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Creating a balance between resources and tasks

One of the ultimate requirements for policymakers is to create and maintain a balance between resources and tasks. There is always a chance to accomplish the above goal either in an individual case or in the system as a whole, both at local government and at central government levels, irrespective of the fact whether this is done within or without a systematic structural reform. Those who consider the above statement unacceptably sterile or alien to daily practice may easily be misled to indefinitely delaying the practical implementation of this requirement. As far as I am concerned, the only practical concession I can allow policymakers is the following: the absence of or distortions in the balance are to be remedied within the timeframe of a political cycle rather than within one budgetary year in order to make sure that the verifiable results of the measures discounted to the present should be immediately visible. I believe that any policy measure that fails to treat and manage the above task in this manner is irresponsible.

BALANCE IS AN ISSUE OF POLITICAL RESPONSIBILITY

Demands for resources always exceed the available resources; consequently, if we approach the issue of balance from the aspect of needs,

we are likely to be faced with a shortage of resources. What is defined under tasks is far from being identical with what may be needed. Tasks can be specified exclusively in terms of a balance relationship: only those components can be accommodated which are reasonably feasible and sustainable, needs which have the necessary confirmation and are backed up by available resources. *A balance – let me repeat it – is not a question of shortage or abundance of resources, but an issue of political responsibility.*

Imbalance, in the strictly material sense of the word, reflects a situation in which financial management in reality is impossible. Financial management is feasible only in the case of an existing balance, without which the regulated, planned and structured operation becomes the victim of spontaneous processes and voluntarism. Under such circumstances, even the implementation of a professional, sectoral or organisational concept, which looks rational in itself, may go beyond the possibilities, and counter-productive, contradictory hand-controlled practices may develop. A “bottom up” approach usually fails to address a situation in which the different rational elements do not add up to the rationality of the whole.

On the other hand, in a political perspective, only the need for balance can enforce the simultaneous co-ordination of competing

needs, interests and values, as well as the concurrent and explicit representation of latently present pressure of choices. In this context, an imbalance – in the absence of such pressure of choices – prevents the unambiguous articulation and open manifestation of interests and values, which results in a democratic deficit and in the erosion of true autonomy.

In addition to the above general comments, I wish to voice a definitely negative answer to the question whether a balance of tasks and resources can be created within one political cycle.

My negative answer is not to be interpreted as the suspension of an all-prevailing requirement. It simply means that the necessary bases for a positive answer are missing.

On the one hand, there is no critical mass in our political life to support the above-outlined approach, and a general shift in political attitude is very unlikely to take place successfully within one election cycle.

On the other hand, the technical conditions are also missing, i.e. the methods, data and regulations needed to handle balance or imbalance. In this sense, even in the case of an immediate shift in political attitude, *the duration of an election cycle only offers an opportunity to make an attempt to elaborate and prepare its technical conditions, not the actual implementation.*

It cannot really be seen today whether there is a balance with regard to the system of local governments as a whole or to the individual local governments (which is, of course, also true for the government), it is not known either what the extent of the imbalance is and whether it is a lasting or temporary one. I do not know any Hungarian local government that would have financial analyses to grasp the above, or that would have an instrument to unite them in a uniform financial management model. As a consequence, I do not know any local government that would have a truly relevant financial management plan, strategic concept.

The present standard information system relating to the above issues

- is cash-flow based instead of being accrual-based;
- provides a static picture even in its components under review, it is not suitable for describing the processes in essence, or for defining the proportions of the needs that are to be corrected in view of the present processes (i.e. the harmonisation of tasks and resources);
- as a result, even in the best scenario, it is only suitable for managing the given situation, but certainly not for controlling the processes, i.e. it is a tool that can be used only for parametric rather than paradigmatic corrections;
- manages assets not in harmony with the operations, in other words, assets are not handled based on real (relevant) criteria;
- does not manage development projects linked to the concept of balanced operations;
- lacks the necessary complexity, because the defining factors of operations are only partly visible in the total picture;
- lacks consolidation, i.e. the relevant data of economic interests that lie outside the budget are not incorporated in it; and
- also lacks risk assessment and risk pricing.

THE MAIN FEATURES OF A UNIFORM MODEL OF MUNICIPAL FINANCIAL MANAGEMENT

A uniform financial management model (including technical features) is badly needed. I believe such a model must have the following main features.

- ▶ *Accrual-based accounting* instead of a cash-flow based system in each relevant aspect.
- ▶ A *mirror of financial management* which can serve as a basis for process control. One of

its most important pre-conditions is to have medium-term forecasts which cover at least a political cycle and a half (with a past review of a similar timeframe based on factual data). Such forecasts would provide us with recognisable individual, transitional and cyclical factors and would also inform us about the direct and cumulated impact exerted by the long-term, structural factors on the processes as a whole. Such forecasts are also expected to shed light on the predictable developments of both external and internal conditions (those that already exist or that are known), i.e. instead of a static mirror it would serve rather as a reflector, more precisely, as a “bend lighting” which is capable of monitoring changes in directions. The well-known problem of what is commonly referred to as a “budgetary corner” can only be avoided by means of such tools.

▶ *Complexity*, i.e. the equal presentation of all relevant actors of balanced operations. Current expenditures (expressed in cash-flow based accounting) are to be performed together with rationalisation supported by an action plan. In order to safeguard the value of assets, which are necessary for the performance of tasks, it is also a basic requirement that the renewal needs calculated at depreciation rates corresponding to real lifetime should be fully taken into account. Adaptation needs that guarantee a balance – needs calculated on a normative basis – show a similar picture, whether they require operational or cumulative expenses (this is one of the essential pre-conditions of a dynamic balance, because without such adaptation needs even local governments that can present seemingly balanced operations may gradually lose ground and may face competitive disadvantage due to their inflexibility in a changing environment). A financial management model must also contain the appropriately priced ongoing obligations as well as the obligations outside the budget (sureties, PPP schemes, etc.).

▶ *Consolidation*, i.e. all relevant data which are related to an ownership share of the local government in business associations and which have or may have a direct or indirect impact of the local government's budget are to be also incorporated in the model.

▶ *Assessment and pricing of risks*.

▶ *The presentation of actual expenditures in view of homogeneity (money) and “sector neutrality”*. This is to be interpreted in the following way: on the one hand, the various allowances and exemptions are to be “accounted” in this model as pecuniary support, on the other hand, equal public dues are to be calculated vis-a-vis public utility organisations in private and public hands or owned by a community.

The model outlined above – briefly, due to the limited space – may rely on existing experience, because there are already half a dozen local governments in Hungary already functioning on the basis of a model that can be regarded as a partial predecessor of the above model. The acquisition of data necessary for the full operation of the model would require at least a few years even if the necessary regulations on data collection and data provision were to be immediately enacted. The limitation of this timeframe is another factor calling for urgent action.

PROPOSED STEPS TO REVEAL AND MOBILISE THE RESERVES OF FINANCIAL MANAGEMENT

The operational imbalance, which can be defined by using the above-described model, can be eliminated in one step. However, it requires practically in each and every case a drastic and painful screening of tasks based on the establishment of a realistic priority order together with its consequences. Many may find this concept somewhat too sterile, neverthe-

less, there is an explanation which is deductible from the above: *the successful identification of the reserves of financial management is feasible only after its basic pre-condition, i.e. balanced operation, has already been created.* Without this pre-condition, adopting both systematic, paradigmatic rationalisation and system-based solutions without the pressure for hand-control remain just a dream. (This “painful” task is generally performed by politics although not in a conscious way, as a result of which, it does not correspond to the original intentions and to the desired values. The pain is not attributable to the extent of the measure, rather to accepting the pressure of choice, while the conscious decisions relying on the model enable local governments to successfully implement what they deem as primary goals.)

It is suggested that rational partial solutions, the improvement of efficiency, organisational development, etc. can be intensively and systematically dealt with only after the primary balance is established not only because of the reasons mentioned above, but also because political players are likely to avoid the performance of the basic duties, they keep putting off the establishment of the balance which can guarantee the long-term performance of priority tasks by off and on satisfying the constant need for the improvement of efficiency.

Let us review again the most important general aspects and let us see the questions to be answered both on the level of local government and its whole system with a special view to their room for manoeuvre:

- what fall and do not fall under public duties;
- what is the systematic solution for the multi-layer confusion concerning the roles and functions of local governments;
- what activities and services are qualified public duties, and which are to be directly fulfilled by the local governments on the basis of normative criteria either in a per-

manent or temporary manner, and which are the ones in which an indirect fulfilment of tasks may be considered either with an immediate effect or alternatively after the necessary conditions are created;

- if the alternative of an indirect performance of tasks is to be considered, a normative comparison needs to be conducted based on homogeneity (money) in order to decide which organisational form is best suited for performing this form of task: the local government's own organisation, market players or non-governmental organisations;
- in the course of the above normative comparison, the principle of “sector neutrality” must be applied for each and every option, and at the same time, the benefit-cost (sacrifice) factors must also be taken into account.

THE FINANCIAL MANAGEMENT MODEL IS ALSO A DISCIPLINARY FORCE

The financial management model outlined above also represents an important disciplinary factor. This model is capable of expressing the sustainability of a local government's operations in one single indicator and presenting its position of balance expressed with a vector providing a clear picture for the leadership of the local government, for its electors and for its partners. Confronting political players with the tasks serves as the most important aspect of responsibility, the most important disciplinary force. Any external disciplinary regulation can only be built upon this force in a systematic way.

There are some other additional steps that can be taken to improve discipline, and here I would like to highlight only one of them in connection with the municipal indebtedness and with the possible debt limit(s). The unsatisfactory nature of the present regulations has

been amply underlined by the alarming developments of the recent few years. An attempt may be made to improve the regulations by fine-tuning the present approach, *however, I would personally find it more useful to introduce an indirect limitation instead of the direct limitation linked to various indicators.* In this case, the regulation contains one single requirement, the obligation to apply the principle of “negative pledge” for raising external funds requiring collaterals (primarily, raising credit and bond issue). Project financing would be an exception. When the principle of negative pledge is applied, the only coverage for the creditor is a document certifying that the borrower has a prudent financial management, otherwise the same principle will prevail, i.e. no positive pledge (assets, pledging revenues as collaterals) can be made.

In reality, the application of the principle of negative pledge provides the creditor with a much stronger guarantee compared to a positive pledge. *A prudent financial management, together with actual creditworthiness, can only be certified by records which, on the one hand, provide an authentic picture about the local government's debt servicing ability, and on the other hand, offer a proof about its reliability based on actual experience.* The clauses attached, in a cogent way, to credit agreements signed according to the principle of negative pledge, such as the *pari passu* and the cross default clauses, provide additional positive guarantees for the creditors while requiring an equal treatment vis-a-vis other potential creditor. In case of a termination due to the breach of a credit agreement, there is a threat of an immediate automatic termination of all other credit agreements, a threat which offers a further assurance for the creditors that the borrower will maintain its prudent behaviour.

Let me return to the main subject of my message: *from technical point of view, the only type of model for financial management that can*

indicate prudent management and genuine creditworthiness is the one that I have outlined above.

The model and especially its primary individual indicator, i.e. the operating result, can be used much more efficiently than the ones relevant today for attaching effective covenants either on a regulatory level or on the level of the local governments concerned for “their own use”. In the credit agreement creditors are obviously keen on stipulating indicators in this context that are more suitable than the current ones to assess and monitor the status and the processes.

Finally, two comments. I am aware of the reservations with which similar concepts have so far been received, and critical comments claim that the approach presented above and also the technical requirements deriving from it are far-fetched from real life saying that most local governments would simply be unable to further cut back their tasks in line with the described balance requirements (their inability is explained by the unusually wide range of tasks and by the pressing needs and expectations). There are also some who believe that there are a number of small local governments in which the minimum necessary personnel and technical conditions cannot be provided for this model to function.

Here is my first comment: *as far as the mandatory tasks are concerned, even without changes in the regulations, the chances for cutting back such tasks are much greater than it is generally believed.* To my best knowledge, there is no one single Hungarian local government which would have methodically scrutinised all tasks, which it regards as mandatory ones based on a strict interpretation of the law, and which would have answered the question: where is the absolute minimum level of mandatory tasks in terms of scope and quality. In terms of the pressing needs and expectations, I can only repeat the clarifying effect of simultaneous comparison: the priority order of needs, values, expectations is surprisingly

different if reviewed in a closed system compared to an assessment in which only individual needs, values are weighed together in an extended timeframe. By all means (within a finite system), it is much easier to accept that the local government will abandon a task – or a partial element of it – which it considers a public duty or alternatively to accept that the expected quality will suffer when such a decision is taken compared with another task deemed absolutely necessary.

Here is my second comment: although I am convinced that *even within the current regulatory framework a balanced financial management can be established in much more local governments than it is usually believed*, I admit that in a number of cases (and possibly even on the level of the system) this goal cannot be accomplished even by means of the strictest consistency. If it is indeed so, let us not delude our-

selves with false hopes: under the present regulatory framework, we cannot speak about local governments in the strict sense of the word. The same applies to local governments which would not be able to use the financial management model necessary for the process control of balance operations, because they lack the required personnel and technical conditions. The question to be answered is this: *do we want to bring about genuine local governments by changing the regulatory framework, or do we at least stop deluding ourselves.*

If we choose the first option, we will have to go back to square one: the inevitable pre-condition of any paradigmatic change either on the level of the whole system or on the level of an individual local government is to accept, as a basis for planning, a type of credible financial management model which I have outlined in this paper.