



Transforming External Control of Municipal Finances in Hungary

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Abstract

The external control of the Hungarian municipal finances has been based on the traditional, continental dual model: the State Audit Office of Hungary, responsible for the professional control of these finances on the one hand, and the County (Capital) Government Offices, performing the legal supervision of the decisions and procedures of municipal finances on the other hand. This paper analyzes how this ecosystem has been transformed, and how central governmental control has been strengthened during the last decade. It also examines the phenomenon of blurring the boundaries between professional and legal control and supervision. Finally, it reviews the complementary elements of this system, such as the inspection competences of the Hungarian State Treasury and the asset management control powers of the public prosecutors.

Keywords

external control, professional control, legal supervision, County Government Offices, State Audit Office of Hungary, inspection of central government funding

1 Introduction: municipal finances in the Hungarian system

The changes of the Hungarian municipal finance system are primarily influenced by the transformation of the Hungarian municipal system. It should be emphasized that the concept of local governments has been transformed after the new Constitution, the Fundamental Law of Hungary, entered into force on 1 January 2012, allowing a relatively wide regulatory freedom on municipal law. Though, the basic structure of the municipal law remained intact, a new cardinal Act on the municipalities shortly followed. This new Municipal Code is the Act CLXXXIX of 2011 on the Local Self-Governments of Hungary (*Magyarország helyi önkormányzatairól szóló 2011. évi CLXXXIX. törvény* – hereinafter: LGA-H). As part of the regulatory transformation of the municipal system, both the subject of local governance and the types of municipalities are defined by the LGA-H, and not by the constitution, as it used to be. According to Section 2 of the LGA-H, local governance is a right of the voters' collective of communities and counties. Thus, the former constitutional rules are now being regulated by the LGA-H.

The municipal model based on the general powers of the local entities has transformed partially. As such, the current second-tier municipalities, that is, the county governments, are practically not vested with general powers. In line with Section 27 of the LGA-H, only regional development, spatial planning, rural development, and general coordination are listed as tasks appertaining to the counties' competences (Hoffman, 2014, 405–406).

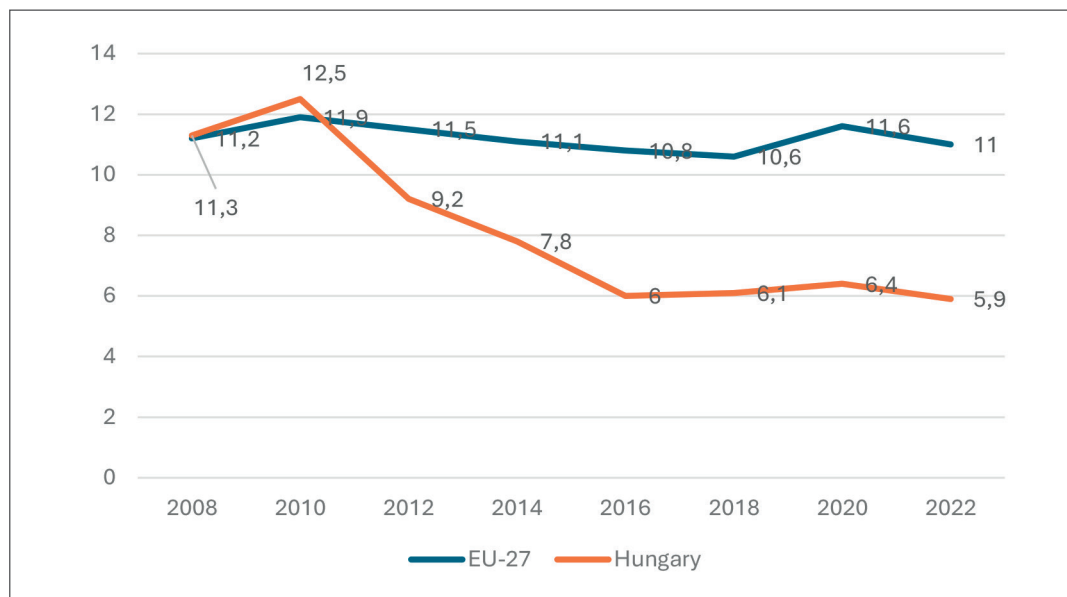
The most important conceptual development in regulation that the new Fundamental Law has brought about, is the paradigm shift in terms of the nature of self-governance. With respect to the former Constitution, self-governance was interpreted as a fundamental right of the local and regional communities, and the main competences and liberties of the local self-governments were considered 'fundamental rights' as well. These municipal rights did not equal the fundamental rights of persons, nevertheless, the Constitution of the Democratic Transition was clearly based on the concept of inherent rights (Bodnár & Dezső, 2010, 220–222). It is this concept which has been transformed by the Fundamental Law. Though, Article 32 of the Fundamental Law lists the major municipal competences, these competences are still not defined as 'fundamental municipal rights', and it is made manifest that municipalities may perform these competences only 'within the framework of the Acts'.

The former paradigm, one may call it an 'autonomous model', has, thus, been transformed into an 'integrated model' (after the classification of Kjellberg, 1995). This is emphasized by Paragraph 1 of Article 34, stating that '[l]ocal governments and state organs shall cooperate to achieve community goals'. This means that the legal protection of the local government has been weakened as well, because municipalities do not have fundamental rights, they cannot file constitutional complaints either against the legislation by which their competences are, constitutionally or not, being restricted.

Thus, the characteristic of the new municipal system is a *centralized one* the provision of public services has been centralized, the supervision competences of the central government and its agencies have been strengthened and the municipal administration has been concentrated (Szente, 2013, 178–180).

These transformations influenced the new concept on municipal budget which has remained part of the public household. However, it is a separate sub-system from the central budget, though municipal finance has a strong impact on the whole public finance system. Municipalities are significant providers of public services and important players in the national economic systems. Although, the economic role of the Hungarian municipalities has been decreased since 2012 (Bencsik & Ercsey, 2020, 235; Siket, 2021, 274–275; Pál & Radvan, 2024, 213), they still have a significant share in the Hungarian GDP (see Figure 1).

Figure 1. Share of municipal expenditures in the GDP in the EU and in Hungary (2008–2022)



Source: Eurostat, 2024.

The regulation on municipal asset has been similarly significantly influenced by the transformation of the Hungarian municipal system. Specifically, the municipal asset has become practically a ‘purpose fund’; this means that if municipal tasks change, the corresponding asset may be transferred to the new responsible body. Moreover, between 2012 and 2017 several important municipal assets were nationalized, such as former municipal hospitals, residential social care homes, municipal elementary, vocational and grammar schools, which were either partly or fully nationalized and then maintained by the central government and its agencies (Szilágyi, 2016, 252–256). In addition, another important change has been implemented, at least in principle, namely the requirement for government permission for municipal borrowing, accompanied by the introduction of restrictive regulation concerning municipal budget deficits.

Although, the Hungarian municipal system has been transformed significantly since 2011/12, municipalities still play a decreasing yet important role in the Hungarian administrative system. As a result, the legality and the security of the municipal finances are important issues for the whole public household system of the country (Feret, 2020, 89–91; Kostrubiec, 2021, 116–118). Moreover, the security and legality of the municipal finances are protected not only by the municipal bodies, but also by other public bodies belonging to the central government and even other branches of power, for example the judiciary (Raudla et al., 2023, 393–395). Therefore, by the analyzing these control mechanisms, the major characteristics of the municipal financial autonomy – and, indeed, the autonomy of the municipalities themselves – can be observed (Radvan et al., 2018, 900–902).

In this paper, I assess therefore the situation in Hungary by examining the major forms of external control over municipal finances (Jensen, 2005, 54–57). In this regard, I focus on the regulation and its administrative and judicial practice. Thus, while the methods of legal studies will primarily be applied, the approach of administrative sciences will also be included in my analysis.

2 Legal supervision and subsequent court proceedings

2.1 Scope of the legal supervision

Pursuant to Section 132 of the LGA-H, the legality of municipal decisions, including those relating to property management, may be subject to an extensive review by the county (capital) government offices (Nagy & Hoffman, 2023, 571–774). Specifically, with regard to Section 132(4) of the LGA-H, *municipal finance decisions involving discretionary powers or margins of appreciation are, in principle, exempt from supervision by the government offices*. However, the Section 132(5) of the LGA-H introduces an important exception: even cases where discretionary power or margin of appreciation is applied, the county and capital government offices may examine the legality of the *decision-making procedure* (Gyurita, 2020, 26–27).

Furthermore, the legal means of supervision are outlined in Article 132(1) of the LGA-H. This provision confirms that beyond requesting information and making proposals, the government office may, in cases of unsuccessful requests, initiate judicial review procedures in the courts responsible for overseeing municipal decisions – primarily the Curia (the Supreme Court of Hungary) and the Regional Courts with Administrative Branches (Rozsnyai, 2023, 361–363). Moreover, regarding financial management, the LGA-H explicitly states that the Government Office may initiate proceedings before the State Audit Office of Hungary. In instances where the government office issues a formal notice and the municipal representative body disagrees with its findings, the court has the authority to rule on the legality of the decision. Finally, municipal decrees and decisions are subject to Act I of 2017 on the Code of Administrative Court Procedures (hereinafter: CACP).

2.2 Judicial review of the legality of the decision-making process of local authorities

The court procedures on the municipal finances are mainly focusing on local regulation on taxes and other public revenues. Although, there are several landmark cases on this topic, their detailed analysis is beyond the scope of this article.

Due to the above-mentioned limitations of the tasks and duties of the government offices, judicial practice in this area is relatively limited. However, in the domain of municipal finances, judicial practice addresses several key issues. First and foremost, the Fundamental Law of Hungary introduced a special procedure by the Curia (the Supreme Court of Hungary) for cases where a municipality fails to fulfill its duties in passing municipal decrees. In such cases, the government office may initiate an omission procedure at the Curia. Should the Curia determine that an omission has occurred and the municipality still does not pass the decree, the Head of the Government Office or the county government commission has the authority to enact the decree on behalf of the municipality. The initial set of decisions by the Curia of Hungary focused on this issue. For instance, several rulings have been passed by the Curia of Hungary, because municipalities failed to adopt their annual budgets or final accounts decrees (Decisions of the Curia No. Köm.5.028/2023/5., Köm.5.027/2023/6., Köm.5.020/2023/7., Köm.5.019/2019/4., Köm.5.012/2018/3., Köm.5.016/2017/4. and Köm.5.072/2013/3.).

Another group of decisions in the field of the control of municipal finances are the decisions on the legality of the annual budget and municipal household issues. The Curia of Hungary stated that municipalities have wide autonomy in organizing and deciding on their finances. It has been emphasized by the Curia of Hungary that the compliance of the municipal financial decrees is an important issue. Thus, those correction which are related to the compliance of the financial

planning, and which are in accordance with the local organizational regulations could not be interpreted as infringing actions (Decision of the Curia of Hungary No. Köf.5.024/2023/7.). Because of the limitations of the judicial review of the decrees based on discretionary powers and margin of appreciation, the Curia of Hungary has a very restrictive practice on quashing municipal financial decrees. It has been emphasized by the Curia of Hungary that the most serious infringements can result in the annulment of a decree. For example, if an annual budget has been passed by the representative body (the municipal council) in a closed session, it could be a reason for quashing the whole decree on the annual budget, because it breaches several important principles, especially the accountability of the annual budget and the open and democratic decision making of the municipality (Decision of the Curia of Hungary No. Köf.5.040/2013/4.). Similarly, if the municipality passes a financial decision-making structure which is infringing the national regulations, those sections of the annual local budget should be annulled (Decision of the Curia of Hungary No. Köf.5.067/2012/4.).

Thus, it is clear, that the judicial control of the municipal management has focused on the decision-making and procedural issues, according to the original concept on legal supervision of the LGA-H.

As I have indicated, under the LGA-H the government offices, as bodies responsible for legal supervision, have extended their powers to examine the organization, operation and decision-making procedures of municipalities. This includes the examination of the decision-making procedures of bodies and officials of local governments that, although not governed by the public law, may still be classified as private law entities.

The decision-making process is a crucial factor in several financial decisions, particularly those involving asset management. This is because compliance with the decision-making rules set out in legislation is essential for safeguarding assets and ensuring transparency in asset-related decisions. For this reason, both the government offices – and their predecessors – and the courts have placed significant emphasis on ensuring that procedural rules regarding asset management decisions are followed. In practice, courts have generally not considered breaches of the rules concerning the publicity of meetings in prior proceedings as sufficient grounds for declaring a decision unlawful. However, if other procedural rules governing the adoption of municipal decisions, – such as those relating to the giving of opinions or those established by the municipality itself – are violated, courts have taken these infringements into account (Hoffman, 2010). Moreover, the courts have applied existing case law to procedural errors in municipal cases by analogy, treating such procedural violations as grounds for deeming municipal decision-making unlawful. Thus, for example, in its judgment No 3.K.30.154/2008/8, the Heves County Court held that a tender decision, in which the county assembly declared a tender successful despite the tenderer not attaching one of the annexes required by the call for tenders, was unlawful. In the light of the above, the court annulled the County Assembly's decision to declare the tender for the conclusion of an asset management contract successful.

2.3 Between legal supervision and professional control: the amendment of the LGA-H in 2023

It should be emphasized that the Hungarian control on the activities of the municipalities is based on the European Charter of Local Self-Government, and the regulatory framework is heavily influenced by the German jurisprudence (Hoffman, 2015, 242–243). According to Article 8 Paragraph 2 of the European Charter of Local Self-Government, supervision of municipal activities is primarily based on the control of the legality. However, professional control of

the activities of municipal bodies is allowed as an exception by the Charter. In the Hungarian system, this professional control mainly focuses on municipal activities that have been delegated by central government bodies. Thus, the system has been based mainly on the German concept of *‘Rechtsaufsicht’* and *‘Fachaufsicht’* (Schmidt, 2022, 145–160). As mentioned above, the practice of the government offices focused on the legality, especially the procedural legality, as a result of the limitations of their legal supervisory powers.

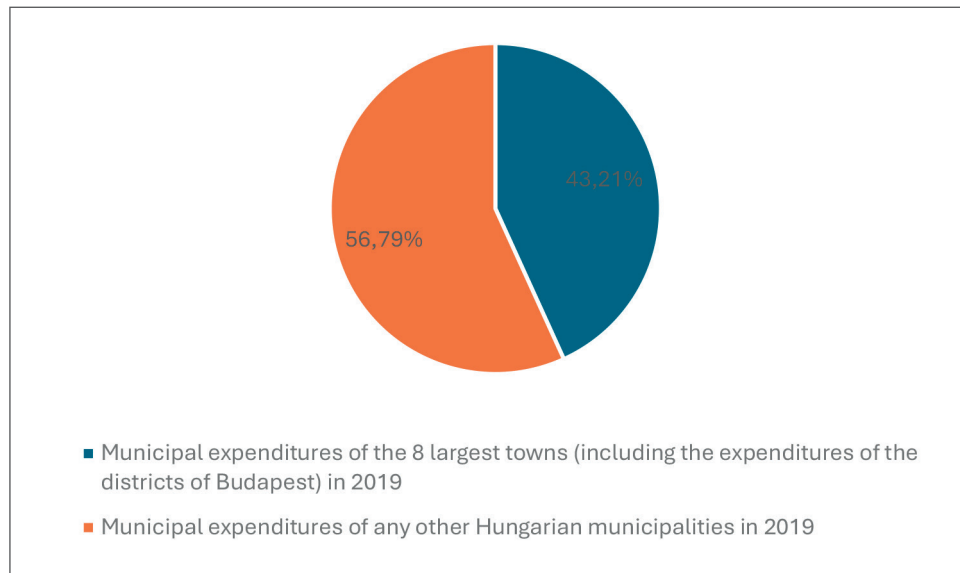
However, this traditional approach will change in 2024. The Act CXIV of 2023 amended the Section 111 of the LGA-H, and new regulations will be introduced. The new regulations, which will enter into force on the new municipal term (1st October 2024), focuses on the aid for the companies owned by the municipalities. Similarly, the government office can check the real cover of the municipal revenues, especially if the planned revenues are increased significantly (by 20% or by 1 billion HUF – around 2.5 million EUR) by the municipal budget. In such cases, the government offices have the right to check the incomes of the municipalities, including whether the planned municipal revenues have real and actual backing. The reasoning of the amendment was the effective enforcement of the regulation banning operational deficits, as defined by the LGA-H. Government offices also have the competencies to appoint an insolvency commissioner to a municipality if they find that it will face an operational deficit due to an unjustified municipal budget, or if the municipality has breached its duty of cooperation during the aforementioned control procedures. The insolvency commissioner is an actual financial guardian of the municipality, because without their consent financial commitment could not be made. Therefore, the financial autonomy of the municipality is effectively terminated by the appointment of this commissioner. The appointment of the commissioner is under judicial control, but regulation is now clear: in case of an unjustified or operational deficit budget, the municipal financial autonomy can be terminated by an agency of central government.

The legal nature of this regulation is questionable. However, the rules are defined by the LGA-H, the content of the regulation has no legal nature, instead it is based on economic control activities, as the cover of the municipal revenues should be checked, and therefore it is at least partially a professional control of the municipal activity (Schmidt, 2022, 159–160). Thus, it cannot be classified clearly as a legal institution of the legal supervision, but it could be interpreted as a partially professional supervision tool. As will be discussed in the next point, there is an opportunity for professional control of municipal finances, although these tasks have been performed by the State Audit Office of Hungary. This regulation was based on the principle of municipal autonomy, as the State Audit Office of Hungary belongs to the legislative power: it is a specialized control body of the Parliament, and is independent of the executive and central government. Thus, it can be interpreted as the control mechanism of the legislative power over the executive power, because in the Hungarian constitutional system, municipalities are considered as an autonomous subsystem of the executive power (Nagy & Hoffman, 2024, 542–548). The new regulation can be understood as a break with this previous, dogmatically clear regulatory model. An agency of the central government will receive a professional supervision task over the municipalities. Although, it is a restricted one, and seems to be exceptional, it has the above-mentioned dogmatical questions. During the last 13 years, the influence of the central government and its agencies on the municipal financial autonomy has been strengthened by the permanent transformation of regulation (Bencsik, 2017, 67). Consequently, this new regulation is another giant step towards the administrative guardianship of the Hungarian municipalities.

Another problematic issue with the regulation is that it seems to be a targeted one, as the regulation on municipal companies seems to be focusing on the budgetary management of the

larger municipalities, which are the major owners of the largest municipal companies (Horváth M. 2015, 24–26) and have the majority of tax revenues in Hungary (Hulkó & Fehér, 2021, 162–165) (See Figure 2.).

Figure 2. Share of the municipal expenditures of the largest Hungarian municipalities



Source: Eurostat, 2024 and the municipal decrees on final accounts

However, this selectivity can be justified, because the larger municipalities have a more significant impact on the debt of the public household. However the introduction could have other reasons, which are not based on the administrative and legal approach (Deets, 2023, 5–7).

3 External control of the State Audit Office of Hungary

According to the constitutional regulation, the State Audit Office of Hungary (hereinafter: SAO) is responsible for the audition of the financial management of the Hungarian local governments. This approach is based on the regulation of the Section 1(3) of Act LXVI of 2011 on the State Audit Office of Hungary (hereinafter: ASAO), “[t]he State Audit Office of Hungary shall have general competence to audit public funds and is responsible for the audit of the management of national and municipal property”, and that according to Section 132(1) Point j) of the LGA-H, the government office may initiate an investigation by the SAO into the management of the local government.

In this context, however, the Administrative Chamber of the Supreme Court – as the legal predecessor of the Curia – held in its opinion published in KGD 1996/1, that pursuant to Section 98(3) Point a) and Section 99(2) of the Act LXV of 1990 on the Local Self-Governments (hereinafter: LGA), which was in force until 2011/12, the bodies responsible for controlling the legality of municipal actions may bring an action against the unlawful municipal decisions. In other words, the predecessor to the Curia concluded that these provision did not preclude the administrative offices – predecessors of the current government offices – from reviewing the legality of such decision. As a result, under this regulatory framework, the control exercised by

government agencies was *purely* judicial in nature, meaning that they could only act in cases of legal violations. While the current practice of the Curia continues to permit legality reviews in such cases, the Curia emphasized in its landmark decision No. BH2023. 206 that individual property disputes – such as disputes arising from agreements on contributing to the operating costs of joint municipal offices – fall outside the scope of conflict-of-law reviews. Moreover, the SAO under Section 1(3) and Chapter III of the ASAO, has the authority to examine not only the legality but also the practicality and effectiveness of municipal management. As mentioned earlier, this approach is based on the German legal doctrine of both legal and professional supervision. Thus, while government agencies are limited to supervising legality, the audit powers of the SAO extend to professional aspects, functioning as a form of professional audit.

The detailed rules of the procedure of the SAO are laid down in the ASAO. Based on these rules, the SAO has a wide range of investigative powers, which are described in detail in the ASAO (Chapter III). In addition to the broad powers of investigation, the ASAO establishes an audit-based control system. This means that the SAO cannot take decisions, but can only initiate proceedings before the relevant authorities. Furthermore, there is no right of appeal against the audit reports of the SAO, but the audited body and its head have the right to submit comments. (Árva, 2013, 444–445).

4 External control of the central government and its agencies

4.1 Central government aid on municipal task performance

In the Hungarian financial system, the municipal revenues are partially derived from their own revenues, especially on local taxes and income from the asset management. However, the role of central budget support is also a significant element of system. As the Hungarian Constitutional Court has stated, this support must be considered an obligatory and inherent part of municipal funding (Kecső, 2016, 248–252). Therefore, the control of these funds can be interpreted as a crucial aspect of the external control of municipal finances.

In the Hungarian legal systems, this financial support is disbursed by the County and Capital Directorates of the Hungarian State Treasury (hereinafter: County Directorates). While several types of support are allocated based on individual (public authority) decision of the County Directorates, the majority are disbursed automatically, relying on data provided by the municipalities. Nevertheless, the Act CXCV of 2011 on the Public Finance (hereinafter: PFA) introduced special control procedures. These procedures are regarded as public authority inspections, and as such they are subject to the provisions of the Act CL of 2016 on the Code of General Administrative Procedures (hereinafter: CGAP). Furthermore, due to the need for rapid and definitive decisions regarding these funds, The PFA outlines specific regulations to expedite the process. Two major types of inspection and control procedures have been established by the PFA. First, Section 57 of the PFA defined an administrative control over data provided by the municipalities. During these procedures, the County Directorates review the data and thus the legality of the municipal aid. If they find the data and the paid support to be inadequate and inappropriate, they can amend it. Decision made by the County Directorate can be reviewed by courts responsible for the review of administrative decisions, with special rules in place for accelerating both administrative and judicial procedures. Another procedure involves the review of annual budgetary reports on central government support. Section 60 of the PFA introduced a special review procedure for this. Because of the importance the County

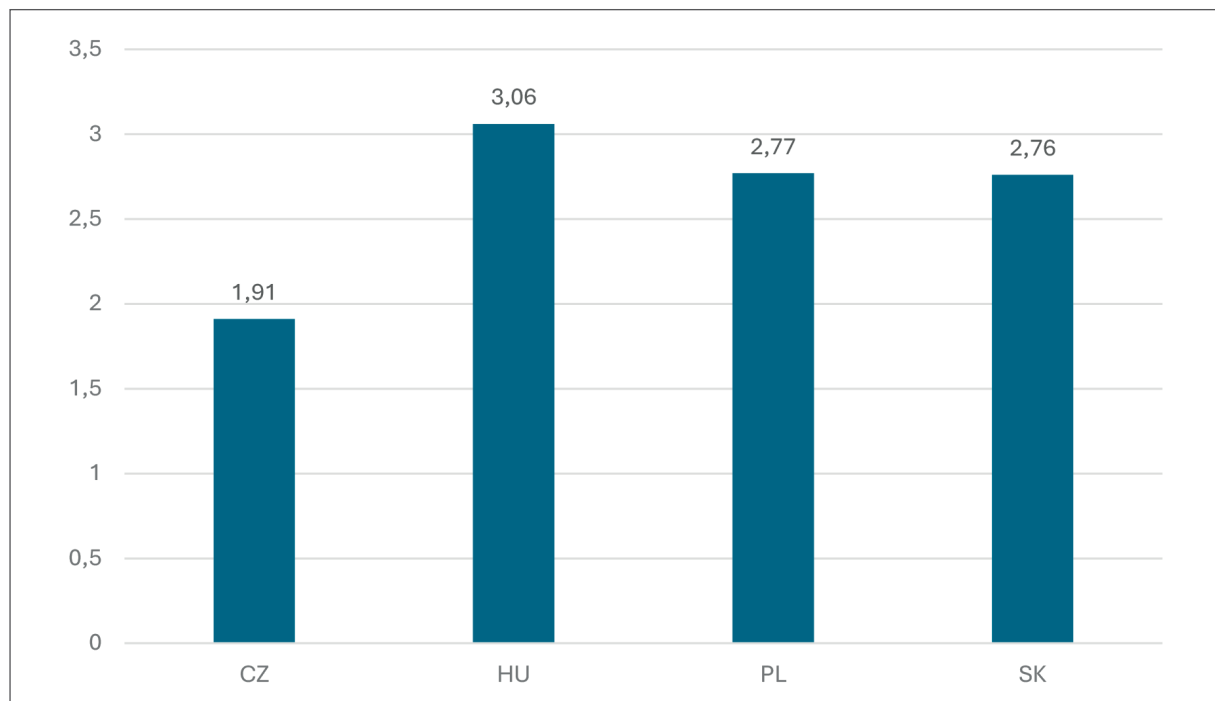
Directorate's decisions, a two-instance procedure has been introduced (Nagy & Hoffman, 2023, 523). It can be interpreted as a special one, because in Hungary administrative procedures are in principle single-instance procedures, with two-instance procedures being the exception. (Rozsnyai, 2021, 494–496).

Thus, there is a 'traditional' individual inspection procedure for municipal finances. The reasoning behind this regulation is that because of the autonomy of the municipalities, the central government support cannot be interpreted as a hierarchical activity. Instead, this relative independence has led to the implementation of an administrative procedure. (Nagy, 2017, 23–25).

4.2 External control on the use of EU funds

In Europe, the European Union has become an outstanding actor in the regional policies. As a result, even municipal activities are widely supported through projects co-funded by the EU. It should be emphasized that the European Structural and Investment Funds (ESIF) play a particularly significant role in Hungary. During the 2014–2020 EU budget cycle, the Visegrád countries received substantial EU funding. According to Eurostat data on national accounts, the ESIF funds received by these countries amounted to 1.91–3.06% of their GDPs (see Figure 3).

Figure 3. Yearly ESIF fundings from EU (2014-2020) in the share of the average of 2014-2020 GDP (current market prices) (%)



Source: Eurostat national accounts 2014–2020 and <https://cohesiondata.ec.europa.eu/countries>

Therefore, the control mechanism on the EU funds is also an important part of the Hungarian municipal funding. First of all, there is a European framework on the remedies on the decisions on funds. Based on the EU regulations, a complaint against a decision to grant aid, which may be derived from the right to complain, is available to the applicant or beneficiary. This allows

the applicant or the beneficiary to lodge a complaint with the Minister responsible for the use of EU funds (currently the Minister for Public Administration and Regional Development). The complaint can be interpreted as a remedy which protects the subjective rights of the applicant, thus, it is only indirectly part of the external control mechanism of the municipal finances. There is, however, a tool that can be seen as an external control: the irregularity procedures. Irregularity refers to an administrative type of sanction related to the use of EU funding (Nagy, 2012, 91–93), and this control is carried out by the managing authorities. If irregularities are detected, an *irregularity procedure* is initiated. In Hungary, given the structure of EU co-financed fund management, the County Directorates are primarily responsible for this control (Hoffman, 2023, 36–40).

The enforcement of the legal consequences specified in a decision of irregularity may be suspended by the Minister for Public Administration and Regional Development until the legal remedy procedure is concluded or terminated. No further appeal is permitted against the decision of the Minister responsible for the use of EU funds in such cases.

The above-mentioned instruments ensure that the bodies responsible for coordinating EU funds domestically can, on the one hand, exercise control over the decisions of municipalities co-financed by the EU, particularly those concerning asset management. On the other hand, they ensure that applicants and beneficiaries of funding receive adequate legal protection throughout the decision-making and control processes.

5 The public prosecutor as an external control body

Additionally, the public prosecutors also have a role – albeit a limited one – in the external control of the municipal finances. A specific case of indirect review of administrative decisions was the power of the public prosecutor, as laid down in Article 36/A of Decree-Law No. 11 of 1960 on the entry into force and enactment of the Hungarian Civil Code (hereinafter: EHCC), which was in force until 14 March 2014. The EHCC allowed the prosecutors to file a claim for the annulment of a contracts that were null and void in order to remedy the damage caused to the public interest. The examination of the above-mentioned question is of particular interest because, pursuant to Article 6:88(4) of Act V of 2013 on the Hungarian Civil Code, in force since 15 March 2014, “[i]n order to remedy the damage caused to the public interest and in the case of a usurious contract, the public prosecutor may bring an action for a declaration that the contract is null and void or for the application of the legal consequences of nullity”, i.e. the prosecutor retained this right to protect the public interest.

According to the Supreme Court’s decision published as EBH2004. 1043, the purpose of Article 36/A of the EHCC is to remedy the harm caused in the public interest, and therefore the prosecutor has the right to bring an action if the nullity of the contract causes actual damage to the interests of society as a whole or of a community. In its judgement, the Regional Court of Appeal of Pécs emphasized that “a void contract which has not yet entered into force can also be harmful to the public interest, and therefore the prosecutor’s right to bring an action for damages extends to the right to bring an action for the nullity of a contract that is subject to a suspensive condition and has not yet entered into force. The public trust in the lawful functioning of the bodies which exercise public authority and administer public property, as detailed in the applicant’s appeal, is in fact also infringed by the conclusion of such legal transactions.” Notwithstanding the above principle, the Court of First Instance dismissed the action brought by the Somogy County Prosecutor General’s Office in the specific case, since the parties had in the

meantime terminated the contract, so that the contract which had endangered public property had not been concluded. The above-mentioned case also illustrates the importance of the decision of the municipal representative bodies (assemblies) in relation to property contracts. Thus, it is recognized in court judgements that the public prosecutor has the competence and power to challenge these municipal activities. Even if the contracting parties have terminated their legal relationship before the end of the proceedings, the prosecutor could challenge the terminated contract. In light of these rules, the role of the prosecutor is exceptional and complementary, focusing on the legality of private law activities of local authorities, especially in the field of municipal asset management.

6 Closing remarks

The Hungarian municipal finances have a multi-layer external control system. However, the system followed the major continental pattern, especially the German and partially the French system, where the professional control of the municipal finances has been performed by the SAO and the County (Capital) Government Offices are responsible for the legal supervision, these strict boundaries are blurred. First of all, it should be emphasized that the Hungarian State Treasury became a major player in the control and inspection of the central support for the local governments and in the control of the application of EU co-financed funds. Similarly, the boundaries between professional and legal control are changing by the introduction of the budgetary control procedure managed by the County Government Offices, which will enter into force on 1st October 2024. Even the public prosecutors have complementary competences in the legal control of several private law contracts. Thus, the control system is changing, and it could be summarized, that the municipal autonomy is not strengthened by these transformations.

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