

Géza Dankó – Zoltán Lóránt

Challenges of the local government regulation

IMPROVING THE TRANSPARENCY OF LOCAL GOVERNMENT FINANCIAL MANAGEMENT

One of the major problems with the public finance accounting and information system is that, as a consequence of frequent amendments, the opportunity for analysis and comparison has much narrowed, while the long-cherished goals, i.e. to enhance transparency and introduce performance-based accounting, have not been reached and thus the efficiency of the changes has been very low compared to the complexity of the system. Regarding the modernisation of the public finance information system it should be underlined in the beginning that, be it in the field of accounting or in statistics, modernisation should always be shaped according to and subordinated to certain planning and decision aspects.

As from 2008, Government Decree 249/2000 (XII.24.) on Specialities of the General Government Organizations Reporting and Public Accounting Rules, amended several times, adopted revenues and expenses without cash flow among the accounting entries within the framework of economic classification initially. One year later, functional classification accounting was added to the decree and, under Annex 26, Performance statement was also to take effect. Through the

amendment of the decree, the date of taking effect of the functional classification accounting of items without cash flow and of Annex 26 were changed from the year 2009 to 2010 and were later repealed as of the year 2010. The usefulness of the Performance statement was disputed from the very beginning, in spite of which its introduction was kept a recurring prospect for two years. The amendment of the Decree to take effect in 2010 prescribes the making of a result-oriented report, although the range of public finance organs preparing such reports covers entrepreneurial public institutions (currently, national institutions listed under this category under the amended Act 140 of 1997 on the Protection of Cultural Goods, Museum Institutions, Libraries and Archives) which, in addition to and parallel with making traditional cash flow oriented reports, have annual reporting as well as bookkeeping obligations, too, under the Act on Accounting.

The budget reports, prepared through considerable administration on top of the high workload, provide no straightforward or comparable information on the actual costs of public services, partly owing to the cash flow aspect, nor do they reveal the nature or expiration of the debt service obligations involved in the payment obligations generated by the bonds issued in the past years and by what are referred to as con-

ditional commitments (PPP¹ and other agreements); the 2009 report provides information only on their volume.

Form No. 44 of the 2009 report “On the annual changes in the debt portfolio of local governments and multipurpose small regional associations” does have some information on the debt portfolio of the years 1–5 and years 6 and onwards after the fiscal year concerned nevertheless. According to this, development purpose foreign currency bonds involve long-term debts of HUF 323.8 billion, 82 per cent of which comprise payment obligations due in the 6th year or later. Total foreign currency long-term liabilities amount to HUF 654 billion, 96.4 per cent of which (HUF 630.7 bn) are debts beyond one year, 78 per cent of the latter being liabilities due in the 6th year or thereafter. According to Form 53, “Data for information”, PPP-related liabilities amount to HUF 8.3 billion, while the guarantee portfolio to HUF 22.2 billion.

Data collections on actual costs are unreliable and are *not supported by bookkeeping*; in health care, for example, they have been unsuccessful for years. (At hospitals, data collections on the actual costs of interventions – code maintenance – have failed one after the other, which is one reason why the revision of the weight numbers of homogeneous illness groups, the bases of financing, has failed to take place for over a decade now.)

The budget financial data of local governments are required not only for legislation preparation but also at the local level; they should foster the comparison of local government data in space and time. This would require comparable data (criteria), the practical elaboration, approval and introduction of which are still to be accomplished. In the report, the data required for the application for and the settlement of per capita support represent a great weight, the complexity and admin-

istration of which have been a subject for criticism for years. (Complemented with the system of preliminary survey, interim cancellations and supplementary applications.)

The system of reporting and the bookkeeping ignore the differing characteristics of the central and the local government systems (central budget organs are, for instance, customers of the Treasury, with appropriation management, while local government budget organs have cash management).

Closing the topic, as a way of summary, it should be mentioned that:

- there is no proper state accounting system despite more than a decade's demand for it; the state accounting lacks internationally accepted standards regarding the bookkeeping, the reporting system or the accounting policy. All these should naturally be included in the long awaited modernisation of state operation;
- the State Audit Office has formulated several recommendations for amending the imperfections of the financial information system and for the implementation of accountability and performance requirements. (Including comment proceedings on annual budget proposals, for instance, during the audits of water settlement and rainwater drainage, green area, solid waste management and social base service activities). There have been some changes made in the information system on the basis of our recommendations (like the registration of PPP-related liabilities) nevertheless, and the order of special functions, too, has undergone positive changes. However, these do not yet comprehensively provide the information necessary for the substantiation of central or local level decisions on the financial management of local governments. (In several fields, e.g. green areas, waste, energy, etc., the information system of local governments is not in compliance

with the data available for the measurement of the implementation of sectoral strategy or policy goals. Without this, the implementation of tasks cannot be measured, either.);

- from the financial information system available, the “real” situation of local government assets and finances cannot be evaluated comprehensively (in the case of local government assets, the evaluation of non-tradable or restrictedly tradable assets and the statement of local government commitments and indebtedness pose problems);
- Finally, it should be noted that the imperfections of the information system and the local government budget data are made public very late only. (In Poland, for example, the budget data of February can be downloaded from the homepage of the ministry concerned in May already.)

RISKS INVOLVED IN THE FINANCIAL SITUATION OF LOCAL GOVERNMENTS

The financial situation of local governments is most heterogeneous and cannot be judged meaningfully or unambiguously also for the lack of precise data or information, varying according to types of settlements and even per individual local government. There seems to be an agreement, however, that *the austerity measures in force for years, meant to improve the situation of public finances, have adversely affected the local government subsystem as a whole. The lack of harmony between the tasks and resources of local governments, partly due to cutbacks in per capita supports and other subsidies and also for the lack of a comprehensive revision of the range of tasks, authority and financing, has been reproduced every year. Beyond these, adverse trends with various effective ranges have been experienced in the financial situation of certain local governments*

owing to some unique mistaken decisions of a local government body or management (it is unfavourable in the short run, for example, that, due to unconsidered commitments, local governments are able to keep their solvency only through current account loans involving high interest expenditure, while local governments overall, with their money reserves in the bank system – a deposit portfolio of over HUF 500 billion – constitute a cheap source for banks.)

A new phenomenon since the year 2007, the *intensive bond issuing practice of certain local governments*, especially those of counties or big cities, does not only reflect an effect of economic constraints; it has been made possible by the too liberal *budget rules* currently in force, the now outdated definition of the *debt limit* and the “generous” *behaviour of banks*. *The risks involved are not only caused by the fact that the liabilities, surpassing the current debt bearing capacity, are shifted to a distant date, the consequences of which cannot be realistically taken into account today, but also by the now similarly unforeseeable consequences of the exposure to exchange rates, the exchange rate losses due to the issuing in foreign currency.*

The *bond issuing* by certain local governments in Hungary, partly a consequence of the revenue maximising behaviour of banks, has intensified *not only due to the lack of balance between tasks and sources*. It is pieces of evidence for the latter that a significant part of local government funds obtained by bond issuing in recent years are held as reserves in bank accounts or in securities and that even local governments with high industrial tax revenues and residual funds have used the opportunity of bond issuing. It is a similar phenomenon when institutions (typically hospitals) accumulating growing debts to suppliers have a significant surplus in their budget accounts set aside for liabilities carried over and for developments.

The current rate of local government indebtedness poses a risk mainly in the longer run; the debt service burden (capital and interest payment obligations) is within the current debt limit. The bonds issued in 2006–2008, mostly Euro or CHF based, with a term of 20–25 years and payment deferred by 3–4 years, may increase debt service burden in the coming years already. According to Form 44 of the 2009 year report, the instalments due after the fiscal year concerned amount to HUF 30.6 bn in the case of Forint liabilities and to HUF 23.4 bn in foreign currency liabilities, while the total debt portfolio is HUF 985 bn. The high debt service burden may cause payment problems for certain local governments, which may disturb the operation of public services run by the local governments concerned. It is the Act on Debt Settlement in force that is applicable here but the governments in office also have underlying responsibility in the problem.

Considering the increasing indebtedness of local governments, the rules on borrowing have become stricter *in several countries: it is obligatory to guarantee the current operating budget balance in the planning phase already. Hungarian local governments approve their budgets² with considerable underfunding*, without any consequence; even though, as regards form, operational and accumulation targeted revenues and expenses are contrasted, in the system of uniform funds there are practically no restrictions. In the course of the year, underfunding problems are then amended through state support (by various forms of what are referred to as 'subsidies to local governments struggling with problems beyond their control') or from other external sources (like liquid borrowings).

Summarising this topic, it must also be emphatically underlined that public finances as a whole suffer from underfunding. The system of local governments is naturally no exception.

The extent of underfunding actually depends on the types of local governments and the range of institutions supervised by them, i.e. the range of obligatory public service commitments. *There is actually no adequate system of indicators to show the costs of obligatory local government commitments.* (The parameters of task performance are not well enough identified, either.) Even if there existed adequate indicators, potential deficit would be indicated at the macro level only, without the actual examination of whether there is harmony between tasks and sources per individual local government.

Considering that, from the 3200 local governments only some 30 have faced bankruptcy, the situation is not too severe. In view of the continuous deterioration of the standard of supply systems, however, or the fact that, repeatedly over the years, there are some 1,000–1,200 local governments that have struggled with problems beyond their control, which has been clear from liquidity indicators as well, it can be established that all these have indicated the deterioration of the financial situation at the local level of public finances.

BALANCING COMMITMENTS AND RESOURCES A COMPELLING TASK

Without the revision of the range of tasks and authorities as well as of financing, or a differentiated delegation of tasks and authorities, the commitments-resources balance can be improved through significant central funds and can be maintained with annually increasing support only. Through the extra sources, the earlier bad local decisions can be made legitimate but an efficient utilisation cannot be guaranteed in an unchanged structure; even in the case of a rising GDP, a gradually worsening balance should be expected. The balance could be permanently

improved by reducing the number of tasks (small settlements could be relieved of certain obligatory commitments, for instance, which tasks could be performed within the framework of obligatory associations, applying the aspect of economies of scale), reconsidering *the division of tasks between the state and local governments* (if the employment and payment of teachers was not a local financing task, as is the practice in neighbouring Austria), while it also depends on local decisions. It is only by *imposing the possibility of sanctions*, however, that *prescribing the sustaining of balance* (adjusting operation to the sources available) *can effectively motivate local decision makers*. Without sanctions, politically motivated local decision makers, aware of the shortcomings of the legislative background, take the risk of indebtedness again and again, which, in turn, also increases the risk from the point of view of meeting the convergence criteria following from Hungary's EU membership.

As a way of summary: even in the period ahead of us, the state funds spent on public services and public administration cannot be increased since, if there are extra sources available to be allocated either by increasing the deficit or by higher economic growth, these are to be spent primarily on fields able to spur economic growth and make it permanent, like small and medium enterprises, etc. Accordingly, the source of balance must be found within public finances. Partly by limiting certain expenditure, in higher education, for instance, which is the source of a growing number of unemployed, and partly by a more healthy delegation of local government tasks. The place and role of counties should be seriously examined, and so should the potential restoration of the level of country districts by concentrating current settlement-level tasks requiring more expertise and higher sources. The latter would also involve concentration in the currently fragmented source regulation.

THE LOCAL GOVERNMENT SYSTEM HAS LIMITED MOBILISABLE MANAGEMENT RESERVES

In addition to those outlined above, a recurring problem of local governments is a *lack of harmony between tasks and financing; the insufficiency of central funds*. The state determines the obligatory tasks of local governments, the size of the staff for their performance and the professional instructions and grants the necessary financial conditions in the complicated system, changing annually and unpredictably, of source regulation. In the financing of obligatory tasks, local governments' *own revenues* have been used to an increasing extent. At the same time, *at a significant proportion of local governments these are available to a limited extent only so, at the majority of the local governments central subsidies have been almost exclusively the only solution*. From the appropriation of over HUF 100 bn meant to mitigate revenue differences calculated on the basis of the tax payment capacity, more than 90 per cent of local governments receive a personal income tax supplement every year; in 2000–2009, about half of the settlements have had a share of various forms of 'subsidies to local governments struggling with problems beyond their control', of a total amount of approximately HUF 200 bn.

The reform of the major distribution systems (education, health care, public administration) has been on the agenda for several decades. In 1990–2009, the number of hospital beds fell by 30 thousand, the number of primary school children dropped by 400 thousand, while the number of health care, social service and education employees has not decreased overall. The number of employed doctors has risen by over 3 thousand, while nobody is satisfied with the efficiency or financing of public financed services. It is a basic problem that, given the current income centralisation, the state is unable to guarantee growing financing for the above

systems and *the unsolved problems fall back on the maintainers responsible for task performance, i.e. local governments*. In order to sustain and improve the balance, the state has expected local governments to operate from less subsidy, while local interests have pointed towards the contrary direction: a simultaneous increase in central funds and more freedom in decision making.

The practice of decentralising decisions (and, through this, tension) has led to wasting in several cases, while deficit can also be proven. Consequences of the former have included the *overdevelopment* of certain institutions, *their unused capacity, duplications, local commitments ignoring capacities* (e.g. sports and tourism investments beyond the demand of the settlements concerned and thus maintainable only with deficit). There have been several analyses and studies attempting to present the economic reserves that could be used within the local government system, on the basis of which some initiatives have indeed been made, while efficiency aspects have repeatedly been ignored in the system as a whole.

There are hidden reserves in the following fields:

- in the revision of the operation of bodies of representatives and general assemblies, of the number of officials, especially in cities, county local governments, regions, counties and cities of county rights,
- in eliminating duplications between the capital and its districts,
- in reorganising public administration by eliminating current disproportionateness,
- in transferring public administration tasks from the independent offices of small settlements to obligatory associations,
- in reducing administration.

While the transformation of small local governments hardly capable of independent administration and the rationalisation of county-level administration have not even started,

the development of small regions has once again led to wasting.

IT IS IMPORTANT TO IMPROVE THE FINANCIAL DISCIPLINE AND PRUDENCE OF THE FINANCIAL MANAGEMENT OF LOCAL GOVERNMENTS

It is several coordinated measures that could foster the improvement of financial discipline as well as considerate and provident management at local governments. These include, among others:

- revising the range of tasks and authorities; unequivocally defining and separating the financing obligations of the state and local governments; making state subsidies and other sources predictable at least in the medium run;
- strictening budget rules (instead of, or in addition to, a uniform fund, introducing obligatory instructions regarding the balance requirements of the current operational budget; imposing stricter regulations on borrowing and sanctioning their violation; strengthening external and internal financial control and, last but not least, restoring the legitimacy control of local governments”;
- introducing indicators to help the public and objective evaluation of the performance of local governments and public services (from the aspects of effectiveness and efficiency, including financial efficiency), their obligatory application and continuous assessment;
- making sure that the consequences of local decisions ignoring efficiency aspects be borne by local communities (and decision makers – e.g. the extra burden involved in the maintenance of the capacities made by investments should be borne by the state only if this was a condition agreed upon in

advance; the adverse consequences of PPP-investments or bond issuing prepared and implemented without control are not to be transferred to all taxpayers as a whole).

It is not by itself that harmony is established between the autonomous decisions of local governments and public finance or, so to say, general national interests, like improving the balance requirements of public finances. The decisions of local governments and their institutions, using 12–13 per cent of the GDP and almost one fourth of public finances, may aggravate economic problems and increase state deficit and indebtedness. *For years, there has been considerable uncertainty on the sides of both revenues and expenses.* On the *expenditure side*, the uncertainty can be put down to local governments' conditional commitments also ignoring risks, and sometimes to the institu-

tional structure ignoring economies of scale aspects; *on the side of revenues*, it has to do with the unpredictability of various subsidies (from the central budget), contributions (referred to as assigned revenues) and, last but not least, of local sources, partly due to uncertainties in economic growth predictions and changes in regulation. Instead of implementing structural changes that would produce savings, improve efficiency but cause political conflicts, all the above foster the attitude of shifting costs to the future. In addition to central (state) measures, it is necessary to strengthen the control on local communities, taxpayers and the users of public services which, beyond the regulation, is primarily and decisively the task of local bodies (especially of bodies of representatives, financial and economic committees, etc.) and the local public sphere.

NOTES

¹ PPP (Public Private Partnership: a form of cooperation between the state and the private sector) programmes can be considered as hidden loans.

² Underplanning revenues, supported by factual figures, in view of applications for 'subsidies to local governments struggling with problems beyond their control' and for other reasons.