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SUSTAINABILITY AND CONTROL ISSUES OF THE FINANCIAL MANAGEMENT OF LOCAL GOVERNMENTS – THROUGH HUNGARY'S EXAMPLE

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The rules and control mechanisms pertaining to the financial management of local governments enhance the sustainability of their budgets, that is, they have an operational risk mitigating effect. This paper presents the Hungarian system of self-government, and its fiscal rules, which have undergone a major reform since 2011, and the system of duties and financing have been aligned. The paper evaluates the reform process that commenced in 2011, and the effectiveness of budgetary regulations. The second half of the paper presents the control system of Hungarian local governments, the strengthening of which also has promoted the sustainability of financial management.

Keywords: local governments; fiscal rules; financial sustainability; Hungary

Introduction

The sustainability of self-government functions consists of several elements. One element is development programmes designed jointly by the leaders of a municipality and the population to raise the standards of public services and increase the satisfaction of the population. Thus in municipal development, sustainable development means that development concepts are designed in cooperation and there is consensus among stakeholders. Sustainable operation requires an effective management of developments and the processes of public services as well as the stability of their financing.

Sustainability, however, also has financial aspects, which means that municipalities design their development policies not to deteriorate the financial conditions of either current or future generations, or their access to public services. This means that loans can be taken out only in cases that do not affect substantially negatively the financial capacities of a local government or the standards of the provision of public services.

Material and methods

The self-government segment, performing a crucial role in providing public services, is not indifferent to the sustainable development of the economy. Since the beginning of the worldwide crisis in 2007–2008, and the accumulation of the effects of the loose fiscal control and the lack of budgetary surveillance from 2010 in Hungary, a profound need for fiscal consolidation has been pronounced for the local level of the government and also for the strengthening of the budgetary control in relation to the entire Hungarian public sector governance (Boros, 2011; Lentner, 2015). Within this framework, this study focuses on introducing the reform of the internal audit process within the budgetary units and entities, including the local governments, and respectively, the three-level (i.e. audit, governmental and surveillance) systems in Hungary. Its background lays in the post-crisis budgetary and audit processes are interpreted within public administration and public finance, which are at the boundary of interdisciplinary law and social sciences. In this respect, they are similar to central budgetary processes, as the government is prevailing in either of the budgetary operation and audit (Sági, 2012). From this background, this study depicts the main economic and legal characteristics of the local municipalities, including a brief review of the international literature. However, the operation and control of public utilities is also very important for the quality of public services (Domokos et al., 2016; Boros and Fogarassy, 2019), but these details are no longer covered in this study.

Results and discussion

Sustainability in budgets – with an international outlook

In the self-government segment, changes in public administration as well as the processes of the world economy have a significant role, particularly in borrowing. The reason is that in the 1960s and 1970s, borrowing became popular due to low interest rate levels, which led to intensified borrowing by local governments. This process was enhanced by the fact that from the 1980s, savings decreased because of negative real interest rates on loans, causing an increase in loan financing. Resulting subsequent repayment obligations, then at an increased interest rate, entailed a setback to investment activities and operating capacities since the 1990s. This phenomenon was observed in Germany in particular, where the federal state had assumed debts of local governments because of the reunion (Dohnanyi, 2002).

In relation to Italy, the permissive nature of regulations had not taken into account that loan financing could be used for purposes other than investment financing, such as covering operating deficits, and as a result of this process, local governments had got into a debt trap by 1976. The convergence programme of the mid-1990s could reduce debts (Dohnanyi, 2002).

Fiscal rules mean a certain degree of – stricter or more relaxed – control over excessive indebtedness of local governments on state level, referred to as the golden rule of financing in literature. In accordance with the golden rule, current expenditures of local governments must be paid from current resources of revenues, mostly tax revenues, or short-term loans in certain cases; investments, however, should be financed through loans and own funds. In fact, differences in debt control between countries lie in the upper limit of indebtedness. A reason for applying the golden rule of public finance

in practice is that it controls the accrual of fixed assets, thereby the provision of public service by local governments is ensured for several generations, and, accordingly, emphasis in financing should be placed on the division between generations (Heijdra and Meijdam, 2002.).

In an operative approach, there are three known ways of controlling the indebtedness and borrowing of local governments. In the first case, there is market-based financing, the second is characterised by the fact that borrowing requires permission, while in the third one central control effectively limits borrowing (Ter-Minassian and Craigh, 1997). The European Union's regulatory fundamentals of maintaining deficit on a required level were introduced within the framework of the Stability and Growth Pact and were studied also in relation to the local subsystem of OECD countries (Van Rompuy, 2016). Although not in relation to the three countries studied, the way how budgetary rules work were presented through Italian and Swiss examples (Monacelli et al., 2016; Burrett and Feld, 2018).

These rules are also important because they guarantee the solvency of local governments and the implementation of the going concern principle both on a macro and a micro level (Duve and Dreschsler, 2011). Foremny (2014) studied the implementation of fiscal rules in the pre-crisis period, and his study concluded that it was not possible to keep a financial equilibrium in all cases, despite the existence of such rules. This was confirmed by Levaggi and Zanola (2003) through the examples of Italian regions.

A draft outline of the Hungarian regulatory system

The Hungarian economic management after 2010 recognised that fiscal compliance with the Maastricht convergence criteria was possible if stricter control was taken on the financial management of local governments, as their debts affected public finances as a whole. Thereby, the provision of municipal public services could also improve.

In Hungarian practice, debt was primarily accumulated in towns with county rank and county governments, which was a serious problem because the role of these types of local government was prominent (concentrated) in providing public services, thus entire regions would have got into an impossible situation, especially because of bank loans the repayment of which had become impossible. The problem was aggravated by the fact that Hungarian local governments incurred debts mostly in Swiss francs or Euros, and not the national currency, which, due to the exchange rate risk, envisaged significant repayment costs, and even the prospect of an unmanageable status. Therefore, the Hungarian government took over the entire stock of local governments' debts deriving from bank loans and bonds into the central budgetary stock. This measure, however, entailed measures limiting further indebtedness, that is, previously "permissive" fiscal rules were tightened. This process fit in the structure which started in 2011 by the re-definition of the legal frameworks of the Hungarian system of self-government (Lentner, 2014).

Debt accumulation can be explained by the fact that in the programming period of 2007–2013, the Hungarian national development policy wanted to provide local governments with a significant share, 15 per cent, of cohesion support granted for this period as a resource. The previous government provided the opportunity of taking out resources in the loan market, instead of national budgetary subsidies, to use these development resources, and arranged by law that they were accounted for as own contribution, although in reality onerous liabilities were assumed. Thus, what happened was that – as local governments lacked own contributions required for using EU resources – the government enabled them to take out bank loans or even issue local government bonds, also underwritten by commercial banks, to provide own contributions.

Another notable circumstance was the process of the evaluation of assets, taking place from 2001 to 2003, during which assets registered until then without an accounting value (registration in Account Group 0) had to be evaluated and entered into books by Hungarian local authorities, as result of which assets of local governments tripled, accounting for 35 per cent of the GDP by 2007, which improved the latent creditworthiness of local governments. This situation was exacerbated by the fact that the creditworthiness assessment carried out by banks was optimistic and more positive than justifiable, which contributed to the debt accumulation of local authorities, which had increasing operating deficit, as the operational-structural problems of the system has been inherited from the past and remained unresolved. After the regime change in 1990, it was a characteristic feature of the Hungarian system of self government that local governments received an increasing number of public service tasks but no funding from the central budget was provided by the state and local governments ran up operating deficits. Deficit was increasing, and in the 2000s, when Hungary, as a full member of the EU, became entitled to opportunities to have access to the Community's sources of investment, there were serious financial problems in the local subsystem of public finances. This means that the accumulation of local governments' debt, however, did not start in the mid-2000s but well before; the pace of growth was significant especially from 2004, due to the opportunity to use development resources opening up after the EU accession. The central budget assigned an increasing role to local authorities in performing duties, which resulted in decentralised deficit and debt, with, on top of that, an insufficiency of own resources from local and central governmental budgetary resources, required for the drawdown of EU grants. Another clear tendency is that in the years of local governmental elections debts were always higher than in previous years, because political forces exhibited a behaviour of over-spending.

New ways of local governments' operations

With the commencement of fiscal consolidation, the Parliament re-regulated the operation, the system of responsibilities and competences of local governments in 2011, acknowledging the local voters' rights to self-government, but equally observing the principles enshrined in the European Charter of of Local Self-Government. When identifying the responsibilities of local governments, the capacities of municipalities were considered, and the new regulation customised the previously wide-ranging obligation to provide public services.

Articles 31–35 of the Fundamental Law, entering into force in 2011, declared the constitutional rights of local governments taking the requirements of the Charter into account. These rights include the adoption of regulatory instruments and bodies exercising the rights of local governments. In relation to public finances, Articles 36 and 38 provide a framework for managing the assets of local governments. One of the novelties of the Fundamental Law is that, as opposed to the previous Constitution, it has incorporated the major guiding principles of public finance regulation.

The act on the operation of local governments declared that voters of municipalities and counties are entitled to the right of self-government. Municipal governments operate in villages, towns, township seats, towns of county rank and districts of the capital, while regional governments operate in counties. The act differentiates between the duties of the capital, districts, towns, villages and towns of country rank, imposes for them to perform the duties and exercise the powers mandated by legislation and those assumed voluntarily, and determines that they may have different duties and powers.

The economic independence of the Hungarian system of self-government is in place under legal conditions, with three main sources of law, including the articles on public finances of the Fundamental Law, and the paragraphs of the Local Government Act, which ensure the independence of managing finances, in the spirit of the Charter. A testimony is the Act on Local Taxes, which embodies taxation sovereignty of local governments, which is, however, limited. Local governments may choose from property-type taxes, communal taxes and business taxes as set forth by law, but the given bases of assessment may be subject to one tax burden only, which is an important limitation. Beyond the prohibition of tax multiplication, taxes levied by local governments shall not exceed the maximum tax rate imposed by the Parliament, for example they may levy a business tax of maximum 2 per cent. The local governments' right to levy taxes has been strengthened since 2015, as, with the introduction of the system of municipal taxes, local governments may levy tax on any basis of assessment which is not a basis of assessment for a central or local tax. Local business tax revenues have significant weight in the system of financial management, since they account for 80–85 per cent of the total taxes realised locally. The share of local business tax differs by local governments and categories of self-government. A disadvantage of this tax is that it is sensitive to economic downturns and can deepen regional differences as economically developed municipalities can raise considerable revenues from it. That is, the upper limit of taxes that may be levied is the locally operating business operators, enterprises and private individuals' power to tax, which is rather heterogeneous across Hungary. Thus, there is no use of an opportunity to levy higher taxes if business conditions are poor and the employment rate is low in a given region.

The local governments' system of central budgetary support works within the framework of financing duties, also governed by law; in addition, its extent and amounts are determined by the current budget act. In financing duties, duties-based subsidies are provided by the Parliament through the system of financing duties to cover operational expenditures of the performance of mandatory duties by local governments, and the subsidies provided for the performance of duties are in line with the public service level established in legislation.

The system of financing duties is based on an imputation regime, which requires the local government:

- to manage its finances economically;
- to have expectable own revenues based on legislation (the rate of which is stipulated by the budgetary act of the current year);
- and the actual own revenues realised by the local government form its basis.

The regulatory environment of financial stability

After 2011, the regulatory environment has taken a rules-based course, manifesting in the Fundamental Law, the Stability Act[1] and the Act on National Assets,[2] which guarantee responsible budget management. The Stability Act has imposed an authorisation requirement on borrowing by local governments and local governmental companies. The National Assets Act included the assets of local governments in national assets.

The Stability Act and the regulations laid down in the act on Hungary's local governments have imposed an authorisation requirement on local governments' borrowing, but procedures for developments co-financed by the EU have remained unchanged and no authorisation is required. However, local authorities cannot launch new developments financed from loans if their debt service exceeds 50 per cent of their own revenues, which is a substantially stricter regulation than the previous one. Another element of the debt rule is that companies owned by local governments are also subject to permission, which prevents the indebtedness of extra-budgetary service providers; an amendment of next year allows the local government owning the company to provide a guarantee in projects that are significant on the level of the national economy (Sági, 2017). No operating deficit can be planned in the budget, which serves the implementation of the golden rule for budgets. In addition to the Parliament, the State Audit Office also had a prominent role in drawing up legislation. Thus, after 2010, it was recognised in the system of self-government that the system in its existing structure was ready for reform, which had arisen as a need earlier, especially following the accession to the EU, but the authorisation related to an appropriate political will to implement the reform had been missing.

Control mechanisms in the Hungarian system of self-government

Beyond a new type of firmer legislation, compelling more disciplined financial management, there are control institutions ensuring the stability of financial management, which lead to competitiveness factor (Zeman et al., 2018a, b). Chapter VIII of the Budget Act provides for the system of financial control and supervision, the fundamental aim of which is to manage public funds and national assets in a compliant, economical, effective and efficient manner, and ensure its conditions as a kind of general principle. The control system of public finances covers all its subsystems, is a complex process, that affects the financial management, the asset management of the public finance system as a whole and budgetary entities, and the development of a regulatory system. The supervisory activity related to the operation of the public finance system encompasses both subtypes of state supervision, that is, legality-compliance-regularity audits and expediency-economy-effectiveness audits.

Normally, public financial control is based on three pillars:

- external audits,
- government-level audits,
- internal control systems of public finances.

The presented structure does not require a hierarchy, thus the internal controls of public finances do not constitute a centralised, hierarchical system; the control system of public finances consist of mentioned three components. However, there are differences in competences, certain types of cases are managed by different supervisory bodies.

External auditing is applied in public finances if the audit is conducted by a body or organisation that is independent from the local government. Pursuant to the Budget Act, the State Audit Office is the only body conducting external audits. It should be noted, however, that in the system of public finances, especially in the local government subsystem, financial audit was one of the executors of external auditing, which was statutory in the local government subsystem if the assets managed reached a certain extent, or the local government was planning to take out a loan or issue bonds. Naturally, there is still a theoretical opportunity, but since 2012 audit has not been statutory in the local government sector.

A new element is that the State Treasury also fulfils an important role in the prevention of local governments' indebtedness, the basis of reference of which is the Stability Act, pursuant to which governments (including local and minority governments, multi-purpose and other associations with a legal entity, as well as regional development councils) can assume liabilities incurring debts – with the exception of transactions set out in

1 Act CXCIV of 2011
2 Act CXCVI of 2011

the Stability Act – only by the Government's consent. The aim of compliant budgetary practices and the debt rule is to prevent the high indebtedness of the local government subsystem, realised between 2007–2010. Within this framework, at the beginning of each year local governments shall supply data on transactions that create debt and are planned in the given year, and during the year they shall file a request for transactions that create debt and they intend to conclude; the regulation is also applicable to companies owned by local governments. Local governments can file their preliminary data supplies and their requests electronically, trough the IT system of the Treasury. The Treasury and the county and capital government offices review requests and requests corrections, and permission is granted by the Government, based on the proposal of the Ministry of Interior and the Ministry of Finance, in the form of a government resolution.

The logic of net financing is that liabilities towards the state are deducted for the institutions financed, ensuring that budgetary entities could not accumulate debts towards the tax authority or social security funds, and achieving considerable cost savings, which enhances transparency.

In addition to financial auditing, the State Audit Office (SAO) also has power of external auditing, which applies to auditing all public finances, due to the fact that it is the financial and economic audit institution of the National Assembly. It works independently of the government, it has a reporting obligation towards the National Assembly, and performs its duties as its subordinate.

The SAO has the right to audit public finances in their entirety, what is more, after 2010 it can control local government-owned companies too (Zeman et al., 2018c). As the supreme state audit institution, it has general powers within its competence, shall conduct its audits in terms of legality, expediency and efficiency.

In relation to local governments, the tasks of the SAO include:

- As part of its audit of the utilisation of funds originating from public finances, it shall audit how subsidies granted from public funds or of the public assets allocated for specific purposes free of charge from public funds are operated, operating or used;
- The SAO's auditing powers apply to local governments, national and local minority governments, public foundations, public bodies, public benefit organisations, economic organisations, social organisations, foundations and other beneficiary organisations. In Government Decree No. 311/2006 (XII. 23) on the Hungarian State Treasury, a material change has taken place as – in addition to the SAO's involvement – the Hungarian State Treasury shall audit the financial statements of local and minority governments.
- It shall audit the management of assets belonging to the scope of public finances; the financial management of such assets; such activities of economic organisations owned for the most part by local governments that are aimed at preserving and increasing the value of such assets; and adherence to and compliance with the rules regarding the alienation and encumbrance of assets belonging to the scope of public finances;
- It shall audit the financial management of assets and the operations of economic organisations owned in full (or in part) by the state or local governments;
- It may audit public procurements funded from the subsystems of public finances and contracts concerning the assets belonging to the subsystems of public finances at the principals (asset managers), at the individuals or legal entities acting on behalf of or representing the principals, and at the contracting parties that are responsible for the performance of such contracts, as well as at any parties participating in the performance of such contracts.

It is not only an external auditing system of the audit of public finances, but it is continuously present also in relation to the given local government and its budgetary entities. Internal audits are independent in terms of their role taken in the organisational structure and form a part of management audits due to their management support function. In the course of internal audits, budgetary entities develop a mechanism to guarantee compliance with laws and regulations, the regularity of activities, an effective, efficient and economical operation in financial management. Furthermore, it is important that budgetary entities should fulfil their obligations to render an account, use their resources optimally, according to their designated purposes. It is also important that responsibilities and competences should be adequately regulated, and compliant with the external legal environment as well as internal policies on the operation of the organisation. Thus, the internal control system ultimately is a system of processes designed to manage risks.

Conclusion

This study presents an overview of the Hungarian system of self-government, from budgetary and fiscal audit perspectives, and evaluates its fiscal rules, in their evolution following a major reform in 2011, when major control elements have been put into effect. The paper concludes that the Hungarian legislation on self-government became rules-based in 2011, and adherence to rules is closely monitored by an internal audit system operated through the State Audit Office, the State Treasury, the Government Control Office and at local governments. Local governments cannot launch developments for which they do not have adequate resources available, or which are not permitted by a higher authority (government office). The complex control system facilitates operations resulting in compliance and the stability of financial management, thereby public funds are used effectively, efficiently and economically, improving the quality of public services provided by local governments.

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