

Municipal Treasury

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Autonomy in financial management is a critical condition of an efficient decentralized local government system. Hungary's intergovernmental finance system initially provided *ex ante* transfers for all kinds of organizations, for example, units of ministries, municipalities, and local budgetary organizations. Dozens of municipal budgetary organizations used their own budget without coordination. They had separate budget, financial management, procurement, and financial reserves. Moreover, looking for supplementary earnings, they invested temporary cash surpluses, yet sometimes failed to comply with their tax obligations. The Hungarian State Treasury (HST) was established in 1996 after the French model. It provides banking services for central budgetary institutions through a treasury single account, manages the internal debt of the central budget, and provides net (tax deducted) financing in central transfers.

Municipalities started to establish local treasuries in 1997, partly as a response to the fiscal squeeze and partly in imitation of the HST. Municipal finance managers quickly became aware not only of their lost interest earning potential, but also the rationality of the treasury system. Commercial banks were partners in establishing local treasuries, because of lost opportunities as a result of the HST system. Two basic municipal treasury models have emerged. The "soft model" is a consolidated cash management plan that refinances local budgetary organizations managed by the municipal finance department. The "hard model" is an independent treasury organization that takes over the planning, financial management, procurement, and monitoring functions from the budgetary organizations.

This chapter addresses the most important issues of innovative cash management. First, we review the key challenges such as size of the municipality, costs and benefits of introducing a local treasury, techniques to ensure autonomy of service institutions, incentives for joining the treasury, and relationships between treasury and fiscal planning. Second, in two short case studies, we summarize experiences when local treasuries were introduced in Tokaj and Szeged, a small town and a large city.

* This chapter is based on Barati and Péteri 1998.

The Conceptual Framework of Cash Management

Modern cash management provides sound liquidity from smaller cash reserves while it ensures efficiency, transparency, and legality of financial management in both the private and public sector. The flows of municipal revenues and expenditures fluctuate over the financial year. Timely and coordinated collection of revenues, expenditures, or disbursements result in real savings and temporary cash surpluses that can be used or invested to generate extra earnings. Taxes, fees, and user charges should be collected in a timely and efficient way. Uncollected revenues can be regarded simply as interest-free loans from the local government. Likewise, money expended before the legally binding deadline sacrifices potential interest earnings, and late payment may invoke a penalty.

Financial investments are conceptually assessed by earnings, risk, and liquidity. Local governments, by law, keep their reserves in bank deposits and state securities, so liquidity is the primary condition for financial investments. For liquidity purposes, cash forecasts should cover all the financial activities of various government entities under the same budget. The municipal treasury concept has been developed primarily for improving the overall liquidity of local budgets.

International Models of Treasury

Various treasury models try to solve the two competing goals of public finances: (a) autonomy and adjustment of appropriations to spending agencies' needs, and (b) unified information, strict planning rules, and budgetary discipline to stop overspending. Two major treasury models are used in developed countries: one is based on the Anglo-Saxon traditions; the other is a combination of the Roman and Napoleonic concepts of the state (description of the international models is based on ADETEF 1998 and RKK 1994).

In the United Kingdom spending ministries enjoy a high degree of autonomy. They are responsible for their financial decisions and also subject to strong parliamentary control, but other organizations (for example, the National Audit Office) provide a counterbalance to their autonomy. The Treasury is not involved in the detailed control of spending; however, it designates the banks at which ministries can open accounts and has the power to release money from the consolidated fund. The Treasury thus plays more of a strategic role and presses the spending departments to improve their efficiency, including the cash management. Local governments are not integrated into this system.

In Germany parallel organizations, *Kasse* and *Zahlstelle*, operate as independent financial institutions and can respond to the needs of spending units of central and local governments. These cashier institutions have developed their information and accounting functions, although they work within a strict hierarchy under the professional control of the Ministry of Finance. The system is therefore decentralized, but the efficiency requirement is strong and keeps control of local units' operations.

The French Treasury is the most centralized among the different state administration management models. A Treasury Single Account at the National Bank of France comprises the entire financial stock of the public sector. Because no real money is transferred within the treasury, the liquidity is increased and the system is more transparent. The Treasury also performs banking functions, for example, placing money on the market, issuing securities, functioning as a saving bank, providing insurance, collecting deposits, and maintaining accounts. These financial services create operational revenues and increase the Treasury's liquidity. The Treasury also manages, records, and pays off the state debt, and ensures the solvency of the central budget. In 1996 it had about 4,000 units all over the country and employed more than 56,000 employees.

The core of the French financial supervisory system is the Ministry of Finance, which actually combines two ministries: (a) the ministry responsible for the economy and finances, and (b) the secretariat of state responsible for the central budget. The Ministry of Finance consists of several directorates; the former treasury is part of the Directorate of Public Accounts, which is subordinated to the minister responsible for the central budget. The accounts of each central budget institution are allocated here, and several other functions are concentrated at the Treasury: management of public money, auditing, control of compliance with laws and regulations, and efficiency. The Treasury is responsible for financing all state expenditures, including salaries.

Local governments are allowed to keep their accounts exclusively at the Treasury. The 36,000 local governments get services from the Treasury: keeping their accounts, advisory activity on financing options and capital investment financing, and solving local budgetary and municipal legislative problems.

The control and audit of financial activities are ensured through managers at different levels of the public administration (in ministries, at local governments, and at institutions) who authorize payments, up to the allowed ceiling for their appropriations. In parallel, a hierarchy of public accountants belongs to the treasury. In every ministry and also in geographic regions, a public accountant's approval is necessary for any disbursement. This accountant also controls the financial-economic apparatus, gives advice during the preparation of the central budget, and checks whether payments are appropriated and funds are available; otherwise any transfer should be refused.

The public accountant has personal financial responsibility for his or her work in the system, so in the case of uncollected taxes, for example, the accountant must demonstrate that he or she has recourse to all measures to collect taxes. Unapproved payments must be refused, because the public accountant will be liable for illegal transactions.

Why Cash Management Became Important

In the mid-1990s Hungary's public sector went through a significant transformation when the amount of public expenditures decreased greatly. Efficient deficit financing was contingent upon proper debt management and effective cash management at the national

level. The central budget, as the largest borrowing agent, is responsible for a well-designed borrowing program with favorable interest and maturity structure. This responsibility required a flexible and accountable administration and proper control by the Parliament or other elected bodies. These considerations led to the establishment of the HST in 1996. In line with debt management objectives, the cash used in the budget must be minimized. From the central budget's point of view, extrabudgetary funds, central budget institutions, and transfers to local governments are the major spending units that created a fragmented system. To decrease the funds to finance the gap between available revenues and appropriated expenditures, cash management should be centralized. As a result, the short-term financing plans of the central budget will be more accurate and the loans required to finance the deficit will be smaller (László 1994).

The HST

The organizational reform of the public sector included, among other things: (a) the separation of the central budget and the central bank functions, and (b) the separation of the central debt management and the cash management from the central budget functions. By the mid-1990s the Ministry of Finance, which was responsible for the central budget, realized that the *ex ante* financing of fragmented public spending units caused uncontrolled spending, expensive fiscal transactions, and vague fiscal planning. The primary goals of the HST and the new cash and liquidity management framework were: (a) to control the cash management of spending institutions, (b) to minimize the need for borrowing by the national budget for liquidity purposes, and (c) to improve the planning capacity in the public sector (see box 22.1).

Box 22.1 Historic Roots

Historically, financial management in the public sector was centralized. In the 19th century, when the modern banking services and public sector finances were established, an integrated system of financial management was developed. It was based on the balance between the Ministry of Finance, the Post Savings Bank, and the National Bank. The regional units of the Ministry of Finance, in charge of controlling any public spending, were transferred to the Post Savings Bank. The cash, which was available at the Post Savings Bank, had to be invested at the National Bank.

Early organizational forms of consolidated local cash management were established during the mid-1980s. Business and technical service support organizations were created at that time to rationalize the operation of local budgetary organizations.

The idea of a national treasury system emerged in the early 1990s, but the HST was not established until a government decree was issued on July 4, 1995. By the end of 1995, an amendment to the Act on General Government Finances, along with new government and ministerial decrees, served as legal bases for the HST. After a half year of quick preparation, the HST started to operate with a few key elements, and in the subsequent years, it was

gradually developed after the French model. The following are the HST's main elements (Thuma, Polackova, and Ferreira 1998) in mandatory banking services for central budgetary organizations and extrabudgetary funds:

- The Treasury single account, where all transactions for the members of the treasury system are accounted and payments are made only for entities outside the treasury circles
- Current and capital expenditures of the member organizations financed through reimbursements (that is, no advances paid for the spending units)
- A net financing scheme for intergovernmental transfers (for example, local governments receive only a net amount of grants, shared revenues, and social security dues)
- The State Debt Management Center.

The operation of the HST is quite simple for members. Each client has a ledger, where all transactions are accounted. Budgetary institutions keep their right to allocate appropriations according to prevailing fiscal rules and regulations. All revenues under the HST are deposited in the Treasury single account, so institutions have little need for cash, and the HST has new investment options. The interest gained through these transactions is shared between the HST and the member organizations. HST also supplies interest-free credit for Treasury members when they need short-term cash (sometimes with limits, for example, up to Ft 60 billion for health and pension funds).

During the first period the HST ran approximately 3,200 separate accounts of 1,800 budgetary units. Later on, other public entities became members of the Treasury (for example, the National Academy of Sciences, regional development councils, and the Health Insurance Fund with special status). All these functions were implemented with a staff of 370 employees at headquarters and an additional 460 staff at the regional branches. The latter were taken over from the Hungarian National Bank and from the National Development Institute, which ceased to exist after the HST started to operate.

The primary benefit of establishing the HST was an immediate improvement in the balance of the national budget. The amount of money required by the central budgetary organizations decreased, and as a result, an additional Ft 50 billion cash was made available at the Treasury single account (a 50 percent increase relative to the previous balance). This boon in turn resulted in Ft 10 billion in interest earnings by the Treasury.

The introduction of net financing intergovernmental transfers also reduced by 45 percent (Ft 187 billion) the amount of money needed to finance municipalities, and that savings also generated significant interest earnings at HST. Because the advance financing was changed, the idle money available to local governments decreased, which obviously resulted in losses in interest earnings of municipalities and gave rise to local treasuries.

The integrated system of state debt management also improved the efficiency of the fiscal system. The HST issues all the treasury bonds and manages the market for these bonds. HST made government action in this area better planned and more precise. This

efficiency helped in restructuring the government securities market and changed financing from short- to longer term instruments.

The most important consequence of the establishment of the HST was the improvement in the quality of fiscal information for both the expenditures and revenues of the central budget. The accounting is still the responsibility of the spending institutions, but the transaction codes introduced by the HST improved the discipline of spending units. HST also has plans to improve the entire budget cycle by combining its analyzing, monitoring, and implementation functions.

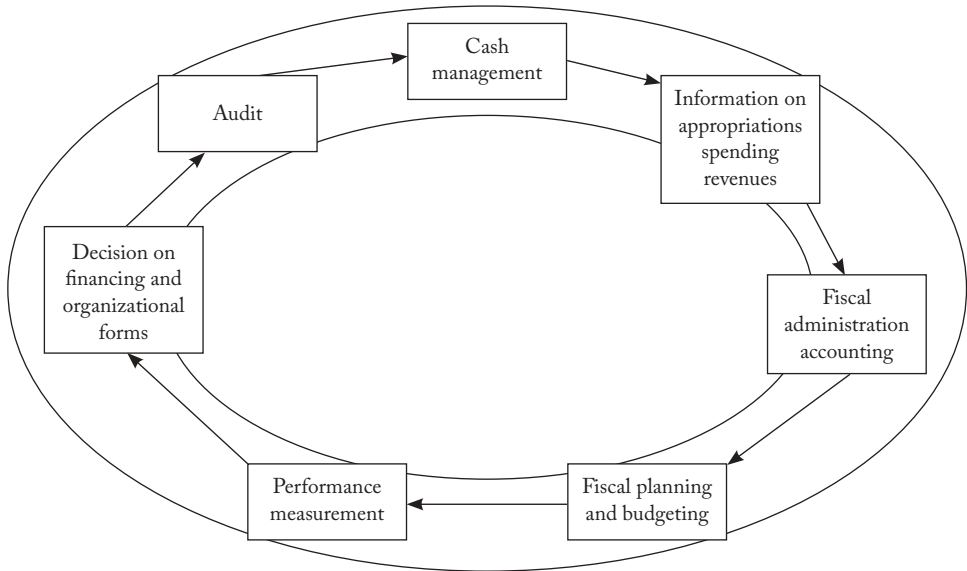
The immeasurable benefit of the partial integration of local governments into the HST is that the Treasury has now direct information on local finances. Financial transactions between the subsystems of the general government budget became more transparent for both the national and the local governments. Based on section 17, subsection (5) of the 1992 Act on Public Finance, the Treasury provides information to the Ministry of Interior and the Ministry of Finance on capital investments supported by central grants. The Treasury remits the grants jointly with the money provided by the local governments or extrabudgetary funds.

The Concept of Municipal Treasuries

The fiscal squeeze and the positive experiences with the HST encouraged local governments to rationalize each component of local finances and financial management, including reform actions that were ultimately directed to the cash management area. The permanent pressure on local budgets encouraged them to raise own-source revenues. Financial investments were good opportunities for raising own-source revenues, especially in large cities that have a significant stock of financial assets. The relatively high inflation rates (the peak was 38 percent) also pushed local governments toward savings and high-yield investments. To keep the real value of municipal reserves and idle cash, local governments made bank deposits and purchased Treasury bills. These opportunities also motivated the development of local cash management methods.

The development of cash management techniques had a significant impact on the other components of financial management. These efforts mutually reinforced each other and cash management apparently integrated into the financial management (see figure 22.1). To have adequate information on the appropriations, actual spending, and potential revenues, accurate fiscal information is needed. This information depends on proper administration of disbursements and revenue flows. Revenue and expenditure administration should be in harmony with local fiscal planning and performance measurement techniques, otherwise no comprehensive information would be available on municipal budgets. Fiscal planning and performance evaluation are critical conditions for local decisions regarding the financing of services and collection of revenues. Local government audits form a critical part of the overall framework for municipal decisions.

Figure 22.1 The Stages in Development of Local Financial Management



Source: Authors.

Similar changes had been launched by Organization for Economic Cooperation and Development countries since the late 1970s. The primary motivation was to improve financial management through better planning methods and decentralization of executive decisions (PUMA 1987, 1990). Lessons from the private sector were also learned by introducing modern fiscal planning techniques. Program- and performance-based budgeting systems served not only fiscal planning purposes, but also efficient use of the appropriations. If the allocations were clearly assigned to the responsible spending units who had more sophisticated professional knowledge and more information, then the budgets would be used more efficiently than under a centralized system.

After the first full year of net financing, municipalities were more frequently seeking local opportunities to launch Treasury-type cash management. They recognized that the *ex post* financing, savings, and other potential benefits in consolidated financial management can also be achieved at the local level. Municipalities are essentially in the same situation as the central budget. The municipal budget must cover the cash needs of local budgetary service providers, but it should avoid both arrears and unjustified overspending. These goals could be achieved by ensuring the availability of current funds at the municipal level without curbing the institutions' professional and decision-making autonomy or their incentives to generate own revenues.

For a period of almost two years reformers did not decide whether the HST would incorporate local budgets or not. The HST was not prepared for absorbing the local governments' accounts. Absorbing would have required a significantly larger apparatus and capacity to work with 16,733 local institutions, more than 3,000 of whom are autonomously managed. Further development of HST was not supported, but these considerations influenced local governments.

In the present legal environment, integration of local governments in the Treasury is not possible. Paragraph (3), section 1 of the 1990 Act on Local Government states that the local government can autonomously regulate and freely administer local public matters under its competency. Paragraph (1), section 17 of government decree number 211 in 1996 (XII.23) states that the representative body of the local government can choose its bank without any restrictions.

Municipal Treasury Solutions and Models

In the course of executing the budget, a local government must fulfill numerous mandatory and optional tasks. It must settle the cash flow required for carrying out local tasks and provide for the related accounting and financial reporting services. In addition, it must ensure that budget appropriations are not exceeded and that its budgetary institutions follow the approved budget plan. It must apply an effective financial service organization and good financial management methods, since the environment forces it to save money and increase revenues.

For these purposes, municipalities created local treasuries, which fall in one of two categories. The “soft” version is an in-house treasury, a unit of the finance department that fulfills cash management and regulatory tasks related to local budgetary organizations and manages the relationship between the local budget and the municipality's bank. The “hard” version is an independent treasury organization that takes over budget planning, financial management, and procurement functions from the local budgetary service organizations and exercises monitoring and control over their operations.

Treasury management is only a tool, regardless of which version the municipality introduces. One can assume that in establishing the simpler version—in the future after favorable experiences—municipalities can gradually introduce local treasuries that perform more complex and diverse tasks. This transition, however, is likely to require a longer period, because the establishment of an independent treasury organization requires significant transformation in the entire local decision-making and management system. (The Center for Civic and Municipal Innovation gathered examples on municipal treasury initiatives in 1996.)

In-house Treasury

The “soft” treasury has a simple organizational structure and does not require major municipal investments. The core feature of the in-house treasury is that the financing system and the supporting bank software ensure that local government’s surplus liquid assets can always be invested or can replace liquidity loans rather than being kept in municipal offices. These short-term deposits provide the municipality with interest revenues. The earlier common situation of a municipality having to borrow while some of its institutions had liquid assets does not exist any more.

The foundation of this local treasury model is a computer program and a bank terminal, used by local government staff who understand finances. The terminal continues to operate as a unit in the municipal financial department, and the jobs of staff who deal with municipal treasury need not change because their initial responsibilities remain the same. The only change is that the manually operated financing is assisted by an effective computerized system.

By monitoring the local budgetary appropriations, this in-house treasury effectively ensures the required financing. Municipal transfers are not paid into the institutions’ bank accounts on a regular monthly basis in advance, but only when the municipality has invoices to be paid. Having been fully informed about the bank account, the municipal treasury has exact information on the own revenues of the institutions, so a smaller municipal fund transfer to the institution’s account is needed.

Consolidating liquid assets at the municipal level also reduces the need for cash and makes secure, continuous, and economical cash management possible. The software monitors the account balances, earnings on deposits, amount of deposits, the size of funds that can be placed, and the maturity structure. At the same time, it provides the municipality’s financial managers with an exact report on expenditures and revenue appropriations, the unused items, and the necessary reallocation of the budget. Income will be generated in the municipality’s budget by using the surplus liquid assets. This financial information, received in a uniform and consistent manner, also makes local decision-making (budget planning, reporting) easier and more sound.

The treasury computer program—depending on the local bank—also provides the following option: if, within a possible maturity period of a short-term deposit, the municipality needs funds for a short period of time, the bank could automatically provide a loan backed by the deposit. For instance instead of losing a three-month interest earnings on a Ft 200,000 deposit, a Ft 100,000 loan for a week costs the municipality much less.

Independent Treasury

The independent treasury is entrusted with management of actual costs, procurement, bookkeeping, accounting, and analyzing, and it makes budget estimates not related to professional staff. It also plays control and monitoring roles. Professional and financial

management tasks of service organizations can be separated (government decree number 156 of 1995). When an autonomous budgetary organization, for example, a school, agrees to hand over its planning and other financial management tasks to another budgetary unit, it still retains its institutional and professional independence. Financial management and logistic tasks, however, should be separated from professional operations and service-providing functions.

This naturally impairs the institutions' financial autonomy, but makes possible a more effective and transparent measuring of the institution's professional activities. The treasury actively participates in the preparation of institutional budgets and performs financial management. Creating a municipal treasury that has a wide range of financial management tasks must be regulated in a municipal decree, because a decree is the only way to impose financial management over independent budgetary institutions.

Because the independent treasury provides *ex post* financing and checks available funds, it becomes increasingly involved in the professional details of the institution's operation. The municipal treasury, having detailed information on the expenses of numerous similar institutions, also strives to improve the financial and management efficiency of their decisions. One possibility is to coordinate the purchase orders of various institutions and achieve a lower price through joint procurement. Naturally, joint purchase also has costs, but the savings achieved and the regulated transparent procedure create greater advantages for the municipal finance management.

The available financial information also allows the evaluation of the institutions' performance. By comparing the service performance indicators and the expenditures, the institution's expenses can also be compared. The cost efficiency and the reasons for the differences can be analyzed based on the detailed financial information.

When municipalities introduced municipal treasuries, they deliberately made budget rationalization and modernization important aspects. In several municipalities the screening exercise, that is, the effort to find reserves and losses, led to the creation of municipal treasuries. A part of this rationalization procedure is the renewal of budgetary planning and introduction of zero-based budgeting. On the one hand, the municipal treasury makes an exact assessment of the institutional activities and cost requirements possible. On the other hand, it helps to control the financial operations of budgetary organizations by building on performance indicators.

Operational Issues of the Two Treasury Models

The two treasury models each have their own merits and drawbacks. The soft model looks more suitable for small municipalities. The more sophisticated, hard model would provide better results in medium and large municipalities. Beyond this first-glance consideration, however, several other issues should be considered before introducing a real treasury model in a municipality.

Size and Type of the Municipality

The first question is whether the size of the municipality is too small to make creating a treasury worthwhile. The experiences of both the system organizers and the users show that a treasury can operate in any municipality no matter how small it is. Two preconditions must be met for creating an in-house treasury: the municipality must have a computerized accounting system and, based on it, the municipality must establish an online connection with a bank.

Beyond the basic conditions, the size of the municipality and the number of budgetary organizations do matter. Thus, only about 3 to 5 percent of municipalities are not suitable for municipal treasuries. Even the smallest ones, however, could introduce the fundamental principles of treasury operation. The smallest operating independent treasury exists in Tokaj, a city of 5,000. In the case of smaller communities—based on the opinion of developers—the treasury is recommended if a municipality has at least 7 to 10 municipal service institutions that have autonomous financial management.

The decision to introduce an in-house treasury model must be based on the savings that can be achieved through jointly managing the institutions' accounts, developing a uniform account system (simplifying accounting), controlling the institutions' financial management, adequately timing expenditures, and measuring the volume of the incremental interest earnings.

The treasury functions not only in municipalities (small and big cities, for example, Tokaj, Balatonfüred, Békéscsaba, Pécs), but also in counties. Borsod-Abaúj-Zemplén county is planning a “good deal for everyone” treasury. New treasuries are under preparation in Bács-Kiskun and Csongrád counties, based on the initiatives of the County Treasury and Information Service Offices. Two Budapest districts are also organizing municipal treasuries. In sum, Hungary's experiences suggest that municipal treasuries can be organized in various sizes and levels of subnational governments.

Financial Advantages and Disadvantages

Naturally, the introduction of a treasury requires expenditures. For an in-house treasury the typical costs emerge from purchasing or renting an adequate computer system for a line department of the local government. If the municipality rents the computer from the bank, rental fees and software costs are involved, although software development is also in the bank's interest. The salaries of the in-house treasury employees could remain the same. Regarding the benefits, generally interest revenues gained from deposits in the soft treasury reach 1–2 percent of the municipal budget excluding long-term loans.

Creating an independent treasury entails the one-time cost of the economic and legal transformation of the entire institutional system, including reallocation of employees, assignments, assets, and real estate.

First experiences of the municipalities that introduced independent treasuries suggest that within a short period their operational budget deficit declined by 10–15 percent.

In addition, their entire planning mechanism transformed: they are now funding only programs and not institutions; they introduced service quality conditions by functions; and they are immediately informed if the institutional budget is exceeded. Through joint procurement the nominal value of material costs as compared to the previous year dropped by 20 percent; they have no debts and their liquidity has become predictable.

A very important advantage in both treasury cases is that the municipal finances have become more transparent. In the case of independent treasury, planning is based on actual data. Using this data, treasuries are able to concentrate more institutional tasks and calculate financing more easily. The indirect social advantage is the improved quality of community services.

Ensuring Institutional Independence

Controlling the assumption of obligations and limiting the regrouping possibilities in everyday financial management also entails reducing economic independence of municipal budgetary institutions. Investment of the institutions' temporary liquid assets provides the municipality with interest earnings as well as some opportunity costs. This profit is the very reason why the joint interest of institutional professional managers and municipal financial management must be created. Nevertheless, the institutions often did not deposit smaller amounts of money, or if they did, they did so under worse conditions than the in-house treasury unit.

The independent treasury does not entail this kind of challenge, because it does not leave liquid assets, other than own revenues, at budgetary institutions. The transfer of financial management functions to the independent treasury does not mean that the budgetary organization's professional independence is curbed or its power impaired. Municipalities introducing the treasury as a separate institution have treasury-operating procedures in which professional autonomy is guaranteed. We must emphasize that in this case, local regulation is done within the framework of the municipal budget planning reform, of which the treasury regulation is only one of numerous elements.

Incentives

In the case of the in-house treasury, regulations on using own revenues for the institution financing must be developed in a manner that maintains incentives for raising own revenues. To increase institutional revenues, interest earned on reserves by the municipal treasury must be returned to the institutions without restrictions on how they will be used.

The introduction of an independent treasury can reward institutions for performing professional duties (for example, funding schools) in a more efficient manner and increasing their revenues. The treasury measures and evaluates efficiency and, based on that evaluation, increases the institutions' incentives by improving both its professional and financial assets in line with strict legal regulations.

Because of its effects on local and budgetary planning, an independent treasury also entails changes in the operation of the elected bodies. As with any organizational restructuring, the introduction of an in-house treasury also interferes with the vested interests of the current system. Within the organization, aside from the financial department, the management of other line departments must also be motivated for change. The mayor or the councilors initiating the independent treasury must convince the decision-makers and those affected of the benefits of treasury. This persuasive effort also requires that the municipality is given guarantees (in a local decree or in the treasury regulations) to preserve institutional autonomy and interests.

Financing Schedule

In the in-house treasury model, the current budget determined for an institution is disbursed in equal monthly installments. A thirteenth installment, which is not used in a timely way at most of the municipal institutions, is also a factor. In addition, spending of the budget in an institution is determined by its tasks, seasonal differences, and varying public utility billing periods, so the municipal treasury must coordinate the different cash in- and out-flows to reduce the overall cash flow.

A critical condition is that institutions with autonomous economic management must prepare a financing schedule agreed upon with the municipal finance department. This schedule must state that the institution should take into account the annual budget estimates, comply with regulations, and should specify the amount of transfer funds the municipality wants to use.

The municipality can also take action in the interest of scheduled spending. For example, most institutions having a relationship with several public utility service providers, so negotiating an optimal invoicing schedule with each of them is advisable. The institutions' capital expenditures also occur on a different schedule and, therefore, are not a part of the institution's regular operating budget.

The independent treasury finances the institutions according to their actual performances under the zero-based budget principle. It simultaneously manages orders, fulfillment, and payment turnover, and it carries out strategic acquisitions. This treasury audits all accounting and financial directions of performed tasks; provides data for the sectional supervision; manages accounting; carries out treasury functions, including cash supply, deposits, short-, medium-, and long-term loans; and assures balanced asset and liability management. Through modern monitoring and controlling data, it assists the work of the municipal council and its committees.

Relationship with Fiscal Planning

Linking the well-functioning financial information system with cost standards also has an effect on fiscal planning because it draws attention to the differences across institutions in

quality and unit cost of services. Transforming the local fiscal planning process means that the professional and financial aspects can be compared even at the elementary decision-making stage. This bottom-up budgeting system, built on a set of performance indicators, requires significant changes in the traditional planning practices and decision-making procedures. Budget planners need to know exactly what services are provided and, using this knowledge, need to analyze the fulfillment of local functions and strategic goals.

This planning function can be implemented through the zero-based budgeting of the entire municipal budget, an approach that offers options and decision-making alternatives in each step of fiscal planning. Thus one can clearly see where the line item budgeting system caused extra expenses in the municipal budget. The program-based budgeting—adjusted to the provided services—enables the real tasks of the service institutions to determine the bases of planning if the funds are available.

Case Studies of Local Treasuries

In this section we briefly summarize the circumstances and policy considerations that resulted in a hard and a soft municipal treasury in two secondary cities.

The Independent Municipal Treasury in Tokaj

The establishment of the first independent (hard) municipal treasury was motivated by economic pressure and not by public demand. Had it been a question of public will, it would have never been established in Tokaj, one of the country's smallest cities (5,000 inhabitants).

Economic and Financial Crisis in 1994

The newly elected local government in 1994 had to establish a new financial management, because the costs of the city's service institutions far exceeded the revenues, and they were not managed in a strictly economical and rational manner. The antiquated infrastructure, deteriorated trade, slumping tourism, and growing unemployment put the city management in a very difficult position.

Given these existing conditions, it became imperative that the most crucial improvements begin, although only modest financial resources were available. Key infrastructure, education, and health care investments received the highest priority. These functions were unavoidable for stimulating the private economy and retaining the residents. Once a bypass highway around the city was completed, the reconstruction of the historical city center and the renovation and expansion of public utilities started.

The severe financial difficulties soon became apparent and many believed that the pace of investments was the cause of the problems. Contrary to these opinions, the local government believed that the high operational costs and low performance were the primary reasons for the problems, because the developments were financed by state grants not from local resources.

It was also well known that the increase in normative transfers appropriated to finance current expenditures of the institutions were significantly lower than the rate of inflation during the “seven lean years.” These trends caused financial difficulties not only in Tokaj. Of course, the problems had to be remedied where they had occurred, and those afflicted could not be appeased by the knowledge that the situation was no more promising elsewhere.

National and Local Crisis in 1995

The local budgetary crisis became more severe in 1995, when serious liquidity problems emerged. Following the approval of central government austerity measures in March 1995, everyone had to realize that an end had come to that carefree period when the national government provided guarantees for the financial management of local governments.

Moreover, towns could no longer hope that the central government would provide additional funds to finance local operations. The programs of political parties vying for power revealed that all parties from right to left agreed that central revenues had to be reduced, local revenues had to be increased, and local governments had to act independently to resolve the transition to a more efficient financial management.

Consequently, only two solutions were possible for the city leadership: either to ignore the impending disaster or to face the gathering storm and develop a plan to ward off catastrophe. The former approach would certainly be less demanding, but the latter would require politicians to show great endurance and professional judgment and to remain steadfast and patient even when subjected to slander.

Tokaj city chose this harder path, although admitting that such wide-ranging local stabilization programs were not introduced on a whim, but rather were forced on them by necessity. Necessity would have its way, particularly when the municipal financial management would be in a crisis situation.

Actions for Recovery

The city’s draft budget 1996—prepared in November 1995—gave the city council a warning signal that bankruptcy was a possibility because of the magnitude of the planned deficit. Clearly without a tough decision to break the previous institutional financing system, which was characterized by the inherited subsidization line-item approach, no resolution would be forthcoming.

Although the intention to reform was clear, many felt that the situation could be improved without the radical transformation of the institutional structure and without affecting the number of public employees and civil servants. In Tokaj's budgetary plan for the 1996 fiscal year, Ft 767 million revenues were planned, and the deficit amounted to Ft 89 million. This deficit, in excess of 10 percent, caused a grave liquidity situation that seriously threatened the operation of the institutions.

The need to find a solution became unavoidable. The local government was most concerned with the apparent problems in operational deficit, because without proper treatment, that deficit would continue to grow and deepen the crisis. For this reason, a comprehensive operational audit was unavoidable at the line departments and at the institutions of the local government. Following a long debate, the viewpoint prevailed that external experts had to be hired to participate in the audit and in resolving the crisis.

A Budapest-based consulting company was commissioned to perform a review, which would include the evaluation of institutional operations from professional and employment perspectives and, based on this examination, to elaborate procedures for cost reduction and the attainment of the new zero-based budget.

The examination procedure began with the formulation of a complicated set of questionnaires for each institution, crammed with control questions designed to filter out false data. This self-assessment method was highly successful because it dispelled suspicions that the leadership sought to force their own opinions on the institutions.

While the completion and analysis of questionnaires continued, arrangements were made with the help of the consultant to avoid bankruptcy. These steps had become all the more urgent because institutional contracting debts reached Ft 16 million by the end of January 1996 (within one month). With this, the deficit projected in the budget plan would swell to Ft 104 million (nearly 20 percent of the budget).

Preventing Bankruptcy

To prevent municipal bankruptcy, Tokaj introduced serious security measures. The debts of each individual institution were identified and recorded by the financial department of the local government and were included in the budget of the institution. The institutions were required to sign collection contracts with public utility operators. The mayor prohibited institutions from using wire transfers to settle financial obligations, so the institutions could make payments only using cash that was derived from their own revenues.

These measures prevented the further growth of liabilities from contractors and suppliers. The mayor reached agreements with each individual contractor, within which he assumed responsibility for paying off overdue liabilities in monthly installments, without paying high or punitive interest rates.

With these agreements and with the help of the Borsod-Abaúj-Zemplén County Treasury and Information Service Office's financing prognosis, the local government prepared a liquidity plan and a task-performance concept recommended by the consultant

and approved by the lead bank of the municipality. Moreover, based on the first results, the bank approved a two-year rescheduling of a Ft 8 million gas loan. The immediate danger of bankruptcy was averted, and the leadership had a window of opportunity to evaluate the audit report and to develop a new institutional structure.

Municipal overstaffing was enormous; of Tokaj's 5,000 citizens, 580 were employed as public servants—a huge percentage of the population. The number of janitor staff (doormen, cleaning crew, kitchen workers, laundry-room workers, and courtyard maintenance workers) in health care institutions amounted to more than 52 percent of the staff. At the same time, the qualifications of the professional staff were extremely low. The permanent payroll positions were not filled in schools, so the proportion of overtime lessons was as much as 50 percent of the base lesson plan in some cases. Cooperation between the institutions in repair and maintenance was totally lacking, so despite the large maintenance staff, contractors were hired for larger tasks. The experts did not recommend reducing the tasks and functions in the city, but rather changing the wasteful structure. Based on the surveys, the employment had to be adjusted to tasks in strict compliance with the relevant laws. They also recommended the strict appliance of the Act on Public Procurement.

Consolidation of the Institutions and Setting Up the Municipal Treasury

Based on the experts' recommendations, five municipal institutions were created from the previous eleven. Three elementary schools were consolidated, the formerly independent boarding school was integrated with two high schools, and four health care and social institutions were merged into one. Furthermore, an independent municipal treasury was created, and although each service institution lost its economic independence, it retained its professional independence.

The city council made these tough and crucial local decisions with qualified majority votes. Of the 12 representatives, 8 voted for, 3 voted against, and 1 abstained. The new system was instituted on July 15, 1996. The approved organizational structure has continued to ensure the task performance customary in the city. By using public procurement the municipal treasury significantly reduced the number of purchase orders; it also consolidated the janitor employees into one maintenance service organization.

New managers or leaders were appointed to head up the restructured municipal institutions through competitive bidding procedures. The treasury manager received a one-year contract after which this position was filled through competing applications, and the same manager was rehired.

Lessons and Achievements

During the reorganization process, 73 employees (15 percent) left the system. The remaining janitor employees were employed only part-time each week or only in summer. The management staff was significantly reduced, and work performance became much more efficient.

Naturally, the reorganization process was not entirely without tension; those negatively affected continuously fed citizens with false information, which was neutralized with a carefully thought-out and executed public relations strategy. Thus Tokaj avoided a scandal and restructured its operation.

A new budget had to be developed for the modified, new structure. They needed a system that was transparent for everyone, could be controlled, precluded lobbying, and assured fair distribution of funds. The zero-based budgeting was an extremely suitable instrument. It replaced the line-item approach and thus the errors and unjustified benefits accumulated through the former budgets. Each year this plan begins with zero budgets of the institutions and finances only actually incurred costs, while taking into account the price changes and wage policy consequences. This method requires the local government to determine which services are provided free of charge and which are financed with fees or charges.

By creating the municipal treasury, financial transactions were almost fully removed from the departments of the local government, and only the planning functions and small cash payments remained there. The municipal treasury's primary task has been to provide financial services to institutions that retained partial autonomy and partially independent financial management.

Aside from the single municipal account at HST, only the municipal treasury has an independent bank account. The partially independent professional institutions have only a petty-cash fund for smaller payments, provided, controlled, and regulated by the municipal treasury. Tremendous results were achieved in liquidity, with the establishment of a single bank account. Handling and paying invoices and accounting the transactions are the treasury's responsibility. These tasks also apply to profession-related invoices ordered and countersigned by the head of the professional institution.

The treasury carries out joint procurement of goods and raw materials, determines the time of delivery and volume, as well as designates the delivery sites based on the location of direct need. Thus the local government does not have to create a central warehouse.

In practice, the treasury has revealed numerous savings possibilities that were not apparent at the time of establishment. Structural changes, staff rationalization, the zero-based budgeting system, and the creation of the treasury made Tokaj's financial management sound and more balanced. Despite all the initial difficulties, the city's budget deficit reduced significantly (to Ft 34 million in 1997), which could have been lower if the compulsory salary increases of civil servants had been fully financed by the state.

That the local government could switch from institution to task financing is definitely a new and fortunate reality. As a result, the institutions deal only with task performance and their leaders are not burdened with financial management. The optimal number of civil servants was determined by the consultant and the local government based on professional surveys, thus during staff reduction the effects of across-the-board cuts did not arise. With the introduction of zero-based budgeting, the funds are disbursed based on fairness and performance. This change resulted in reducing the chances of conflicts with organizations seeking to protect their interests.

Through the successful changes in Tokaj, the psychological burden caused by the constant lack of funds and bleak outlook was terminated. Today, the liquidity is excellent, and the city has regained the confidence of both the contractors and residents.

Introduction of a Treasury-type Financial Management in Szeged

As of January 1, 1997, the General Assembly of the Municipality of Szeged adopted a funding system (soft treasury) that does not violate the service institutions' professional and financial management autonomy and yet ensures the solvency of the municipal budget.

The local budgetary institutions no longer receive monthly municipal transfers in advance, but only at the time when the actual payments occur. This action made fundamental changes in the institutions' financing practices. Small daily expenses are primarily financed by the institutions' current revenues. Transfers may be disbursed from the municipal budgetary account only if the expense exceeds the institution's own revenues, so the daily account balances show a zero or minimal positive balance. If a balance on the institutions' accounts remains, this amount is not withheld but rather used to cover the expenses of the following period.

Each month, the municipal budgetary institutions are eligible for one-thirteenth of their annual budget appropriations to cover their expenses. Institutions performing seasonal activities—for example, financing open-air theater or park maintenance within the approved annual budget—finance their activities by an independently determined schedule. Because of the January settlement of bonuses paid as a 13th month salary, the institutions are granted two-thirteenths of their budgeted annual transfer. Grants exceeding the proportional payments are subject of the decision of the Financial Committee of the Local Government.

The payment orders of the budgeted monthly transfers of the service institutions, prepared by the economic bureau, are sent to the local government's bank. Based on the payment orders, the bank will disburse cash if the institution does not have sufficient revenues. The bank monitors compliance with the approved budget projections, and payments are made only within the given limit by automatic transfer from the city budget account to the institution's account.

Following the last day of the month, the bank prepares and submits to the city's economic department a summary statement on the use of the institutions' budget envelope. The bank automatically increases the institutional current budget envelope with the unused amount left from the previous month. In other words, the institution could use the previously unused funds at any time.

Changing institutional financing also entails modifying the agreement with the lead bank, so in addition to the previously used current account, a roll-over (sweep) account is opened, too. Funds that can be saved for a minimum period of seven business days are deposited in the rollover account. Based on a standing order, the bank automatically transfers the daily balance of the current account—with the exception of state subsidies

and shared tax revenues—to the rollover account. With this, in addition to the long-term fixed deposits, the municipality’s revenues are continuously held in accounts bearing higher interest rates.

For approving regularity in cash flow, agreements were concluded with the largest public utility providers (for example, electricity, gas, telephone, water and sewage, district heating, and the post office). After the fixed state grants have been transferred at the end of the month, the utility bills are paid on a set date, so both the spot collection orders and advance payments ceased.

The content of contracts regarding capital investments and renovations were also regulated. Deadlines were set for paying the liabilities at a minimum of 15 days after the contract has been signed or invoice has been received.

Having the institutions accept the idea of introducing treasury-type financial management was the most difficult aspect, because the directors believed this new form of financing would limit the use of their own income resources. They believed that they had no interest in raising revenues, so the municipal budget decree was supplemented with a section on institutional incentives. According to this section, the general assembly will acknowledge the institution’s cash surplus as an item as a supplement to the liquid assets obtained aside from the previous year’s business revenue and state grants.

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