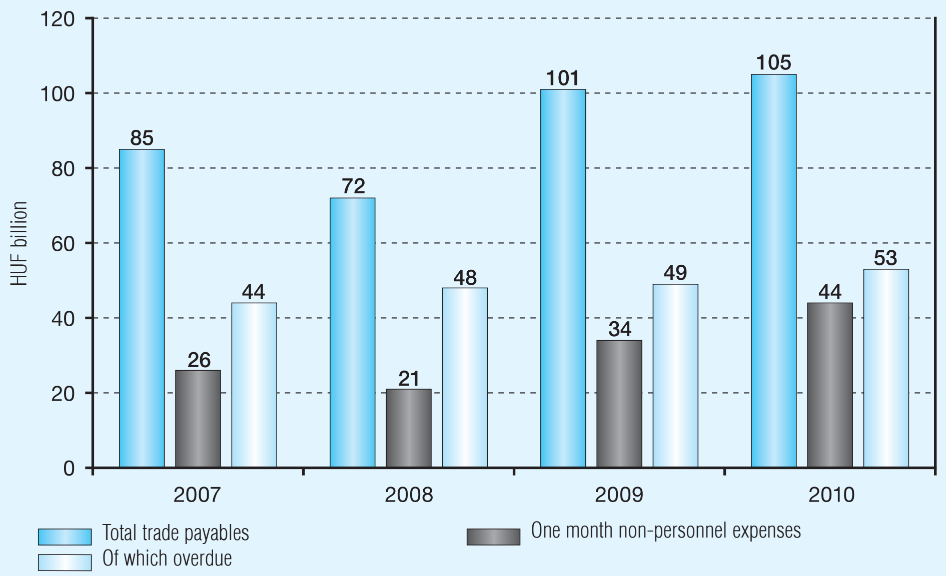
Due to the limited availability of bank loans, local governments considered suppliers instruments of external financing. The end of year portfolio of trade accounts payable – with the exception of a single year, 2008 – exceeded the two-month level of non-personnel expenses. The fact that from 2007 to 2010 total trade payables increased by 23.5 per cent and overdue debts by 69.2 per cent poses a risk *(see Chart 2)*.

Paradoxically, the financial situation of local governments was adversely affected by the intensive investment activity related to EU tenders. The balance of capital income and expenditure between 2007 and 2010 reported a deficit in every year for all types of local governments. In addition to the EU and domestic government grants, local governments would need an additional HUF 217 billion in external funding to be able to finance the HUF 1 154 billion still due on investment projects in progress. The increase in the willingness to invest created liabilities, where the future funds necessary for

Chart 2

THE DEVELOPMENT OF THE TRADE PAYABLES OF LOCAL GOVERNMENTS

(2007–2010)



Trade payables data in HUF billion	Municipality of Budapest				Local governments of counties				Local governments of towns with county rank				Local governments of towns			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total trade liabilities	13	14	16	12	22	19	26	24	22	17	24	24	28	22	35	45
Of which: overdue	1	1	3	2	8	5	9	9	6	6	6	9	11	9	16	24
Of which: hospitals	1	1	3	2	4	4	8	4	3	4	5	4	2	2	3	2

their repayment were not ensured. The operation, maintenance and future sustainability of facilities created through developments are further risk factors. It is also a problem that during the operation of these facilities additional supplementary revenues or considerable cost savings are not generated on the part of the local government.

According to the experiences of the SAO, when making development project decisions high ratios of financing from subsidies often took priority. ROI requirements, the developments necessary to perform mandatory tasks, the improvement of equipment effectiveness, and the preservation of the condition of existing equipment were often relegated to the background. Hidden debt originating from the wear and tear of equipment and delay in complying with replacement obligations is considerable. Furthermore, the financing of these debts in the future is doubtful.

Outstanding liabilities to financial institutions between 2007 and 2010 increased by a total of 77.7 per cent. Indebtedness increased as follows: 8.8 per cent in Budapest, 143 per cent in county local governments, 100 per cent in towns with county rank, and 92 per cent in towns. A significant number of local governments took on liabilities that exceeded their financial means. One of the unique characteristics of the indebtedness of local governments was that typically loans were not required to finance "run-away" deficits, but were used rather to finance subsequent developments and to generate a sort of financial reserve.

Foreign currency denominated loans and foreign currency denominated bond issuing became typical. Considering the exchange and interest rates in 2007–2008, this seemed to be a better solution than taking out long-term HUF loans. Eighty-five per cent of the bond and loan repayment obligations of local governments outstanding at the end of 2010 will have to be settled in the period starting in 2014, which is a significant risk in light of the current volatility of exchange and interest rates. As the majority of local governments failed to generate sufficient reserves for repayment, as of 2014, the number of local governments with financial difficulties is expected to rise.

In order to assess their true financial situation, it is essential to take the finances of local government-owned companies into account. As the finances of a family are not independent of the finances of the family business, in the same way a town with county rank cannot separate itself from its own public utility companies. SAO audits clearly demonstrated that business associations in which local governments are majority shareholders have accumulated significant debts. The shareholder is accountable to pay for these debts, which carries significant financial and consolidation risk. Local governments failed to pay sufficient attention to prevent their business associations from becoming indebted. It was also a problem that the representative council did not get a comprehensive overview of the financial risks of business associations and their local governments, and therefore did not have enough information to assess the real financial situation of these entities.

The transparency of the finances of local government-owned companies was largely complicated and hindered by the fact that until 2011 the State Audit Office did not possess a mandate to audit local government-owned business associations. The SAO Act in force until that point only allowed the auditing of government-owned business associations, and did not extend to local government business associations. At the SAO's recommendation, the statute was amended by the National Assembly before the new Act on the State Audit Office was drafted. The relevant audit mandate was bestowed upon the SAO as of 1 January 2011.[9]

LOCAL GOVERNMENT MEASURES

In order to improve their financial situation, the SAO recommended measures to the local governments. 39 per cent of the local governments of towns with county rank and half of town local governments were called on to immediately restore financial equilibrium. We made recommendations to 27 per cent of the other towns (among them towns with county rank) to restore their financial equilibrium in the mid-term, whereas 26 per cent need to prepare to preserve their financial equilibrium in the long run.

Following the county local government system reforms of 2012, the management of the debt portfolio of county local governments became the responsibility of the Hungarian State. Although this measure took the debt portfolio out of the hands of the local governments, it did not resolve the problem at hand. The liabilities will have to be settled using public finances; therefore, the findings and recommendations of the SAO remain valid and applicable.

It is true for the entire economic sector that economies of scale and a corresponding institutional structure are needed to put finances in order. This is also true for local governments; therefore, institutional rationalisation is definitely a road to be taken in this sector as well. Another possible way to restore financial equilibrium is to bring the execution of mandatory tasks into focus and to narrow the scope of voluntary tasks. According to the new Act on Local Governments, set to enter into force in 2013, the Financial Regulation of local governments will have to specify the funds and expenditures related to mandatory and voluntary tasks separately. In the future, this requirement will have to be underscored by the reporting system as well, and that will improve transparency as well as the effectiveness of planning.

Previously, it was also a problem that when assessing eligibility for ÖNHIKI support the number of voluntary tasks undertaken by the government, and whether it had any development projects that could propel its operating deficits further were not considered reasons for exclusion. The government grant system did not encourage local governments to take reorganisation measures ensuring long-term financial equilibrium. Therefore, the requirements of the ÖNHIKI support scheme should be modified in a way so as to ensure based on strictly applied rules, that only local governments on the brink of insolvency through no fault of their own receive support as part of individualised debt management.

The accrual based reform of the fiscal accounting system is a priority task, one that has been urged by the SAO for years. The current rules of accounting do not make it possible to recognise reported depreciation in the expenditure of individual tasks or to take them into consideration for financing. That is unfortunate, especially considering that depreciation is one of the main sources of attaining return on investment. Therefore, it would be reasonable to require local governments to generate a replacement fund equal to amortisation. The introduction of accrual based public accounting is of key importance, because it would make it possible to book actual expenditure against the financial and income accruals on transactions and to recognise its effects on total assets. The system would eventually improve performance, increase reliance on real data, and improve transparency and accountability.[10]

Local government development projects must also be kept within limits. In recent years, the goal of investment projects was often not the development of the material conditions of mandatory task performance, or the improvement of equipment effectiveness. The EU tender opportunities, considerable compared to local governments' own funds, overheated investments, which, in turn, adversely effect the financial situation of the local governments. Though not on purpose, EU grants tempted some to make bad public finance decisions. This option must be eliminated, i.e. new regulations must be developed. It would be expedient to create rules that are able to distinguish between investments that generate returns and 'prestige' investments that never will. The subsequent financing of projects implemented with the help of EU grants also caused liquidity problems. This too makes it necessary to rethink the financing of EU programmes.

Furthermore, it is a priority to make the relationship of local governments and business associations performing local government tasks more transparent. By outsourcing public tasks to business associations, financial management and the risks of the financial standing of local governments have been removed from the local government sub-system, but indirect risk remained nonetheless. Without transparency, the monitoring and enforcement of mandatory task responsibility could be impaired.

THE PRACTICAL UTILISATION OF AUDITS PERFORMED BY AUDIT INSTITUTIONS

As the SAO is an agency, auditors' work is utilised indirectly. The Act on the State Audit Office that entered into force on 1 July 2011 opened a new chapter in this regard. That is because pursuant to the new Act, auditees are now obliged to prepare action plans and notify the SAO of this within 30 days. Legally, therefore, the conditions are in place that will allow our reports to be utilised more efficiently than before.

During the auditing of mid-level and town local governments, one of the main benefits of SAO work was that in many cases the discrepancies were corrected and deficiencies were resolved. Eight county presidents and ten mayors reported forward-thinking interim decisions, while the others approved action plans based on our recommendations *(see Table 1)*.

It is of the utmost importance that the National Assembly was also able to make use of the audit experiences. On 18 November 2011, as the President of the SAO, I spoke at the general debate on the bill on local governments, as I considered it important to personally inform MPs on the experiences of our audits. Our goal was for these reports to serve as a compass for the drafting of the bill, for a good local government act to be created based on our recommendations and for us to take another step towards a well-governed state, a requirement set out by the new law. We were glad to observe over the course of the debate that the findings of the SAO were often cited and that our recommendations were reflected in the new act.[11]

In order to introduce good practices to manage economic difficulties, the State Audit Office organised a seminar last November, the

Table 1

THE IMPACT OF LOCAL GOVERNMENT MEASURES

	Expenditure cuts (HUF billion)	Revenue increase (HUF billion)
Budapest	7	9
Counties	35	22
Towns with county rank	41	20
Towns	48	79
Total:	**131**	**130**

purpose of which was for local governments in difficult situations to learn from the experiences of more successful local governments. Following the seminar and the related press conference, close to 50 articles, news reports and in-depth interviews dealt with the SAO findings. As a result, our main observations, recommendations and messages gained widespread recognition, which according to *Dye* (2009) is a basic pre-condition of, and at the same time one of the forms of utilisation.

CLOSING THOUGHTS

The strategy of the SAO[12] is to promote transparency and regularity of public finances through value-creating audits performed on a solid professional basis, thus contributing to 'good governance'. It is of the utmost importance that we also complete our mission at the level of public administration closest to everyday life, namely at the level of local governments.

In order to overcome Hungary's economic and social troubles, we first and foremost need order in the field of public finances. To do so, we require more transparent relations, more efficient and stricter regulations as well as more responsible decisions. The State Audit Office of Hungary – as the supreme financial and economic audit institution of the National Assembly – considers its responsibility to lay down the foundations of and to facilitate the above. Our local government audits serve to accomplish this goal, and the new legislative environment will allow the work of our auditors to be utilised in practice as well.

NOTES

[1] The present article is an edited, supplemented and updated transcript of the author's lecture given at the 17 April 2012 international conference of the State Audit Office of Hungary. Pál Péter Kolozsi, PhD was a contributor to this study.

[2] In this matter, see Article 43 (1) of the new Constitution, as well as Article 1 (1) of Act LXVI of 2011 on the State Audit Office of Hungary.

[3] In 2011, the State Audit Office transformed the auditing of the systems of financial management of local governments based on its new strategy. Within the new system, the SAO does not announce specific audit locations, but takes debt and asset management risks of the given local government, follow-up audit risks from previous years and other indications and reports into account. The SAO classifies local governments according to the resulting data.

[4] The reports can be downloaded from the official website of the State Audit Office of Hungary (www.asz.hu).

[5] In the end, on-the-spot checks were started in 62 towns, as the State Audit Office did not receive the requested documents from the town of Esztergom, therefore the President of the SAO suspended the audit.

[6] Thanks to representative sampling, the SAO was able to make observations valid for the entire group of towns selected, and did not have to send auditors to each and every town.

[7] See State Audit Office: Summary evaluation of the audit experiences of mid-level local governments. 11 November 2011.

[8] ÖNHIKI subsidy = subsidies for local governments with financial problems through no fault of their own.

[9] The situation of Budapest shows clearly how important it is treat local governments and their companies as one unit. That is because the audit carried by the SAO found the books and finances of the Municipality of Budapest in order, while the majority owned companies of the Municipality of Budapest, e.g. the Budapest Transport Company (BKV), had debts in the tens of billions of HUF. Obviously, these hidden debts need to be settled or managed in some shape or form from time to time. Consolidations represent a serious burden for the budget and indirectly contribute to rising government debt as well.

[10] In the spring of 2012, the SAO entered into two negotiations on accounting system reform: with the Association of Cities with County Rights at the end of March and with the National Association of Local Governments at the beginning of April. At the consultations, the parties came to an agreement that the state accounting system must be modernised and steps must be taken to introduce an accrual based, public finance information system.

[11] Act CLXXXIX of 2011 on the Local Governments of Hungary

[12] The Strategy of the State Audit Office of Hungary (2011–2015). 2011

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