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Financial management on the local level of public finance

– an analytical overview of SAO experiences

The State Audit Office (SAO) has been helping the work of the fifth Parliament since the régime change over a decade and half ago. The number of reports by the Audit Office on the local level of public finances has exceeded 500 since, and on-site audits of local governments have numbered in excess of 15,000.

The SAO audits the financial management of local governments on the authority vested in it by sub-paragraph (1) of article 92 of the Act on Local governments and sub-paragraph (1) of article 120/A of the Public Finance Act, with particular focus on the financial management of the financially more affluent local governments of the following entities: Budapest, counties, cities of county status, and the districts of Budapest supported by the express agreement by Parliament decree 35/2003 (IV.9.). The SAO has published its audit reports of the comprehensive audits of that set of local governments¹ from 2003 on (16-18 reports annually).²

The aim of the present article is to provide an analytical overview on the local level of public finances on the basis of the experience of investigations performed in local governments.

The purpose of comprehensive audits of local governments – similarly to previous years – has been to assess if:

- Local governments had ensured all the conditions of legitimacy, and regulatory

compliance in the course of the process of planning, the implementation of the budget, asset management, and final accounts;

- Was harmony between the responsibilities of local governments and the requisite resources ensured with particular attention to some priority tasks;
- Were the provisions of the Act on Public finances and the applicable governmental decrees enforced in the course of the financial management of local minority governments;
- Did controls meant to ensure the regulatory compliance of financial management³ appropriately promote enforcement.

We have also performed other types of regularity audits at local governments of communities and major communities to follow up the comprehensive audit of local governments' financial management with the specific aim of investigating the creation, and operation of internal controls meant to ensure the regulatory compliance of financial management. Our work at these local governments involved an overview of the control applied to financial management, and the regulatory compliance of records, the establishment, and operation of the internal audit system, and the extent to which the recommendations of previous SAO audit reports have been taken into account.

In 2005 we performed the comprehensive and other kinds of regularity audits of 817 local self-governments (25.6% of all local governments) and 71 local minority governments (3.9% of all minority governments), and reported on our findings in 2006 to the Local governments and regional development committee of Parliament. As part of that exercise we audited – apart from the Budapest Capital City Local Government – local governments of four counties, six cities with county status, five districts of Budapest (collectively referred to as priority local governments), 65 cities, 21 major communities, and 715 community local governments. The annual gross expenditure by all local and local minority governments audited totalled 1030.3 billion HUF, constituting 37.3% of all local government expenditure. As regards the regulatory compliance of support provided by community (i.e. non-minority) local governments to the operation of local minority governments, and the compliance of the implementation of their financial management, they have been audited to include all priority and all local minority governments operating besides the city governments. (see table 1)

In the course of the audit we have primarily focussed on last year, but kept track of finan-

cial/economic processes until the conclusion of the on-site investigation, and likewise evaluated the economic events, and statistics of the period in 2002–2003 when assessing certain tendencies of financial management.

In addition to summarising our findings at the local governments audited we also present the nationally characteristic tendencies, and main statistics, financial indices of local governments. We have been auditing the financial management of local governments for several years using a standard piece of software, whereby the findings of the comprehensive audits have enabled us to provide comparative analyses including ratios, trends, and tendencies.

It must be highlighted still in the introduction that palpable improvement has been observed in local governments' financial management, and in the creation and operation of the internal control systems of local governments as a result of the comprehensive and other types of regularity audits carried out since 2003, the reports published, and our recommendations made to some ministers. Another step forward in support of the progress described above was the establishment of the internal public finance control system and its extension to all budgetary agencies.

Table 1

LOCAL GOVERNMENTS SUBJECT TO COMPREHENSIVE FINANCIAL MANAGEMENT AUDIT AND OTHER REGULARITY AUDITS

Name of local gov.	2003	2004	2005	2006 (budgeted)	Audits	
					total number	as a % of loc. gov.
Budapest capital city	1	1	1	1	1	100
county	4	6	4	5	19	100
city with county status	6	4	6	6	22	100
district of capital city	6	6	5	6	23	100
city	54	64	65	72	255	100
major community	27	22	21	20	90	60
community	252	268	715	450	1685	60
total	350	371	817	560	2095*	63

* Note: Including also the regularity and performance audits, the number of on-site audits reaches 2381 during the four years, thus – even with the overlap of the audit locations – we completed nearly 4500 on-site audits during the cabinet term at local governments.

In what follows I will first proceed to give an evaluation of the local level of public finances, and will then present the main findings and conclusions of the experience crystallised from the on-site audit performed at 2095 local governments, and will finally attempt a short summary.

ON THE FINANCIAL MANAGEMENT OF LOCAL GOVERNMENTS IN THE LIGHT OF FACTS, STATISTICS, AND TENDENCIES

Out of the 2002–2006 office term of local governments only 3 years are essentially available for analysis as only the first three years have supporting statistics deriving from comprehensive and other types of regularity audits mentioned in the introduction. As regards the fourth year, i.e. 2006, we only have the original appropriations, the Budget Act and the prognosis submitted for the debate on the bill available, on the basis of which the main tendencies of the last financial year of the office term may only be estimated rather than calculated.

The budget of the local governments forms part of public finances, and relates to it through its cash-flow in a 'net' manner⁴. The weight of local governments in the national economy, and in society was indicated over the last years by their 12–13% share of the GDP, and 23–24% share of all public finance expenditure. The importance of local governments within public finances is reflected not only by the total assets in excess of 9,800 billion HUF, an annual expenditure plan and revenues in excess of 3,000 billion HUF, nearly 3187 mayor's offices, plus nearly 1800 local minority governments, and more than 10,000 budgetary institutions but first and foremost by the quality of the public services that they provide.

The essence of the resource control and support system of local governments has not changed over the last years, and it continues to

be characterised by powerful concentration of revenues with regard to the central budget, while in terms of duties, competency, and responsibilities the tendency is that of decentralisation. 60% of the revenues of local governments in the year in question was subsidy received by various sub-systems of public finances. A general statement concerning the 2005 financial management of local governments is that they could only maintain their financial integrity by economic decisions aimed at modest, money-wise operation restricted almost fully to performing compulsory tasks, and identifying revenue reserves. In the social and educational sectors local governments tried to compensate shrinking revenues resulting from the reducing children count by downsizing, merging, closing, and transferring institutions, and capitalising on expanding opportunities for applying from funding, performing duties jointly with each other, and participating in various associations.

The GFS-type revenue of local governments⁵ equalled 2891 billion HUF in 2005, rising 36% on the corresponding value in 2002. Revenues of local governments have risen each year in excess of inflation. The real value of budget revenues of local governments in the past year exceeded the 2002 value by nearly 15%.

The ratio of operating expenses was steadily high among other items of expenditure in the same year (in 2002 it was 69%, in 2003 and 2004 74%, and in 2005 72%), which is characteristic of budgetary institutions.

▶ The decisive item in 2005 among operating expenses was the increasing amount of staffing costs; allowances to personnel grew by 7.8% as opposed to the 3% of the previous year, a rate exceeding annual inflation (3.6%). In 2005 local governments and their institutions employed a total of 487,124 persons dropping 9,317 compared to the same number in 2002. 83% of the workforce were public servants, and 8.8% civil servants. The gross monthly average earnings among full time civil servants equalled

214,167 HUF, 12% more than in 2004, while public servants earned 149,030 HUF, increasing 8.4%. It must be pointed out that 1% of central salary increase at the level of public finance translated into an expense of about 8 billion HUF/year.

► Non-personal expenses – following operation-related VAT, and unusually high, 11% increase of energy costs in 2004 – rose in 2005 to an extent around the inflation rate.

As regards the ratio of expenditures used for cumulative purposes, 2005 saw improvement as the corresponding rate in 2002 was 20.8%, in 2003–2004 it was 16.5%, and in 2005 18.7%.

► Revenues for accumulation in 2004 were affected by the freezing of public subsidies, and allowances. Assistance to local governments was cut by 11 billion HUF with the aim of improving the equilibrium of public finances, the majority of which was made up of the cancelling of development related subsidy, which equalled 4.2 billion HUF in the case of targeted/labelled subsidies, and 6.5 billion HUF in the case of centralised appropriations. In 2005 development and revenues for accumulation grew by 25% as a result of EU funding.

The obligation of generating public finance reserves affected local governments unfavourably. Cash supply to local governments shrank to an extent identical to the amount of public finance reserves; the reduction affected personal income tax revenues by receiving only 38.1% VAT instead of the 40% otherwise due. These cuts totalled 21.7 billion HUF. Expenditure rose mostly as a result of

operating loans, and to a smaller extent the increase of own revenues. The short-term operating loans of local governments grew by 34.1% in 2005, to a rate almost identical to the public finance reserves built up by them.

The consolidated 2005 revenues and expenses of 3187 local governments and the 1825 local minority governments⁶ exceeded 3000 billion HUF, which is about 10% higher than in the previous year. The rate of annual growth in 2003–2004 was above 6%. (*see table 2*)

It is our experience that actual revenues and expenses exceed the budget appropriation by 4–6%, thus it may be presumed that the final figures for 2006 will also exceed previous year's. That discrepancy is caused characteristically by revenues for accumulation and financing not known in the budgeting period.

In 2005 the increase of revenues was of decisive importance including the amount of borrowing rising by about 20 billion HUF. The revenue derived from taking out the loans grew by more than one quarter in 2004 and 2005 compared to previous year. (*see figure 1*) The total debt of local governments due to loans and credit amounted to 385 billion HUF in 2005, a value 18.4% higher than in the previous year. Within the general tendency we continue to experience significant differences even among local governments with similar conditions/features, which is only partly explained by different geographic and historic determinations. What I consider important is how many budgetary institutions manage their finances independently and how many partly independ-

Table 2

REVENUES AND EXPENSES OF LOCAL GOVERNMENTS

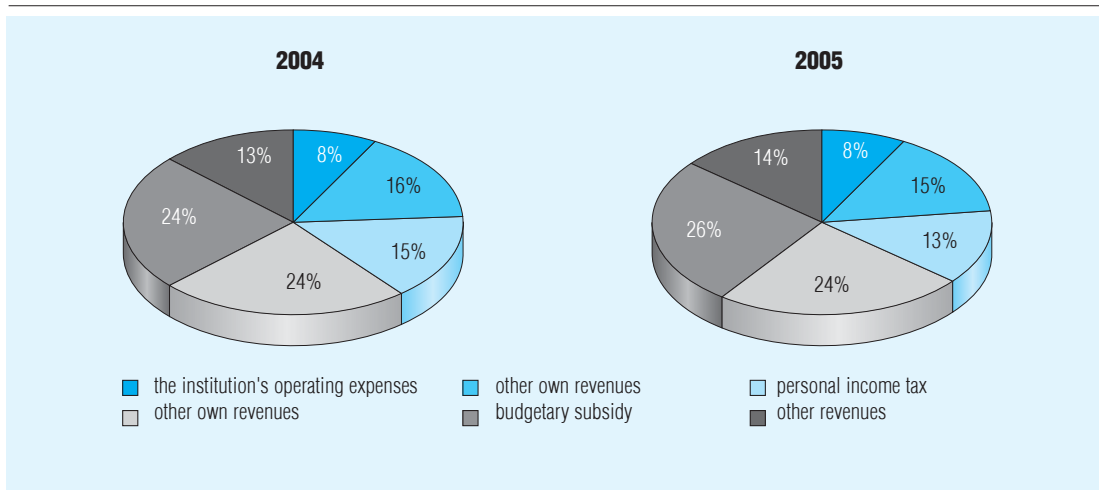
(national aggregate)

Name	2004 (final accounts)	2005 (final accounts)	2006 appropriations
revenues (million HUF)	2761.2	3010.3	2926.8
expenditure (million HUF)	2740.2	3009.8	2926.8

Source: 2004–2005 final accounts. 2006 budget

Figure 1

THE DISTRIBUTION OF LOCAL GOVERNMENTS' REVENUES*



*Note: Based on the computations by the SAO

ently in the light of tasks to be performed, and whether they take advantage of the opportunity of jointly performing tasks or jointly operating institutions as a result of the associations.

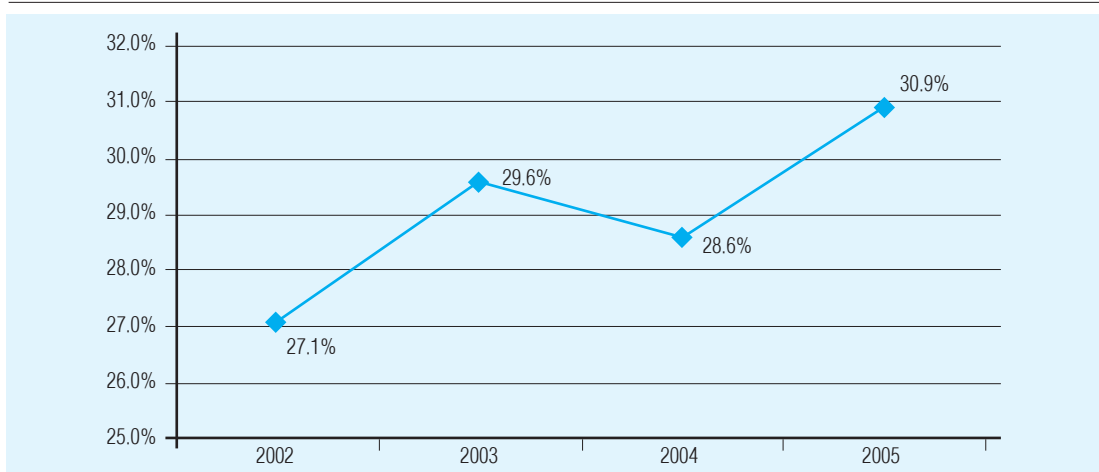
It is a key issue what ratio central budgetary support, normative allocations, and transferred revenues represent in funding tasks of the local government, and compulsory tasks transferred by the state. *Diagram 2* below illustrates these processes.

The sum of state support and allocations along with the transferred personal income tax totalled 1321.3 billion HUF in 2005 increasing 38.6% on the 2002 value.

Local tax revenues in 2005 amounted to 398 billion HUF, which is 34% higher than the relevant 2002 figure. That tax generated 23.5 billion HUF more for local governments than in the previous year, which is the result of the price level and economic growth.

Figure 2

RATIOS OF CENTRAL BUDGETARY SUPPORT AND ALLOCATIONS AMONG GFS-TYPE EXPENSES OF LOCAL GOVERNMENTS⁷



From among local governments' own revenues – except for stamp duty revenues due to local governments of counties, cities with county status, and the capital city – the most dynamically growing one was that of local business tax.

Local business tax gave 334.1 billion HUF in 2005 (252.6 billion in 2002), which corresponds to 32.3% growth (which, if statutorily cancelled, will pose the serious challenge of finding another, similarly stable and dynamically growing source of revenue for local governments).

The number of local governments having business tax revenues grew by 91 in 2005, and a total of 2639 local governments, equalling 85% of local governments imposing a local tax, had revenue from that source⁸. About 80% of local governments collecting business tax have set a rate in excess of 1.4%. 1113 local governments including Budapest collected the maximum 2% tax rate, equal to 42% of local governments collecting any rate of business tax.

The aggregate sum of stamp duty collected by duty offices – payable to the central budget – totalled 40.3 billion HUF in 2002, 52.9 billion HUF in 2003, 60 billion in 2004, and 65.1 billion in 2005.

Local governments' budgetary equilibrium did not change in 2005. This unfavourable situation was due to some measure of financial overstretching, many instances of unused reserves of operating potential, and the unpractical arrangements of service provision. Nearly 90% of local governments with short resources resorted to selling some of their assets in order to increase their revenues.

As a result of stricter regulations for support granted to insolvent local governments (no support is available to local governments with a population less than 500, not belonging to a notary district, and they have to account for any discrepancy between operating revenues related to the institution's purpose and the value indicated in the application for special local governmental revenues (not includ-

ing P.I.T) the number of ÖNHÍKI [assistance available to local governments with financial problems through no fault of their own]⁹ aid recipients dropped between 2002 and 2005 while the grant sum increased by nearly one billion HUF: in 2002 there were 1483 local governments receiving 16.7 billion HUF, while in 2005 1150 local governments were granted 17.5 billion HUF of central budgetary support.

Besides the rising number of ÖNHÍKI recipient local governments and a gentle increase of the support sum the average amount granted to one local government grew from 13.0 million HUF in 2002 to 15.2 billion in 2005.

In 2005 over 60%, 715 local governments had to repay the ÖNHÍKI for not complying with some of the relevant criteria such as not producing their own revenue set as a condition to granting the support, extra demand for normative support, or deficient justification for shortage of resources. The grant to be repaid was 1.5 billion HUF, 8.9% of the support used. The greatest demand for ÖNHÍKI support came from community (i.e. non-minority) local governments of a population less than 1000.

The high level of indebtedness indicates that local governments can only deliver their statutory public services with the help of outside resources. Local governments' and institutions' long-term debts exceeded the 2002 figure by 64%, and their short-term ones by 63%. (*see table 3*)

The increase of short-term loans in 2005 exceeded the increase of investment/development related borrowing by 7%. An indication of the general worsening liquidity status is that long-term loans for operating purposes grew over 2.5 times.

A more difficult and tighter economic environment is reflected by the fact that – as opposed to previous years – the total value of loans and deposits approached each other in 2004–2005. At the end of 2005 the bank accounts of 3,187 local governments and the

Table 3

LIABILITIES

	2002	2005	2005/2002
	billion HUF	billion HUF	%
Long-term liabilities	174.8	285.9	163.6
Short-term liabilities	181.9	295.6	162.5

budgetary institutions under their financial umbrella held cash and various fixed deposits worth 239.0 billion HUF, while their total loans amounted to 241.4 billion HUF.

It deserves special attention that among those taking out loans there was a higher ratio of local governments of communities, large communities having some property, and some revenue of their own, who in 2002 were recipients to 10.9% of all loans, and in 2005 already to 16.7%. The reason in the case of local governments concerned was presumably the 'forward escape route', i.e. the pressure to develop.

Liquidity indicators – following a downward

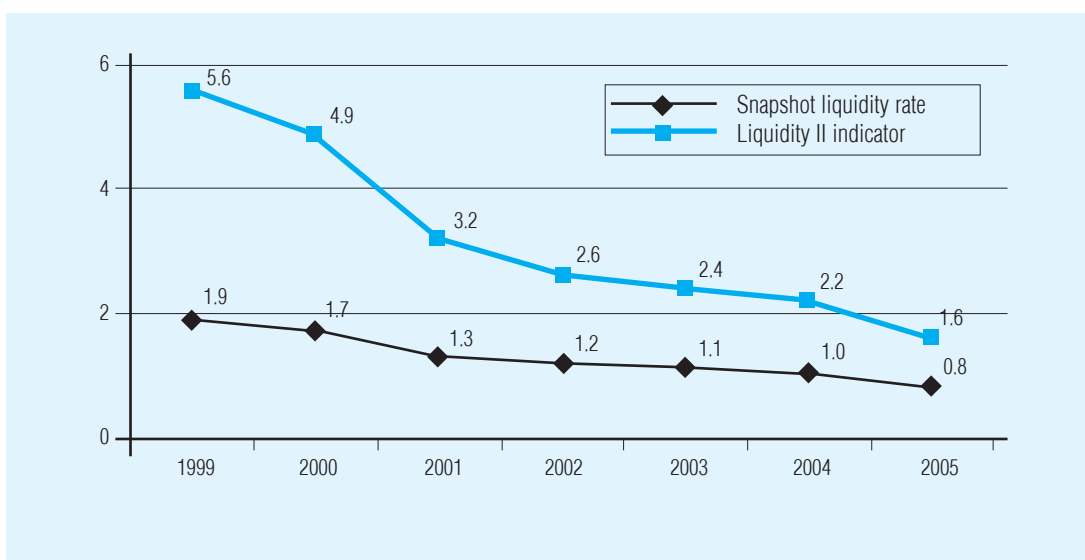
trend since 1999 – reflect the worsening of the financial status of local governments. (see figure 3)

The snapshot liquidity rate in 2005 equalled 42.1% of the 1999 value, and the liquidity II indicator dropped by 71.4% during the same period. The sinking of the snapshot liquidity rate below 100% indicates that local governments' financial instruments remain below their short-term liabilities. In 2005 securities and financial instruments covered 103.8% of short-term liabilities. Local governments' assets taken at book value increased tenfold over the last decade, while gross asset value currently amounts to 9.861 billion HUF.

The dynamic increase of asset value during

Figure 3

LIQUIDITY TRENDS



Snapshot liquidity indicator = financial instruments/short-term liabilities

Liquidity II indicator= claims + securities + financial instruments/short-term liabilities

the last three years is a less direct reflection of the actual increase of physical assets, investments of local governments of their own instruments, or development projects effected through target and ear-marked state subsidy (it resulted mainly from the statutory reconciliation of the asset inventory and the property register).

The significant growth of assets in accordance with the balance sheet discontinued in 2003 breaking a three-year tendency until that year as the appraisal process of the real estate previously registered at zero value was generally completed meanwhile¹⁰. As a direct effect, the number of pieces of real estate registered at zero value reduced from 580,000 in 2001 to about one tenth, 51,000 by 2004. Another major change occurred between 2003 and 2005 in the amount of securities and liabilities. (see figure 4)

MAIN FINDINGS AND CONCLUSIONS OF SAO AUDITS

In the case of city local governments and local governments *in the priority group* there has been an increase over the last years in the ratio

of those having an economic plan¹¹. All local governments of counties, cities with county status, and three quarters of Budapest district governments, and city governments audited had an economic programme for a longer term accepted by the council of representatives, setting sector level objectives, and tasks. It assisted the planning process, budgeting, and constitutes the fundamental document of financial management in budgetary institutions.

A ratio higher than last year of budgets accepted complied with statutory requirements of structure, and content. At the same time about 10% of local governments failed to comply with relevant legislation in not providing the required details of operating appropriations by budgetary agencies, and the annualised presentation of the appropriations of tasks implying a liability spanning several years.

Local governments in their budget decrees specified no or only deficient local rules to implement their budgets, a practice seen in last years. Nearly one third of local governments failed to provide the re-allocation procedures of appropriations, the administrative order of amendments, the rules of using budget surplus, and competencies of financing budgetary deficit.

Table 4

TRENDS IN THE AMOUNT OF ASSETS OWNED BY LOCAL GOVERNMENTS

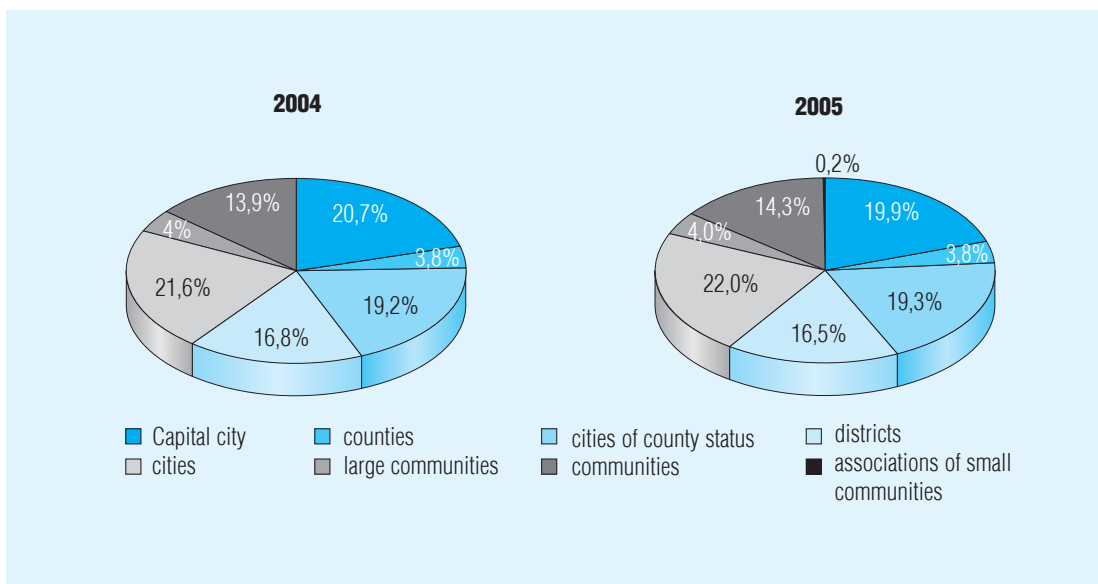
(Billion HUF)

Local governments' own property based on their balance sheet				
Assets	2002	2003	2004	2005
	<i>31 December</i>			
Intangible assets	9	11	16	21
Tangible assets	4 350	6 832	7 021	7 238
Invested financial assets	565	566	575	556
Instruments handed over for operation, and management	930	1 254	1 396	1 482
CURRENT ASSETS	569	571	610	564
TOTAL ASSETS	6 423	9 234	9 618	9 861
LIABILITIES	490	518	589	697
OWN ASSETS	5 933	8 716	9 029	9 164

Source: final accounts 2002–2005

Figure 4

DISTRIBUTION OF ASSETS AMONG DIFFERENT KINDS OF LOCAL GOVERNMENTS*



** Note: based on SAO computations

In almost one quarter of all budget decree proposals there were no annualised accounts for information purposes of decisions with financial implications spanning several years, and over half of local governments' indirect subsidy was not backed up with a narrative analysis. Without knowing future implications such as expected operating costs no justified and responsible decision may be made by the council of representatives.

The general level of legal compliance of financial management rose (see figure 5) as indicated by the fact that in 2005 more local governments had their statutory regulations, however, the quality of regulation mainly in local governments of large communities and communities failed to improve. The task of creating legislation continues to be settled by 'borrowing' one from other local governments, which becomes a problem as soon as it is not customised to fit local conditions.

An indication of the low level of control applied to financial management is that about half of Organisational and operating regula-

tions, funds management rules fail to comply with applicable regulations.

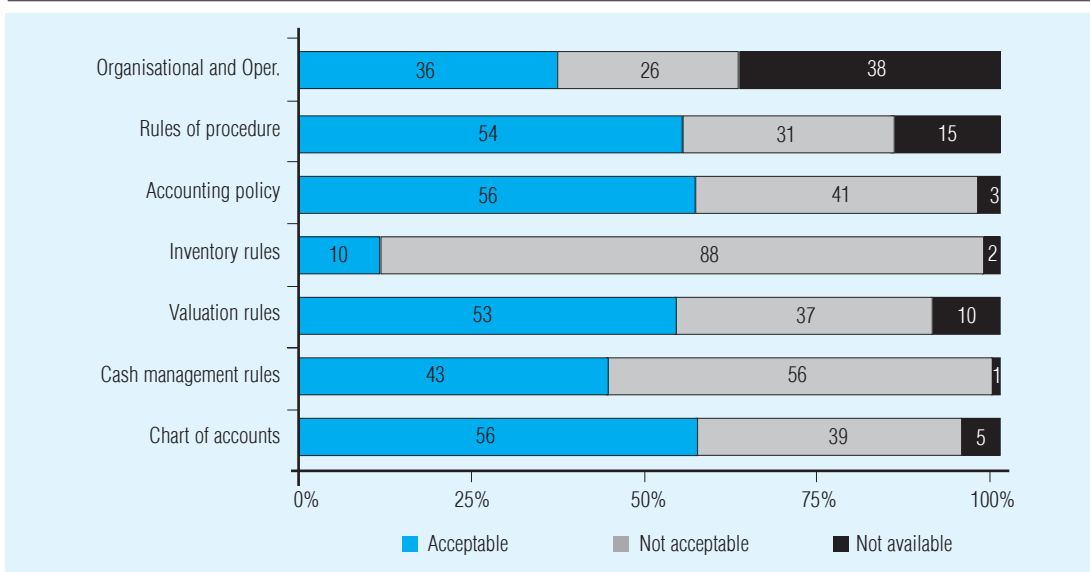
Regulatory deficiencies also contributed to the fact that the standard of in-process controls failed to improve on last years. Audit experience tends to confirm that the required regulations are still produced with a general meaning rather than customised, therefore such regulations continue to lack responsibility, and accountability, and the routine operation of internal audit runs aground on missing labour market conditions (in local governments of small communities neither financial resources, nor qualified workforce are available).

A result of that is that one third of local governments breach the provisions of the Act on Public Finances, the most basic legislation of budgetary institutions' financial management, by taking commitments, and initiating transfers without an approved appropriation. (see figure 6)

Technical performance remained uncertified or was certified by a person not entitled to do so in 50% of the cases – prior to ordering dis-

Figure 5

REGULATION OF FINANCIAL MANAGEMENT AT LOCAL GOVERNMENTS AUDITED



bursement of funds or collecting revenues - because it was not specified how and by whom it should be done.

Endorsement was carried out deficiently at nearly half of the local governments, thus it eventually failed to play its function. The deficiency was compounded by the fact that mainly in local government offices of large commu-

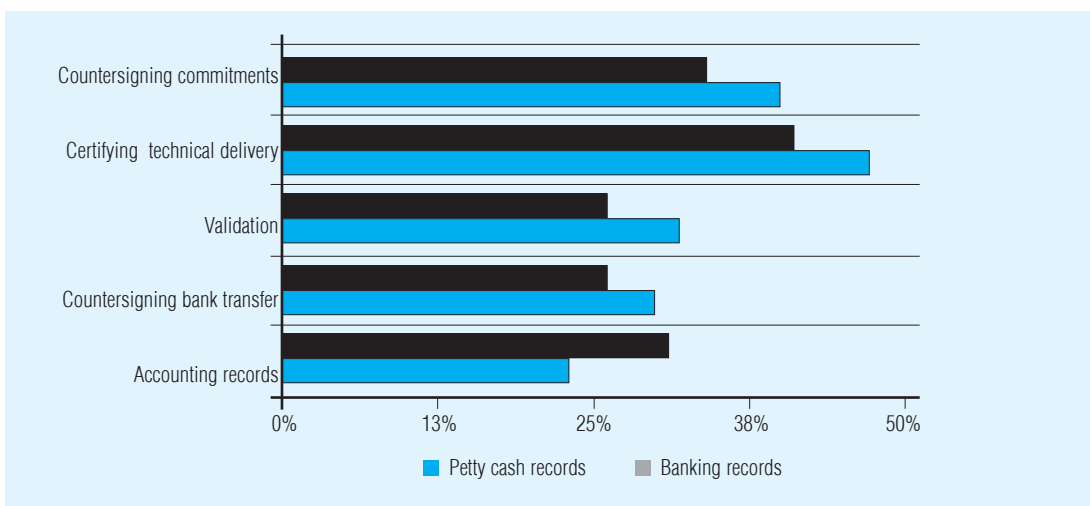
nities and communities persons performing a particular function did not have the required schooling or professional qualification.

One fifth of local government offices failed to post all asset items in their accounting records due to full or partial neglect of maintaining analytical files.

Over half of local government offices con-

Figure 6

RATIO OF LEGALLY INCOMPLIANT PETTY CASH AND BANK RECORDS BROKEN DOWN BY TASKS



sidered the necessity of posting depreciation similarly to previous years in the case of claims, shareholdings, and securities, but one third of them eventually failed to post depreciation. Valuation deficiencies resulted in inaccurate statement of book value of local government assets.

Nearly all local governments controlled the competency related to asset management in their asset management regulations. However, in almost half of the local governments audited there was no record of the fact and the conditions of changing the marketability status of assets of limited marketability as established in the asset management regulation, or of the conditions of reclassifying assets into other than the nominal assets. This contributed to the sales by some local governments of asset items belonging to their nominal assets in spite of legislative prohibition.

Our experience suggests that some local governments 'preferred' avoiding the public glare, one third failed to determine the value limit above which assets could only be sold, handed over for management, or transfer the right of use or operation for financial gain through a public tender to the party submitting the best bid. Half of the local governments that had determined a value limit included enabling legislating in their asset management regulations to omit the tendering process, and in 13% of them in 2003–2004 the value limits specified were unrealistically high¹². Over one third of local governments ignored the regulation concerning the obligation to run a tender in the course of asset sales.

Another indication of avoiding transparency was that 9/10 of local governments provided targeted support for development purposes or concluded contracts of a net value exceeding five million HUF for goods procurement, construction investment, services, asset sales, asset operation for financial gain, transferring assets of a right representing assets. One quarter of

local governments did not or did only partly comply with publication obligations related to these subsidies and contracts.

In accordance with the information bulletin of the Council of Public Procurement the total value of public procurement processes amounted to 1129.7 billion HUF in 2004, while in 2005 the same value equalled 1291.3 billion HUF, of which local governments had a share of 22%. Our audits indicated that compliance with public procurement regulations qualifies as a high-risk area (suspicious of corruption) in local governments' financial management.

Nearly one third of local governments of the priority group of cities failed to conduct public procurement procedures in breach of the provisions of the Act on Public procurement. The local governments' bodies of representatives could decide on determining the budgetary appropriations for procurements of goods or services of an identical or similar purpose, investments, or renovation projects whether to ensure the requisite funds from the budgets of several budgetary organisations or in the budgets of a single budgetary organisation appointed to conduct the procurement process. The majority of local governments chose the first solution.

The Public Procurement Arbitration Committee decided against, and imposed a fine on one fifth of local governments having conducted a public procurement process for contravening the provisions of the Act on Public procurement.¹³

Local governments handed over resources worth 180.4 billion HUF in 2004, and 186.1 billion HUF in 2005 as targeted subsidy to foundations, public foundations, and other not-for-profit organisations, businesses, households, and local governments' extra-budgetary organisations other than their own institutions, and to foreign communities to deliver tasks for their communities. The local governments granted nearly two thirds of these

funds for operating, and one third for development purposes. Local governments set stricter guidelines regarding the sum, the objective supported, reporting on use, and deadline than last year.

In one half of the grant providing local governments grants to foundations, and public foundations, were approved by a party other than the council of representatives in breach of the provisions of the Act on Local governments. Budgetary institutions of one quarter of the local governments audited granted support to social organisations without the permission of the council of representatives, contravening the provisions of the Act on Public finances. Our experience with the local governments audited has been that less than one third of support recipient organisations complied with their financial reporting obligations with regard to the content, and the deadline of such reports. The financial reports were not controlled in one fifth of the local governments thereby violating the provisions of the Act on Public finances. In less than 90% of local governments there were no on-site controls to

ensure if the grants provided were used for the specified purpose.

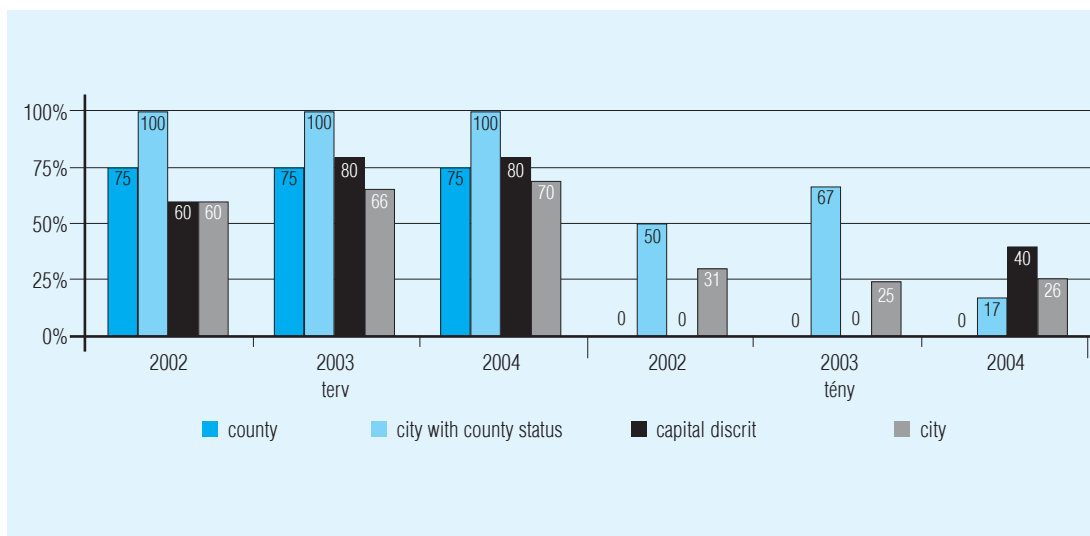
The budgetary equilibrium of the local governments audited failed to improve compared to last years. About two thirds of the local governments audited budgeted a deficit for both operating and cumulative purposes. The budget deficit was partly due to inefficient working arrangements, low rate of utilisation of operating capacities, and assuming voluntary tasks way above their load-bearing capacities, and errors in planning.¹⁴

Figure 7 illustrates the planned and the actual level of budget deficit.

Extra resources received during the year, and measures by the local government aimed at improving equilibrium contributed to only one third of local governments audited having a budget deficit by the end of the year. Equilibrium problems of operating revenues/expenses characterised one fifth of local governments audited at the end of the year. In the case of revenues for accumulation the deficit came to the budgeted level in spite of the fact that one third of local governments

Figure 7

THE RATIO OF LOCAL GOVERNMENTS BUDGETING AND REALISING A DEFICIT IN A BREAKDOWN BY COMMUNITY TYPE



audited used part of their operating revenues for cumulative purposes. The deficit planned was reduced in the course of implementing the budget by extra resources received through applications, and surplus revenue of their own, revenue from selling off assets, and relative surplus through conservative budgeting. Two thirds of the local governments audited instituted a set of restrictive measures in an attempt to cut costs e.g. merging institutions, dismissals, energy rationalisation, holding back spending on special assignments, etc. and/or rescheduled/postponed some of their planned investments. They did not, however, quantify the effect of these cost-cutting measures in each case.

Two thirds of the local governments audited decided on making a commitment resulting in debt (*'debt-generating commitment'*). These most often took the form of borrowing. The local governments audited took out further loans to repay part of their debt service in the current year thus further exacerbating their financial equilibrium. About nine tenths complied with the Act on Local governments concerning *the debt-generating commitment* by controlling in advance and observing the top limit prescribed in the.

All local governments of cities with county status audited took out a liquid loan in 2002–2004, while 75% of county local governments, 69% of city local governments, and 40% of Budapest district governments did the same.

The local governments audited did not 'go bankrupt', i.e. they did not initiate debt rescheduling.

In order to mitigate their short resources, local governments decided voluntarily on catering for their duties in the most economical, and most effective manner including institutional streamlining during the period under review. Almost half of the restructuring measures aimed at establishing, restructuring, and discontinuing budgetary organisations. By merging the economic organisation of budget-

ary institutions the number of institutions with independent financial authority reduced. Restructuring, mergers, and terminations reduced the number of public employees on payroll, while at the same time the number of public benefit companies contributing to public tasks grew by 29 in the period 2002–2004. As many as 33 more economic companies took their share of compulsory tasks by local governments¹⁵. The local governments audited had an interest in 136 more partnerships from 2003 on compared to the previous year. Such partnerships performed primarily social, medical, and public education tasks. Another target in creating partnerships was harmonising territorial and regional development programmes.

In the educational and social institutions of the local governments audited the cost per one pupil/student/client rose as a result of rising operating expenses, and less users of the services (except creche services).

In educational institutions the per capita expenses grew by over one third in the period under review caused partly by centrally ordered wage rises to public employees, and one-off procurements to ensure technical conditions e.g. those related to introducing new forms of training and new subjects in secondary education.

The rate of public contribution/support in funding the educational tasks of creches and the primary school shrank, and was compensated by a higher rate of local governmental resources.

In social institutions the expenditure per one client grew by nearly one third in the period under review, and the rise was mostly ascribable to one-off spending on necessary infrastructure, and pay-roll costs arising from public service wage increases. The ratio of public support reduced in financing social expenses.

The local governments audited spent 1–23%¹⁶ of their budgetary expenses on funding voluntarily undertaken tasks in the period

under review. The district governments of Budapest, and the city governments typically funded the operation of institutions of secondary education, and social homes, and operated out-patient and in-patient wards. By providing earmarked aid to non-profit organisations, economic partnerships, and other organisations, local governments added to the list of voluntarily undertaken tasks. (see figure 8)

Performing compulsory tasks was usually not jeopardised by funding voluntarily undertaken tasks in the local governments audited, however, they are in violation of their obligation of ensuring free access to public buildings by 1 January 2005, a duty they cannot afford (our investigations suggest that they fall nearly 500 billion HUF short of the required funds.)

SUMMARY

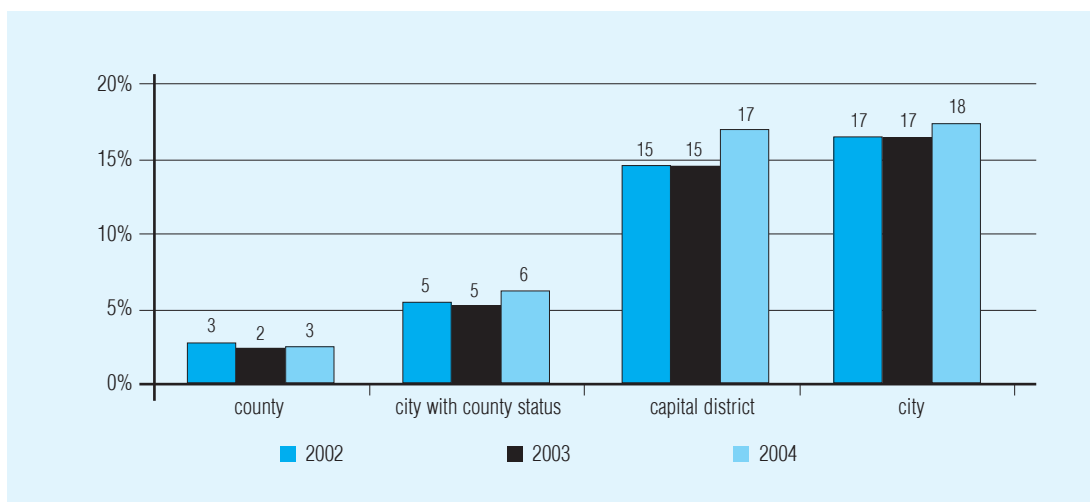
There has been no essential change to the organisational structure of local governments since the passing of the Act on Local governments. The tasks of local governments achieving major success in developing community

infrastructure, orchestrating public services, have been extended by statutory duties laid down in sectoral legislation over the past decade. However, these extra tasks are supported only partially by the necessary central funding. The budget of nearly one third of local governments was in deficit in the last years. Even today, local governments decide on the use and allocation of major sums of public funding and public assets of significant value in a rather fragmented system. On the other hand, more than 350 statutory provisions including 133 Acts impose over 3500 tasks and competences on local governments and their bodies/organisations. About one quarter of public finances is spent on providing local governments' budgets, that is why they have such an important role in the effective use of public funds, and the shaping of social mood.

Several government resolutions were issued over the last years instigating the review of local governmental tasks and competences, the improvement of the control of their resources based on reasonable principles of allocating competence and jurisdiction, however, no significant change has so far occurred.

Figure 8

RATIO OF EXPENDITURE ON SELF-IMPOSED TASKS TO TOTAL EXPENDITURE IN THE LOCAL GOVERNMENTS AUDITED



Minor adjustments have been applied to legislation including the ceding of the entire sum of vehicle tax to local governments from 2003 onward. While that move undoubtedly increased local governments' revenues, it likewise brought with it some duties, thus it meant by no means net revenue to them.

The most important regulatory and service-provision related achievement of local governments was the creation of multifunctional small regional association. That may give rise, through further encouragement, and through continued recognition of real interests, to the creation of associations that could render daily service provision more cost effective, successful, and efficient.

Our audit experiences (almost 4500 on-site audits over the last 4 years, equal to one third of the annual capacities of the SAO) lead us to conclude that the comprehensive rethinking of the system of service provision and resource control by local governments cannot be further postponed.

It is necessary for the state and the local governments to agree on a division of labour, and the comprehensive upgrading of the financial management system following a matter-of-fact review of the authority and competency of local governments including the revisiting of the entire subsidy system, the elimination of the contradictions arising from the various sector-related laws and regulations, the management of tensions/frictions between the weight and rate of compulsory duties imposed on local governments and their funding capacities. Similarly urgent is the task of determining a differentiated set of authority and competency for local governments.

A final, crystallised position and a specific recommendation on the structure of resources of the local level of public finance, and on the transformation of funding will have to be created in the framework of the state reform so that, in addition to financial/legal reinforce-

ment of local governmental independence also decentralisation should become unambiguously established along with the weakening of the dependence on the central government. It would be likewise desirable to ensure that business size in the service sector should come in line with the economically optimum value, and that local government for both small regions and regions can finally materialise. The latter would of course necessitate a novel type of division of labour among the various levels of local government through the detailed review and narrowing down of technical regulation of sectors, the deregulation of trades and professions, and, following a review of compulsory tasks, the simplification of the system of normative subsidies, and contributions (significant reduction of the number normative rules, and applying more stringent conditions to providing normative subsidies). All that cannot, of course, go without re-thinking the taxation system as the reinforcement of the revenue position of local governments remains necessary also through local taxes.

The outcome of SAO audits greatly depends on the extent to which their findings, recommendations are applied/realised, and what legislative amendments are implemented at Parliament, governmental, ministerial, and local governmental level, and what measures the organisations audited take themselves. The SAO is not an authority, so it is not in a position to impose sanctions, or extort compliance with its recommendations or suggestions. It must be emphasised by all means that from among reports and studies published in 2002-2005 the competent committees of Parliament placed on their agendas 308 times. During the previous cabinet term at 70% of the Parliament session days there were over 1200 references made to SAO reports, studies, findings, and recommendations in contributions. A significant part of such references concerned SAO findings related to difficulties of financial man-

agement, funding problems in health, education, political party financing, privatisation, and experiences concerning PPP investments.

One may regard it a favourable process that SAO recommendations to local governments of counties, cities of county status, Budapest and the districts of Budapest subject to comprehensive audit were put to practice within a short period. In many instances measures were taken to rectify omissions, and replace deficiencies identified already during the on-site audit.

In summary, one needs to refer by all means to several important legislative amendments effected as a result of the budgetary relations of local governments including e.g.:

- As a result of several of our recommendations the distribution of personal income tax has changed as from 2003.
- Following our initiative the Act on the Central budget was amended in 2005 to include the financial limit above which local governmental assets may only be sold, or their use or management for financial gain may only take place through a standard open tendering process.
- Since the Act on Regional development and regional management took effect the Regional development councils have been given an increasingly important role besides County regional development councils when decentralising development related decisions, a significant improvement effected as a result of our recommendations.

- It is similarly a move forward that the rules of applying for centralised appropriations have been laid down in formal decrees since 2005 by the ministries concerned.
- It is certainly an achievement in conjunction with the audit of local governments' support from sources other than the central-budget that the rules of interest on subsidised public utilities loans have become more rigorous in line with our recommendations.
- We have likewise been recommending for years that the regulations concerning the principles and the framework of the normative methods of resource allocation between the Budapest local government and the district governments, which was eventually amended by Parliament in December 2006 should be made more specific.

The State Audit Office wishes to make effective contribution through its audit experiences to the achievement of similar objective. We are convinced that effectiveness of local governments' financial management may and must be improved through the reports themselves, 'holding up the mirror' to them, and by making the reports publicly available to help them share their experience. At the same time by summarising our recommendations based on the systemic approach we may assist the work of the ministries concerned and last but not least the effectiveness of decision making of the fifth democratic Parliament.

NOTES

¹ It must be noted that in line with international practice and with INTOSAI standards, the SAO audits of local governments concentrate on regulatory compliance and performance, thus in the course of so-called comprehensive audits we apply these two types of control with a weighting system depending on individual issues.

² Reports by the State Audit Office are accessible at www.asz.hu.

³ By controls meant to ensure the regulatory compliance of financial management we mean the complete and operational management and control system as well as the performance of internal audit functions.

- ⁴ The net financing of local governments began with the creation of the treasury system in 1996 (established by Act CXXI of 1995 on the budget of 1996 by amending 63 of the Act on Public finance (Áht), and article 91 of the Act on Local governments (Ötv.). The essence of net financing is that the treasury deducts from the various support sums payable to local governments – following the principle of gross accounting and net cash-flow – all payments to be made and other obligations payable by local governments on a monthly basis.
- ⁵ It does not include revenues from lending, and those from investments in securities, state bonds, and other financial investments, the balance of purchasing and selling securities within one year, and financial instruments received from local governments for operational and development purposes.
- ⁶ It means the adjustment of gross revenues and expenditure by the result of clearing of funding transactions among local governments and their institutions ignoring the following:
Financial instruments handed over or taken over for accumulation purposes,
- Short-term loans, short-term securities,
 - Balance of expenditure without movement of cash
 - Pending, carryover and equalising items
- ⁷ Expenditure calculated based on the GFS system does not include the sums spent on loan-repayment, state bonds, and other financial investments, the balance of purchasing and selling securities within one year, and financial instruments handed to local governments for operational and development purposes.
- ⁸ Source: 2005 final accounts of the Ministry of Finance.
- ⁹ ÖNHIKI = local governments available to local governments with financial problems through no fault of their own. The Budget Act of 1995 created a new source of subsidy which is available through application to local governments.
- ¹⁰ Government Decree 218/2001 (III.27) prescribed for local governments to have their real estate cadastre reviewed until 1 January 2003 (local governments did not comply with that deadline, and the figures in their balance sheets and the real estate cadastre have not yet been fully reconciled).
- ¹¹ In line with our recommendation in 2005 Parliament specified the content requirements of the economic programme.
- ¹² In our Comprehensive audit report of 2004 on the financial management of local and local minority governments we suggested that the amendment of the Act on Public finances should contain a value limit for tendering applying uniformly to all local governments. In line with our recommendation Parliament has been specifying that value limit each year since 2005 in the annual Budget Act.
- ¹³ According to the statistics produced by the Public Procurement Arbitration Board of the Public Procurement Council in 2004 at the request of the SAO, local governments violated applicable legislation the Public Procurement Arbitration Board found local governments in breach of applicable legislation 148 times in 2004, and imposed a total sum of 137 million HUF in fines. There were 502 proceedings aimed at legal remedy in conjunction with procurements by local governments in 2005. Out of these the Public Procurement Arbitration Board stated the fact of the contravention 195 times, and imposed fines of 142 million HUF.
- ¹⁴ By analysing the expense side of the budget one realises that the operation of 13,000 budgetary institution appears as a 'permanent expense item' including the major elements of wages and public contributions and real costs, i.e. the overhead costs of institutions, and the institutions operated on top of the reasonable load-bearing capacity (kindergarten, creche, primary school, sometimes secondary schools) with less than optimum occupancy rates causing funding problems in day-to-day financial management.
- ¹⁵ Among local governments audited in 2001–2003, too, there was a characteristic endeavour to rationalise their institutions, the expansion of the role of public benefit and economic partnerships in performing public functions, while maintaining the decisive role of budgetary institutions (see in Report on the financial management of comprehensive audit of local governments and local minority governments, report No 0544 pp.54–56, State Audit Office, Budapest, 2005).
- ¹⁶ We determined expenditure on voluntarily undertaken tasks during the on-site audits from various accounting records in cooperation with the staff of the local government offices.