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Municipal Debt Management and Bankruptcy Intervention in Hungary 1995-2002: Policy Suggestions for Russian Federation Legislation

IGE CONSULTING LIMITED
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Introduction

Debt-induced temporary insolvency occurs in those systems of sub-national finance where the State allows borrowing to take place to fund municipal tasks that otherwise would not be performed by another level of government. Debt-induced insolvency is possible when a system of preventive mechanisms is either not in place, or is not monitored closely either by the State or by an independent systems of controls at the local government level. In states where infrastructure responsibilities are allocated to regional self-governments, or where specialized institutions provide financing, or where the State itself guarantees the debt of local government, municipal insolvency caused by debt payments is rare or non-existent.

Thus debt-induced insolvency can take place in those systems where local governments are small, their service areas are consequently small, and their fiscal and performance responsibilities high. This is the case in Hungary, where the smallest villages to the capital city have essentially the same responsibilities for providing environmental infrastructure. Since the grant system does not provide 100% coverage of capital costs, and the EU requires co-financing, the need to borrow is evident. In local government systems with more generous grant programs, larger service areas, and "higher level" responsibility for environmental infrastructure, sub-national borrowing is either not allowed, or does not need to take place.

The purpose of this study is **NOT** to address a problem prevalent in many Central European transition countries, namely, the "unpaid bills" or persistent operational deficits situation. Hungary and Bulgaria, in particular, have fiscal transfer systems that do not provide enough cash flow to the smallest municipalities who year after year face operating deficits in trying to provide mandatory services. Ideally, the local government law and constitution provide protection against such situations but in reality 1/3 of Hungary's 3,200 independent and equal municipalities face operational deficits on a yearly basis, caused entirely by an inadequately designed transfer system and an inability to take advantage of local tax sources. In the cases examined below, and the Debt Adjustment Law to be described, it is not the operational deficit that caused insolvency, rather the inability to make debt payments to lenders or to contractors on capital projects. Villages with operational deficits who cannot even perform their mandatory functions should, and do not, borrow. The persistent operational deficit problem is thus a separate issue and will only be dealt with in passing.

Municipal systems in the OECD states have instituted a variety of mechanisms to prohibit, control and prevent municipal defaults on both domestic and foreign debt. IMF conditionalities, and the need to apply consolidated public accounting in the EU member-nominees, have also convinced national regulators to treat municipal debt as a part of overall public debt, even in situations where the state explicitly does not guarantee sub-sovereign debt. Municipal insolvency caused by missed debt payments or excessive capital spending is not a problem in most OECD countries. To the best of our knowledge, only Hungary has prepared a municipal debt adjustment (bankruptcy) law that is carried out through the court system, since the fiscal transfer systems are still buoyant in other similar states like the Czech Republic and Poland. Or, conversely, municipalities are strictly regulated as in Austria, Germany, France and Britain, where regional governments assume roles that are taken by the lowest level in the three Central European states. Switzerland, Latvia and the German federal states have intervention mechanisms carried out by the executive branch, i.e. by a ministry or level of executive power one level above that of the affected municipality. These interventions can be initiated by the next level of government and in no way encourage a voluntary agreement of the creditors and debtor. Instead, these procedures focus on

creating emergency budgets and restoring the fiscal balance at the local level. The question of accumulated debt is not significant given heavy-handed regulation by the higher levels prior to borrowing in those countries. By Hungarian standards intervention by supervisory and supreme organs of the State, not by an independent judiciary, seem to violate the principles of self-government and subsidiarity. But Hungary is an extreme case. In other former socialist states like Serbia, Croatia and Slovenia, municipal borrowing is strictly regulated, and important projects funded by international lenders all require a sovereign guarantee. Furthermore, specialized lending institutions as they exist in France and Germany have unique advantages over banks, and end up lending funds with very low risk to only projects that are not only environmentally feasible but can also generate “fee based” cash flows. This is unfortunately not yet possible in most of the ex-socialist states where the cost of capital and environmental services is at world prices, but users cannot afford all costs, including capital financing, operational expenses and amortization.

Statement of Problem

Why this law in Hungary? Hungary’s Local Government Law, in effect since 1990, allocates great responsibilities to local governments regardless of size with respect to public services. These responsibilities are matched with the authorization to conduct for profit businesses, to own and manage commercial property, to own and manage portfolios of securities, and to borrow for capital investment projects, freely, without any need for approval from or registration with a higher level of government. Hence Hungarian local governments were free to borrow for capital investment purposes from domestic and foreign banks, and to issue bonds, at whatever terms and in currencies the two parties found acceptable. Given the freedom to operate businesses and to conduct for profit operations, the assumption was that profits from these operations could be used to finance debt to build infrastructure in the environmental, health and other infrastructure fields. With the advent of the 1990 Local Government Law, Hungary’s 3,100 plus local governments became independent entities subject only to the supervision of Parliament, with no intermediate layer of government or administration (counties, districts etc) to approve, intervene or monitor their activities. Given virtually unlimited freedom to manage assets and to conduct business, local government operational budgets and mandated activities could be threatened if the proper prudence and experience were absent. Any proposal to monitor or control local government activity by the central government was hence viewed with suspicion. For these reasons, as well as fiscal stress at the national level, several local governments borrowed too much for non-mandatory purposes that by the end of 1994 the central government had to consider methods to reign in irresponsible borrowing and activities at the local level.

Situation in early 1995. Besides budgeting for the 25 basic, and several hundred subsidiary tasks that local governments must perform by law, municipalities began to borrow funds for profit-seeking activities, endangering mandatory tasks and solvency in many cases. Borrowing in some cases exceeded the total budgets of smaller municipalities, and the economic viability of non-mandatory infrastructure was also questionable. Given the unfettered freedom of local governments to manage their assets and budgets (within the constraints of shared taxes, transfer payments and local tax capacity) the central government faced the possibility of having hundreds of cases of contingent liabilities and the risk of having to directly carry out mandatory local tasks if local governments failed.

Municipal Borrowing Restrictions in Place 1990-March, 1995

-No absolute nor formulaic limit on local government borrowing within one budget year or on a multi-year basis
-Central government shared revenue, transfer payments, normative grants, infrastructure grants cannot be used for loan repayment (implicitly the central government would not finance a local government's debt)
-Local government may borrow for whatever purpose at whatever terms the city council approved in a local resolution
-Local Government Act (1990) states that the central government will not assume responsibility for local debt

By 1995, Hungary's trade, budget and current accounts deficit placed such pressure on the government, that in March it enacted a serious of fiscal restrictions known in the popular parlance as the "Bokros package." Combining a one-off devaluation with a commitment to predetermined crawling peg devaluation, and a host of real cutbacks in spending and other restrictions, the situation of indebted local governments became more serious. By the end of 1995, several local governments lobbied for, and received one-time grants from the central government's general reserves to resolve insolvency caused by mismanagement and excessive debt.[1] The availability and disbursement of funds to five municipalities in distress due to irresponsible and excessive borrowing for non-mandatory purposes threatened to establish a bad precedent, and immeasurable contingent liabilities for the central government. The eventual repayment of these temporary bridge grants to the Central Government was to be addressed in a future debt adjustment law where the central government would assume the role of a creditor. Given that the International Monetary Fund and other international organizations wished to make the entire state budget as transparent and unequivocal as possible, negating contingent or implicit state liabilities became a policy goal. In this climate, the issue of municipal insolvency or perhaps bankruptcy became unavoidable within the policy-making ministries, i.e. Interior and Finance.

The *restrictions cited above were not adequate to withstand the political pressure* on the government to assist potentially insolvent local governments who through poor investment decisions were endangering the provision of mandatory public services. Though municipalities receiving these emergency funds were restricted to performing a short list of mandatory tasks[2], the precedent of central funds being available after all posed a real danger for the state budget and gave no incentive to the local level to make more reasonable investment decisions. The availability of these "soft funds" also reduced some of the risks lenders faced and encouraged them to continue to lobby for such bailouts in the future. In 1995, municipalities began to borrow long term to finance short term operating deficits, and other capital borrowing was largely to finance investments in non-mandatory infrastructure, i.e. in activities that were voluntarily assumed, not mandated by the state. Some localities began to make late payments, i.e. in technical terms defaulted, and both creditors and debtors began to lobby for wide-scale bailouts.[3] The essential question of maintaining and protecting public services while securing the rights of creditors went unanswered. Hungary's corporate bankruptcy law, in force since the late 1980s, was not entirely applicable to borrowers who could not be liquidated without the state taking over their duties. Furthermore, each citizen has a constitutional right to representation at the local level, so local government cannot be liquidated like a commercial code enterprise. Without the political will or ability to tightly control local

[1] Government Decision 1092/1995 (IX.28) transferred funds to cover a portion of the expenses of municipalities in distress due to their own fault. These communities included: Bakonszeg, Nágocs, Bátorliget, Szerencs and Páty, all of which (except Szerencs) eventually underwent a debt adjustment process.

[2] These eight tasks applied to the 5 communities receiving emergency funds: primary schools, educational facilities, and where appropriate, facilities for ethnic minorities; social welfare; education for children undergoing health treatment, facilities for physically and mentally handicapped children; public lighting; public cemeteries; operating the mayor's office, the town hall, and conducting local and state administration tasks as called for by the law; where appropriate, operating the local fire department and ambulance service. (annex to Government Decision 1092/1995 (IX. 28). Note that drinking water and sanitation service were exempted temporarily.

[3] The authors were members of an informal working group on municipal finance where representatives of several commercial banks explicitly stated that these loans were in essence for the public benefit, and hence deserved bailouts by the state. Representatives of the ministries responded that loans entail risk since Hungary was already a market economy.

government borrowing and business practices by constitutional and legislative fiat, the Hungarian government decided to propose a municipal debt adjustment law that would be invoked if prudence and other preemptive measures failed.

The Municipal Debt Adjustment Law was approved by the Hungarian Parliament on March 26, 1996, by an 84% to 16% margin.[4] The law went into effect in June 1996. Since then, only 18 municipalities have filed for debt adjustment (two of them twice), and the last debt adjustment process was initiated in 2001. Contrary to expectations among experts and in the press during the period of fiscal restrictions enacted in 1995 and 1996, only a handful of municipalities filed for protection, and creditors initiated none of the proceedings. The law was able to preempt additional filings as both creditors and debtors were encouraged to seek redress outside of the court system, and to take other steps to ensure solvency and operational efficiency. In essence the law is successful since within the overall legal framework and capital market, municipalities stopped borrowing in excess of their capacity to service debt.[5]

The initiation of the debt adjustment act in 1995 and its coming into force in June, 1996, must be viewed in the context of declining real resource transfers to the local government sector, the privatization of the economy, and the stated goal of successive governments to rationalize local government services without changes in the constitutional framework. Instead of revamping task allocation due to political obstacles, Hungary's approach has been to regulate where possible and to allow market actors to assume risk.

The Essence of Debt Controls

Methods used in Western Europe to deal with municipalities with financial difficulties: debt payment problems and operational deficits[6]

Persistent operational deficits, "unpaid bills" and accumulated accounts payable problems are observable in both the mature market economies of the OECD countries, as well in many of transition economies. National governments have devised many schemes to overcome temporary deficits caused by natural disasters, changes in economic policies and other "one time" events. What is less common is that operational deficits persist year after year on the local level with unconditional deficit grants made by the central government year after year. Persistent operational deficits and unpaid bills are symptomatic of fiscal imbalance in terms of both revenue and task allocation.

What is common to all countries in which the local governments sometimes face operational deficits is that national government schemes distinguish between deficits caused by excessive borrowing and between the inability to fund current operations. A less clear situation exists when accumulated unpaid bills are converted to debt through contractual mechanisms, or by court decisions. There is a common dilemma of financial assistance by the State to local authorities: it is individually rational for a single local authority to maximize the assistance it receives, while

[4] Cited as Law XXV of 1996. The official Hungarian version was published in the Magyar Közlöny (number 28, April 12, 1996)

[5] See the following for details on fiscal restrictions, grant flows and other framework legislation, see World Bank Discussion Paper No. 417, "Hungary: Modernizing the Subnational Government System," May, 2000, Mihaly Kopanyi et al editors.

[6] Sources of information used:

"The risks arising from Local Authorities Financial Obligations," Draft Report by the Steering Committee on Local and Regional Democracy, no. 76, Council of Europe Publishing, August, 2002;

"Recovery of Local and Regional Authorities in Financial Difficulties," Local and regional authorities in Europe, no. 77, Council of Europe Publishing, August, 2002;

Bernard Dafflon, editor, Local Public Finance in Europe: Balancing the Budget and Controlling Debt, Cheltenham, UK: Edward Elgar Publishing, 2002.

collectively too much assistance would undermine local autonomy. From the State or higher level of government perspective, the problem is to distinguish between legitimate and illegitimate cases.

The need to distinguish between "innocent" financial stress caused by prudent decisions in an uncertain environment, and "bad" decisions concerning current spending or debt is critical in developing both the deficits grants policy of Russia ***and*** *in devising a scheme to deal with municipalities in fiscal stress caused by both "legitimate" and "illegitimate" debt. In both cases, the State and municipalities have to take responsibility for the resources and decisions that they do indeed control.*

Concerning Russia's significant problem with persistent unpaid bills or accumulated accounts payable that through certain mechanisms is, or will be converted to debt, we suggest that the Council of Europe's recommendations be taken seriously:

COE Recommendations (No. 96-3) "on local authorities budgetary deficits and excessive indebtedness"

If discretionary power of the central or regional government is high, then it may have credibility problems if it makes arbitrary decisions.

-need clear and widely accepted definition of what constitutes financial difficulty
-need to define legitimate reasons for financial assistance by law
-other means should be put in place before financial assistance is attempted (recovery plans)
-central assistance should be matched by significant financial effort on the local level
-central government should not guarantee local loans (except certain developmental loans)
-the consequences of "illegitimate" financial difficulties among local authorities should be made clear, for example, in a municipal bankruptcy code
-strong local tax and revenue systems are an alternative to central assistance
-balanced budget requirements tend to work well
-central government should not explicitly nor implicitly guarantee loans of local authorities

Examples of extraordinary assistance granted in surveyed countries:

Belgium: Belgium is a federal state with a balanced budget requirement for local authorities. One of the regions created a fund to provide loans to municipalities that could not balance their budgets. These loans were granted only after approval of a recovery plan, and a regional inspector was sent to the municipality to monitor its financial performance.

Bulgaria: Deficit grants require significant restructuring of local services, privatization, and the increase of local taxes and fees.

France: France has a very strict system of deficit grants that are only provided in the case of unfunded or under funded mandates, or in other situations that are not the fault of the local authority. These grants cannot be used to fund capital investment programs, and are not considered to be deficit subsidies rather a source of funds to start a recovery plan. In 2000, only 5 French local authorities received such assistance. (natural disasters are an exception).

Germany: Each state has a controlling authority that approves annual budgets for municipalities. Deficits are only allowed in extraordinary cases, with grants from the federal states repayable within two years.

Poland: Grants exist to recover from severe flood damage with strict criteria applied to documenting physical destruction.

Debt control mechanisms in effect in Europe:

Most OECD and Council of Europe (COE) member states allow local borrowing for capital investment purposes but require liquidity loans to be paid back within the year. Only a few countries use stock-based municipal borrowing limits, even when the total stock of municipal debt is counted against the Maastricht criteria. Examples of these restrictions include:

Restrictions on volume of borrowing and debt service ratios:

UK: Credit approval ceilings are given each year by the government, the government defines a maximum borrowing amount. All sources of repayment are directly or indirectly controlled by the central government. Even the level of local capital spending is "suggested" by the appropriate ministry.

Denmark: No municipal borrowing is allowed at all with a few exceptions. Municipalities must finance all of their expenses, including capital expenses, through current revenues. Budgets must be balanced. Automatic permission is granted for fee-based borrowing for public utilities and other priority investments in social welfare facilities, energy conservation etc. In certain economic situations, the Interior Ministry gives permission for discretionary borrowing to stimulate local economies, sets borrowing limits for real estate and fee-supported infrastructure borrowing on an annual basis.

Germany: Each Bundesland has its own volume of borrowing limits and explicit approval is needed from the Land. Most commonly used are the projected operational surpluses that are to exceed projected capital expenses, including a mandatory "transfer" from the current account to the capital account.

Poland and Czech Republic: 15% of current revenues may be used to fund debt service.

Croatia: 20% of own resources may be used for debt service and the MOF needs to approve each loan.

Ireland: Each municipal borrowing must be approved by the Minister who determines whether they need the loan and whether they can pay it back

Austria: Each Land has a different set of criteria for debt needing higher-level approval, and differing absolute or relative limits

Spain: The current account surplus may be used to finance the capital account with the Finance Ministry's approval. Total municipal debt may not exceed 110% of annual revenues.

Norway: Borrowing is allowed for investment only. The current budget may have amortization expenses equal to the annual cost of interest and capital payments.

France: Operational surpluses and savings from prior years must exceed the annual burden of capital repayment. No other restrictions apply.

Italy: Municipalities must have balanced capital and current accounts. Interest payments may not exceed 25% of current revenues. Loans must have terms of at least 10 years. The State Treasury sets the maximum legal interest rate.

Restrictions on municipal guarantees:

Guarantees to third parties are allowed and not counted against debt limits: UK, Sweden, Czech Republic, and Finland.

Municipal guarantees are restricted to public purpose organizations, non-profit organizations, communal enterprises, or enterprises and institutions with municipal majority ownership: Belgium, Norway, Denmark, and Croatia.

Guarantees to third parties are counted as municipal debt and included in the limits on debt volumes: Croatia, Denmark, France, and Austria.

Restrictions on collateral:

UK: no municipal asset may be used to guarantee debt, only cash flow.

Property may be used to guarantee municipal loans: Ireland, Norway, Finland, and Denmark. (By Bundesland permission only in Germany, assets may only be purchased for public purposes, and sold only if they do not serve a public purpose).

Public sector assets may not be used as collateral: Belgium, France, Italy, Spain, and Portugal.

No restrictions on the use of municipal assets as collateral: Czech Republic, Poland, and Croatia.

"Bankruptcy" or debt adjustment elsewhere

Of 27 COE member states, only 5 have some type of procedure similar to bankruptcy adjustment. Only two, Hungary and Latvia, have actual legislation on file. In 22 COE members it is legally impossible to have a bankruptcy on the local level. There are functional equivalents to bankruptcy procedures in Switzerland, some German states and UK, i.e. administrators or trustees may be appointed to oversee reorganization and repayment plan (do not provide "protection" from all creditors). In other transition countries such as Poland and Czech Republic, local governments are able to run budget surpluses to fund capital investment and borrowing, so far. The Czech and Polish governments have ignored the possibility of debt adjustment, and conflicts with banks and bondholders have been handled based on loan agreements, contracts and civil law. The Government of Estonia is considering a debt adjustment procedure of some type based upon the Hungarian model.

Controls in Hungary

In contrast to the West European models outlined above, Hungary's debt adjustment law operates in the context of several important rules and laws that regulate the economic and budgetary functions of local self-government. These controls emerged over the 1990-2002 period, but most of them are found in basic laws and were in effect in some form throughout this period.

The Law on Local Self-Government designates the local assembly as being responsible for the stability of the local budget and economic activities. The mayor is responsible for the legality of municipal decisions. But neither the local assembly nor the mayor can in effect be held responsible personally or collectively for bad decisions. There are neither personal nor collective sanctions for irresponsible management. The local assembly may set a borrowing policy that is in compliance with the law (detailed elsewhere). The assembly can authorize the finance committee and the mayor to conduct negotiations with lenders on behalf of the municipality without any requirement for public hearings, approval or information on the purpose of the borrowing and its details. Often such information is labeled as constituting business secrets. There is also no formal, operative or logical link between assumed debt and the need to raise taxes and local fees (that are legally available for debt service, most shared revenues and transfer payments are off-limits). The law defines "debt" as borrowing or given guarantees. But there were several cases where debts were

owed to vendors, and these were not formally loans. Vendors often disguise their deferred payment plans that are really loans. The bookkeeping and accounting system cannot handle hidden debt like this, nor can it demonstrate contingent liabilities, nor place a probable value on balloon debt payments in current money terms (net present value). Municipalities went around "debt" payment limits by issuing purchase orders to vendors, who expected deferred payment, and hid interest costs in the price of the goods and services to be sold.

Certain types of municipal property in Hungary are not available as collateral, and cannot be sold by municipalities. These include all properties used to deliver mandatory services, for example schools, historical monuments, parks, and streets. This "core property," normative state grants, the personal income tax and other shared taxes are not available for debt payment or guarantees. Before 1995, banks simply seized money transfers from the Treasury until the Finance Ministry issued decrees that banned the seizing of municipal funds from a variety sources. These seizures often endangered mandatory functions. Restricting the types of assets and revenues that are available for debt service is a very effective form of debt control, provided that the bookkeeping and accounting system can segregate funds by source, and up to date information is always available. (The debt service limit formula is detailed elsewhere in this study). Internal controlling is required by law where the local government controls the financial activities of its institutions and agencies. The State Audit Office oversees the use of public funds, but does very few full audits per year and is not enough to truly prevent fraud, waste and abuse. External audits of municipal financial statements are required above a certain budgetary size, or if a municipality engages in borrowing. These "audits" are actually compliance audits and seem to be only a formal review of formats and do not investigate the efficiency of the municipalities' use of funds.

Maintaining essential public services, protecting debtors, creditors, and the state budget, while making it entirely clear what would happen in the case of municipal default, formed the main justification for creating a debt adjustment law. Instead of tight regulations in use throughout Europe (and North America), the Hungarian government decided that both lenders and borrowers should be held responsible for their decisions, while the government put in place mechanisms for ultimately protecting mandatory services.

Stress on municipal budgets. In 1994, nearly 5 years into the post-Communist local government system, several factors placed severe stress on operating budgets of municipalities of all sizes. While local governments depended largely on transfer payments and shared taxes for their operations, each has significant taxing powers and the ability to earn portfolio income on assets, both of which qualify as own-source revenue. These own source revenues are used to cover the gap between the actual cost of operating mandatory services and the normative and other transfers provided by the central government. Borrowing or capital projects of any type are financed in part from own revenues, either taxes or from the management of real and financial portfolios. Local taxes of all types became more widespread in the 1990s since several central government assistance grants to distressed local governments applied a standard that certain funds needed to be raised via local taxes. Besides local taxes, significant income could be generated from the multitude of real estate, shares, treasury bills, and other securities transferred to the local government sector in the early 1990s. These assets were sold off during the early 1990s to finance operational deficits and to fund investment projects, not all of which supported mandatory public services. The assets and taxing powers of Hungarian local governments vary widely, but despite this variation many of the poorest communities assumed voluntary tasks and engaged in business activities that were far in excess of their taxing and fiscal capacities (and the needs of the population). Larger villages, and smaller cities, that are those between 5,000 and 20,000 in population, were the most endangered through excess borrowing and the withering of assets for consumption and non-mandatory investments. These same communities were less likely to form notary districts and associations

with neighboring villages to share the burden of providing services, since each insisted on an independent administrative staff and set of institutions, despite an inability to finance them. Banks in the 1990-1995 period considered local governments to be good borrowers since through control of their current accounts they could debit interest and principal payments, and the implicit role of the state further reduced their perceived risk. (Despite the low risk, some banks charged interest rate premiums of several hundred basis points over the sovereign). In sum, borrowing in excess of financial capacity, declining free cash flow, reduced assets, excessive voluntary services etc. led to the use of borrowing to fund short-term operational deficits that were rolled over (illegally) from one budget to the next by the mid 1990s.

Despite the existence of restrictions on borrowing and other preventive rules, municipalities in the early 1990s were able to borrowing to fund operational deficits, essentially an illegal act. The also sold their real estate and financial assets at low prices to pay debts or to finance operations. Accounting was not always accurate and realistic. Furthermore, municipalities misunderstood the risk of providing guarantees to for-profit businesses or to their own institutions. The finance committees of local assemblies did not take their work too seriously, and ignored the repeated warnings of the internal controllers and independent auditors. In short, there is no sanction if an assembly ignores the reports of auditors and controllers!

> In mid 1994 local governments had long-term debts of 53 billion HUF, while in 1996 short-term operational loans amounted to 42 billion forints, with loans for investment projects amounting to only 14 billion forints. While asset sales were used to pay interest and principal, and competing banks offered to refinance these loans, this trend was clearly not viable since long-term funds should not be used for funding operational deficits. Cash management was not an issue as long as debt payments were being made. Loans were also used as matching grants for obtaining central government funds for infrastructure such as water, wastewater and solid waste facilities. Loans qualified as "own source" contributions; hence municipalities were reluctant to cease borrowing since a multitude of free funds would be lost. Instead, assets that were negotiable and had a market price were sold off, including not only real estate but also portfolios of stocks, bonds and ownership shares. These sales were not always at optimal prices, thus localities made balance sheet losses while trying to pay back loans that were largely used to fund operational deficits.

Purposes of the Debt Adjustment Law

In the course of the debate surrounding the creation of the debt adjustment law, policymakers in the Finance and Interior Ministries, as well as some experts appointed to perfect the proposal (including practicing commercial bankruptcy trustees and judges, as well as volunteer foreign experts in municipal finance) concluded that if the State is not willing to administratively or legislatively control the risks of municipal borrowing, then an unambiguous law would need to serve the following purposes: a) prevent and preempt municipal defaults with respect to any lender, bondholder or vendor; b) provide clear administrative and legal procedure for affected creditors to follow; c) provide reorganization and workout procedures; d) make certain that the national government will not guarantee local borrowings as sovereign guarantees need an act of parliament and specific authorization in the annual budget; d) maintain public services; e) allow for expansion of borrowing as local taxes and revenues increase. Municipal debt adjustment, combined with preemptive reorganization, budget cutbacks and some emergency funding from the state, were seen as methods of discouraging irresponsible borrowing.

Risks associated with municipal defaults and financial stress

Borrower/Local Government
- Inability to make timely payment, penalties and sanctions imposed
- Strain on operational budget
- Halted or partially finished investment projects don't pay returns
- Assets and collateral lost
- Disruption of essential public services
- Risk of losing next election
- Sanctions from national government (eligibility for other grants, criminal prosecution etc)
- Repayment of other debts endangered
- Blacklisting by financial institutions
- Ultimate dissolution of local government, forced merger and state supervision

National Government
- Guarantees called, stress on national budget
- International obligations on gross state debt (Maastricht, IMF etc.)
- Bad precedents set in case of repeated bailouts
- Lose value of grants and investments already made if projects are halted midstream
- Service provision obligation may revert to national level (safe drinking water)
- "bad publicity" for entire local government system
- need for policy reform and incipient debate

Lender, vendor, bondholder
- balance sheet losses (value of loans made or bonds held, or accounts receivable written off)
- provisioning and regulatory problems
- cost of managing bad assets
- negative publicity for banks "pressuring" municipalities
- risk of losing entire asset/loan in a workout agreement or liquidation procedure
- lost future business with municipal sector
- cost of maneuvering to shift cost to taxpayer (bank bailouts, selling off loans)

A debt adjustment procedure and restrictions on borrowing were also justified by the risks cited above.

Description of Debt Adjustment Process (outline)[7]

The Hungarian debt adjustment procedure consists of 7 major phases that are as follows: (1) Initiation of debt adjustment procedure, (2) Court review of the petition, (3) Formulating a debt adjustment committee, (4) Adoption of budget developed for financial crises, (5) Formulating the financial reorganization plan and the proposed agreement (6) Debt agreement negotiations, (7) Asset liquidation if no agreement reached.

Summary of the Debt Adjustment Process. If a municipality does not pay an acknowledged obligation to a creditor, vendor or to another party, appearing either as an invoice or a court order to pay, within 60 days of the due date, the Mayor is obligated to notify the city council and to petition the court within 8 days. The court has 15 days to examine the petition and to ask for more information and corrections. The Mayor has 8 days to respond to the court's requests. If the court agrees that the municipality is truly in a crisis situation and cannot meet its obligations, it declares the debt adjustment process's initiation, and host of obligations are then imposed upon the mayor, the city council, and a separate set of actions are required of the creditors. Once the debt adjustment process begins, no creditors may file suit, and all claims are to be reported to the bankruptcy trustee.

[7] Please see translation of the Ministers' expose (appendix).

A creditor may also petition the court if a municipality is in default, i.e. more than 60 days late in paying an obligation.[8] The court, at its option, may reject a debt adjustment petition if it determines that the obligation can easily be met with existing assets and cash flow, thus "false bankruptcies" can be prevented at least according to the intent of the law. The Mayor faces strict financial sanctions as a private person if a debt adjustment process is not initiated due to delays on his part.

Initiation of debt adjustment procedure

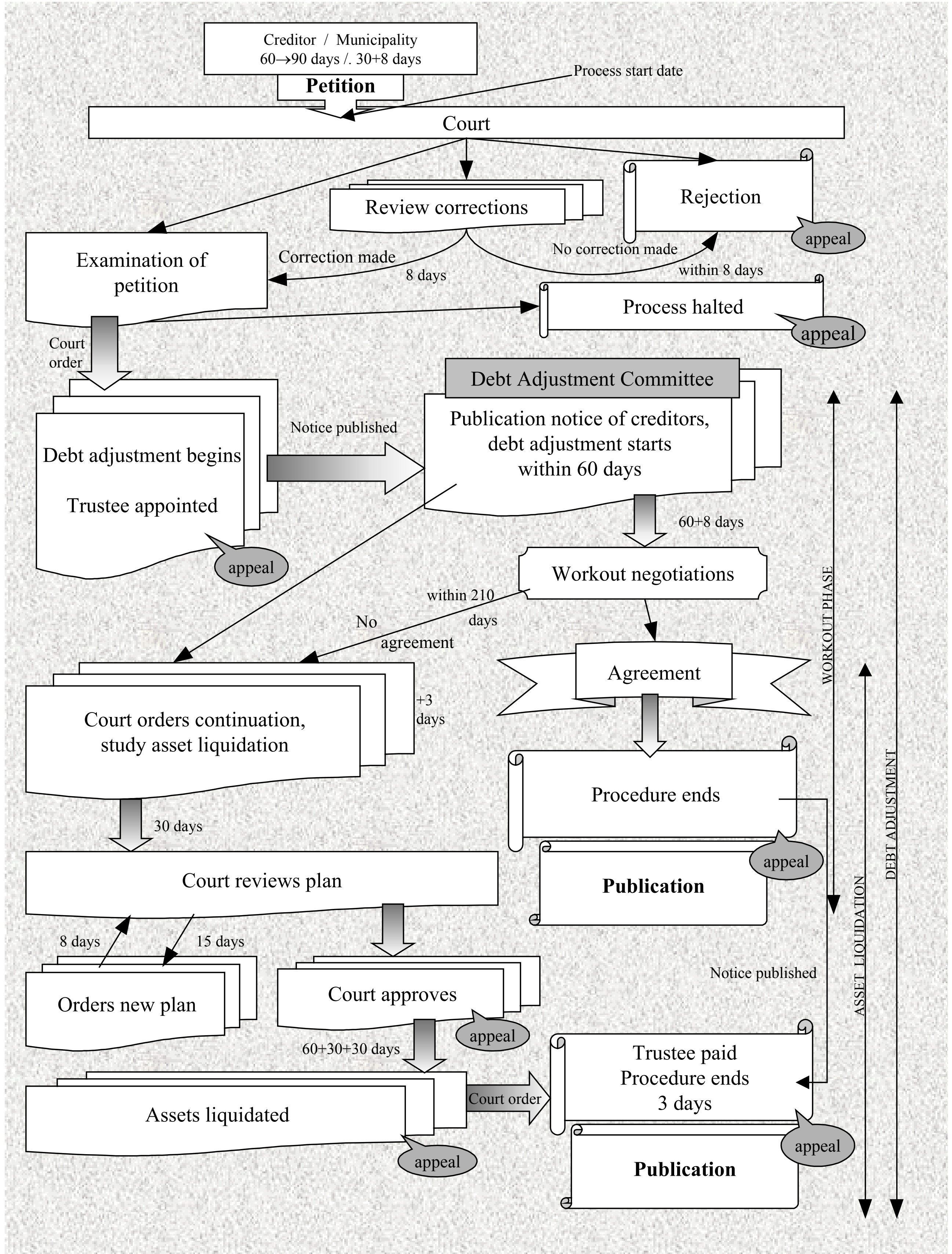
If a municipality does not pay an acknowledged obligation to a creditor, vendor or to another party, appearing either as an invoice or a court order to pay, within 60 days of the due date, the Mayor is obligated to notify the city council. The representative body shall pass a resolution to meet the payment obligations or authorizes the mayor to initiate the debt settlement procedure immediately.

If the delay on obligations is over 90 days the mayor of the local government has to make a petition to court and start the procedure of debt adjustment regardless of the approval of the city council or any committee.

The creditor himself is also entitled to initiate the process but if the creditor initiates the commencement of the debt settlement procedure, their application must indicate the title and expiration date (due date) of the local government debt. The documents verifying the claim shall be enclosed in the application.

The court shall inform the local government about the submission of the application without any delay by sending them a copy of the application. The mayor must declare to the court within 15 days of receiving the notification whether the local government acknowledges the situation described in the application. In the absence of such a declaration it shall be assumed that the existence of the debt is a fact.

[8] See the complete English translation of the Debt Adjustment Law for a more detailed description of the procedure.


Creditor / Municipality
60→90 days /. 30+8 days
Petition
Process start date
Court
Review corrections
Rejection
appeal
Examination of petition
Correction made
8 days
No correction made
within 8 days
Process halted
appeal
Court order
Debt Adjustment Committee
Publication notice of creditors, debt adjustment starts within 60 days
Notice published
Debt adjustment begins
Trustee appointed
appeal
60+8 days
Workout negotiations
within 210 days
No agreement
Agreement
WORKOUT PHASE
DEBT ADJUSTMENT
Court orders continuation, study asset liquidation
+3 days
Procedure ends
30 days
Court reviews plan
appeal
Publication
8 days
15 days
ASSET LIQUIDATION
Orders new plan
Court approves
appeal
Notice published
60+30+30 days
Trustee paid
Procedure ends
3 days
Assets liquidated
Court order
appeal
appeal
Publication

It is important to stress that the creditor can independently decide on the initiation of the process and put its claim into process. However if he fails to submit those financial claims in due time outlined in the act, he is entitled to submit them only two years later after the whole procedure is finished.

Court review of the petition

If the court finds that the conditions of insolvency are met –any financial obligation that is in delay over 60 days or more - it ordains by virtue of a decree the commencement of the debt settlement procedure, or else shall terminate the debt settlement procedure. The declaration by the court that the debt adjustment process has started means that a legal notice is posted in the Enterprise Registry, an official document of the court, and public notices are placed in the appropriate newspapers. The court simultaneously appoints a trustee, and the municipality has 8 days from inception to form a crisis committee. The municipality then has 30 days to prepare a bare bones emergency budget that services only mandatory tasks allowed by the law in case of financial stress. (see box). These mandatory services, defined in sectoral laws as well, do not necessarily have to be performed by the municipality. The municipality is free to outsource these services to neighboring towns, to private firms, to NGOs or to an association of municipalities. The services regardless of how they are delivered have to be available to residents in a community undergoing debt adjustment.

Mandatory Services During Debt Adjustment

The Annex to Law XXV (1996) on Municipal Debt Adjustment mandates that a local government only perform the following tasks upon initiation of debt adjustment, essentially banning optional, non-mandatory, and other services voluntarily assumed by a municipality. These tasks are defined in various laws and decrees and actually cover hundreds of sub-tasks, but only a *fraction* of those required of local governments not in financial distress.

1. Maintaining cemeteries.
2. Providing for chimney sweeping
3. Providing and maintaining septage dumping stations
4. Street cleaning, solid waste removal
5. Protection of natural environment, habitats
6. Provision of drinking water, sewage collection and disposal, flood and groundwater control, run-off control
7. Local road maintenance, snow removal
8. Public lighting
9. Removal of animal carcasses, animal control, removal of diseased animals
10. Protection of fauna and flora
11. Rodent control
12. Fire protection and rescue
13. Provision of kindergartens, elementary schools, and educational facilities for national and ethnic minorities
14. Facilities for handicapped children
15. Dormitories for non-resident students, secondary and vocational education, adult education, basic artistic training, speech therapy etc.
16. Special educational services for hospitalized children, and handicapped children who cannot be schooled together with other students etc.
17. Services to evaluate the needs for special education
18. Child and family welfare
19. Basic health care (medical clinic, dental, nursing)
20. Outpatient care
21. Social services, day homes etc.
22. Rehabilitation
23. Access to special rehabilitation services
24. Unemployment compensation, social assistance, public aid etc.
25. Certain national defense and mobilization tasks
26. Civil defense
27. Operating the mayor's office and the city council (except providing honoraria to city council members)
28. "Workfare" for long term unemployed

The municipality stops payments on all debts, and finances only the mandatory functions listed above. The Trustee examines the legality and legitimacy of all decisions leading to the financial crisis, and makes recommendations to the court for criminal and civil prosecution, if needed. The trustee must co-sign all payments made by the municipality during this period, and all creditors are notified to file their claims.

The court shall promulgate its non-appealable decree on the commencement of the debt settlement in the Enterprise Gazette without any delay as a first priority

In its decree ordaining the commencement of the debt settlement procedure the court shall also appoint the Receiver (also called trustee).

The receiver

a.) reviews the financial management of the local government and reveals the reasons underlying the commencement of the debt settlement procedure;

b.) may inspect all documents pertaining to the assets of the local government;

c.) attends public and closed sessions of the local government and the committees - which have bearing on local government assets - in the capacity of advisor;

d.) may make motions regarding debt settlement, which are to be deliberated by the representative body or the committee as a first priority on the agenda;

e.) initiates the collection of the local government's matured claims;

f.) informs the creditors, at their request, about the local government assets and the debt settlement procedure;

g.) informs the head of the county/Budapest public administration office if the representative body does not meet its obligations stipulated by this Act;

h.) within 90 days of the commencement date of the debt settlement, the receiver may, by filing a claim on behalf of the local government at the court exercising general jurisdiction, contest contracts and legal statements made by the local government or its budgetary organ within 1 year before the commencement date of the debt settlement if the subject of the contract or the statement is a gratuitous alienation of local government assets, or a gratuitous compromise encumbering local government assets, or a transaction which constitutes an onerous contract.

From the date of the commencement of the debt settlement onwards the local government may not:

a.) make decisions through which it incurs additional pecuniary liabilities,

b.) found businesses,

c.) acquire ownership in businesses in commutative contracts

d.) fulfill its financial obligations assumed earlier,

The mayor shall hand over to the receiver within 30 days of the date of the commencement of the debt settlement:

a.) his/her report on financing and the locally adopted ways of implementing mandatory or optionally assumed local government duties and excising mandatory or optionally assumed local government powers;

b.) the inventory of and annual report on local government assets prepared as of one day before the date of the commencement of the debt settlement which includes, with adequate justification, the following categories separately: registered assets, assets necessary for performing and exercising duties and powers required by law, and assets which can be used to meet creditors' claims,

c.) the draft crisis budget by-law,

d.) a detailed summary of proceedings in progress at court and state authorities and a detailed summary of execution proceedings in progress,

e.) contracts regarding local government assets which were concluded within a year before the date of the commencement of the debt settlement procedure together with statements, made any time, incurring liabilities with regard to the assets,

f.) detailed information on business organizations operating with the involvement of the local government,

g.) detailed information on the financial situation, debts and accounts receivable of local government institutions,

h.) other documents which are needed by the receiver to perform their responsibilities.

Forming a debt adjustment committee

Within 8 days of the commencement date of debt settlement, a debt settlement committee is set up the membership of which includes the mayor, the notary, the chair of the financial committee (in the absence of a financial committee a local government representative) and a local government representative. The receiver shall serve as the committee's chair. The local government representative member(s) of the debt settlement committee is elected by the representative body by a simple majority vote. If none of the representatives undertakes membership in the committee the debt settlement committee shall be constituted notwithstanding - without a local government representative. If the debt settlement procedure started because of the insolvency of a health care institution of the local government the representatives of the National Health Insurance Fund and the health care institution shall also be committee members.

Adoption of budget developed for financial crises

The notary, the chief notary (henceforward generically: the notary) shall prepare the draft crisis budget by-law within 30 days of the commencement date of the debt settlement procedure.

The crisis budget includes - in view of the conditions set by Subsection (3) - the operating costs of the basic residential services and authority duties.

If the representative body does not approve the crisis budget by-law within 60 days of the commencement date of the debt settlement it is incumbent on the receiver to report this fact to the court which shall ordain the continuation of the debt settlement procedure and turn procedure to asset liquidation of the debtor.

Formulating the financial reorganization plan and the proposed workout agreement

When the representative body has approved the crisis budget by-law, the debt settlement committee draws up a reorganization program and drafts and agreement for a compromise in bankruptcy.

In addition to a detailed description of the financial situation of the local government, the reorganization program includes proposals regarding the utilization of the assets which may be involved in the debt settlement as well as proposals for taking various measures to expedite the debt settlement effort (e. g. through taking loans), also indicating the level of income each of these measures yields to the local government.

In the compromise proposal, the debt settlement committee groups the creditors of the local government into groups by the amount of the creditors' claims, the original maturity date of the claims or by other categories, and the committee may propose different types of compromise for the different groups with adequate justification.

As the compromise is drafted, the debt settlement committee according to the claim reported by the creditor inasmuch as judicial proceedings are in progress in order to enforce the claim - takes creditors with contested claims - into account.

Subsequent to their preparation, the receiver shall submit for approval the reorganization program and the compromise proposal to the representative body that has been convened by the mayor with no more than eight days' notice. The representative body shall pass a decision at a closed session, with a qualified majority and voting by name. If the representative body turns down the reorganization program and the compromise proposal the debt settlement committee shall revise them.

If the debt settlement committee does not prepare the reorganization program or the compromise proposal, or if they are not approved by the representative body within 150 days of the commencement date of the debt settlement procedure, the receiver informs the creditors thereof the creditors may prepare a creditors' compromise plan/compromise plans regarding the settlement of the local government debts within 30 days of receiving the receiver's notification. This intention of theirs shall be communicated by the creditors to the receiver within 8 days of the notification.

The receiver, at the request of the creditors, shall provide all the information and data necessary for the preparation of the compromise plan.

Debt agreement negotiations

The receiver shall send the reorganization program and the compromise proposal approved by the representative body to all the creditors, and at the same time the receiver invites them to a conference to negotiate the compromise. The receiver shall forward the invitation complete with its attachments to the creditors at least 8 days prior to the meeting. Depending on the number of creditors, creditors may be invited in separate groups to negotiate a compromise in bankruptcy.

The proceedings of the compromise negotiations shall be recorded in the minutes. Creditors may attend the compromise conference either personally or through their representatives. The representatives must verify their capacity of attendance - even without request. Creditors who are absent may consent to the compromise in bankruptcy in writing, too. If the minutes contain the compromise in bankruptcy, too, in addition to the two attesters the minutes shall also be signed by those listed under Subsection 1 of Section 25.

A compromise in bankruptcy may be concluded if more than half of the creditors having extant claims at the time the debt settlement procedure starts consent to it, provided that the total claims of these creditors amount to at least two-thirds of all the reported and uncontested creditors' claims. If the creditors were divided into groups in the compromise proposal then at least half of the creditors in a group should consent to the compromise in bankruptcy.

The compromise in bankruptcy is also applicable to those who have not consented to it, or have not attended the conference in spite of being duly notified thereof. The compromise in bankruptcy may not stipulate different conditions for these creditors than for those who have consented to the compromise in bankruptcy. If the local government has divided the creditors in

groups already in its compromise proposal the conditions set by the compromise for a group may not vary within the group.

Asset liquidation phase

If the debt adjustment negotiations fail to reach agreement or neither party makes a debt agreement plan or the city council fails to develop a crises budget in 60 days the court shall determine the continuation of the debt settlement procedure according to the rules of the partition of assets by court. No appeal against such an order is possible.

The receiver
a.) determines the locally applicable forms of how the local government discharges duties and exercises powers that are required by law;
b.) determines which local government assets and which kinds of support allocated centrally from the central budget are necessary for discharging the duties described under heading a.),
c.) determines the range of assets that may be involved in the debt settlement procedure.

The receiver submits their report, with adequate justification, on what is included in Subsection (3) to the court within 30 days of the delivery of the order defined in Subsection (1) and shall also send it to the local government and all the creditors.

The local government and the creditors may make observations on the receiver's report at the court within 15 days of the reception of the report. The court shall send the observations to the receiver, and gives the receiver 8 days' notice for responding. At the same time the court sets a date for a personal hearing as an urgent priority to which it summons the receiver, those who made the observations and if the observations were not made by the local the government, the local government, too. The receiver may modify their report in view of the observations received,

In view of the receiver's report and the comments made by the local government and those who submitted the observations, the court approves the receiver's report in an order or requires the receiver to write a new report

The assets which may be involved in the debt settlement procedure must be divided among the creditors in the following way (priority order of settling the claims):
a.) regular emoluments including severance pay for the termination of civil servant or public employee status;
b.) claims secured with lien, mortgage or caution money up to the value of the pledge, mortgage or caution money, provided that the security was stipulated at least 6 months prior to the commencement date of the debt settlement procedure. This constraint is not applicable to the security of a credit provided in relation to a compromise in bankruptcy concluded in the course of a previous debt settlement procedure.;
c.) the state's claims arising from interest payment support provided for a compromise in bankruptcy concluded in the course of a previous debt settlement procedure, and the amounts of reimbursable targeted support and further reimbursable central budget support;
d.) social security debts, taxes and public debts that may be collected like taxes;
e.) other claims;
f.) interest claims, default penalties and fees on claims, and charged during the debt settlement procedure;

The claims of lower priority group creditors shall be settled after the claims of higher priority group creditors are fully settled.

The amount available for settling the claims of creditors shall be divided among the creditors in proportion to their claims, however, the social security debts must first be fully settled and subsequently the claims of the rest of creditors under the same heading shall be settled in proportion to their claims.

After the approval order the receiver shall:

a.) within 30 days priorities the creditors' claims as per the priority order and notifies the creditors thereof,

b.) within 60 days attempt the public sale of those assets of the local government which may be involved in the debt settlement procedure at the possible highest market price. The creditors shall have the right of first refusal in the course of the sale of assets. The 60 days' period may be extended.

Within 30 days after the expiration of the deadline the receiver shall propose the partition of the assets available for the debt settlement procedure among the creditors. Settling the creditors' claims can take place by virtue of money or through the transfer of unsold assets to the creditors. In the latter case it is to be established - corresponding to the priority order of settling the claims and the ratio of creditors' claims - in what proportion the creditors shall share the local government assets.

If no agreement is reached. In this uncooperative scenario where the debtor and the creditors cannot come to an agreement 210 days after publication of the debt adjustment notice, or more than 270 days after non-payment, allowances are made for public auctions of assets, and for numerous appeals, public notices etc. In the most difficult situations, the court can request the Parliament to dissolve the city council and call for new elections. At this time criminal and civil prosecution can also take place. Fortunately most cases since 1996 have ended up with a court-approved workout agreement, and forced asset liquidation only taken place seven times out of 18 cases. The entire process, including appeals, and if needed, public auctions of municipal assets, is set to take place within 270-300 days of initiation, depending on whether each actor, the municipality, the court and the trustee, uses their full allotment of processing time. (This statutory schedule has been confirmed by most of the 18 cases filed and resolved to date).

The framers of the law were aware of the negative effects of delays and stalling by the legal representatives of all parties, and built in sanctions and incentives at each stage to a) encourage quick workout agreements b) support tax increases, rationalizations, and the elimination of "luxury" spending while guaranteeing the public health and welfare functions required by law, c) allow for criminal and civil prosecution of corrupt, fraudulent and reckless decisions to borrow for non-mandatory purposes that endanger public services. Since the law was modified in 2001 to include more possibilities for appeals, several cases have taken much longer than envisioned in the original law. Forced liquidations took place in these cases since there was no incentive to reach an agreement.

Analysis of Debt Adjustment Cases and Successful Preventive Methods

Actual Court Cases

Analysis of the workings of this law will be broken into two phases. First, the actual debt adjustment filings and their resolutions[9] will be used to demonstrate both causality as well as lessons learned from workout negotiations and crisis management. The second part of this section focuses on detected prevented municipal financial crises, i.e. will try to demonstrate not just the regenerative but also the preemptive effects of the law in practice.

The Local Government Law of 1990 included two passages that turned out to be unenforceable. One stated that upon the request of creditors the court could declare a municipality to be in default, the other stated that only mandatory public safety; health and welfare tasks are to be performed in a financial crisis situation. The Debt Adjustment Act and amendments to the Local Government Law clarified and specified these two earlier provisions. Effective January 1, 1996 prior to passage of the Debt Adjustment Law, a debt service limit was added to the Local Government Law, which was able to severely constrain the ability of local governments to borrow, issue guarantees, and otherwise assume contingent liabilities of all sorts.[10] These provisions intended to impose market discipline on both borrowers and lenders while also clarifying the minimum level of municipal services. (See box earlier in this document).

Municipal Debt Adjustment Filings in Hungary, 1996 - 2002

		pop.	size of debt	petition field	process end	result
1	Bakonszeg	1278	154 million HUF	08. 1996.	03. 1997.	liquidation
2	Bátorliget	783	65 million HUF	08. 1996.	03. 1997.	workout agreement
3	Csány	2298	46 million HUF	08. 1996.	04. 1997.	workout agreement
4	Egerszólát	1107	24 million HUF	08. 1996.	04. 1997.	workout agreement
5	Páty	4998	400 million HUF	08. 1996.	01. 1999.	liquidation
6	Nágocs	856	123 million HUF	09. 1996.	05. 1997.	workout agreement
7	Kács	654	32 million HUF	12. 1996.	07. 1997.	workout agreement
8	Domaháza	1082	22 million HUF	09. 1997	06. 1998.	workout agreement
9	Somogyudvarhely	1208	31 million HUF	01. 1998.	10. 1998.	workout agreement
10	Sóstófalva	3509	6 million	11. 1998.	12. 1999.	workout agreement
11	Sáta	1391	45 million HUF	02. 1999.	08. 2002.	liquidation
12	Sorokpolány	825	11 million HUF	02. 1999.	12. 1999.	workout agreement
13	Csepreg	3333	93 million HUF	03. 1999.	04. 2000.	liquidation
14	Somogyfajsz	553	86 million HUF	07. 1999.	09. 2001.	liquidation
15	Bakonszeg (2)	1278	60 million HUF	06. 2000.	08. 2001.	liquidation

[9] This section relies on official bankruptcy court documents published in the Enterprise Gazette, as well as upon news clippings from the Center for Civic and Municipal Innovation (a USAID project in Hungary 1996-1999). Data was also collected by Mrs. L. Sashegyi and Barbara Tóth of the College of Finance and Accounting. Finally the State Audit Office made available its reports on municipal inspections for the years 1995-1999. Compliance reports of various County Administrative Offices were also researched for this study.

[10] The debt service limit, 70% of own source revenues (local taxes, business income, rental income, dividends, interest etc but not one-off asset sales) adjusted for operational expenses and existing debt service, was imposed by Decree in March 1995. Since the Local Government Law has the force of a constitutional amendment, a 2/3 majority is required to amend it, the formula was added to the law later.

16	**Gilvánfa**	341	26 million HUF	08. 2000.	in progress.	
17	**Nágocs (2)**	856	45 million HUF	08. 2000.	04. 2002.	liquidation
18	**Atkár**	1685	86 million HUF	09. 2001.	08. 2002.	workout agreement

In the 18 cases of municipal debt adjustment declared and processed from July 1996 to the end of 2002 the law met its objectives. The bankruptcy trustees were able to supervise emergency budgets and to reorganize municipal services, while of the 18 cases 10 resulted in workout agreements that were approved by the court and published in the Enterprise Gazette from 1997 to 2002.

Case Descriptions

Bakonszeg (pop. 1330). Located in an impoverished area of Hungary, Bakonszeg engaged in a variety of profit-seeking business activities in the period 1990-1995. This included establishing a spa company, guaranteeing the debts of several other commercial companies, as well as borrowing significant amounts to finance the construction of a resort village. In 1995 the State Audit Agency uncovered evidence of fraud and illegal activity, including the falsification of signatures on municipal guarantees. The debt adjustment process began soon after the law came into force. At that time, there were 154 million forints in creditor claims, with only 2 million forints in collateral available. This meant that 1.2% of the debt was covered. The municipality and the commercial companies it controlled succeeded in borrowing funds from at least four different financial institutions within a five-year period. The village filed for debt adjustment in August 1996. The bankruptcy trustee, the creditors' committee, and the municipality could not come to an agreement; hence the court began to process the forced liquidation of debts and assets on December 22, 1996. The liquidation process ended in 1998 upon payment of the trustee.

Bátorliget (pop. 777). This small village had operational and payments problems throughout 1995, filed for debt adjustment in August, 1996, as it could not make payments on debts of at least 65 million forints, 41 million of which was owed to a construction company building public utilities. The balance was owed to a bank for financing school construction and to the Interior Ministry that had provided a refundable emergency grant in 1995. The court approved a workout agreement in March 1997, in which the vendor was paid in full, while the bank and Interior Ministry's payments were rescheduled for 2000. The village has been operating under a deficit consistently, and has requested additional emergency operating grants ever since.

Csány (pop. 2312). The village built a natural gas distribution system in 1994. These led to 46 million forints in debt that could not be serviced in 1996. Debt adjustment was requested in August 1996, and the workout agreement was finalized in February, 1997. At that time the salvage value of the completed natural gas distribution system was nearly 50 million forints. The system was sold and the creditors satisfied. In April 1997, the case was closed. The village lost 27 million forints from its balance sheet due to the low price it was able to get for the gas system. (Why a village of this size needs piped gas is another matter). In this case nearly all of the debt was owed to one bank, thus negotiations were simple.

Egerszólát (pop. 1120). The village's natural gas distribution project led directly to default in 1996 on 24 million forints in debt ultimately accepted by the bankruptcy trustee. The village had 1.7 million forints in cash, and negotiable assets of about 23 million forints. The workout agreement called for selling the gas network, worth 45 million forints, at a 75% discount for 11 million forints. The local government paid off the debt, but suffered a loss of 21 million forints on its balance sheet. The case was closed and approved by the court in April 1997.

Páty (pop. 4605). The village of Páty, located in a fast growing semi-rural area near Budapest, engaged in intensive infrastructure projects starting in 1991 that included natural gas distribution systems, and a sewer system in 1994. By 1995 the village faced financial difficulties and its debt neared 600 million forints. The 1995 budget was in crisis, the village applied for emergency grants, and could not even perform the most elementary functions since lender intercepted its revenues and simply paid itself first, leaving few funds for basis tasks. A the mayor and the administrator were forced to resign due to this and other ambiguous business activities, hence and entirely new village government was elected in January, 1996. In January 1996, the village was 4-5 months overdue in making utilities and other payments as the bank continued to remove funds from the village's account. The State Budgetary and Public Administration Office (Takisz) finally stepped in, and intercepted all funds flowing to the village from the central government, and this stopped the bank from depleting the village's accounts to the detriment of public services. Of the 600 million in estimated debts, 200 million were owed to the bank, 26 million to the tax office, and 14 million to the Interior Ministry. Debt adjustment was initiated in August 1996, with the appointment of a bankruptcy trustee. Upon further investigation, of the estimated 600 million in debt the trustee determined that only 400 million forints were justified and legitimate, and owed to 53 creditors. The village was only allowed to finance its basic functions, and no utilities were disconnected. The village became solvent under the tight supervision of the trustee, and was able to finance its basic activities (see list earlier in this study). The court approved the workout agreement in April 1997, and this started a nearly two-year asset liquidation phase. The local government held three auctions to raise funds were the creditors had priority rights to bid. At first glance it seemed that all creditors could be paid if the sewage treatment and collection system were sold for about 300 million forints. But because of several restrictive laws, *assets built in part with state funds could not be sold*; therefore, less than half of the claims could be satisfied. All creditors were paid in cash or in securities and receivables, and the asset liquidation phase ended in January 1999.

Nágocs (pop. 820). This village was investigated by the State Audit Office in May, 1995, when it was determined that the village council had engaged in fraudulent activity, had violated accounting and financial standards, and had engaged in borrowing to finance non-mandatory profit-seeking activities that causes the village to default on 123 million forints in debt. The central government provided emergency assistance to the village in 1995 and 1996 in the amount of over 25 million forints. As the debt adjustment law went into effect in June 1996, the village filed its petition. Twenty-three creditors submitted claims for 78 million forints in principal and 45 million forints in interest. The workout process resulted in 63 million forints of principal claims being recognized, and the bankruptcy trustee submitted the agreement to the court for approval in April 1997. Assets that could serve to pay off the debt amounted to only 50 million forints at book value. Most of these negotiable assets were formed by industrial land belonging to a defunct shoe factory that could only be sold for 20 million forints. These funds were proportionately distributed among the creditors. Other assets to cover the debt amounted to only 13 million forints. The court declared the debt adjustment process closed in May 1997, less than a year after filing.

Kács (pop. 684). This tiny mountain village, with abundant biomass available and located 15 kilometers from the nearest gas main, decided to build a natural gas distribution network, and defaulted on its bank loan and missed other payments to vendors and suppliers as well. The workout negotiations recognized claims of 32 million forints. The bank and the Interior Ministry are to be refunded with annual budget allocations by the end of 1999. The other creditors were to be repaid from proceeds from selling the natural gas system. The court closed the case in July 1997, about seven months after the village filed for debt adjustment.

Domaháza (pop. 1061). In September 1997 16 million forints in unpaid claims came due, and the mayor petitioned for debt adjustment. By December 1997 legitimate claims against the village amounted to 22 million forints. The court approved the workout agreement in 1998.

Somogyudvarhely (pop. 1218). The village borrowed 20 million forints from a bank in 1994 to build a natural gas system. The 20 million forints were borrowed despite difficulty in servicing an existing 11 million forint debt. After cost cutting measures and tight budgets, the mayor petitioned for debt adjustment in January 1998. The court approved the workout agreement and the case wound up in October, 1998.

Sóstófalva (pop. 3509). The debt adjustment was started by the local government in November 1998. The village had 6 million forints debt in this case. The village-house building led to bankruptcy for this settlement. The debt came from loans and from the inability of the municipality to pay the enterprises working on the building. In this case legal proceedings were started against the major of the village charging with defalcation. The court approved the workout agreement in December 1999. According to the law the creditor who has not reported their assets may do it two years after the end of the process. The local government intends to avoid filing the petition again, that is why the municipality makes negotiations now about 5 million forints debt that remained from the debt adjustment process.

Sáta (pop. 1391). The members of the local government filed the debt adjustment petition in February 1999. The settlement got into debt because of the public utility investments and institution maintenance costs. The 45 million forints debt of the village was for public utility companies and private enterprises. The municipality could offer shares, lands and estates. Because of the number of persons involved in the affair they could not compound. The reason, why the case lasted for three years was the many appeals and negotiations in the court.

Sorokpolány (pop. 825). The local government of Sorokpolány filed for debt adjustment in February 1999. The 11 million forints debt for the state came from the inadequate interpretation of the law. After the building of the natural gas system in the village the local government claimed the VAT, but it was not entitled to do. The municipality offered estates, but could not come to an agreement. Ultimately the case ended with liquidation.

Csepreg (pop. 3333). The local government of Csepreg filed for debt adjustment in March 1999. The 93 million forints debt for the state came from the inadequate interpret of the law. After the building of the natural gas system in the village the local government claimed the VAT, but it was not entitled to do. Besides of these the settlement also had debt for a private creditor, though the small amount (110 thousand forints), it was important in the case. This was the reason that they could not reach an agreement before the debt adjustment procedure (for the state the lands would have been enough, which were offered from the municipality). So finally the local government could not come to an agreement, hence the court began the process of the forced liquidation.

Somogyfajsz (pop. 553). The debt adjustment petition was filed in July 1999, by the municipality of this small village. The 86 million forints debt for APEH (State Financial Control Office) and TB (National Health Service) came from illegalities. Besides of these they had debt for private enterprises as well. According to the court judgment the properties of the village - estates, lands, and machines - was converted into money, and distributed among the creditors.

Bakonszeg (pop. 1278). The creditors who did not reported their claims for their assets during the debt adjustment process; they could do it in two years after the end of the first procedure. Bakonszeg would have liked to close the debt adjustment procedure finally, so after that the two years had passed they filed again the petition with the remaining 60 million forints debt in June 2001. After the first process the budget of the village became empty, and the village ran out of estates, sources were exhausted so in this time the creditors got a very small amount of money after the liquidation.

Gilvánfa (pop. 341). This small village is in a disadvantaged region of Hungary. All residents belong to the gipsy minority, which generally means that they are under qualified, pour people with different culture from the majority. In this settlement most of the people live from social aid. The local government could not solve its tasks without debts, and all institution in the village has a huge amount of debt for the public utility companies. The petition was filed for the debt adjustment process in August 2000, by the municipality. This case is in progress.

Nágocs (pop. 856). The creditors who did not report their claims for their assets the during the debt adjustment process, they could do it in two years after the end of the first procedure. In the case of Nágocs there was a company that announced its purpose for that, but the application was filed by the local government again in August 2000. The village had another debts for the APEH (State Financial Control Office) and the Employment Center of Somogy County. The settlement should have paid off 40 million forints in this procedure, but it had only little value estates. This case was ended by court decision, because the state-owned companies (APEH and Employment Center of Somogy County) needed judicial decree to account for this huge deficit unquestionably. The biggest creditor (the Employment Center) got only 171 thousand forints.

Atkár (pop. 1685). The local government initiates the debt adjustment process in September 2001. The settlement had 86 million forints debt, of which 83 million was owed to a bank and the rest 3 million to private creditors. That was the natural gas project of the village starting in 1994 that caused the default later. Then the main contractor took out a loan from a bank, the guarantee was the natural gas system, which was under construction. This amount of money could not be paid back. In the legal proceedings the first judgment of the county court supported the village, but the supreme court sent back the case with its own observations, and the second decision ordered to pay back the debt by the municipality. This legal procedure took six years, while the debt went through two other banks and arrived to the Hungarian Demand Administrator Stock Company at the end. During the debt adjustment process the creditors realized that the local government could only discharge a little part of their money, so the procedure ended with workout agreement. The properties of the village was converted into money and distributed among the creditors, which only 1.7 million forints.

To what extent were claims satisfied?

Data on the satisfaction of claims is only available for 9 of these cases as cited below. While it appears that workout agreements resulted in 100% payment of creditor claims in a few cases, and that the liquidation process often ends with zero to 50% satisfaction, this data is not sufficient to draw general conclusions. Instead, what may be determinant in predicting or explaining the extent to which creditor claims were satisfied is the relative size of the property and assets offered as security versus the size of the loan. In cases where the size of loan exceeded the total budget and total assets of a municipality by many factors, it is safe to predict that in either the workout or liquidation scenario, creditor claims would not be fully satisfied. In other words, creditors took risks that were excessive compared to the collateral, security and sources of repayment offered. So if the creditors decided not to agree to a voluntary workout arrangement based upon their assessment of the assets available, then they do not take a great risk by allowing the process to go into involuntary liquidation.

Municipality	Debt in mil HUF	Amount paid to creditors in mil HUF	% of claims satisfied	Outcome
Atkár	86	2	2	agreement
Bakonszeg (1.)	154	2	1	liquidation
Bakonszeg (2.)	60	0	0	liquidation
Bátorliget	65	65	100	agreement
Csány	46	46	100	agreement
Egerszólát	24	24	100	agreement
Nágocs (1)	123	30	24	agreement
Nágocs (2)	45	0,17	0	liquidation
Páty	400	227	57	liquidation

Why so few formal debt adjustment cases 1996-2002?[11]

These eighteen cases demonstrate that the debt adjustment process is essentially avoided at all costs unless the local government has lost its ability to deliver the most fundamental services. In all of these cases debt adjustment was requested when fundamental services, such as schools and health clinics, lost their access to public utilities, and key staff members had to go without pay. A local government undergoing debt adjustment does not have access to any construction or development grants and grant-equivalent subsidies, therefore maintaining potential access to these funds is another incentive to undergo operational cutbacks, avoiding the debt adjustment process as a secondary benefit. Despite significant claims with doubtful sources of repayment, neither vendors nor banks initiated these debt adjustment processes. These creditors probably were convinced that the local government had few negotiable assets available for settling claims, and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims that became due after a period of non-performance. The small size of each village that has petitioned for debt adjustment suggests that large infrastructure projects, such as natural gas distribution, and piped sewage collection, are not just technically but financially unrealistic. Mayors seek "political rent" by borrowing to build such projects that neither user fees, local taxes nor capital income on other assets can finance. Banks and vendors, of course, at least in the early phases (1994-1996) willingly lent to such small villages for unfeasible projects since they assumed that the state would step in to rescue municipalities in default.[12] To a certain extent this expectation was rational in that in 1995 the state did give one-off grants to the four villages listed above that eventually underwent debt adjustment, and also to a city that managed to avoid debt adjustment through budget cutbacks, tax increases and the rationalization of its institutional structure. Pressure for expansion of those one-off grants in 1995 contributed to the formulation and passage of the Debt Adjustment Law.

[11] In the first quarter of 1996 before the law was passed, and immediately thereafter, the popular and professional press made claims that 50-100 municipalities would immediately declare bankruptcy. These claims were not substantiated, neither the Finance nor the Interior Ministry had any information as to how these numbers were derived. On the other hand, the emergency operational grants program eventually handled 700-1000 applications (out of a total of 3,200 municipalities) on an annual basis, and one can safely assert that the emergency operational grant system (Önhiki) is an active form of debt adjustment (bankruptcy) prevention.

[12] Banks denominated loans in hard currency in some cases given the 2000 basis point difference between hard currency and forint interest rates in 1994-95, but the borrowers assumed all of the devaluation risk. Banks also charged 500-1000 basis point premiums above forint securities issued by the sovereign, despite the expectation that the state would step in if a municipal default took place.

The Deposits and Credits of the Local Governmental Sector in the Hungarian Banking System (billion HUF)

The End of the period	Local Governmental Sector			
	Deposits in Banks	Loans from Banks	Net Creditor Position	Loans/Deposits
31 December 1995	80.7	49.9	30.8	62%
31 December 1996	86.8	38.5	48.3	44%
31 December 1997	115.8	30.3	85.5	26%
31 December 1998	123.5	44.4	79.1	35%
31 December 1999	126.1	50.0	76.1	40%
31 December 2000	148.3	57.6	90.7	39%
31 December 2001	197.5	73.1	124.4	37%
30 November 2002*	140.5	97.9	42.6	69%

*Distorted by year-end bonuses, and tax deposits arrive only in December.

Source: MNB (Hungarian National Bank)

The dearth of municipal bankruptcy or debt adjustment procedures suggests that there may be effective preventive measures being put in place even in the smallest communities to avoid the risk of asset liquidation. It also suggests that since 1996 financial institutions are a lot more prudent in lending to municipal natural gas and wastewater projects. As the table indicates, since the passage of the debt adjustment law, municipalities increased their deposits in the banking sector by over 227% by the end of 2001, while their loans from banks increased only by 190%. As net creditors to the banking system, only 37% of deposits were lent back to the municipalities in 2001, compared to 62% in 1995, the year some of these restrictions were put into force. In fact, the amount of deposits that were lent back to the municipal sector ranged between 26-44% from 1996 to 2001. The municipal sector has still not regained its position lost in 1995. Data for 2002 are tentative, and show a large drop in deposits, with a nearly 32% increase in borrowing over 2001. But November 2002 data show seasonal distortions since significant transfers take place in December, and municipalities accumulated 86 billion forints in treasury securities outside the banking system by that time. The general tendency that municipalities are net lenders to the banking system, and borrow about 40% of their deposits (but not total financial assets) since 1996 indicates that after the one-time correction in 1996, the restrictions have not "killed" municipal borrowing but have stabilized its size in comparison to banking deposits and financial assets.

Furthermore given a system of deficit grants for covering certain operational deficits, local governments must cut back non-mandatory and optional activities, rationalize their operations etc. in order to qualify.[13] Of course, deficit grants may only be used to finance mandatory activities that have been rationalized, and borrowers do not qualify for deficit grants, and these grants may not be used to finance any kind of debt.

[13] The emergency grant system, described in paragraph 87 of the 1990 Local Government Law, intends to finance basic services to which the population is entitled. Experts close to the process, both within and without the public administration sector, are convinced that the emergency grant system and the rationalizations it imposes have prevented many debt adjustment situations from taking place. See World Bank Discussion Paper No. 417, "Hungary: Modernizing the Subnational Government System," May 2000, Mihaly Kopanyi et al editors.

Some Preventive Measures at the City Level

Though the debt adjustment filings to date have all been by villages with populations ranging from 300 to 5000 (average population 1500), cities too have taken measures to avoid default. Some examples follow:

Tapolca (pop. 18,000) Tapolca reorganized its city hall, and cut employment by 100 in 1996. Its entire network of budgetary institutions was rationalized, including closing kindergartens, and designating new uses for buildings. Savings were applied to reduce debt and to close gaps in the operational budget.

Komló (pop. 28,000) This mining city with high unemployment conducted a performance audit on its institutions in 1995, and reduced its staff by 82 in 1996. Two institutions were closed, several others were combined. Capital, labor and payroll tax costs were applied towards mandatory operations.

Baja (pop. 37,000) This city on the Danube faced a rising debt burden and an operational deficit in 1995. In 1996 it cut 150 jobs in education and 70 positions were put under hiring freeze in health care. Several institutions were completely reorganized or combined with others. Foundations and associations were formed to take over some the tasks previously performed by municipal budgetary agencies.

Preventive Effects of the Law

Capacity and Compliance. Given the large number of smaller villages who annually request deficit grants (over 1,200 of 3,200 municipalities sought such funding in 2002, about 1,000 actually qualified), and the low number of actual debt adjustment procedures, other evidence for the successful preemptive nature of the Debt Adjustment Law can be found in a rarely-cited passage. Paragraph 18 of the law states that an emergency budget and reorganization plan must analyze capacity usage figures for institutions that deliver health, social and educational services. Specifically, an emergency budget cannot fund institutions that are operating at less than half of their capacity, unless that institution is the only one of its kind in a village. In other words, villages with two barely used day care centers must consolidate them, but if the village only has one, it may keep the facility in the emergency budget. Another indicator is whether the facilities' per capita average cost exceeds the national standards for villages of that type by 30% or not. There is anecdotal evidence that these two standards, while found in the Debt Adjustment Law, are being applied by municipalities in crisis prevention measures.

In other words political and professional leaders cite this standard when preparing a deficit grant application, or when taking other steps to prevent default and to continue financing mandatory tasks. Even if a municipality in financial crisis is not considering filing an emergency operational grant application with even stricter standards, emergency budget capacity usage standards could be used to justify politically controversial "preventive" cutbacks in local budgets. Another explanation for the low number of actual debt adjustment filings may come from a *lack of compliance*. Since creditors hesitate to petition the court in the hope that they may achieve some type of preemptive settlement, debtors may chose to ignore the triggering conditions in the law. Unless the municipality is randomly selected for inspection by the State Audit Office or another authority, or are reported with probable cause by a watchdog organization, these failures to invoke the debt adjustment process will go undetected and unpunished.[14]

[14] The State Audit Office in its annual random sectoral compliance (1,000) and comprehensive financial audits (30-50) of municipalities has indicated that about 10% of the comprehensive auditees, or 3-5 municipalities per year, should have petitioned for debt adjustment but have not. Several of the early filings in 1996 were instigated by State Audit Office inspections in 1995, though the more recent inspections have not forced any new filings as preventive and compensatory measures are implemented immediately. These figures should not be projected upon the entire population of municipalities, but are indicative of the compliance problem.

Defining "near misses." The preventive capability of the Debt Adjustment Law cannot be ascertained from any register of municipalities in distress. If a municipality does not apply for a deficit grant, and the press is quiet about its financial difficulties, then there is no source of reliable information based upon which to estimate the volume and nature of municipalities in "near distress" situations. In general, all municipalities in Hungary have a difficult time balancing their operational budgets and in maintaining a certain standard of services while keeping the number and extent of institutions unchanged. Furthermore, the nonexistence of a centrally located and publicly-accessible file of municipal budgets, annual financial statements and other forms of disclosure, not only hinders the capital market but makes guessing the number of near-bankruptcies rather difficult. The law gives a clear definition of when a municipality must petition for debt adjustment, and under what circumstances a creditor may file such a petition. The law however does not define any pre-debt adjustment disclosure or registry requirement. Evidence for debt adjustment prevention, however convincing, is circumstantial and haphazard at the macro level, while individual cases of municipalities negotiating with creditors and passing difficult budgets with real cutbacks seem to imply that creditors, and certainly all municipalities, wish to avoid the debt adjustment process. (including choosing non-compliance as an option…). Even the level of municipal debt can only be assembled post-facto from projected figures in budget resolutions, and from annual reports that are filed 6 months after the close of the calendar year. Both sources of information are unwieldy for making predictions in real time about incipient debt service difficulties. Municipal debt to finance development projects in and of itself cannot be an indicator of future financial stress unless the particulars of the project, the balance sheet of the municipality, and its predicted/expected revenue stream are well known.

Generalizations about preempted cases

Description of financial difficulties. All the analyzed localities gave quite similar answers to the question that focused on when and how the financial and economic difficulties began with long lasting liquidity tension. *Békésszentandrás* borrowed to finance its own share of a development project that did not produce revenues directly, while the town's institutional structure remained extensive and overstaffed. Pay increases were granted for political reasons, and the town nearly defaulted in the second half of 1996 on its loans. *Tokaj* faced similar problems in 1995 when its large network of institutions employed nearly 10% of the total population of the small city. Tokaj was running a large operational deficit caused by overstaffing and the fixed cost of the buildings and organizations belonging to the city. The operating deficit ran close to 10% of the total budget and local services became jeopardized and the city's accounts payable rose dangerously. *Szerencs* made environmental and infrastructure investments in 1995 using state grants that it had to match with "own source" funds, i.e. a bank loan. The loan payments simply exceeded the city's capacity to generate free revenue. The city complained that normative operating grants declined in real terms, forcing them to use funds otherwise available for debt service to subsidize operating expenses. *Szécsény* began an extensive development program in 1990, financed in part by bank loans and a variety of state grants. The development program included the construction of a telephone system, wastewater treatment and piped gas networks. The total cost of these networks was underestimated, and the city had to borrow additional funds to complete the projects. Higher interest payments of course placed stress on the budget that tried to finance an oversized and overstaffed institutional network that was not appropriate for a city of that size. *Nagykőrös* decided to go forward with a city hospital reconstruction project in 1993 despite being awarded a targeted grant only with a much higher own-source requirement than the addressed grants usually used to finance these types of projects. This translated into a larger own source requirement, hence more borrowing. By 1995 the city's interest payments caused a financial crisis. *Tápiószentmárton* also borrowed excessively in 1994 to finance infrastructure projects, and debt service was not in line with its operating budget nor with its ability to generate capital income.

In these "near bankruptcy" situations the most common reason for near default were borrowings and debt service burdens that exceeded the free financial capacity of local budgets. These borrowings were coupled with a politically motivated desire to maintain bloated staffing in numerous institutions (schools, clinics, social welfare facilities) that were operating below capacity in buildings that are oversized and expensive to maintain. The flow of normative grants in real or nominal terms does not explain debt service problems caused by excessive borrowing, or the oversized projects that do not generate revenue directly, and cannot produce "general economic benefits" that can be captured and taxed at the local level to finance debt.

Why are financial services exempted from the public procurement law?

The terms of these loans, while not a part of this study and considered secret by local governments, most likely do not reflect the low risk involved in lending to municipalities, and are likely to have excessive interest and non-interest costs that are not exposed through a public bidding cycle for financing services. In fact, the *Law on Public Procurement*[15] exempts financial and securities services from the public procurement process, regardless of the cost and size of financial services involved. Loans whose interest, service charge and other costs greatly exceed the procurement threshold for all other goods and services are therefore not put up for bid unless the municipality wishes to do so. *Given intense competition in the financial sector among Hungary's 40 plus banks, and an equal number of securities firms and brokerages, this exemption should be lifted or clarified since it demonstrably causes damage to the Treasury in the form of deals disadvantageous to local governments*. Since these loans are rarely competed, are negotiated in secret, are not subject to a public hearing and approval process, and are not disclosed in detail, it is likely that these municipalities were paying too much for the funds they borrowed, and that factor also lead to their near defaults.

Typical of these situations were grossly underestimated construction costs and/or oversized projects that forced municipalities to borrow more than originally intended. The incipient debt service costs then put pressure on funds otherwise needed for operating the bloated service delivery institutions. In the case of Tokaj and Tápiószentmárton the extensive network of budgetary agencies led to fiscal crisis, while in the other cases excessive debt service costs triggered the need to make difficult political decisions.

Preemptive Methods in Practice

Treasuries and Budget Cuts. Turning to next step, we analyzed the methods and interventions that were carried out by distressed local governments so that ultimately court adjudicated debt adjustment could be avoided. The following last minute measures addressed unpaid accounts payable and missed debt service payments. *Tokaj* municipality worked out a multi-step reorganization plan in 1995. First of all an independent consulting firm was retained conduct an internal audit on the network of institutions and on the policies of city management. The city actually experienced organizational proliferation but lacked the political will to close down and merge some of them. Traditional personal relationships impeded effective measures especially when it came to cancellation of certain positions and jobs within the institutions and offices. With 580 public employees in the city with 5000 inhabitants, about half the population had an immediate family member whose salary came from the city budget. Besides taking decisions and actions to sharply reduce the labor force and the number of institutions to a normally satisfactory level, the municipality of Tokaj embarked on merging organizations and institutions with similar fields of operation.

[15] Paragraph 9, section c and d exempt services provided by financial institutions and securities services from the public procurement requirement. (Law XL, 1995

Tokaj's Microtreasury[16]

There was no sense in operating all the institutions as economically independent units with own bank account, financial management unit and budget. The policy of institution operation and financing was changed with the help of the municipal treasury, i.e. a cash pool. The merged institutions still remained independent in a sense but the number of bank accounts was reduced and the municipal treasury forced them to carry out financial plans with all revenues and expenditures monitored and paid by the cash pool.[17] Beyond these organizational changes the unpaid accounts payable and the missed debt service were prolonged through agreements with creditors and suppliers. All the bank loans and interests were analyzed by date of expiration and were put in a comprehensive liquidity plan. The maturity and interest payments were matched with the elements of the liquidity plan. As a result of the effective actions, especially with the municipal treasury the city managed to pay off its 16 million forint unpaid accounts payable for suppliers within half a year. All in all the total expenditure of the city and institutions were reduced by 12-13 per cent per year.

An effective management information system was established when working out the new policy of finance and made it possible to deliver up to date information to the decision-makers of different levels.

Negotiations with creditors. In the case of *Békésszentandrás* the most important action was an agreement with the bank to reschedule debt payments. The municipality asked for restructuring of its debt and the sold some of its securities portfolio and real estate. *Szécsény* also had an internal organizational audit and the outcome resulted in severe saving actions at all levels. The previously independent budgetary agencies were financially merged with a common financial administration. Szécsény rescheduled its accounts payable and chose a new financial institution in 1997. (rather rare in the municipal sector). As in Tokaj the local government created a municipal treasury. The network of institutions was rationalized through closings and mergers, some of the institutions were transferred to the county government. In a case when there is no financial capacity to run a certain public institution, the local governments can either close them or transfer the operation with all financials to the county government. The county within its authority can either decide to close the unit or operates it further if there is a countywide need for it. *Szerencs* also urged a restructuring its debt and conducted an internal audit. Szerencs however was recipient of emergency funds that were distributed in 1995 in compliance with a Government Decree. The lobbying landslide that was a consequence of Szerencs' et al bailout led directly to the formulation of the debt adjustment law. The four other municipalities covered by the one-time emergency grant all underwent debt adjustment as the law came into force in June, 1996. *Tápiószentmárton* like all other distressed local governments adopted saving actions within the city budget and in the institutions as well. The measures incorporated labor force and certain municipal service reductions as well. As a consequence mandatory tasks are executed with fewer financial sources than before. The large village's financial difficulties continued throughout 1999 but the mayor managed to avoid having to file for debt adjustment.

Mandated internal controls and debt monitoring. Besides spending cutbacks, organizational reforms, and micro-treasuries, local governments in Hungary have a mandate to set up a system of internal controls to monitor spending and debt. The finance committees of city/village councils have the legal responsibility to act as de facto supervisory boards or controlling bodies. City council committees, with a few exceptions have not set up spot checks and routine procedural audits of the various budgetary agencies within a municipality. If these committees were to regularly monitor borrowing limits and debt service, then reports could be issued to the professional staff in a timely manner. These reports by city council committees could perhaps detect impending defaults

[16] About 50 cities and several counties have established micro-treasuries modeled upon the central government's treasury. The treasuries in some cases have little say in budget execution except for actually conducting cash management for all municipal institutions at their instruction. In the harder version of micro-treasuries, the cash pool manager actually controls the budgets, revenues, expenditures, liquidity and daily financial operations of municipal institutions. In this version institution managers are essentially only responsible for the technical performance of their organization such as schools, hospitals and social welfare facilities.

[17] Prior to this system Tokaj's institutions with excess cash purchased treasury bills, while other institutions and city hall itself borrowed at high interest rates for liquidity purposes. Overall the forgone interest was much less than the interest expense of numerous small liquidity loans, and the cost of maintaining numerous bank accounts.

on obligations of any type, including to vendors. Local governments with budgets above a certain magnitude are also obligated to have their annual budget reports and financial statements "audited" by a certified accountant who has special training in budgetary accounting. However these audits are limited to compliance and numerical accuracy, and never extend to making recommendations for improvements, nor are they intended to reveal waste, fraud and abuse. The "auditor" who certifies an annual financial statement does not have the right to call a special meeting of the municipal council in the case of an impending financial crisis. Municipal councils in general do not take the reports of finance committees seriously, and seldom provide resources adequate for genuine internal controlling to take place. Local governments have an obligation to monitor the debt and repayment structure of the various budgetary agencies they control. This is particularly critical in larger cities with deeply indebted hospitals and health care facilities that are financed by the social security system.[18] These facilities, if in default, also fall under the municipal Debt Adjustment Law since passage of the 1998 budget law, even though the overwhelming sources of technical guidance and funds are various components of the social security system and the ministries responsible for health care. A majority of local governments do not have a firm grasp of the debts and accounts payable of not only health care but other budgetary agencies under their control. Many municipalities contacted for the purposes of this study first heard of these monitoring requirements from the research team.[19]

Municipal-appointed receivers at institutions

In Hungary municipal service providers such as hospitals, could be municipally owned non-profit corporations, or budgetary agencies. Institutions, including schools, may have income from outside the municipal or national budget, such as rental fees they charge for the use of classrooms or meeting halls. Though they are budgetary agencies, or a separate legal entity, the municipality has service obligations laid down by the Law on Local Self-Government, since the founder, owner and first line supervisory agency is the municipality. In the Russian context, despite their legal, tax and accounting status, these municipal institutions are "objects" of the budget. Elsewhere, such as in Serbia, they would be called "direct" or "indirect" budget beneficiaries.

The municipal debt adjustment law was modified in 1998 to include municipal hospitals in a process similar to the one that applies to municipalities overall. Municipalities may appoint their own receivers to financially troubled institutions, departments and other service organizations they control through their budgets.[20] These receivers, in theory, could prevent municipal defaults on debts, payment problems or other financial crisis by essentially taking over the administration of their own institutions. These receivers could go to work in schools and other facilities to prevent institutional financial difficulties from affecting the guarantees or other obligations of the municipality acting as owner or founder. Municipalities did not really use this option in the debt adjustment act in the case of hospitals that were a large source of financial risk to them. The law was modified to include the reorganization, i.e. debt adjustment, of municipal hospitals as a separate legal entity from municipalities. As a result, hospital debt adjustment cases caused intervention by municipalities to prevent a general default. Instead of the court appointing a trustee to oversee the municipality, the municipality could appoint a receiver with similar powers to reorganize critical institutions that could lead to general default by the entire municipality. The health fund continues

[18] Municipal hospitals receive operational funding from the social security system based upon a set of national norms. Technical and health standards are imposed by ministries, while maintenance and capital improvement, as well as ultimate responsibility for accounts payable and debt lie with the local government. Health care reform and financing problems exceed the scope of this study. However, larger cities face a time bomb that could lead to debt adjustment procedures if these hospitals impose debt and operational burdens that cannot be covered by local budgets.

[19] Government Decree 212/1996 (XII. 23) also requires municipalities with institutions in fiscal distress to appoint special commissioners to essentially take over the operations of these facilities. With the exception of hospitals, this decree is not being obeyed. This decree was reinforced in Government Decree 217/1998 that details the functions and powers of a municipally appointed receiver or trustee, who works to prevent an overall bankruptcy caused by the institution that may be in trouble.

[20] A municipality must appoint its own trustee to a financially troubled institution if its accounts payable that is over 30 days late exceeds 10% of projected spending, and is not capable of reducing this lateness to below 30 days within a month. The municipality may impose stricter conditions on its institutions with lower thresholds if it wishes.

to pay for the operation of hospitals, but municipalities are expected to cover maintenance, replacement, amortization and capital investment. Regardless, the legal obligation to provide certain health services remains at the municipal level, and consequently the extension of the debt adjustment law to municipal hospitals independently stimulated the use of receivers appointed by the municipalities themselves.

Why did debt cause problems? General Conclusions about Hungary

Debt accumulation, and debt service problems flow nearly without exception from financing the own source portion of partially state-financed infrastructure projects in the energy and environmental sector. When debt service payments to lenders began to threaten other vendors and mandatory operations, municipalities applied the debt adjustment law. Much of debt owed to vendors is invisible in the form of deferred accounts payable and vendor loans that are packaged in a series of progress invoices spread over the standard 3 year financing grants. Thus the extent of potential debt owed to vendors that may be in default is objectively difficult to determine. Vendors and implicit lenders to date have not filed debt adjustment petitions against municipalities out of fear that their claims would enjoy a lower priority than taxes, wages and other “more important” obligations. There still exists a potential for more municipal debt adjustment procedures in the formal sense if all vendors decided to press valid claims and stopped overlooking overdue accounts receivable. All of the problem municipalities examined, including those that underwent debt adjustment and those who experienced difficulties, had not used the debt service limit calculation since its imposition predated these borrowings. After imposition of the debt adjustment law and the debt service limit there have been no debt adjustment filings for problems predating these restrictions. Local governments reported that the county-level accounting and data offices of the Finance Ministry and private consulting firms were the most helpful in both preventing as well as providing debt adjustment technical assistance. Most banks and creditors were willing to cooperate in restructuring the debt since none have ever filed a debt adjustment petition against a municipality since the law came into force in mid-1996.

General summary of debt adjustment avoidance methods in municipalities and municipal institutions.

- Restructuring of debt and rescheduling of accounts payable with all lenders and vendors;
- Conscious rationalization and restructuring of the network of institutions aimed at eliminating parallel functions by closings, mergers or transfers to the county government;
- Establishing a local treasury to reduce short-term borrowing and to capture interest income across the entire municipal government, including agencies and other budgetary institutions.
- Labor force reduction at all levels based upon thorough internal performance audits;
- Decrease of optional (non-mandatory) municipal services;
- Applications for emergency operating grants essentially forces an examination of capacity usage, per capita costs, as well as the options for associations and notary districts;
- Stricter application of internal controlling and debt monitoring mandates.

Analysis of Russian Federation proposal for municipal debt adjustment and crisis intervention

Our research team has had the opportunity to review the English translations of the Russian Federation's Budget Code, and a draft act called "On measures for the financial rehabilitation of the subjects of the Russian Federation and municipalities displaying the signs of insolvency." This effort was supported by discussions and interviews with experts in Moscow during December, 2002.

General Comments:

We acknowledge that the draft act was very much a work in progress, i.e. many discussions were being held about its content, and what we reviewed should not be considered in any way as being final.

Overall, the main concern with the draft act was that the concepts of "unpaid bills" accumulation for current operations, and the flow and stock of debt for capital projects were discussed in the same act. The problem of accumulated unpaid bills for operational purposes, or operational deficits that may be rolled over into the next budget comprise a different set of problems from debt-induced insolvency. Settling fiscal crises caused by unpaid current invoices, or unpredictable fluctuations in taxes and transfer payments should be handled separately from missed interest and principal payments on long-term loans for capital purposes.

A part of the confusion in the Draft Act is caused by definitional problems in the valid Budget Code that is in force that defines financial crises and insolvent situations in Article 112. The first set of specific comments we have stem from concerns we have with the Budget Code, and with the definitions from the Budget Code that the writers of the Draft Act on Financial Rehabilitation had to use.

Concerns with the Budget Code:

The following concerns with the Budget Code were identified that affect our views of the Draft Act.

Article 90 and 100: Definition of "municipal debt"

This definition includes guarantees issued by a municipality to a third party but excludes: vendor loans (extended payment terms from suppliers that are really disguised loans), and leasing arrangements that look like a recurring expense but are actually loans in economic terms. This definition also does not mention that a Court can redefine accumulated overdue accounts payable as involuntary municipal debt.

Long term (over one year) and short term debt needs to be defined separately, and there should be no shifting of short-term debt into the next year, that is conversion to long-term debt, should be discouraged. Redefining the unpaid bills of Municipal Unitary Enterprises as "debt" should be spelled out in detail. Why are long term loans and bonds limited to 10-year terms? (Some assets have an economic life that exceeds 10 years, such as roads, sewer systems etc.)

Article 107 and 111: Municipal Debt Limit

Maximum debt service is defined as 15% of total expenditures (why not relate it to revenues?) Experience from other transition countries suggests that numerical debt service limits applied to a restricted set of revenues, such as an operational surplus, (or all revenues) operate better than stock limits. On the other hand, the most effective limitation is to restrict the types of revenues that may be used for debt service, i.e. to ensure that municipalities first provide all of their

mandated services, then generate operational surpluses to finance investment, including debt service.

Article 112: Exceeding the maximum limit

Paragraph 2: who monitors whether a municipality violates one of the provisions of Article 111? Is there "real time" information available? Who reports to authorities that the 15% limit has been exceeded? How would a lender know that a potential borrower has violated one or more provisions of Article 111?

The definition of financial crisis needs to be clarified, and separated from financial problems caused by missed or late payments on long-term debt. Procedures for dealing with unpaid bills, or the sudden accumulation of unpaid bills within a current budget year should involve a different process than settling a situation with outside actors such as banks. In the first case, a majority of unpaid bills are owed to employees, vendors, tax offices and other parts of the budget system.

Comments on the Draft Law on Financial Rehabilitation:

In general, there are four areas in which the Rehabilitation Law needs improvement. Firstly, the definition and separation of the two types of trigger events, i.e. being in crisis versus being insolvent, need to be clarified. Crisis situations as defined in the Budget Code and in the Rehabilitation Act do not necessarily lead to insolvency, and a municipality may be insolvent regarding a debt payment yet still be a perfect actor on the operations side of the budget. There are indications that several levels of the budget system routinely violate the provisions of Article 111-112 and others, so the issue of equality before the law also emerges. The second important area of concern with the draft act is that particularly in the case of insolvency, the Ministry of Finance official appointed to oversee a crisis budget and the rehabilitation process is most likely in a conflict of interest situation. As described by experts in Moscow, municipalities, besides having unpaid bills, owe most of their other debt to a different level of the budget system, i.e. to the regional or federal level.

Our experts strongly disagree with proposed Rehabilitation act's approach, that is, one creditor, the regional or federal authorities, having a distinct advantage over other creditors and vendors in the insolvency scenario. The third area of concern involves the "slippery" transition between being in "crisis" and being insolvent if certain debts of municipal enterprises and institutions are converted from unpaid accounts payable into debt. The "crisis" category is real and prevalent that justifies strict intervention and reforms, and perhaps supervision by the Finance Ministry since public services may be in danger. But this unpaid bills or crisis situation may not necessarily be caused by irresponsible behavior on the part of the municipality, its vendors and suppliers. The reason to deal with the "insolvency" situation in a separate law with an independent trustee or expert is that in an insolvency situation, someone most likely made a bad or irresponsible decision. A bank can take an undue risk, or a municipality could borrow in excess of its ability to generate income to pay back a debt. In these cases, someone is individually or collectively responsible, and an independent, perhaps court-supervised procedure is more appropriate than simply continuing the procedure started while the municipality was only in "crisis." In other words, a distinct "triggering event" and the establishment of responsibility by an independent expert or authority are recommended. (All of the debt adjustment cases in Hungary involved bad decisions by either the creditor or debtor, or both).

A final problem area with the insolvency section of the draft Rehabilitation act concerns the principle that 100% of the debt should be repaid, regardless of the cost, effect on the future of the municipality, and whether the lender (bank) took an undue risk. If banks can expect 100% satisfaction of their claims, then essentially they have passed on all risk to the borrower and to the State if it assists the borrower. This type of delayed guarantee could have serious consequences for

the fiscal balance of the entire country. Instead, any debt adjustment should aim for full satisfaction of "reasonable" claims, and the risks should be borne by those who took them. An opportunity for a negotiated settlement should be given first, and if that does not succeed, then both the debtor and creditor take a calculated risk in letting an arbitrator, court or other expert decide the extent to which claims will be satisfied.

Detailed Comments on the Draft Act:

The aim of these comments is to give some critical remarks on the draft law on municipal rehabilitation. The solvency of localities involves a larger horizon and has significant effect on local economics i.e. economic power of a certain region or city, the unemployment rate, the ability to attract foreign and domestic working capital, nature protection and the standard of living.

To put it very simply what are or what can be the goals of this federal act? First of all (1) the Act should be an important step in moving away from federal or state budget guaranteed loans or open issues involving future obligations of municipalities and hence should force independent market actors to cooperate and compromise out of court and find the ways to avoid bankruptcy using all tools they can; (2) a clear sign to all market actors and a key step in the distinction between state and local debt obligations by making the localities 100 per cent responsible for the debt they incur; (3) the Act should serve as a protective bastion for lending institutions and also suppliers when is comes to solvency problems; (4) the Act should also be a measure to allocate responsibility and financial burden as well when a municipality goes bankrupt by looking to both the creditor and the debtor as well. (5) Last but not least the Act should be realistic in a sense that a municipality should survive and continue its obligatory duties even after the budget recovery proceeding.

Responsibility for insolvency and consequences in a financial sense

According to Article 3 of the draft law, the number one objective of this Act is to protect the interest of the creditors and ensure the fullest possible satisfaction of their claims. This thesis favoring lenders unbalances the responsibility cycle. All the lending institutions must be somehow and to some extent responsible for their decisions to provide credits to municipalities and therefore they must be as careful as possible when lending to financially weak localities.

In most cases one can detect mutual responsibility for budgetary insolvency: on the lender side when lending without prudential debtor analyses and collateral, plus taking false decisions on the creditworthiness of the municipalities, and on the debtor side when taking too optimistic business decisions.

Most important issue: Why guarantee full satisfaction?

At the beginning of this Act and later on in Article 23 (3a) (3b) the plan of settlement simply guarantees the creditors and lenders the full satisfaction of their claims. One should really think in terms of proportional satisfaction when it comes to reorganizing the operations of a financially collapsed local government. This is truly a philosophical issue whether the law differentiates between responsibilities by judging the debtor and the creditor such that satisfaction might not be full regardless of the type of the proceeding. As the Hungarian law on bankruptcy takes this as a principle that full satisfaction is possible only in cases when through agreement with creditors and other suppliers the debated debt can be restructured so that nobody takes forced losses.

Unnecessary trigger on lending

Just one more remark on full satisfaction, if the law transfers 100 per cent full satisfaction to market actors especially banks and other lending institutions, their logical reaction will take the form of strengthening their lending activities regardless of real needs. In global numbers, if the retail-home savings on national level expand, the commercial banks see an extra option and feel also a must to expand their lending activities and where else would they turn rather than to best debtors, local governments. One could see same trends in Hungary before adoption of the act.

Scope of debt and debtor

Different sentences of Article 4 define the debt and debtor but seemingly exclude the suppliers' claims, that is, accounts payable. One should bear in mind that an economic actor or local government can be badly insolvent not only owing to heavy debt but to unpaid suppliers' bills. A slight modification is necessary when defining the meaning of debt and debtor. In Hungary and many transition countries localities embarked on infrastructure investments gas, electricity, sewer system, landfills and were unable to pay the invoices of suppliers. The claim of suppliers must be included in the aggregate of total debt.

Recovery proceedings when really not necessary

Article 5 of this Act strictly defines the signs of insolvency and includes all financial situations when the ratio between the forecasted revenues and total aggregate debt obligation is below 30 per cent. This is also a philosophical issue whether force financially solid and still solvent localities into proceedings. Maybe many of these cases could somehow survive and remain solvent unless all the investment and banking community anticipates their financial collapse as press releases and all the proceedings and consequences detailed in Article 9 predestines them to fall short of their obligations. If a local government or subject can fulfill its obligations even if it is not easy financially and politically, they should be given a chance to survive by finding hidden resources or restructuring debt or restructuring its operational labor force.

In the proceedings there are some illogical steps. Article 9 defines the consequences of the commencement of the proceedings on recovery. As Article 7 defines the parties who can turn to arbitration court by issuing a petition. Upon detecting an insolvent debtor the creditor is given this chance as well although the steps before the judge decides on the petition –to declare the municipality insolvent or not – would involve suspension of collections from the debtor. This is the step a creditor never takes as this stands sharply against its interest.

Consequences detailed in Article 9

Article 9 defines all the measures that take place before (!) the arbitration court decision on recognizing the debtor as being insolvent. Some of the detailed steps are very harmful for the localities.

In detail, if the court decides that the case finally is out of proceedings the suspensions of budget funds and different types of collections make absolutely no sense ex ante. This will do much harm for the municipality and there is no compensation for potential losses, getting in higher risk category in debtor analyses when incurring debt etc.

Some of the measures should be taken right after the positive court decision but not anything beforehand. This applies to Article 10 as well: before judgment on solvency the commencement of the proceedings must be published in the next issue of The Bulletin of the Supreme Arbitration Court of the Russian Federation. The investment community and the population gets information on some hypothetical issue which is going to proven by an investigation process detailed later on in Article 11. This is illogical and should be reverse. If the investigation process proves that the case is truly insolvent, the procedure must start and all the consequences must be applied.

Examination of the budget of the debtor

Article 11 (4) states that the creditors' representative shall be involved in the budget investigation, which is absolutely against the future interest of the municipalities. There might be pieces of business information that simply do not belong to anybody else rather than to the local government itself and making them "public" is against their future interest. Nota bene, the local government is not yet recognized as insolvent at this moment but all of its business information is made well available for the creditors. It is also not quite clear how to define at this point in time the creditors representative as this body is formed only after the creditors' meeting specified in Article 17.

Critical remarks on the procedures

According to the draft law there are major steps in the bankruptcy procedure as follows.

Market actors define the municipality in question as one that is displaying the signs of insolvency based upon the grounds for commencement of the proceedings and criteria detailed in Article 6. (and Articles 111-112 of the Budget Code).

- Market actors – Ministry Of Finance, Financial Body of subject of the Russian Federation, creditors and the debtor- are given the right to submit a petition to the arbitration court. One short comment pertains to the phase "The right to submit…" meaning that they have a chance if they want to but by this it is not obligatory for the debtor! Would any municipality turn to court if it can lose only rights and not gain anything? How will the creditors get budgetary information to submit a petition against a municipality with earnings less than 30 per cent of total debt obligations (plus unpaid supplier bills) defined as anticipated insolvency? Seemingly creditors cannot take anything before realizing the failure of current debt obligation. Would state or budget agencies push the localities under procedure in the "case of the 30 per cent revenue limit"?
- Information Presentation phase by budgetary agencies that is due in two weeks.
- Commencement of proceedings defined in Article 8 and judgment on the petition by the court and appointment of arbitration representative.
- Consequences of the petition and commencement of the proceedings
- Announcement about the commencement in The Bulletin of the Supreme Arbitration Court
- Examination of the Budget and budgetary performance via the auditing committee of the Ministry of Finance of the Russian Federation. It is strongly recommend to involve independent auditors.
- Decision of the arbitration court on insolvency or solvency. One remark to this decision. What are the ratios that will predestine a local government as being insolvent? Are there any? Are they commonly well known? The court can make a decision only to state the failure of a due obligation, interest, capital etc. If so, why run the whole examination? The court simply should see only one thing that is focusing on the failure of due debt obligations that are agreed and admitted by the debtor.
- Actions and steps stated in Article 14 based upon the arbitration court decision, until the plan of rehabilitation comes into force
- Completing the list of creditors and their claims in Article 15. Relating to the power of the arbitration representative, it is sharply criticized that one person is given the right to change the composition and amount of claims of creditors without any type of court decision. If the federal or state ruling aims to favor some debt types or obligations to certain parties, this must be clearly defined and made publicly well known otherwise these impacts are set against clear lending activity and increase banking risks and interests i.e. risk premiums well.

- Approval of preliminary list of creditors by arbitration court, and final approval of creditors' claim.
- Meeting of creditors and forming the committee of creditors
- Development of rehabilitation plan of the insolvent municipality. In Article 23 (2) the ruling says that the plan is to be developed by the representatives of the Ministry of Finance and with the participation of creditors. First of all the principle of subsidiarity is sharply violated when pushing away the representatives of the debtors. It is the obligation of the debt party to create a new recovery budget or plan with the supervision of federal representatives. This article in such a form states a declaration towards the financially weakened and insolvent locality. When the most relevant party is left out from plan development, the questioned debtor mentally feels the plan doesn't reflect its interest and is suspicious and unwilling to adopt. At some points such an action is standing against the principle of governing locally. In point (3a) the term validity and in point (3b) plan of settlement is defined which are the core points of this Act. The plan takes the aggregate volume of debt obligation and prescribes a share of 10-30 per cent of the total income volume that is directed to repay the fullest debt obligation during the validity period. This way it is clearly stated that all responsibility for insolvency and failure on repayment interest and capital etc. is on the shoulders of the municipalities. As said before mutual responsibility as a principle is to be used in such cases. If a lending institution is not installing credits with the highest possible rate of debtor analyses, is not judging on creditworthiness of a debtor than all the outcomes are common in such cases even the financial ones.

If we take a closer look at the settlement plan and the elements and restrictions of the action plan detailed in Article 23 we would come to the conclusion that having such burdens regardless of the causes of insolvency the local economy and the whole local population will suffer and it is questioned whether it can survive and serve as a local government any more. Having those actions resulting in capital and investment shortage during the whole period of term validity.

Control over the execution of the plan of rehabilitation

Suggestions on principles:

Instead of the plan defined in Article 23, a new principle is recommended which takes measures that focus on proportional satisfaction taking into consideration the (a) total debt obligation plus unpaid and matured suppliers' bills, (b) total marketable assets and securities, any type of valued receivables (c) portions of debt obligations. After satisfaction or proportional satisfaction the municipality gets rid of all debt and other obligations.

- There must be a period given for all the creditors and suppliers and the debtor before the arbitration court decision to reach an out of court agreement which in case of lack of agreement is followed by court process.

- The Act should strictly deal with insolvent municipalities and those cases where only symptoms ("30 per cent income limit cases") can be detected must be taken away from scope of the Act.

- Preventive methods should be incorporated into the Act that serve as protection for lending institutions, which can take form of obligatory yearly audit for municipalities over certain debt limit and total expenditure.

- The Act should somehow serve as a legal institution that prevents court run cases and should focus more sharply on strengthening the necessity of out of court agreement as the process – with proportional satisfaction- brings less favorable financial positions for all parties.

Conclusions and Implications for Russia

If national regulatory bodies and the constitutional structure of a state do not allow the competent authorities to directly regulate the ability of subnational units to borrow for capital projects, then all market players, including municipalities, their vendors and lenders, should have a clear set of procedures in place to deal with defaults. If the state chooses to regulate municipal borrowing out of existence at its discretion on a case by case basis, like Great Britain, or organizes its task assignments in such a way as to allow (mandate) an intermediate level to perform public services instead of municipalities (Scandinavian model), then that state does not need a debt adjustment law since municipal bankruptcies are essentially impossible. If the State guarantees municipal borrowings, or acts as a lender directly or through various state-owned intermediary organizations, then that society most likely does not need a municipal debt adjustment law. If the constitutional and political structure allows the state or intermediate level of government to monitor municipal budgets and borrowing, or if any intermediate or state agency is involved in approving borrowing, then that serves as an implicit guarantee, and most likely, a municipal debt adjustment process is not needed. If the State willingly subsidizes essential public services in the case of fiscal stress at the local level, then debt adjustment can be avoided. But this last situation opens up the limitless unpaid bills problem if the State does not impose strict conditions for assistance to municipalities undergoing fiscal stress.

These conditions do not apply in Hungary where municipalities face a plethora of tasks, regardless of size and scale economies that the state agrees to finance based upon national cost norms. In a system where municipalities are free to borrow, invest and spend at their own discretion within certain guidelines, municipalities are themselves quasi-market actors that could face default due to unfettered freedom and irresponsible decisions. Public hearings and approval are not required for municipal borrowings in Hungary, loans are treated as secrets due to bank secrecy, and financial services are exempt from public procurement standards. In this secretive, not necessarily competitive environment, banks are tempted to offer deals that are unfavorable to local governments. Since there is no public review, nor approval from any other body than the city council itself, many misguided loan decisions were made. Banks could abuse this environment as well.

The necessity for a working municipal debt adjustment process depends on all of the above factors and given the tight regulation and controlled borrowing at the municipal level in most of Western Europe and in many US states, the Hungarian municipal debt adjustment law is an anomaly that works rather well in unique environment. Until task allocation is reformed and local revenue options increased, the danger of intentional debt adjustment will exist, hence justifying the continued existence of this legislation. Given the constitutional and highly politicized nature of the rights and obligations of local governments in Hungary, it is highly unlikely that a thorough reform of task allocation and budgetary practices will emerge in Hungary before EU accession expected in 2004.

The debt adjustment law has been criticized for reducing municipal capital borrowing, though this trend is a result of a host of factors related to infrastructure grants, fiscal restrictions and many related capacity questions. The actual net lender position of the municipal sector versus the commercial banks has been rather stable since 1996, the first year the full effect of various restrictions could be detected. In a one time shock, bad loans were squeezed from the system by the

Debt Adjustment Law and prevented by the other restrictions and rationalizations described in this study. The law also seems to favor the debtor giving it the option to reschedule debt indefinitely since creditors are hesitant to file petitions due to the uncertain outcome of workout negotiations or forced liquidation. The debt adjustment law has been effective since it is not used as a last step in a theoretical series of unintentionally related preventive measures, and lenders as well as borrowers have been forced into more responsible behavior. Capacity questions, task allocation, the sharing of revenues, the dearth of the intermediate level of service delivery etc. are related questions that the debt adjustment law cannot address, only repair situations that went out of control.

Reaction of lending institutions. The bank that handles a municipality's current account is familiar with its financial status, spending patterns and risk profile. The existence of the debt adjustment law and the debt service limit thus limit the most egregious examples of inappropriate lending, while the lack of true creditworthiness is fully apparent to the lending institutions. Vendors and competing financial institutions, such as bond underwriters, do not have access to information of this quality. Other lenders have indicated that given their conservative collateral policy, *the debt adjustment act is not a factor in making a lending decision*. A risk factor, however, is legislative redefinition of what funds are available for debt service. For example, attempts at equalizing or centralizing the business tax altered the funds available for debt service in a 5 year fixed interest bond issue organized by a universal bank on behalf of a first tier city from one year to the next. Financial institutions have a legitimate fear that the debt adjustment act does not necessarily protect their interests in a workout negotiation or forced liquidation since negotiable assets available to settle debts are usually not sufficient, and projects funded do not generate sufficient revenues on a stand-alone basis. In contrast to Anglo-Saxon legal systems, loan covenants in Hungary do not contain provisions for mandatory rate or tax increases to fund debt service, nor do workout agreements mandate tax and rate increases. In other words a legitimate critique of the debt adjustment law is that it fails to fully protect the rights of creditors, especially those who rely on revenue-generating projects and not liens on property as security. Another valid criticism of the system is that the mayor, city council members and senior executive staff cannot be held personally liable for bad decisions that damage the interests of the community.

Reaction of municipalities. It is not the existence of the debt adjustment law that prevents local governments from borrowing for infrastructure projects, rather the dearth of freely available cash generated either by a project or other local revenues such as tax collections and capital income. Those who are not creditworthy do not receive bank loans, and the strict prerequisites of the deficit grant system are forcing staffing and other cutbacks in smaller communities with persistent operating deficits. The most vivid reaction of municipalities to the debt adjustment act is evidenced by the various steps taken to avoid formally filing for debt adjustment. Given the hesitancy of lenders and vendors to petition the court, municipalities have leverage to delay defaults and renegotiate accounts payable within certain limits. That is, operating loans and deficits cannot be rolled over from one budget year to the next. Projects in Hungary are not yet of a sufficient scale to generate enough revenues to support stand-alone financing, while localities cannot capture the economic benefits of better infrastructure through ad valorem property taxes to support a general obligation-type debt structure and the covenants usually used to mitigate risk. Operating budgets are under stress hence do not generate surpluses sufficient for large-scale borrowing. On the other hand sewage collection and treatment projects for example are of such magnitude in terms of capital cost that user fees cannot support debt, amortization and operational expenses given the long economic life of the assets and the short (3-6 year) terms of the usual loans to municipalities. (the asset being constructed partially from state funds cannot be offered as collateral as it cannot be sold off in a liquidation scenario nor privatized for 10 years).

Some policy issues for further research

- *The bookkeeping and accounting, reporting and disclosure requirements* applicable to Hungarian local governments are due for reform. Acting essentially as holding companies, budgetary agencies, authorities and the ultimate arbiters of local democracy and self-rule, these accounting and budgetary practices do not capture the complexities of their balance sheets, the need for separate capital budgeting and the realities of delivering mandatory services. For example the debt service limit cannot be truly captured in a balloon payment scenario since the bookkeeping system does not use accruals, and local governments cannot provision for future obligations in an accounting (and compliance) sense. Bad investment decisions and costly debt obligations could perhaps be avoided through a mandatory public hearing and approval process, though this conflicts directly with banking secrecy regulations.

- A register of municipal debt, maintained on a real-time basis, as well as other credit bureau-type information currently monopolized by account holding banks should be made available to vendors and creditors alike.

- Examination of the few long-term borrowings (both bank loans and bonds) would reveal how debt is secured, repayment assured, how funds are used and what risks market players cover. Such an examination would reveal how existing restrictive regulations are used in practice, and perhaps suggest reforms to the existing legal and regulatory framework in order to attract more private capital into the municipal sector.

Annexes:

Annex 1: Preamble to Debt Adjustment Law

Annex 2: Hungarian Debt Adjustment Law

Annex 3: Council of Europe Recommendations on Local Authority Deficits and Debts