

State Audit Office of Hungary

THESES ON THE REGULATION OF PUBLIC FINANCES

THESIS NO. I

THE KEY ISSUE FOR SUCCESSFULLY REFORMING THE PUBLIC SECTOR IS MODERN REGULATION OF PUBLIC FINANCES

The competitiveness of the Hungarian economy considerably depends on the capacity of public institutions and the quality of their operation. The fundamental purpose of public finance reforms is to establish conditions whereby the decision-makers pass responsible decisions on public funds, the rights and obligations of users are unambiguous, and the costs, profits and results of operating and transforming the public sector are clear. A necessary but insufficient condition of institutional reforms – by which we mean the reorganisation of the system of operating rules and organisation – is the modernisation of the conditions of the public sector's economic management. The required solutions

- restore public confidence, facilitating – actual or tacit – social agreements among the fundamental interest groups and various generations;
- ensure the predictability of fundamental institutions (tax system, pension system, social benefits, etc.), social solidarity and equitable sharing of public dues;
- enforce responsible exercising of the budgeting right of the legislature and the local bodies of representation;
- harmonise the tasks and the allocated resources concerning both the governmental levels and the areas of public policies, and
- require the managers and users of public funds to pursue responsible and transparent economic management.

Reasonably, institutional reforms should be represented in the legislation first. Clear legal regulation is the basis of any change in terms of quality. Predictable and enforceable rules of public finances are also considerably weighted in terms of regaining international confidence. The development and passage of laws reflecting the best international practice would demonstrate the existence of consensus in the key issues of public funds regulation within the country, and of sufficient determination to implement the necessary reforms.

The new provisions of law related to public funds should ensure that the legal security for the operation of the public sector is not more risked by political conflicts than to a minimum extent. This is the key issue of authenticity in the current Hungarian economic policy.

THESIS NO. II

REGULATION OF PUBLIC FINANCES REQUIRES MAJOR MODERNISATION

There is a need for comprehensive modernisation of the laws mainly passed in the early 1990s, determining the operation of the public sector, including the planning, collection and utilisation of public funds. The legislature and the legislation preparatory staff attempted to adapt to the changing requirements by continuously amending these laws and the related implementation decrees. Due to the innumerable amendments – each justified in itself –, the regulation of the economic management of public funds is complicated even to the law appliers. In many cases, it is not clear which issues to regulate in law and which in decrees.

Today, unjustified deviations exist in both directions. Regulation by law calls for extension both in terms of contents and depth compared to the currently effective laws, i.e. multiple regulatory subjects can be and should be transferred from today's decrees to new regulation by law with more current contents. At the same time, we often find provisions of procedural nature stipulated in laws, which could be regulated in decrees as well. A review of regulation with a view to deregulation would also be relevant.

The approach and terminology of the current regulation of public finances is obsolete, and is outdated by development, primarily as a result of our accession to the European Union. International literature, and practice in the wake of it, brought considerable changes in the regulation of public finances in the second half of the 1990s. International organisations adopted a number of financial, “good governance”, auditing, accounting and statistical principles that would be essentially justified to be incorporated in the domestic regulation of public finances, similarly to the leading foreign methods of budgeting and public finance management. Continued use of the proven elements of the domestic regulation is certainly expedient.

Transparency should be added to the structure of public finance regulation. It would be necessary to stipulate the principles of public funds management in law (possibly the Constitution), with an effect applicable to all laws on public finances, laying the foundations of the rules for such laws. Relying on this, the regulation of public finances – according to a systematic approach – is expediently divided into blocks. (It is not necessary, however, to regulate each block in a separate law; what is more, separation of the various topics would break the uniform logic of regulation.) The recommended blocks of regulation are:

- budgeting and final accounts;

- information management and financial management (commitments, preliminary audits, allocation, payments, cash management, management of obligations and claims, accounting);
- definition of the organisational forms of organisations operated under state budget control, their legal status and rules of economic management (the so-called status issues);
- regulation of balance-related issues of the budget, the system of budgetary responsibility, and
- economic management of public assets.

THESIS NO. III

REGULATION OF PUBLIC FINANCES SHOULD BE BASED ON INTERNATIONALLY ACCEPTED PRINCIPLES CONFIRMED BY DOMESTIC POLITICAL CONSENSUS

In developed and democratic states and in international organisations, the principles and best practices that should be represented in the modern regulation of the public sector have crystallised. International recommendations can only be actually beneficial if the adoption is confirmed by domestic professional, political and social consensus.

On developing the new regulation, the majority of indispensable principles can be identified using our current knowledge. On regulation, the principles of representation of the people and limited authorisation should be materially applied. We consider it a fundamental principle to ensure broad transparency, directly supported by full compliance with the principles of publicity and controllability. (For example, in addition to current expenditures, the resulting financial commitments and determinations should also be disclosed.) The principles of performance orientation, foresight and sustainable balance should be

enforced in budgeting and economic management. The representation of all these principles can be ensured by actual application of the principles of completeness and specification. These principles need to be complemented by consistent representation of the principle of authenticity.

THESES NO. IV

THE CORNERSTONE OF REGULATING PUBLIC FINANCES IS ACCURATE SPECIFICATION OF PUBLIC DUTIES

Public financing becomes uncontrolled and intransparent if the state does not pass a clear-cut decision on specifically which assets and services it wishes to provide itself. Unambiguous assignment of each task to a governmental level is also crucial. Declaring a task to be a public duty (state or local governmental duty) is a legal act. Full listing of all state functions and duties cannot be resolved under a single law, and this cannot even be a task of public finance regulation. At the same time, the procedure of defining tasks requires prudent legal regulation. As a consequence of the currently valid constitutional rules, state duties include establishing the internal/external security of the country, ensuring democratic operation of the state organisation, maintaining the institutional guarantees for enforcing fundamental rights. These frameworks also provide the bases of the new regulation. The new law (or the Constitution) should necessarily stipulate

- that public duties may only be allocated by law, concurrently designating the necessary resources and the responsibilities for each task;
- that the minimum scope of public duties should be defined to avoid the prevention of rights stipulated and institutions listed in the Constitution, and

- that the services provided by the state should be available to those affected (entitled), providing equal opportunities.

Catering for public duties obviously incurs public expenses, and raising and distributing the funds necessary for financing public expenses is a privilege and an obligation under public law derived from the Constitution and other provisions of law. Public duties, however, can also be provided by natural persons and/or private enterprises, under contracts and assignments.

THESES NO. V

THE NEW REGULATION OF PUBLIC FINANCES SHOULD DISTINGUISH TWO LEVELS WITHIN THE STATE BUDGET

It seems expedient for the new public finance regulation to define central and local levels instead of the two levels and four subsystems defined by the current regulation of public finances. The central level includes the current central budget, the Pension and Health Insurance Fund and the dedicated state funds. The independence of each of the latter funds needs revision. Special rules may remain applicable to social security and dedicated state funds in the future, too. This, however, does not justify handling these as a separate subsystem.

The second level comprises budgets for local governments (minority self-governments). The financial relations of the two levels need regulation, with special regard to the harmony, predictability and transparency of tasks and resources.

The accepted principles of public funds should be enforced at both levels of public finances, however, the particularities of the two levels should be considered to the utmost on regulation and selecting the methods.

THESIS NO. VI

REGULATION OF PUBLIC FINANCES IS NECESSARY, WHICH EMBRACES THE ENTIRE STAFF AND PROCEDURE OF PUBLIC FUND MANAGEMENT

The theoretical (transparency, controllability, etc.) and general rules of the new legal regulation should be extended to all entities managing public funds, irrespective of the organisational form and ownership relations. A narrower scope of rules will be valid only for the actors of the public sector (organisations under state budget control and organisations outside state budget control but directly related to the state in terms of foundation and financing). The effect of certain special rules of law will be exclusively applicable to organisations related to public finances and under state budget control.

A fundamental issue in regulation is clear and accurate terminology (public sector, public finances, public funds, etc.). On defining and construing terms, the solutions evolved and accepted in the international practice are applicable. The public finance regulation should specify the notions of governmental sector and public sector. The reason is, on the one hand, that these are indispensable for supplying sufficiently accurate data related to the convergence programme. On the other hand, the way non-governmental organisations of the public sector participate in budgeting, data supply and reporting needs to be defined.

The new regulation should use the broadest notion of public funds as a starting point, regarding all revenues under public law, contributions to public services, the portion of state assets represented by funds and all revenues from the utilisation of assets as public funds.

The regulation that adopts a new approach should embrace all movements of public funds management observing identical principles, i.e. the principles accepted here should be promoted not only on passing new legislation but also

on amending older legislation that cannot be abolished for the time being.

THESIS NO. VII

THE NEW REGULATION SHOULD ENSURE EXERCISING THE BUDGETING RIGHT OF THE NATIONAL ASSEMBLY AND THE REPRESENTATIVE BODIES, AS WELL AS THE RESPONSIBILITY OF THE EXECUTIVE POWER

The currently valid regulation grants unjustifiably great liberty for the current governments (chapters, institutions) to regroup various appropriations accepted in the budget act, while overloading legislature with a large quantity of unmanageable information.

The purpose of the new regulation is to establish securities in the system of budgeting (the presentation and the acceptance procedure), reporting and settlements that guarantee for the substantial decisions related to the distribution of public funds to be actually passed by the National Assembly and the representative body of local governments. For this reason, the actual decision-making options offered by the current political decision (budget) need to be clarified. The formal political acceptance of previously decided and basically automatic expenses from year to year may just as well deprive political responsibility of its substance as the intransparency of decision preparatory materials. It is important for MPs/representatives to pass decisions only in substantiated situations of decision-making. It requires voting units, i.e. the tasks and appropriations MPs/representatives actually need to pass decisions on, to be adequately defined in budgetary documents. Politics should decide on aggregates that adequately promote political preferences and accountability in terms of implementation, but do not disturb the operability of implementation.

In terms of regulation, flexibility indispensable for reasonable implementation of the budget needs to be ensured, however, the practically unlimited possibility of regrouping appropriations without parliamentary controls should be eliminated. The environment for implementing budgets is rather variable, which requires the conditions for flexible responses. The current regulation of setting up a supplementary budget is easily avoidable, while the rules of procedure are rather complicated and time-consuming, for which reasons the obligation to prepare a supplementary budget does not comply with the intended role. Establishing new, more flexible conditions for budgeting under the National Assembly's control would facilitate better implementation – besides promoting the principle provided in the thesis.

Another important means of providing parliamentary control over the executive power is the acceptance of the final accounts. The National Assembly can exercise its jurisdiction materially if the structure of the final accounts is bound to be identical with the structure of the accepted budget. It is worth considering assigning legal consequences to the non-acceptance of the final accounts – except in a period of government change.

Emphasizing the responsibility of executive power in general raises the issue of legal consequences. Intentional or negligent violation of rules related to public funds currently incurs sanctions under labour law and – in particular cases – criminal law. The proposed new public finance regulation that lays down the general principles of public funds management (transparency, completeness and specification) not only in general but also in specific provisions, may represent great progress in this field. With the existence of specific provisions, the responsibility under labour law or criminal law can be construed for those violating the rules of publicity, completeness or authenticity intentionally or through negligence.

THESIS NO. VIII

BUDGETARY BALANCE IS A FUNDAMENTAL REQUIREMENT TO SUSTAINABLE DEVELOPMENT

In the current situation of public finances, the challenges of budgetary equilibrium and financial stability (sustainability) are placed in the foreground. Foreign experience shows that – in case of adequate political intentions – adoption of a rule-based budget and/or involvement of independent institutions may present a solution. The convergence programme or the criteria applicable to the Euro zone define the requirements of equilibrium applicable to the entire public sector. In order to comply with these, it is reasonable to stipulate the rules that ensure budgetary equilibrium and sustainability in law for each level of public finances. These rules are to be confirmed by procedural rules aimed at nipping overspending in the bud. Such a requirement may be, for instance, that a financial impact study is required to be submitted with any act affecting the budget, indicating the extra financing requirement of the act and the related resources. On budgeting, appropriate reserves need to be generated to handle risks endangering the equilibrium, and financial sanctions need to be applied if the expense appropriations are exceeded.

However, a public finance equilibrium, i.e. a sustainable budget, is a necessary but insufficient condition to the country's actual objective, i.e. sustainable development. A budgetary equilibrium cannot be ensured through over-taxation or curtailments risking the provision of fundamental state duties, even in the medium term. The efforts made to reach a budgetary equilibrium may not jeopardise the competitiveness of the economy, the welfare of the population either on the revenue or on the expenditure side, but it is the sharing of public dues and public expenditures that are precisely aimed at reinforcing these. This requirement

again confirms a necessity for a comprehensive public finance regulation by emphasizing that commitments made for public expenditures and waiving public revenues should be assumed considering the principles described above.

THESIS NO. IX
THE REGULATION SHOULD ENSURE
TRANSPARENCY OF COLLECTING
AND ALLOCATING PUBLIC FUNDS, IRRESPECTIVE
OF THE ECONOMIC ACTOR PERFORMING THESE

Transparency is an important value of public finance systems. When implemented, it contributes to restoring public confidence, reducing losses derived from various irregularities, and may improve financial discipline. Transparency may significantly reduce the costs of handling public debt. In providing state duties, an increasing role is assigned to organisations in the non-governmental sector. For public-private partnership to be fruitful for the public, all users of public funds need to be accountable. Transparency is ensured by an adequately organised information system, and the publicity of processes and decisions. Information should be available to an appropriate depth and with contents specified in international standards – i.e. also in compliance with administrative, economic and functional classifications.

As a result of transparency, risks intrinsic to the whole and various parts of public finance should become known. An important condition of revealing these is for the state accounting to demonstrate the change in the financial standing of the sector, the off-balance sheet risks and the risks related to tasks provided outside the public finance. (These include various state receivables, conditional and contingent liabilities and receivables from and liabilities to business organisations owned by the state/local governments.)

Another important requirement is transparency of the financial legal system. The regulation of public finance should contain securities for the stability of legal provisions affecting both the revenue and the expenditure sides, and, if any changes are necessary, the transparency of those.

Publicity, at the same time, is also security for political competition to be materially promoted on elections. This would also be the purpose of a statutory report issued – with predefined contents – prior to elections, which would explain compliance with the government programme and, in connection with that, the situation of the budget, with special respect to any future risks thereof.

Disclosing the details of public assets management may not be limited by the protection of business secrets. At the same time, it needs careful deliberation what should and what can be disclosed of public finances, in order to avoid premature disclosure of data (on public procurements or debt financing, for instance) weakening the business position of the state.

THESIS NO. X
THE PRINCIPLE OF “VALUE FOR MONEY”
SHOULD BE ENSURED ON BUDGETING AND
ALLOCATING PUBLIC FUNDS

The principle of performance orientation can be promoted in public finance regulation by enforcing the principle of “value for money” for financial management – from budgeting to providing specific services. This means that each forint of the budget should be used effectively and efficiently.

In the current practice of budgeting, performance orientation is not promoted: instead of the actual resource requirements of each task, budgeting takes the evolved situation as a starting point, and the central allocation of

resources is not based on performance requirements. This is what programme-based budgeting would change.

A significant and increasing part of expenses should be planned based on the relevant programmes. The system of programmes consists of major programmes, programmes and sub-programmes. According to international experience, the central budget of a country contains 30–40 major programmes in general. The programmes within each major programme would be the voting units for decisions on the budget. The programmes may be permanent or temporary ones. Typical cases of temporary programmes are capital expenditures, but these could also be programmes of transition to a programme-based budget. The voting and the decision-making procedures are different in case of the two programme types. It is recommended that a programme-based budget is adopted for EU funding programmes and mostly ministries with “chapter managed appropriations”, as a first step.

The remaining balance of budgetary expenses are to be planned in an institution-centred way, starting from the resource requirements of maintaining apparently necessary capacities, which are not necessarily identical to baseline budgeting.

An opportune field for using programme-based budgeting is the system of local governments where experimental projects have been staged since the mid-1990s. At the same time, the introduction of new budgeting methods for local governments requires a differentiated approach and in certain cases longer time.

Subsequent to budgeting and in the course of economic management, performance orientation can be promoted by assigning performance indicators to the application of budgetary appropriation, and monitoring compliance with these at the levels of organisation, sector and government.

THESIS NO. XI

APPROPRIATE RULES SHOULD BE APPLIED TO ECONOMIC MANAGEMENT AND INFORMATION SYSTEMS TO CATER FOR THE CONDITIONS OF REASONABLE AND ECONOMICAL ECONOMIC MANAGEMENT AT THE LEVEL OF INSTITUTIONS

Performance orientation needs to be ensured even at the fundamental levels of implementing budgets, i.e. with budgetary institutions. Depending on the nature of public duties, regulation should define the legal status and rules of economic management of organisations under state budget control in a differentiated way. For budgetary organisations performing public services a flexible environment of economic management needs to be created, which – without prejudice to the principles described above – does not diminish their competitiveness compared to enterprises performing similar services.

The modern budgeting methods outlined in the previous section should be complemented by the creation of institutional conditions suitable for performance measuring. What is necessary for this is that the information systems of budgetary organisations provide better service to the heads of these organisations and supervisory (steering) bodies. An important condition to adopting programme-based budgeting is transition to the modified (partial) accrual accounting. The preparation of this presumes a thorough professional discussion and focussed work.

The greatest shortcoming of the current information management is that it does not apply a systematic approach in managing the accounting and statistical information generated in the public sector, nor the information systems. Today, institutions are required to supply an excessive quantity of details, unutilised.

Budgetary institutions use a somewhat modified version of accounting developed for com-

panies. Development of a state accounting system seems necessary, which is better adapted in terms of approach to the peculiarities of budgetary management, and provides a better service in response to the management information requirements of the government and local governments. By consistent promotion of international standards applicable to the governmental sector, such a regulation can be developed. In the course of this, particular attention needs to be paid to a complex reflection of financial risks in the public sector and of changes in the public assets. The current practice of disclosing the accounting issues regulated by law for the competitive sector only in government decrees for budgetary institutions cannot be maintained. This is justified to be regulated by law instead.

THESIS No. XII
AN IMPORTANT ESTABLISHMENT FOR
COMPLIANT AND SUCCESSFUL FINANCIAL
MANAGEMENT IS A SYSTEM
OF INTERNAL CONTROL

The internal control system for public finance includes the objectives, guidelines, operating procedures and rules set up by the management of the respective organisation. Without operating this control mechanism, it is not possible to make the organisation ensure economical, effective and efficient implementation of its mission and various efforts, operation in line with the relevant legislation and internal rules, protection of the organisation's assets and information, the appropriate quality of the accounting information system, reliable and timely annual financial reporting, avoidance and investigation of faults and frauds. An important function of the renewed regulation is to cater for this area, which is also neglected by the current regulation, in a way that reflects its significance and complies with the international standards. The notion and significance of

internal control mechanisms need to be incorporated in the new regulation, and it should be declared that the elements and structure of internal control systems to be set up at the level of each institution – relatively independently – should comply with the international standards. The basic requirements related to the independent internal control function within the internal control system are justified to be laid down in law. Parallel to this, the current regulation by decree should be eliminated.

THESIS No. XIII
ADJUSTMENT OF THE PUBLIC FUNDS AUDIT
SYSTEM TO THE NEW REQUIREMENTS
IS INEVITABLE

Auditing is a priority function of public funds management. On specifying the new regulation, the audit system needs significant improvement. The workload shared by organisations providing internal audit functions needs to be specified in a clear and unified structure (Hungarian State Treasury, organisations performing audits related to the EU funds, supervisory audits and organisations performing internal institutional audits). It is particularly important to promote the principles of effectiveness, efficiency and economy over the whole audit system. Concerning the changing functions, it needs to be indicated that an increasing emphasis is placed on compliance with the professional requirements of the plans and the performance evaluation of each area, in addition to traditional compliance auditing.

A changing role of external audits and a broadening scope of tasks represent an international tendency. The SAO's audit licences need no extension, but the changes of the whole public finance regulation may justify further specification of these. Audits performed by the State Audit Office increasingly focus on revealing the financial and operating risks in public

finances, and the advisory role performed for the legislature is growing.

Audit capability is necessary not only for financial but also for professional reasons. Enforcing various controls derived from the peculiarities of specialized duties is a task of specialised audits. The activities of these also need to be made more coordinated.

Modern democracies set up adequate audit facilities also for civil organisations. Instead of replacing them, these supplement the audit facilities of state organisations. In order to enforce a targeted spending of public funds, the controlling role of publicity is worth utilising.

THESIS NO. XIV
REGULATION OF PUBLIC FINANCES SHOULD
BE PREDICTABLE AND RELATIVELY STABLE

On regulating public finances, the requirement of long-term predictability and social acceptance of the state's behaviour, as well as public confidence in new solutions are attached key significance for the participants of the economy. For this reason, the stability of regulation and the avoidance of frequent modifications are particularly important for legislation on public funds. Predictability includes careful preparation of laws (impact studies, social coordination, consideration of local government specialities), creating harmony among various blocks of the law, and specifying the effective dates of laws in a way that leaves sufficient time for preparing for the application thereof. The proposed regulation of public finance adopts a completely new approach, new methods and techniques compared to the domestic practice in the systems of budgeting, final accounts, state accounting, auditing and financial control. For this reason, providing as much as years between the acceptance and putting in to force of new rules may be justified, or a phased enforcing of new provisions. An

important requirement is that implementation decrees are known subsequent to announcing new legal rules but well before they come into force, including the requirement that sufficient time is also available for local governments to create their own implementation decrees.

Establishing – or maybe codifying – a practice whereby at least a year's preparation time is provided for completely new rules applicable to public finance (including the adoption of new tax types) between announcing and putting into force.

THESIS NO. XV
FOR PREDICTABILITY OF THE SYSTEM
OF PUBLIC FINANCES AND DEVELOPMENT
OF PUBLIC CONFIDENCE, THE FUNDAMENTAL
RULES NEED TO BE INCORPORATED
IN THE CONSTITUTION

If no majority is available on this in the National Assembly, the regulation of public finances by law may be implemented without changing the Constitution. The regulation, however, would be complete, and would best serve the financial security of citizens and increase the confidence of actors in the money market if constitutional guarantees were set up to enforce the major principles of public finance (e.g. authorisation of people's representation, transparency, completeness, specification, sustainability).

Such a guarantee would be, among others, to require a budget to be produced for each calendar year, and the implementation thereof to be accounted for under the final accounts within a period defined in the Constitution; equilibrium to be ensured between the expenditure and revenue sides of the budget to be prepared following the new approach; in addition, to budget for the required financial cover to provide each state duty.

The Constitution should indicate the function of final accounts: settlement by the government, and in case of acceptance, release from the obligation of implementing the budget. Bills on budgeting and final accounts may exclusively be tabled by the government, and these bills may not contain amendments to other laws.

The Constitution should define the notion and exact contents of sharing public dues – more accurately than currently, detailing each form of sharing public dues: the persons and their organisations are required to contribute to covering the expenses of common needs based on their participation in the economic traffic, their revenue and financial statuses, activities, in line with their ability to bear burdens, especially with taxes, duties, contributions, customs and the consumer contributions

payable for public services used (collectively referred to as: public dues).

In addition, the supreme law should provide for a situation where the National Assembly has not created the budget act for the next year in due time. In such cases, the government should immediately submit a bill on transitional economic management to the National Assembly. Such a law loses effect on the day the new budget act comes into force, and on the date defined in the Constitution at the latest. Until the law on transitional economic management is created, or if that law has lost effect before the new budget act was put in to force, the government is authorised to collect the revenues under the relevant legislation and to perform the proportionate expenditures within the expense appropriations of the previous year's central budget.