

SUPPORTING THE EFFECTIVENESS OF GOVERNANCE

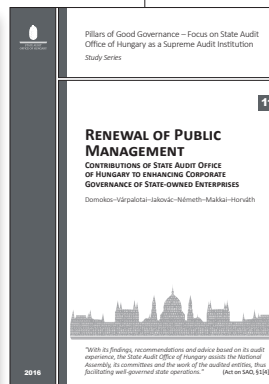
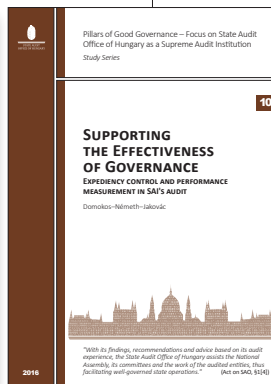
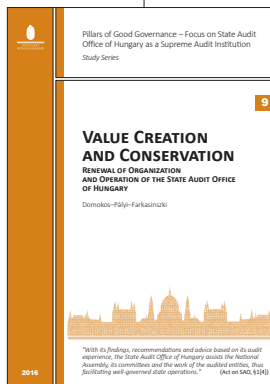
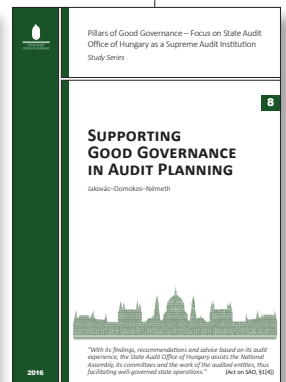
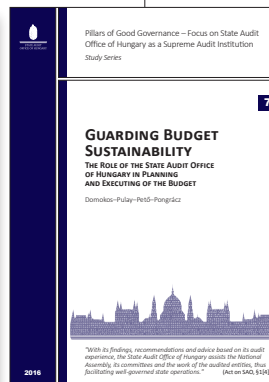
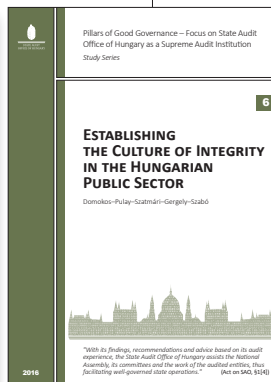
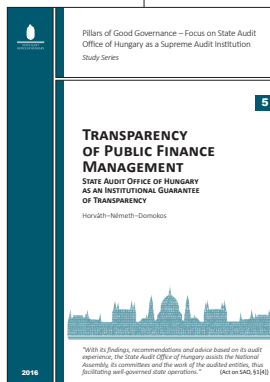
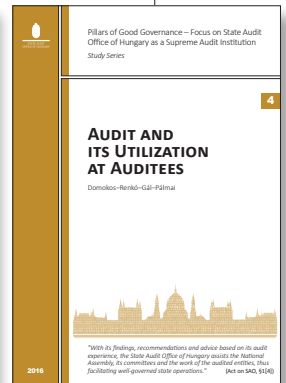
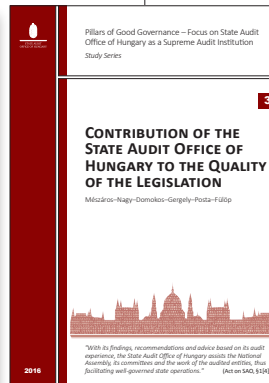
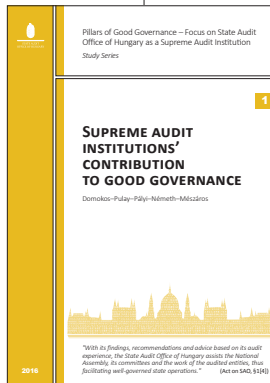
EXPEDIENCY CONTROL AND PERFORMANCE MEASUREMENT IN SAI'S AUDIT

Domokos–Németh–Jakovác



"With its findings, recommendations and advice based on its audit experience, the State Audit Office of Hungary assists the National Assembly, its committees and the work of the audited entities, thus facilitating well-governed state operations." (Act on SAO, §1[4])

INDIVIDUAL STUDIES:



PILLARS OF GOOD GOVERNANCE – FOCUS ON STATE AUDIT OFFICE OF HUNGARY AS A SUPREME AUDIT INSTITUTION

Study Series

SUPPORTING THE EFFECTIVENESS OF GOVERNANCE

EXPEDIENCY CONTROL AND PERFORMANCE
MEASUREMENT IN SAI'S AUDIT

KEYWORDS:

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SUMMARY

The main goal of the management of public funds and public assets is to promote social well-being. In order to realise the main goals and to evaluate individual measures, it is indispensable to sub-categorise the primary objective, determine the hierarchy of objectives, assign measurable criteria to the objectives, evaluate performance and provide feedback. By performing objective, professionally sound evaluations and providing feedback, independent audits contribute significantly to the improvement of performance. A basic requirement of all audits, however, is the auditability of the objectives' implementation and effectiveness and the definition of performance criteria for each objective. A large part of the proven methods and tools used in the for-profit sector for performance assessment can be applied successfully at organisations of the public sector as well, if the specialties are treated appropriately.

Ideally, legal regulations serve to specify expectations regarding the strategically controlled, result-oriented and efficient operation of organisations using public funds. When such expectations are enshrined in legislation, it means that the expectation is high-level, binding and enforceable. In this regard, Hungarian regulations are still insufficient in many cases; in other areas, however, some positive developments are in progress which are expected to improve the quality of public spending.

The audit findings of the State Audit Office of Hungary (SAO) confirm that the management and control systems of both public entities and state-owned enterprises need to be improved significantly in order to ensure good governance and public sector management. Indicators that capture and adequately measure the effectiveness and efficiency of public spending are important prerequisite for the efficient management of public funds and for the planning process.

This is also a precondition for the SAO's ability to demonstrate the utilisation of public funds in a measurable and comparable manner, thereby contributing to the improvement of the efficiency of public sector management.

1. INTRODUCTION

The management of the diverse and complex economic, social and environmental problems of our time presents a serious challenge for public management and governance. Programmes and public services with high financing requirement must be implemented and provided from a limited amount of public funds, while there is also a need to meet the expectations of an information-intensive, competition-oriented society.

Mainly as a result of economic and financial crises, the state appeared as a market participant in several segments, increasing its participation, among others, in the banking sector and the energy service market (see for example, *Turcsányi, 2008, or Domokos, 2015*). In these areas, both sectoral governance and organisation management are determined by different aspects than those seen at budgetary institutions. Companies have to be managed under market conditions, in a continuously changing environment, with revenue and profit targets in mind. As a result, the management of state-owned companies is often forced to rely on the same management techniques as those applied by other market participants.

Although public entities do not operate under market conditions and typically enjoy monopolistic positions, they are linked to the private sector in several regards (purchases, recruitment, certain services, e.g. deliveries). The hierarchy of objectives and the operational frameworks are fundamentally defined by legislation. Consequently, the organisation is far less flexible than a business association, and it is at the discretion of the manager¹ to fill these frameworks with substance. In addition, the manager of a public sector organisation needs to consider rapid shifts in the environment that pose numerous challenges, as regulatory changes tend to follow them with a lag or sometimes belatedly. Accordingly, public sector managers are increasingly expected to have innovation skills and an ability to promote risk management and organisational learning, and

as such, their role goes far beyond a passive type of organisational management focusing solely on regulatory compliance.

It is clear, therefore, that governing a public entity and managing a state-owned company both require adequate managerial skills. The definition of the entire objective hierarchy, the optimisation of organisational processes, performance-oriented, responsive and flexible operations, high-quality services and the improvement of employee performance constitute the backbone of management expectations. In addition, with respect to public spending, management is required to meet the expectations of all stakeholders, i.e. households using the public services, market participants, civil society, etc. In our information society, the ability to monitor governance, the transparency of management and the participation are basic needs. This calls for a new approach on the part of public sector managers. The principles of 'good governance' reflect this new approach.

The basis of good governance is the thoroughly planned, effective, efficient and responsible management of public funds. By controlling this process, state audit offices provide objective assessment and feedback on the performance of public spending. After the presentation of the theoretical background related to these qualitative aspects of good governance, this paper explores the subject based on the experiences of the State Audit Office. The paper provides a number of examples to demonstrate what happens when the objectives of public spending are not defined adequately, or when no outcome criteria have been assigned to the pre-defined objectives. It shows the implications of a failure to collect data, which leads to a failure to monitor and measure the implementation of the objectives, and thus the use of public funds is either not expedient or it is impossible to determine whether it is expedient and effective. In the course of its performance audits, in many cases the SAO itself defined indicators in order to ensure its ability to assess the effectiveness and efficiency of public spending. This, however, raises several problems to be discussed later in the study.

¹ Certainly, the frameworks imply different things at different management levels; moreover, even subordinate public sector employees have a degree of independence, and hence, responsibility.

2. QUESTIONS RELATED TO THE EFFECTIVENESS OF GOVERNANCE

2.1 How does effectiveness relate to good governance?

Nowadays, good governance is expected to strive for the reform of public administration and the enforcement of modern management and institution-organisational aspects (*Pulay, 2014*). Policy-makers and decision-makers often meet these expectations in consideration of the corporate governance principles and practices applied in the for-profit sector, even though the two sectors show significant differences. The hierarchy of objectives is wider and more sophisticated in the case of public spending, and social expectations necessitate tighter ethical requirements. If so, how can a management approach tailored to profit-oriented organisations gain ground in the non-profit sector? For what purpose and to what extent can the public sector adopt these management techniques?

Since the 1980s, public sector management in developed countries of the world had been subject to considerable changes. This can be attributed to the economic problems arising in the aftermath of the oil crisis on the one hand, and to shifts in the operating environment of governance on the other hand (*Turcsányi, 2008*). Establishing a cost-efficient state to reduce the burdens of economic participants became an increasingly important objective. The outbreak of the financial crisis in 2008 and the ensuing

surge in public expenditure (as a percentage of GDP) pushed this objective back into the spotlight (*Felméry, 2014*). In addition, the continuous improvement in the quality of market services raised the expectations set for public services, which also motivated the public sector to improve effectiveness and efficiency (*Hajnal, 2004*). The information technology boom and the development of the internet also called for the application of modern technologies which, in turn, gave rise to a dramatic development in management information systems and thus improved the transparency of the operation of the public sector. All of this incited policy-makers to adopt novel approaches to the problems of governance. Essentially, they were aimed at modifying state participation, improving the effectiveness, efficiency and economy of the public sector and enhancing the quality of public services primarily by the adaptation of the management philosophies and techniques applied in the private sector.

The guiding principles of the new public administration mainly reflected the impact of the New Public Management (NPM) movement, but the new approach to public sector management also drew from the theories of neoliberalism², Public Choice³ and neo-taylorism⁴. According to Hajnal (2004), the government and administrative reforms implemented in recent years entailed the adoption and dissemination of NPM principles and methods (both among certain multilateral organisations such as the OECD – PUMA/PGC or SIGMA⁵, and the developed countries of the world, including Hungary). An important component of the NPM is to establish a new culture for public administration and, in a broader sense, governance. This culture “is based on partnership and individual initiatives

² According to the neoliberal movement, since competition strengthens the economy, the state should be downsized, public services should be steered to the market and in general, the economic role of the for-profit sector should be increased.

³ In the bureaucracy theory of Public Choice, policy-makers and executive officials seek to maximise their personal utility, and the movement explores the implications of this choice.

⁴ Taylorism studies the topics of process management and performance improvement.

⁵ OECD PUMA (Public Management Committee) and subsequently, PGC (Public Governance Committee) were established to provide support to participating Member States in the planning, implementation and evaluation of public policies and public services.

rather than (excessive) state power, effectiveness/performance rather than regularity, co-operation and flexibility rather than command and hierarchy and the values of (market) competition rather than (state) monopoly" (Hajnal, 2004). The effect of the NPM was also perceivable – and can still be perceived – in Hungarian administrative reform processes, such as the vertical breakdown of ministries (into a strategic control centre – ministry – and a number of subordinate organisations), which was a typical structure until 2011–2012. Other examples include the connection of the private sector into the public service systems (e.g. through PPP projects), the performance assessment of public service employees, the system of ex ante and ex post impact assessment and the application of quality assurance (e.g. ISO).

Subsequently, the adaptation of corporate management to the public sector in general, and the application and applicability of the NPM in particular, were subject to widespread criticism for several reasons. The areas challenged included, for example, problems surrounding the output measurement of government activities, or the complexity and uncertainty of the issue of effectiveness and efficiency, in other words, what was to be considered the result of the activity and whether the result achieved could be considered a good result. This notwithstanding, the main tenets of the movement dominate public management to this day, and they are also reflected in some of the principles of good governance.

Indeed, effectiveness, efficiency, economy and high-quality public services are the prerequisites of good governance. This is emphasised in the 2014 report of the OECD⁶ and in several national-level recommendations and guidelines⁷. In short, objectives and measurable effectiveness

criteria should be assigned to public spending. It must be ensured that each component – from addressing a problem through planning, decisions and implementation to feedback – is carried out transparently and checked against measurable effectiveness criteria. Only this can enable state audit institutions to ascertain and control whether the management of public funds is driven by real social needs and public spending indeed serves the interests of the public.

Objectives and results should be determined at multiple levels; therefore, expediency and effectiveness can be interpreted at several levels. This is illustrated by Chart 1.

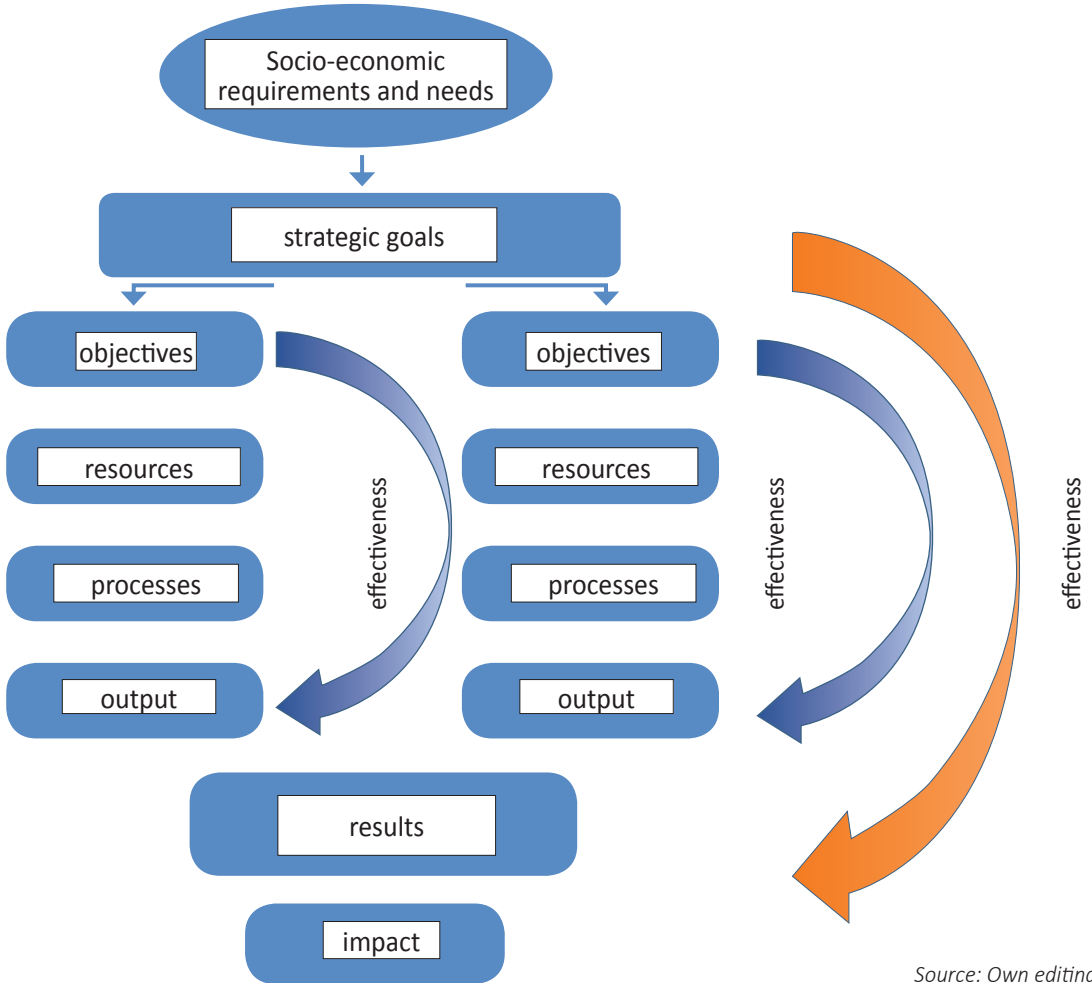
As a first step, governance defines the strategic objectives to be achieved (e.g. to increase the activity rate) on the basis of socio-economic needs. Strategic objectives are usually defined (as policy strategy) in legislation (e.g. employment policy strategy). Strategic objectives are broken down to sub-objectives, which comprise a hierarchical system (e.g. easing labour market entry for inactive workers, including, for example, the establishment of a counselling network; increasing the number of new enterprises, including, for example, the introduction of tax benefits). Harmony between the objectives defined at the various levels is ensured by the hierarchy of objectives. Relying on the resources available, the given process generates an output (e.g. a new tax law). The processes serving the achievement of the strategic objective end with a certain result (e.g. 10% of mothers on maternity leave return to the labour market). The impacts arising from the implementation of the programme in other areas (e.g. negative/positive externalities) must be assigned to the results (e.g. number of employees crowded out by new labour market entrants).

In order to gauge the extent to which the public funds allocated to the given programme

⁶ *Partners for good governance: mapping the role of supreme audit institutions* (OECD, 2014)

⁷ E.g. the 2004 publication entitled *"The Good Governance Standard for Public Services"* by the Independent Commission for Good Governance in Public Services, or the publication entitled *"Principles for Good Governance and Ethical Practice"* by the Independent Sector in the USA; *Good Governance in Practice*, Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ), 2012; *International Framework: Good Governance in the Public Sector*, Chartered Institute of Public Finance and Accountancy (CIPFA) and the International Federation of Accountants® (IFAC®), 2013; *Good governance guide for public sector agencies*, Government of Western Australia, 2013

Figure 1

Multi-level interpretation of effectiveness

Source: Own editing

served the implementation of the pre-defined objectives, the effectiveness of the programme should be examined. While countless questions may arise regarding the measurement of effectiveness, it is extremely important to examine effectiveness at different levels in any case, depending on the level of the objective to which it can be linked. Problems surrounding the effectiveness should be explored and analysed. On the one hand, this is performed by management as part of its monitoring duty, while the external assessment of performance is carried out by the shareholders, the controlling organisation or the

proprietor, or – as an independent organisation – state audit offices by way of objective and professionally sound audits.

In democratic and rule of law states, the final control of the management of public funds and public assets is performed by supreme audit institutions (SAIs), independently of the executive power. Essentially, SAIs can contribute to good governance in two different ways (OECD, 2014). On the one hand, through their existence and operation, they reinforce the effectiveness of bodies responsible for government oversight and for public financial management. Profes-

sional and independent SAIs strengthen the accountability chain, which is required to ensure that public interest prevails over personal interest in decision-making. On the other hand, through performance audits, SAIs assess the effectiveness, efficiency and economy of implementation of programmes, providing feedback on their performance. The fundamental mandate of supreme audit institutions is to strengthen public confidence in state institutions, primarily with respect to the fair, effective and expedient management of public funds and public assets. This affects all other areas of citizens' confidence in their government.

Objective and reliable SAI assessments play an important role in informing decision-makers of the government and parliamentary representatives. In this context, SAIs verify the proper use of budgetary resources, the fulfilment of public policy objectives, whether the implementation of the policies complies with legislation and the objectives and, in general, whether the performance of the government succeeded in implementing strategic objectives. Upon performance audits however, SAIs often encounter the problem that the legislation providing the regulatory framework of public spending fails to provide the objectives to be achieved and the criteria against which objectives can be deemed achieved. This poses severe problems in the evaluation of individual public projects as, in the absence of objectives and criteria, the objective of the government intervention must be presumed and indicators for its measurement must be defined subsequently. The selection of objectives and indicators is a key factor. Indeed, the definition of which indicators must be met in order to reach a certain goal may determine the outcome of the assessment as a whole – some indicators could be relevant to certain goals, while others could be irrelevant. In addition, the selec-

tion of the indicators is limited by the quantity and quality of the data available. Policy-makers can support and limit the evaluation of the use of public funds to a clear framework if they determine the objectives of government interventions in advance, allocate measurable indicators to them, and ensure the regular collection and processing of data required for the calculation of the indicators.

2.2 Regulatory environment pertaining to the expediency and effectiveness of public spending in Hungary

Below we provide a brief overview of the regulatory environment that defines the expediency, effectiveness and efficiency requirements of public spending.

It is a reasonable expectation of public spending that it should generate social benefits⁸ (increase public good); therefore, the objective of public spending should always be measurable against a social utility target value. At the macro level, the objectives of the use of public funds are fundamentally determined by regulations and regulatory instruments under public law.

The basic principles of the strategic governance of the government are laid down in a government decree⁹. The Decree supports the government's goal to ensure that strategic thinking becomes a fundamental element of organisational operation, and that the organisation becomes capable of concerted, high-quality strategic planning, identifying its short and medium-term objectives, defining the tasks and assigning responsibilities, as well as monitoring and assessing the implementation of the tasks

⁸ Social utility means the benefits reaped by society as a whole. It consists of direct and indirect components, and considers environmental impacts and, for example, the effects on job creation. It is a broader category than financial utility. It is primarily used for cost-benefit analyses prepared for development projects financed from EU funds.

⁹ Government Decree No. 38/2012 (III. 12.) on Strategic Governance

and the pre-determined objectives. The legislation defines the hierarchy of strategy papers¹⁰, the persons responsible for drawing up the documents, the principles of follow-up, evaluation and review, and rules pertaining to individual document types.

Sometimes, however, even the legislation fails to define the regulatory objective, which renders the interpretation of the expediency of public spending difficult or impossible. Hungarian regulations do not include a requirement for the definition, application and monitoring of effectiveness, efficiency, economy or other performance indicators pertaining to the entire group of public fund users. By contrast, the legislation defines in detail the amount and the main allocations of the public funds available (prevailing Act on the Budget and the budget decree pertaining to local governments) and the criteria for the use of public funds by budgetary institutions. They state that the economy, efficiency and effectiveness of the use of public funds and public assets must be ensured; however, the meaning of these concepts is unclear.

Besides legislation or in-house regulations, the performance criteria of the given organisation can be enforced by other means; for example, by the expectations of the controlling body, the proprietor or the shareholder. This includes the public service contract concluded by the state and the public service provider, which is a written contract for the performance of a public function or a part thereof on behalf of the organisation¹¹. In addition to the basic requirements of the performance of public services, the contract also stipulates quality requirements and conditions¹².

Obviously, the existence of the regulation cannot ensure effective and efficient operation in itself; it only provides a framework for it. The

head of the organisation is responsible for filling these frameworks with substance.

The greatest deficiency of the regulation, therefore, is the fact that it fails to enforce the declaration of the objectives, expected results and performance criteria of public spending at the systemic level; consequently, it is impossible to measure the effectiveness and efficiency of public spending subsequently. As has been confirmed by the findings of the State Audit Office, the deficiencies suggest that the social utility of public spending falls short of the level that could have been achieved by a clear definition of the objective and by result-oriented operation. Recognising this problem, regulatory processes commenced in relation to a segment of the economic agents managing public funds: public administration organisations. These processes shift the system of public spending specifically toward strategic control and result-oriented operation. (Apart from this, there are a number of other policy programmes and strategies of the government where regulations have commenced; they, however, are not targeted at ensuring the effectiveness and efficiency of public spending or demanding follow-up and evaluation).

¹⁰ strategic planning documents: *country forecast, national medium-term strategy, ministerial programme, institutional work plan (i.e. mandatory documents), as well as the long-term concept, the white book, policy strategy, policy programme, institutional strategy and green book (optional)*

¹¹ Pursuant to Act CLXXV of 2011 on the Freedom of Association, on Public-Benefit Status, and on the Activities of and Support for Civil Society Organisations (Act on CSOs).

¹² As prescribed, for example, by Act XLI of 2012 on Passenger Transport Services or Government Decree No. 317/2013 (VIII. 28.) on the Selection of Municipal Waste Management Service Providers and on the Contract on the Municipal Waste Management Service.

3. FINDINGS OF SAO AUDITS

The audits of the State Audit Office measure different aspects of performance to ensure that public funds are managed in an orderly, growth-stimulating fashion. The methodology of the SAO's performance audits are based on the INTOSAI standards (ISSAI 100 and ISSAI 300). "Performance auditing promotes the transparent operation of organisations by providing, based on the audit evidence, an independent and authentic perspective, by issuing conclusions for the targeted users of the audit results, and by offering an insight into the implementation and outcomes of audited activities related to the management of public funds and public assets. Accordingly, it provides useful information while serving as a basis for the acquisition of knowledge and performance improvement. Performance audits support the responsible parties in the improvement of accountability by offering new evaluation criteria." (SAO, 2015)

In addition, the SAO's compliance audits and results of the Integrity Survey¹³ also identified effectivity problems. These experiences can be used in the planning process of performance audits, too.

3.1 Audit findings of SAO's performance audits

The performance audits of the SAO shed light on a number of problems that derived from inadequate indicators or backtesting, or the inadequate definition of objectives. *Németh and Kolozsi* (2015) processed the audit findings, and the possible problems arising during the audits

were found to be the following (the number in brackets indicates the number of the relevant audit report):

- a) Objectives have not been set or proved to be deficient (e.g. the reorganisation of psychiatric health care, No. 1286);
- b) Objectives have been set but the system of indicators and criteria designed to measure the successful implementation of the objectives is either missing or inadequate (Subsidy scheme of public employment, No. 13097).
- c) Objectives have been set, an indicator system has been designed and a set of criteria has been developed and applied; however, there is no follow-up and the reasons for deviations are not analysed (implementation of rural development objectives, No. 1293).
- d) There are simultaneous deficiencies at multiple levels with respect to the definition of objectives, the performance criteria, as well as backtesting (financial management of business associations in majority state/local government ownership).

Reorganisation of psychiatric care: consequences of the lack of efficiency objectives

In 2012, the State Audit Office conducted a performance audit with regard to the reorganisation of psychiatric care. The purpose of SAO's first-time audit of psychiatric care was to evaluate whether the resources being spent on reorganising psychiatric care were appropriately utilised and whether the reorganisation led to a more cost-effective, higher-quality and more evenly accessible service. The audit covered the period between 1 January 2006 and 30 September 2011.

The audit found that goals had not been set at the macro level neither in terms of the effective-

¹³ The goal of the series of surveys performed annually by the SAO since 2011 has been to identify the risks which may adversely influence the integrity of the given organisations within public sector institutions. In addition to identifying the risks, the survey also maps out the coverage levels of controls serving to manage these risks. In addition to the fight against corruption, expanding the circle of institutions that accept and endorse the integrity-based mentality is another high priority of the integrity surveys. The ultimate goal is to promote cultural change and to create integrity-based institutional operation and to spread thinking in terms of risks in the Hungarian public sector.

ness nor in terms of the efficiency of psychiatric care (neither in the professional or public health, nor in the financial areas); the relevant indicators had not been designed, and therefore, it was not possible to monitor and backtest the effects of the reorganisation.

Due to the grave deficiencies of planning, severe problems emerged in the already distressed health care system. For example, closing down the National Institute of Psychiatry and Neurology eliminated the national institution for psychiatric care that was meant to provide a comprehensive framework for the individual types of psychiatric care; the institutions designated to take over the tasks were unprepared, and a substantial amount of financial liabilities accumulated.

The audit found that even though several government initiatives had been announced for the reorganisation of healthcare in the period of 2006–2011, they did not specifically determine the tasks and size of psychiatric care. Hospital restructuring in 2007 terminated inpatient psychiatric care in 11 hospitals, curbed the number of total active beds in psychiatry by 20% nationwide, and closed down the National Institute of Psychiatry and Neurology – which was considered to be the apex of the mental health profession – without any surveys with respect to the regional distribution of psychiatric diseases or to the expected impact of the decisions. In addition, there was no consultation with professional organisations or patient advocacy groups, and the health care system was unprepared for the dramatic change entailed by the reorganisation. Although the goal of the reorganisation – including the termination of the national institution – was to streamline the care system, the lack

of adequate professional planning deteriorated the conditions of psychiatric care. Bed cuts in inpatient psychiatric care as part of hospital restructuring did not address earlier capacity imbalances, nor were there any legal provisions on adjusting capacities in specialist outpatient care. The elimination of the National Institute of Psychiatry and Neurology – a top quality professional institution – was an unreasonable decision; decision-makers failed to survey the financial implications of the institution's elimination in advance; the institutions designated to take over the tasks were unprepared. The target date for the institution's liquidation, therefore, was delayed by a year.

Starting from 2008, the Ministry of Health and Hungarian psychiatric professional organisations commenced the development of a criteria system suitable for measuring performance; however, the evaluation of cost efficiency and effectiveness did not have an established and applied methodology at the time; therefore, the State Audit Office developed its own indicators suitable for performance assessment during the audit. Through the analysis of these indicators, the SAO found that the cost-efficiency and effectiveness of public spending on psychiatric care deteriorated in comparison to 2006. The primary reasons behind this deterioration were capacity imbalances in psychiatric care; in the absence of disease registers, health care and social care capacities were not based on morbidity data. There was no organised care regulating services for patients, and regional access was unevenly distributed. Moreover, in the absence of accurate disease registers, no information was available on the actual prevalence of psychiatric disorders by region.

¹⁴ Az egyesülési jogról, a közhasznú jogállásról, valamint a civil szervezetek működéséről és támogatásáról szóló 2011. évi CLXXV. törvény (Civil tv.) alapján.

¹⁵ Mint ahogy ezt pl. a személyszállítási szolgáltatásokról szóló 2012. évi XLI. törvény, vagy a közszolgáltató kiválasztásáról és a hulladékgazdálkodási közszolgáltatási szerződésről szóló 317/2013. (VIII. 28.) Korm. rendelet is előírja.

¹⁶ A Magyar Program hatékonyság fogalma magában foglalja az alábbi fogalmakat is: eredményes, gazdaságos, hatásos, biztonságos, felügyelhető, alkalmazkodó.

¹⁷ Common Assessment Framework – CAF: egy teljes körű minőségirányítási eszköz, amelyet a közszféra képviselői dolgoztak ki a közszféra számára az Európai Minőségirányítási Alapítvány Kiválóság Modelljét alapul véve

Reorganisation has failed to lead to a more even distribution of hospital capacities or create a more sustainable care system better geared to treatment needs.

In summary: the centrally executed reorganisation of the institutional system did not have a pre-determined hierarchy of objectives and the expected results were not defined; therefore, it was not possible to assess the objectives of the public funds spent on the project or identify the social utility of the reorganisation. In such situations, there is a threat that objectives are set randomly, reflecting prevailing interests rather than being defined as a result of a thorough and concerted planning process with maximum consideration to social utility. In the absence of a hierarchy of objectives, it is impossible to measure the expediency, effectiveness and efficiency of the programme as a whole, which calls into question the expediency, effectiveness and efficiency of public spending.

3.1.2 Public employment, consequences of the lack of an appropriate indicator system and criteria

As it became apparent, the establishment of a hierarchy of objectives is indispensable for expedient, effective and efficient operations. The example presented below illustrates the possible implications of deficiencies in the indicators designed to measure the achievement of goals, the relevant criteria, and the information system supporting their measurement.

In September 2013, the State Audit Office published its Report No. 13097 on the performance audit on the efficiency and effectiveness of the subsidy scheme of public employment and the related training programmes. The objective of the audit was to assess whether the public employment system being in place in the period between 2009 and 2012 Q1 – including the related subsidy scheme and training system and

the changes introduced –, as well as the cooperation between local governments and labour organisations efficiently and effectively assisted in increasing the participation of the long-term unemployed with low-level academic qualifications who are capable of work through public employment or training schemes, in facilitating their return to the open labour market and in improving their labour market position.

The audit found that the strategic objectives regarding public employment in the review period had been set (in several, interdependent documents), and from 2011, specific goals and tasks were defined in relation to the strategies. However, they did not – or insufficiently – set the effectiveness and efficiency indicators and criteria that are suitable for confirming the implementation of the objectives and allow for continuous monitoring and ex-post evaluations. The entire infrastructure of the measurement was missing, or deficient as well. Due to the lack of a comparable indicator system measuring the effectiveness and efficiency of the public employment system in place, there was no central evaluation.

Therefore, wherever the quality and quantity of the data available allowed, the State Audit Office derived its own indicators from the pre-determined objectives, and drew its conclusions on the basis of the analysis of these indicators. As a result, the SAO found that the number of persons involved in public employment doubled from 2009 to 2011, which means that the public employment system was effective in supporting the increased involvement of the unemployed in public employment, and in accomplishing the strategic objectives concerning subsidised employment. Public employment had a positive effect on both the employment rate and the unemployment rate (improving the employment rate by 0.8–1.1% and the unemployment rate by 1.4–2.0%). In addition, the subsidy scheme efficiently contributed to involving those of ac-

¹⁸ A Magyar Program célkitűzései alapján került elfogadásra a jogalkotásról szóló 2010. évi CXXX. törvény hatásvizsgálatokra vonatkozó része, valamint az előzetes és utólagos hatásvizsgálatról szóló 24/2011. (VIII. 9.) KIM-rendelet.

tive age and receiving social benefits in employment. These goals were, at the same time, also employment policy objectives.

Based on the audit findings, the SAO issued a recommendation for developing a criteria and indicator system suitable for measuring the performance of public employment, and for setting up a monitoring system with a view to monitoring the implementation of the pre-determined objectives.

Another problem explored by the audit was the fact that, owing to deficiencies in the continuity, timeliness and reliability of registries and disclosures, the information system of public employment did not support regular reporting and feedback to policy-makers in the review period; in some areas the quantity or quality of the data available was insufficient for the monitoring process. For example, they did not collect data systematically with respect to the exits of public workers from the open labour market – which would have been required for comprehensive government analyses –, and no comparable data was available with respect to the entry of public workers into the open labour market (neither at the central nor at the local levels). Consequently, it was impossible to assess the effectiveness and efficiency of the efforts to facilitate the return of public workers to the open labour market. With that in mind, the SAO recommended the development of a data reporting system that provides reliable data for the evaluation of the implementation of public employment objectives.

In this case, it is not possible to decide whether the objectives were implemented effectively and efficiently, because, in the absence of pre-determined indicators and criteria it remains unclear which outcome would have been considered effective and efficient by those who set the objectives. In any event, the SAO found that the use of public funds contributed to the reduction of the unemployment rate and the improvement in the employment rate through a

sharp increase in the number of public workers, and that the efficiency of the public employment subsidy system improved by 2011 from the aspect of the central budget (i.e. the per capita subsidy amount declined with a simultaneous increase in the number of public workers). In other words, the results achieved by the use of public funds contributed to the implementation of the pre-determined objectives.

3.1.3 Implementation of rural development objectives; consequences of deviation from the objectives

Sometimes, even though strategic objectives are defined, the related, multi-level sub-objectives are set and the adequate indicators and criteria are put in place; during implementation the programme is modified (e.g. in terms of funding, the criteria system or target groups) on the basis of priorities that are not in line with the original objectives; and consequently, its effectiveness and efficiency fail to achieve the pre-determined level.

In August 2012, the SAO published its report on the performance audit on the effectiveness and efficiency of the utilisation of funds used for the implementation of rural development objectives and the strengthening of the role of local communities and its role in the improvement of the quality of life in rural areas. The main purpose of the audit was to assess whether the utilisation of funds allocated to the implementation of rural development objectives – to improve the quality of life in rural areas, to encourage diversification of the rural economy and to strengthen the role of local communities – was effective and efficient in the period of 2007–2011.

The audit found that the objectives of the New Hungary Rural Development Programme (NHRDP) were in line both with the objectives of the National Development Policy Concept and with EU requirements. Output, result and impact indicators had been defined to measure the im-

¹⁹ „A jó állam mérhetősége”, Jó Állam Kutatóműhely, NKE 2014

²⁰ A 2015. évi jelentést lásd a http://ati.uni-nke.hu/uploads/media_items/fo-allam-jelentes.original.pdf link alatt.

plementation of the targets and the impacts (e.g. number of villages and micro-enterprises supported, number of new jobs, total amount invested, and net number of new jobs created as a result of development).

However, problems arose during the implementation of the programme as a result of the low number of completed projects, the commitments undertaken in relation to the funding and the limited rate of payments. The programme was modified several times, but the substance of rural development objectives remained the same. Thus, for example, there was a shift in the allocations between the measures aimed at improving the quality of life in rural areas and encouraging the diversification of the rural economy: more than a half of the funds allocated to the measure aimed at the creation and development of micro-enterprises was reallocated to the measure targeting the improvement of the image and attractiveness of rural life and the quality of services. This modification was contrary to the objective set out in the NHRDP's economic development programme intended to strengthen micro-enterprises operating in rural settlements and to improve local employment. Increasing the resources for improving the image and attractiveness of rural settlements and the quality of services rendered did not contribute to managing the social tensions generated by the restrained economic activity of the population living in rural areas, by the low employment rates and hence, by the limited amount of income.

The reorganisation of resources was not accompanied by an overall review of indicators intended to measure the implementation of the objectives (e.g. number of micro-enterprises supported, total amount invested, number of multi-functional service centres, etc.). The indicators were modified only in part; without underlying calculations and impact assessments.

The monitoring committee tasked with the follow-up of the programme monitored and eval-

uated the achieved results on a continuous basis. However, the efficiency of the function – which was designed to supervise the quality of execution partly independently of the executive organisations – was low.

In summary, although the objectives and the related effectiveness indicators were defined at the start of the project, during subsequent modifications of the programme – justified by reasons irrespective of the project – the indicators intended to measure the results and the resources ensuring that such indicators are achieved were not changed in a complex and coordinated manner, and the results, performance and impacts expected from the support system received less attention. Consequently, the originally defined regional development and convergence objectives were implemented only in part and therefore, the expediency, effectiveness and efficiency of public spending fell short of the originally desired levels.

3.2 Audit findings pertaining to business associations in majority state ownership

The SAO reports prepared on the macro-economic correlations of fiscal processes (the latest one of which was issued in September 2015) pointed out that the ratio of public spending on economic functions to GDP had increased continuously since 2011. The increase in expenditures allocated to economic functions primarily reflects the high absorption of EU grants and state acquisitions. This trend reflects the increasing economic participation of the state, which, according to Domokos (2015) opens up new opportunities on the one hand (e.g. increasing national wealth, development of depleted but unreplaced assets, increasing economic strength of the state), but also carries a certain

²¹ Azon szervezeteknél, amelyek már bekapcsolódtak az önkéntes integritási kérdőív kitöltésébe, ott az adatszolgáltatás minőségét értékelte az ÁSZ. Egyéb szervezeteknél ellenőrzési tanúsítványok kitöltésére került sor integritás témakörben.

degree of risk. For instance, the need to ensure the funding required for a more active participation in economic functions entails the reallocation or withdrawal of resources, which may pose funding risks over several time horizons in other areas (e.g. among those receiving reduced budgetary subsidies or subject to special taxes, as well as in areas receiving a smaller proportion of EU transfers). In addition, a competition for the acquisition of public funds materialises between traditional state functions and the economic functions of the state.

The fact that the state is at the same time a legislator, shareholder and supervisor in an increasing number of economic areas may also be a risk factor. Being responsible for all three functions simultaneously gives rise to a conflict of interest between, for example, the legislator and the shareholder (the creation of a regulatory environment encouraging competition vs. the crowding-out of competitors and monopolistic endeavours). The change in ownership implies that, through its business associations, the state now operates in markets where its presence was previously limited to a regulatory role. Accordingly, there is a risk that the level of expertise required for the management of a state-owned company competing under market conditions is insufficient, and thus the operation of the organisation is ineffective or inefficient. This increases the risk of losses and wasteful operation. These risks may be mitigated by an adequate regulatory environment and by the exercising of ownership rights (e.g. shareholder's control), and by facilitating transparent and performance-oriented operations.

In consideration of the risks involved, the auditing of the financial management of business associations in majority state/local government ownership has become a relatively new but increasingly important area of SAO audits (e.g. transportation companies, district heating providers, waste management companies, water

and public utility companies, theatres). The audit findings contribute to improving the relevant regulations, as well as state-owned company management and processes for exercising ownership rights and ultimately, to improving the state's performance.

The SAO performs the assessment of business associations in the context of compliance audits. Propriety audits are performed where certain issues cannot be judged on the basis of legal provisions or where there are clear deficiencies in legislation. Performance audits are intended to establish whether the stewardship of public funds and public assets complies with the principles of effectiveness, efficiency and economy, and whether there is room for improvement. Typically, however, there are no effectiveness requirements in place (set by the exercisers of ownership rights, the bodies of the company or its management) to determine the objective to be achieved and the desired impact; therefore, in most cases the accountability of public spending is limited to its regularity and propriety. SAO audits are primarily intended to verify and evaluate financial standing, asset management, the existence of internal control systems and the regularity of the areas constituting an integral part of these items. At the same time, audit findings allow us to identify critical areas that may not be separated from the scope of responsibility of management and the exercisers of ownership or oversight rights.

SAO audits pointed out that deficiencies in the management of state-owned companies generate losses in numerous areas, including financial and non-financial losses (e.g. loss of confidence, moral hazards). These losses stem from various sources and could reflect deficiencies in the exercising of ownership rights and management-related problems. The materialisation of deficiencies at multiple control levels may amplify one another, leading to significant economic, effectiveness or efficiency losses.¹⁴

¹⁴ The last study of the Study Series identifies the key factors of well-managed state-owned enterprises, summarizes the results of SAO's audits and proposes detailed recommendations for ownership entities, supervisory boards and management of state-owned companies.

3.2.1 Deficiencies arising in the exercising of ownership rights

Appropriate exercise of ownership rights, tight ownership control and the definition of the direction of public asset management are indispensable factors in responsible public spending and asset management. Audit findings point to a lack or ambiguity of directives regarding the use of public funds and public assets (e.g. the National Asset Management Directives defining the strategic and annual frameworks for the responsible management of state property, or the Annual National Asset Management Programme have not been completed). Moreover, the exercise of ownership or oversight does not fulfil its intended role in several areas (definition of performance criteria, reporting system, ownership control, evaluation). Audits and analyses on areas playing a key role in terms of competitiveness (acquisition and utilisation of knowledge, investment projects, inexpensive energy, employment, market organisation, sustainable development) found evidence for the absence of targeted indicators (indices) suitable for measuring results, direct and indirect benefits, and pointed out – in the case of the use of domestic funds – the lack (or deficiencies) of monitoring systems ensuring reliable and up-to-date data reporting and feedback. The SAO has drawn attention to these problems on several occasions, and identified the risks entailed.

Ownership control is a particularly important item of ownership rights which, in the case of local governments, is typically manifested in the activity of the Supervisory Board. The primary asset manager (Hungarian State Holding Company) monitored the activity of the companies primarily on the basis of controls relying on requested data disclosures. However, it failed to perform on-site inspections regarding the financial management, preservation, accumulation and use of public assets. The companies' disclosures were insufficient, and prob-

lems were detected with respect to the owners' reporting systems as well (non-compliance with regulations, failure to provide the required information, failure to demand reports), which impaired the enforcement of transparency.

The Supervisory Boards discussed and approved the annual business plans and the annual reports; however, they usually did not inspect – for the protection of the owner's assets and public interest – changes in wealth, the financial management of company assets and stewardship of the state property entrusted to the company.

In order to ensure the accomplishment of the objectives, clear effectiveness requirements must be defined for management on the one hand and, on the other, the fulfilment of these performance criteria needs to be monitored and evaluated on a continuous basis. In case of deviations, the owner must take the necessary measures. Evidence shows that the performance assessment system of corporate managers is not consistent, and it lacks a related, efficient incentive system.

As regards ownership control, in addition to its recommendations based on the audit findings, the SAO also issued letters of warning, advising the exercisers of ownership rights – among other things – to review the financial management of the business association and in this context, to define expectations regarding the content of business plans and reports, and to review and manage the accounts receivable of the business association. The SAO also advised the owner to define – in the context of exercising its ownership rights – a set of criteria to measure, for example, the efficiency of public service functions or professional standards for evaluating service levels for the company.

3.2.2 Management of state-owned companies

The audits found that, in many cases, the financial management of the companies did not comply with statutory requirements (e.g.

important accounting policies were missing, prime cost calculations were unfounded or missing, the requirements of accounting separation were violated). Severe regularity and financial management problems went undetected in many cases; neither management, nor the exerciser of ownership rights took measures to reduce the risks arising from these problems, and the Supervisory Boards failed to raise attention to the risks jeopardising the implementation of the objectives.

For the most part, business plans did not include criteria pertaining to the effectiveness, economy and efficiency of financial management and professional performance. In the absence of pre-determined criteria, the performance of the company's management cannot be measured, and the loss-producing or profit-generating areas cannot be identified. In numerous cases, the plans did not include detailed information about the scheduled projects; therefore, it is impossible to make informed decisions about the allocation of public funds or about investment projects.

The SAO found that, in many cases, the internal regulations pertaining to prime cost calculation did not adhere to legal regulations in the case of companies providing public services. This issue is not only important from the perspective of compliance with the Act on Accounting; indeed, another important function of prime cost calculation – in the economic sense – is to support the decision-making process. In the case of business associations performing public functions and providing public services, there are numerous areas where it is impossible to make well-founded and forward-looking decisions in the absence of adequate prime cost calculations. These areas typically include the execution of planning tasks, price formation, cost analysis, calculations providing the foundation for economic decisions, indicators designed to measure internal performance. These areas are also within the management's scope of responsibility and, through the approval of

the business plans, they are of decisive importance from the perspective of the supervisory exerciser of ownership rights.

4. CONCLUSIONS

In several cases, the audits conducted by the State Audit Office of Hungary shed a light on general problems that may give rise to risks jeopardising the achievement of policy or social objectives. The audit findings of the SAO confirm that the control systems of both public entities and state-owned business associations need to be improved significantly in order to ensure good governance and public sector management. This calls for a paradigm shift; new horizons should be opened up in the public sector management approach. It is indispensable to ensure the transparency, publicity and measurability of public sector management's performance, because this is the only way to ensure effective, efficient, cost-effective and sustainable public management and to increase social well-being.

First, the regulatory environment should be improved to identify objectives, to specify the expected performance and to develop the indicator system related to public spending. The owner needs to define the criteria for the implementation of objectives and sub-objectives in a manner that ensures the objective execution of performance assessment and control. At the same time, objectivity requires reliable databases, which are currently not available in the whole sector.

Parallel to this, it is also essential to improve the regulations pertaining to management along the lines of new aspects. The ethical requirements set for public managers should be tightened to properly reflect the fact that they act on behalf of the community, bearing responsibility for public property and for safeguarding the future of the community. Public confidence in management must be earned and retained. Good managers act as an example for all and do everything in their power to ensure that the organisation entrusted to them fulfils the public purpose for which it was established.

The State Audit Office, as a supreme audit institution, plays a prominent role in the renewal of public management. Its performance audits are designed to evaluate the use of public funds focusing on expediency and effectiveness, enforcing its transparency and the measurability of performance. The execution of performance audits, however, is often impaired by the lack of the required indicator system. Therefore, in recent years the SAO has supported – and will continue to support – the enforcement of the expediency/effectiveness/efficiency requirement in the planning, implementation and evaluation of government objectives through the publication of a series of performance-oriented studies.

In its advisory role, the SAO has often called the legislator's attention to problems surrounding the effectiveness and efficiency based assessment of public spending, and issued a number of recommendations. Some of the proposals pertained to the selection, performance assessment and remuneration of management. The proposal package included the following recommendations:

- the performance of the management of state-owned companies should be evaluated from the perspective of compliance, effectiveness, efficiency and economy on a continuous basis;
- the ability and activity of the exerciser of ownership rights to evaluate effectiveness should be strengthened;
- managers of state-owned companies should comply with strict ethical and integrity principles; and
- the remuneration system of company managers should be reformed.

The SAO wishes to continue to play a leading role in the creation of a knowledge base in order to enable economic actors responsible for the management of public funds, as well as those controlling and supervising the process, to safeguard public funds and public assets in an ethical and highly professional manner.

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