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In memory of Anita Papp

**Intergovernmental Finance in Hungary
A Decade of Experience
1990–2000**

© 2004 The International Bank for Reconstruction and Development / The World Bank
1818 H Street, N.W.
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Internet www.worldbank.org
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1 2 3 4 10 22 04

A co-publication of the World Bank and the Local Government and Public Service Reform Initiative / Open Society Institute–Budapest who has provided financial support for this publication.

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ISBN 0-8213-6051-5
ISBN 963 9419 77 X

Library of Congress Cataloging-in-Publication Data has been applied for.

First published in October 2004
Design and layout by Createch Ltd. / Budapest, Hungary
Printed in Hungary



Local Government
and Public Service
Reform Initiative

WORLD BANK INSTITUTE

Promoting knowledge and learning for a better world



THE WORLD BANK

Intergovernmental Finance in Hungary A Decade of Experience 1990–2000

Editors

Mihály Kopányi, Deborah Wetzel, and Samir El Daher



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Foreword



Decentralization has been taking place worldwide for more than a decade. It has been a particularly important phenomenon in the countries of central and eastern Europe and the former Soviet Union as they implemented dramatic shifts in economic paradigms. Now more than ten years of experience enables us to assess how countries have managed decentralization in the context of economic and political transition.

Intergovernmental Finance in Hungary provides an in-depth examination of how these processes evolved, from the perspective of the national and international experts who helped design the key elements of Hungary's new intergovernmental finance system. Most of their policy proposals have either been successfully implemented or integrated into plans for a second generation of reform. Although ten years is a relatively short time frame in such a historic transformation, the country's early and sustained modernization justifies a comprehensive analysis of reform implementation as well as an assessment of their outcomes and impacts.

The book is made up of conceptual essays and detailed case studies on different aspects of intergovernmental finance and municipal management prepared for the World Bank Institute's learning program on decentralization. Twenty-eight studies—highlighting successes, shortcomings, and failures—capture experiences that are highly relevant for many developing countries. This volume will be of interest to government practitioners, students, trainees, and academics, serving as a kind of handbook on the process of fiscal decentralization.

Frannie A. Léautier
Vice President
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Preface



Sometimes controversial and often questioned, fiscal decentralization has been a mainstream paradigm and movement in the last decades in developing countries. Modernization of the public sector, reform of intergovernmental fiscal relations, enhancement of capacity in implementing local strategies, and development of the legislative and institutional framework for efficient delivery of public services are still among the biggest challenges in transition economies. Even relatively advanced countries are faced with serious challenges in creating a modern subnational system at the beginning of the 21st century.

This book illustrates the decade-long transformation of the Hungarian subnational system with a focus on subnational finance. It shows the rocky path of transition from central command to decentralized local self-governments. Hungary has decentralized and refurbished the state administration, reestablished full autonomy of local governments, and tightened budget constraints. The public and private sectors are bound to each other in public utility supply, and civic organizations are also undertaking a growing role in providing social services. This book summarizes what worked well and what did not and why, and then shows the challenges the country faces on entering the European Union.

The present local government system reflects the euphoria of reestablishing democracy in the transition to a market economy through a strong belief in fiscal decentralization and openness towards the private provision of public services. This approach recognizes the right of individual communities of whatever size to retain a separate identity and a representative body, but it puts increasing pressure on them to share an administrative apparatus and run services jointly. Although the process is still incomplete and the results are not perfect, Hungary's transition and its innovative and adaptive local governments have proven the merits of fiscal decentralization.

The book builds upon dozens of policy analyses prepared by local and international specialists. The studies have provided a broad range of evidence of a steady learning process against the background of a deep economic recession and an inevitable fiscal squeeze in the midst of the 1990s. Hungary not only was a pioneer reformer but it moved far ahead of other transition economies in devolving central functions to the local level; and in developing an adequate legal and regulatory framework for a deeply decentralized system. Local governments have gained their first experiences of asset and financial management, strategic

planning, outsourcing, municipal enterprises, public–private partnership, project preparation and implementation. In addition, they adopted the principle of cost-recovery service fees and tested target subsidization of the poorest social groups.

One can conclude that the first “bachelor” phase of intergovernmental reform is over and the actors at both national and local level should continue modernization at a more demanding “graduate” level. Our assessments of the achievements reflects the latter perspective.

This book provides a comprehensive and consistent analysis of a decade-long transition. Several chapters have been presented and received outstanding interest in workshops, training sessions, and conferences (for example, in various CIS and Balkan countries). These experiences suggest that the material is useful for government practitioners and specialists, and a kind of handbook for trainees and university students in the transition economies and beyond.

The book consists of two parts. The first is a comprehensive overview of developments in the 1990s with a list of policy proposals in view of Hungary’s advanced stage of transition. The second part consists of 28 case studies in three sections. The first addresses issues of enhancement of the overall intergovernmental system. The second sets out experiences in building local government capacities in strategic management and finance. The last section addresses requirements for building a competitive framework for financing subnational governments.

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Acknowledgments



This book is a result of the World Bank subnational development program—a joint effort of the Poverty Reduction and Economic Management Unit, the Enterprises and Financial Sector Development Unit, the Infrastructure–Urban Development Sector Unit (all in the Europe and central Asia Region of the World Bank) and the Government of Hungary. It aimed to assist in Hungary’s legislative and policy development. This program has mobilized remarkable funds and benefited from a useful partnership with bilateral donor agencies including the United States Agency for International Development, the Urban Institute, the British Know-How Fund, the Canadian Urban Institute, the Metropolitan Research Institute Budapest, and the Local Government and Public Service Reform Initiative of the Open Society Institute–Budapest.

The authors have benefited from the valuable comments and advice of Millard Long, Lead Financial Advisor; Bruce Courtney, Senior Economist; and the valuable assistance of Zsófia Hertelendy, Vivien Gyuris, Imre Holló, and Dora Jankovics, all members of the staff of the Budapest Office. Edit Kusztošné-Nyitrai, Ágnes Hegedűs, Péter Szegvári, István Várfalvi, and Álmos Kovács, senior specialists of the Hungarian government have provided invaluable feedback and assistance. The authors are thankful to Roger Grawe, Country Director, Central Europe and the Baltic State, for his professional support. The authors benefited from the remarkable support of John Didier, Senior Publication Officer, and Robert Ebel, Lead Economist, World Bank Institute, and the feedback of Fitz Ford, Sector Leader, Urban Development Centre, internal reviewer, and Mila Zlatic and Joanin Sorin, external consultant reviewers.

Abbreviations and Acronyms



| | |
|---------|---|
| ALG | Act on Local Government |
| APEH | Hungarian central tax administration |
| ÁPV Rt. | State Property and Holding Co. |
| ATAG | Act on Targeted and Addressed Grants |
| ÁVÜ | State Property Agency |
| CEE | central and eastern Europe |
| CG | central government |
| CIT | corporate income tax |
| CMEA | Council for Mutual Economic Assistance |
| CSO | Central Statistics Office |
| DRG | Diagnostic Related Groups |
| EC | European Commission |
| EIB | European Investment Bank |
| EU | European Union |
| FDI | foreign direct investment |
| Ft | Hungarian Forint currency |
| GDP | gross domestic product |
| GFS | government finance statistics (IMF) |
| HIF | health insurance fund |
| IBRD | International Bank for Reconstruction and Development |
| LG | local government |
| MDF | municipal development funds |
| MEs | municipal enterprises |
| MLGFI | market-based local government financial intermediaries |
| MoF | Ministry of Finance |
| MoH | Ministry of Health |
| NGOs | nongovernmental organizations |
| NUTS2 | nomenclature of territorial units for statistics (Eurostat 1995). NUTS2 regions are basic administrative units. |
| OBRE | off-budget revenues and expenditures |

| | |
|--------|--|
| PHARE | Poland–Hungary Aid for Reconstruction of the Economy |
| PIT | personal income tax |
| QGOs | quasi-government-operations |
| RSS | revenue sharing system |
| SCLRA | Steering Committee on Local and Regional Authorities |
| SNA | system of national accounts |
| SNDP | Subnational Development Program – Hungary |
| SWOT | strengths, weaknesses, opportunities, and threats analysis |
| TAKISZ | County Treasury and Information Service Office |
| VAT | value added tax |



INTRODUCTION



1

Hungary's Macroeconomic and Subnational Context

Mihály Kopányi and Deborah Wetzel



Hungary, a country of 10 million people, sits at the crossroads of Europe. With its rich history of the Austro–Hungarian empire crossed with “goulash” communism, Hungary is now at the forefront of the countries undertaking the change from command to market economies. This transformation has required radical changes on almost all fronts: political, economic, and social.

The objective of this book is to illustrate the transformation of the Hungarian subnational system with a focus on subnational finance viewed from a variety of perspectives. The shift away from centralized government is an important issue in all transition countries, and debates about decentralization are taking place in both industrial and developing countries. Given Hungary’s advanced stage in the decentralization process, an examination of its successes in developing its subnational finance system and the challenges that remain may be a useful guide for policymakers and others in other countries.

The work in this book was initiated under the World Bank’s Subnational Development Program at the request of the Hungarian government. The Subnational Development Program aimed to bring major donors, local institutions, and consulting firms working in the areas of intergovernmental, urban, and local finance together with financial specialists working to develop a municipal credit market. Partners in this effort included the U.S. Agency for International Development, the Urban Institute, the British Know-How Fund, the Canadian Urban Institute, and the Metropolitan Research Institute in Budapest. The program also brought together teams within the World Bank working on intergovernmental finance, municipal finance and local capacity-building, and the financial sector.

Structure and Contents of This Book

This book consists of two parts plus this introduction, which gives a broad perspective on Hungary’s macroeconomic and subnational context.

Part 1, “The Subnational System,” consists of one chapter, “Modernizing the Subnational System,” a policy note presented to the Hungarian government in 1999. Chapter 1 gives a comprehensive overview of developments in the 1990s. Many of the chapters in this book were prepared as background to the policy note; other chapters represent ongoing work to fill in some gaps. As such, this book presents a smorgasbord of topics and chapters with an overarching theme of the evolving system of subnational development.

Part 2, “Issues of Subnational Development,” contains three sections that form a proverbial three-legged stool:

- Section 1: “Modernizing the Intergovernmental Finance System” (chapters 2 through 13)
- Section 2: “Local Management—Structural Adjustment and Future Challenges” (chapters 14 through 26)
- Section 3: “Developing a Competitive Subnational Finance System” (chapters 27 through 30).

All three legs are needed for effective development of the system, and each must be evaluated and considered in the context of the others.

The overall system of intergovernmental finance, the first leg of the stool, underpins subnational development by setting the framework within which all levels of government must operate, that is: (a) which level of government is responsible for a given function; (b) how local governments are financed, either through local taxes or transfers; and (c) ultimately, how much real autonomy and decision-making authority local governments have. The intergovernmental finance system sets the incentives for subnational governments and greatly influences the degree to which they act in a responsible or irresponsible fashion; section 1 touches on a wide range of issues in this context. In chapters 2 through 5, section 1 considers, first, the allocation of functions in theory and in practice, and then the legal and regulatory frameworks that influence these allocations. Chapters 6 through 9 focus on transfers, and chapters 10 through 13 discuss different aspects of local revenues, in particular, the property tax.

The second leg, strengthening the abilities and capacity of subnational governments to manage their affairs, includes the ability to think strategically, to manage both revenues and expenditures, to make the best use of local assets, and to be aware of how to provide services most efficiently. With the development of these skills, subnational governments are well placed to respond to the incentives that the overall framework sets. Section 2 looks at basic service delivery, contracting out, off-budget activities, municipal enterprises, management capacity, asset management, strategic planning, regulation of urban development, and enhancing local financial management.

The third leg covers building a competitive framework for financing subnational governments. Currently, transfers from the central government finance the bulk of subnational activities. Local governments augment these resources by building their local

tax bases. Given the extensive needs, however, as well as the important fiscal constraints placed on the government by the European Union, economists realize that public sector financing will be insufficient. The question of how to develop a sustainable and sound credit market for subnational governments then arises. Section 3 touches on the key issues in this area: credit market and specialized institutions, financing municipal infrastructure, municipal revenue bonds, and a framework for municipal bankruptcy.

Several issues require further efforts for Hungary to capitalize on the progress it has made so far:

- A large number of local governments are still small and fragmented.
- The role of a regional level of government is still under discussion.
- Financial autonomy for localities remains low.
- Strategic planning and budget management capacities still need to be strengthened.

Localities still look to the central government as their key source of financing. Nevertheless, Hungary has made great progress in developing a system that, for the most part, supports responsible fiscal behavior by all levels of government. It is, therefore, a useful example for other countries grappling with similar issues.

Throughout this book, authors use the Eurostat 1995 nomenclature of statistical territorial units, referred to as NUTS (nomenclature of territorial units for statistics). NUTS2 regions are basic administrative units.

Before delving into the details, the reader unfamiliar with Hungary needs to understand the macroeconomic context, since it greatly shaped the actions taken in relation to lower levels of government and the local government structure during the 1990s. The next two sections provide a brief overview.

The Macroeconomic Context

The forces shaping the evolution of the subnational finance system were greatly influenced by macroeconomic development over the course of the past decade. In the early stages of the transition, Hungary experienced a deep recession, as indicated by a 15 percent drop in gross domestic product (GDP) between 1990 and 1993 (see table 1.1) stemming primarily from the collapse of exports under the Council for Mutual Economic Assistance trade arrangements. Recovery from this early recession was interrupted by the emergence of extreme external imbalances, as indicated by current account deficits approaching 10 percent of GDP in 1993 and 1994, and by a significant increase in external debt. These severe external imbalances were primarily caused by fiscal imbalances, although the real appreciation of the Hungarian forint and other factors also played a role. The country suffered a sharp loss in creditworthiness, caused not only by these large imbalances, but also by the perception that privatization and other important structural reforms had stalled.

Faced with the prospect of a balance-of-payments crisis, the government initiated a comprehensive program of stabilization and structural reforms in March 1995. The program included a sharp fiscal adjustment, a 9 percent devaluation of the forint, followed by a pre-announced crawling peg and a rigid wage policy. The extent of the fiscal support to the program is revealed by the sharp decline in the general government deficit—from 8.4 percent of GDP in 1994 to 3 percent of GDP in 1996 (excluding privatization revenues)—and was made possible by a reduction in fiscal expenditures by 10 percent of GDP during the same period. These reductions in fiscal expenditures affected both the central and local governments and implied significant reductions in the transfers allocated to local governments.

Table 1.1 Selected Economic Indicators, 1991–2000

| <i>Indicator</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>1999</i> | <i>2000</i> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Real sector (percentage change) | | | | | | | | | | |
| Real GDP | -11.9 | -3.1 | -0.6 | 2.9 | 1.5 | 1.3 | 4.6 | 5.0 | 4.5 | 5.3 |
| Exports of goods and services (real) | n.a. | 2.2 | -10.1 | 13.7 | 13.4 | 7.4 | 26.4 | 16.9 | 13.2 | 20.7 |
| Imports of goods and services (real) | n.a. | 0.2 | 20.2 | 8.8 | -0.7 | 5.7 | 25.5 | 22.8 | 12.3 | 21.1 |
| Real fixed investment | -12.3 | 1.5 | 2.0 | 12.5 | -4.3 | 6.7 | 8.8 | 13.3 | 6.6 | 2.2 |
| Real private consumption | 5.6 | 0.0 | 0.4 | 0.5 | -5.5 | -2.4 | 2.0 | 3.6 | 4.6 | 3.3 |
| Average consumer price index | 35.0 | 23.0 | 22.5 | 18.8 | 28.2 | 23.6 | 18.3 | 14.3 | 10.0 | 9.8 |
| Unemployment rate (end of period) | n.a. | 9.8 | 12.6 | 10.9 | 10.9 | 10.7 | 10.4 | 9.1 | 7.0 | 6.4 |
| Real sector (percentage of GDP) | | | | | | | | | | |
| Exports of goods and services | 32.8 | 31.5 | 26.4 | 28.9 | 37.3 | 38.9 | 45.5 | 50.3 | 51.7 | 60.3 |
| Imports of goods and services | 33.7 | 31.7 | 34.6 | 35.4 | 38.5 | 39.9 | 46.0 | 52.8 | 57.8 | 66.5 |
| Fixed investment | 20.7 | 19.7 | 18.9 | 20.1 | 20.0 | 21.4 | 22.1 | 23.5 | 23.1 | 25.7 |
| General government (percentage of GDP) | | | | | | | | | | |
| Overall balance (excluding privatization) | -3.0 | -7.2 | -6.6 | -8.4 | -6.4 | -3.0 | -4.9 | -6.8 | -4.3 | -3.6 |
| Overall balance (including privatization) | -2.9 | -6.1 | -6.0 | -7.5 | -3.2 | 0.8 | -1.8 | -6.3 | -3.4 | -3.5 |
| Expenditures | 56.4 | 60.2 | 60.1 | 59.5 | 52.4 | 48.5 | 49.6 | 47.8 | 46.6 | 46.7 |
| Public debt | 74.6 | 79.0 | 90.4 | 88.2 | 86.4 | 72.8 | 64.6 | 62.3 | 60.7 | 59.2 |
| External accounts (percentage of GDP) | | | | | | | | | | |
| Trade balance | 0.5 | -0.1 | -8.4 | -8.8 | -5.5 | -5.9 | -3.8 | -4.4 | -4.5 | 3.5 |
| Current account balance | 0.8 | 0.8 | -9.0 | -9.4 | -5.6 | -3.7 | -2.1 | -4.8 | -4.3 | -3.3 |
| Foreign direct investment | 4.4 | 4.0 | 6.0 | 2.8 | 10.0 | 4.4 | 3.6 | 3.0 | 7.8 | 3.3 |
| Gross external debt | 67.8 | 57.6 | 63.7 | 68.4 | 70.9 | 61.0 | 51.9 | 56.0 | 63.8 | 66.8 |
| Net external debt | 43.6 | 35.0 | 38.7 | 45.4 | 36.6 | 31.4 | 24.4 | 25.8 | 24.6 | 24.7 |

Source: Ministry of Finance and National Bank of Hungary data.

The stabilization package was accompanied by an acceleration of structural reforms. During 1995–98, Hungary implemented comprehensive reforms that included the privatization of major utilities as well as the restructuring and privatization of major banks.

This program generated a large increase in the volume of foreign direct investment and heightened the prospects of major efficiency gains. Hungary was also the first country in the region to implement systemic reforms to the public pay-as-you-go pension scheme and introduce a second, fully funded, private pillar. These and other reforms restored Hungary's image as the pioneer of structural reforms among transition countries.

The fiscal adjustment and the restrictive wage policy caused a temporary slowdown in the growth rate of GDP in 1995–96. Growth accelerated in 1997, however, driven by strong increases in exports and fixed investment. The output recovery was accompanied by large inflows of foreign direct investment (US\$ 23 billion by 2000) and an improvement in the external accounts, as indicated by the sharp decline in the current account deficit (from 9.4 to 2.1 percent of GDP between 1994 and 1997) and by the decline in Hungary's net external debt (from 45.4 percent of GDP in 1994 to 25.8 percent in 1998).

In the late 1990s, Hungary maintained its front-runner status among European Union accession candidates and posted one of the strongest economic growth rates in the region in 2000. Real GDP grew by 5.3 percent in 2000, up from 4.5 in 1999, driven by strong external demand. Domestic demand growth remained moderate, reflecting slow real wage growth (1.5 percent), while exports grew rapidly (more than 20 percent in volume terms), pulled by western European demand and underpinned by Hungary's competitiveness. Inflation has fallen markedly since 1995, though the disinflation process came to halt in 2000 when average inflation was 9.8 percent, barely down on the 10 percent recorded in 1999 (see table 1.1).

Nevertheless, fiscal policy continued to be tight in 2000. The headline deficit was slightly lower than budgeted at 3.4 percent of GDP compared with a 3.7 percent of GDP outturn in 1999. As will be seen in some of the chapters in part 2, "Issues of Subnational Development," the government's efforts at keeping fiscal deficits low have led to a fiscal squeeze at lower levels of government that has pushed them to strengthen their own sources of revenues, to sell assets, and to improve the management of expenditures.

The Structure and Context of Subnational Governments

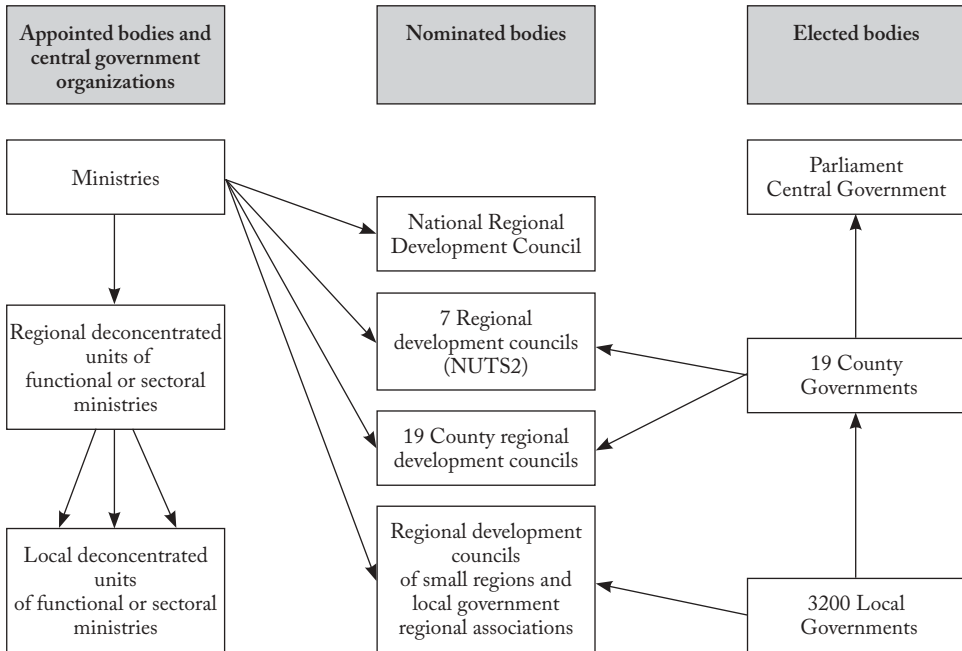
The structure of government includes three levels of elected bodies: the central government, the 19 county governments, and the 3,200 local governments (figure 1.1). These three bodies appoint subordinate organizations to carry out the business of government.

Local Government

The Constitution and the 1990 Act on Local Government established that the basic rights of all local governments, regardless of size, are equal, and that only laws (as opposed to decrees and regulations) can modify their conditions. The legislation set conditions of strong local autonomy. This step was a major one in reestablishing democracy. Some 3,200

communities emerged from the previous 1,500 local units with a strengthened role in the new system. The average population of municipalities, including Budapest, is 3,249, but more than half have fewer than 1,000. In other European countries average municipal populations range from 1,580 inhabitants in France to 30,000 in Sweden.

Figure 1.1 Hungary—Intergovernmental Relations



Note: NUTS—Nomenclature of territorial units for statistics.

Source: Authors.

Counties

Hungary has 19 counties. Although the Act on Local Government downplayed the role of county governments, it provided some room to expand their role as regional service providers. The act states that the county government can be made, by law, to:

- Provide regional public services covering the whole of the county or the larger part thereof
- Organize regional public services when the majority of the users are not citizens of the municipality where the service provider is located.

Other provisions of the act are not consistent with this, such as the authority for municipalities, unilaterally, to take on obligatory county services, either alone or in association. In such a case, the Act on Local Government guarantees state support to the municipality in proportion to the degree of service taken over. If municipalities are unable to perform basic mandatory functions, county governments are obliged to take them over. In 1994, the act was modified to clarify the functions of the county governments. The tasks assigned to the county are not so much service provision but “professional promotion and harmonization,” with little definition of what is meant by this.

Cities with County Rank

Hungary has 23 “cities with county rank,” which in effect are required to act as both counties and municipalities. Legally, these cities are considered to be separate entities, not part of the county. The legislation is not clear about what functions should be carried out by cities with county rank versus the county government, and each of them has tended to develop its own allocation of functions. Thus no systematic approach exists: such cities often have to provide services for broader areas (so-called spillover effects), and many county residents are drawn to the city to benefit from services (agglomeration effects).

Regions

In 1996, the government adopted the Act on Regional Development. While keeping existing county administrative borders, the legislation aims to create a new central–local government balance by creating new subnational decision-making units to elaborate regional development plans and priorities. The National Regional Development Council and 19 county regional development councils were created in 1996, and seven development councils for larger (NUTS2) regions were formed on a voluntary basis. In addition, about 135 small or “micro” regions have developed to improve coordination among local governments in a given area.

This new framework puts emphasis on the county regional development councils, which are entitled to make proposals and decisions on county regional development issues. They are also the constituent members of the regional development councils and have a role in developing regional programs and allocating the development funds provided by the state. Neither the old county assemblies nor the regional development councils have a mandate in other resource allocation. The Act on Regional Development authorizes the county development councils to decide on the decentralized component of targeted grants. Recent decrees (no. 9/1998, no. 31/1998, and no. 32/1998) outline the objectives for these decentralized targeted grants, in particular, those related to the European Union.

Conclusion

The effects of the changing macroeconomic environment and the evolving structure of government are reflected in the basic fiscal situation of local governments (table 1.2). Total revenue and grants of local governments have declined from a high of 17.4 percent of GDP in 1992 to 11.9 percent in 2000. Local tax revenues have increased slightly over time, but transfers (current grants from central government) have fallen by 4 percentage points of GDP. Until 1998, capital revenues also provided a steady source of revenues, but these have fallen off in recent years.

*Table 1.2 Revenues and Expenditures of Local Governments,
1991–2000 (percentage of GDP)*

| <i>Indicator</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>1999</i> | <i>2000</i> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| REVENUE | 15.7 | 17.4 | 16.6 | 16.4 | 14.6 | 14.0 | 14.1 | 13.3 | 13.0 | 11.9 |
| Tax revenues | 2.6 | 3.1 | 2.5 | 2.4 | 2.7 | 3.0 | 3.2 | 3.5 | 3.7 | 3.6 |
| Income taxes | 1.9 | 2.1 | 1.4 | 1.4 | 1.7 | 1.5 | 1.6 | 1.8 | 1.7 | 1.9 |
| Real estate taxes | 0.3 | 0.4 | 0.4 | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 |
| Taxes on product and services | 0.4 | 0.6 | 0.7 | 0.7 | 0.8 | 1.1 | 1.2 | 1.3 | 1.6 | 1.3 |
| Nontax Revenues | 2.0 | 2.5 | 2.2 | 2.2 | 1.9 | 1.9 | 2.1 | 2.1 | 1.9 | 1.6 |
| Current grants | 9.8 | 9.9 | 9.6 | 9.1 | 7.7 | 7.0 | 6.2 | 6.4 | 6.2 | 5.8 |
| Of which from central government | 9.7 | 9.6 | 9.4 | 8.9 | 7.7 | 6.8 | 6.1 | 6.3 | 6.1 | 5.7 |
| Current revenues | 14.3 | 15.5 | 14.3 | 13.7 | 12.3 | 11.9 | 11.5 | 12.0 | 11.9 | 11.0 |
| Capital revenues | 0.5 | 0.7 | 1.0 | 1.2 | 1.0 | 0.9 | 0.9 | 0.7 | 0.7 | 0.7 |
| Capital grants | 0.8 | 1.1 | 1.1 | 1.2 | 0.8 | 0.6 | 0.6 | 0.3 | 0.2 | 0.2 |
| Of which from general government | 0.8 | 1.1 | 1.1 | 1.2 | 0.7 | 0.5 | 0.5 | 0.2 | 0.2 | 0.2 |
| Capital revenues | 1.3 | 1.8 | 2.0 | 2.4 | 1.8 | 1.5 | 1.5 | 1.0 | 0.9 | 0.8 |
| Privatization revenues (lending minus repayments) | 0.0 | 0.1 | 0.2 | 0.3 | 0.5 | 0.6 | 1.1 | 0.3 | 0.2 | 0.1 |
| EXPENDITURE | 14.8 | 16.9 | 16.8 | 17.2 | 14.3 | 13.3 | 13.3 | 13.4 | 12.8 | 11.9 |
| Current expenditures | 12.4 | 13.6 | 13.6 | 13.3 | 11.8 | 11.1 | 10.7 | 10.7 | 10.5 | 9.7 |
| Capital expenditures | 2.4 | 3.2 | 3.2 | 3.9 | 2.5 | 2.1 | 2.6 | 2.7 | 2.2 | 2.1 |
| Other expenditures | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.1 | 0.0 |
| BALANCE | 0.9 | 0.5 | -0.2 | -0.8 | 0.3 | 0.7 | 0.8 | -0.1 | 0.2 | 0.0 |

Source: Ministry of Finance—Government Finance Statistics data.

The fall in revenues was also accompanied by a fall in local government expenditures. These expenditures peaked in 1994. The fiscal retrenching at the central level spilled over to local governments, with 1995 current and capital expenditures dropping by 3 percent of GDP. By 2000, total expenditures had fallen to 11.9 percent of GDP. Overall, local

government balances reflect a similar story, with deficits in 1993 and 1994, followed by retrenchment in the following years except 1998, when a small deficit occurred.

The 28 chapters in part 2 explore the details underlying these broad trends in Hungary's evolving local governments. The changing macro-environment and the evolving structure of government raise important issues for effective intergovernmental finance and service delivery. Major changes to the government structure are unlikely in the foreseeable future. The key question, therefore, is how to improve the functioning of this system beyond the substantial progress that has been made.

Reference

Kopányi, M., S. El-Daher, D. Wetzel, M. Noel, and A. Papp. 2000. *Hungary: Modernizing the Subnational Government System*. World Bank Discussion Paper No. 417. Washington DC: World Bank.



PART 1.

THE SUBNATIONAL SYSTEM



2 Modernizing the Subnational Government System

*Mihály Kopányi, Samir El Daher, Deborah Wetzel,
Michel Noel, and Anita Papp*



Hungary has been a pioneer in local government reform among transition economies. Through a series of legal reforms introduced since 1990, Hungary has decentralized the state administration, reestablished the autonomy of local governments and delegated to them broad responsibilities for public service delivery, implemented a legal and regulatory framework to enable private participation in local infrastructure and services, and tightened budget constraints. The public and private sectors have joint responsibility for public utilities, and nongovernmental organizations (NGOs) are playing a growing role in providing social services. Hungary has reinforced the intermediate levels of government by establishing regional development councils and has tried to promote municipal associations. The issue of the fragmented system of some 3,200 municipalities is still unresolved.

Decentralization has highlighted the need for improving the capacity of local governments to carry out their new responsibilities of delivering local services, maintaining assets, and promoting economic development. The successful completion of fiscal decentralization, a joint responsibility of the central and local governments, will require concerted efforts in national regulatory reforms and local institution building. Only by removing regulatory impediments to local efforts to improve cost efficiency of service delivery and to make it more responsive to local needs—by increasing local revenue generation capacity and addressing deficiencies in capacity building—can the desired effects of fiscal decentralization be fully realized.

Hungary faces a medium-term challenge to increase private and public investment to support economic growth and modernize infrastructure while maintaining internal and external macroeconomic equilibrium. Local infrastructure investment needs have been growing against a background of tight fiscal policies that have constrained budgetary

* This chapter is based on Kopányi, and others 2000.

transfers from central to subnational governments, especially since 1995. The funding sources for municipal investments have included local operating surpluses, central government transfers, and proceeds from asset sales (these are coming to an end). Municipal borrowing for investment has been negligible. Nevertheless, a significant financing gap is envisaged in the coming years, even when European Union (EU) structural funds are taken into account. This financing gap could be filled only through private sources, including foreign direct investment.

This chapter raises policy issues that need to be addressed to develop and implement a comprehensive program of local government modernization in Hungary and is a summary of Fiscal, Local Management, and Municipal Credit Market Policy Notes, a report prepared under the Hungary Subnational Development Program. The chapter contains the following sections: facing main challenges of subnational modernization, modernizing the intergovernmental finance system, strengthening local management capacity, and developing a competitive subnational finance market. Foreign and local experts tested the primary results of the subnational reform in Budapest and several secondary cities; *inter alia*, Kaposvár, Nagykanizsa, Németskér, Nyíregyháza, Orosháza, Ózd, Püspökladány, Szeged, Szentes, Szolnok, and Tatabánya.

Facing Subnational Modernization Challenges

In 1990, in the euphoria of the transition from a command to a market economy, a highly decentralized government system was created. The resulting 3,200 municipalities are responsible for providing local public services in a time when fiscal constraints are tight, citizens are demanding quality services, and the country is stepping through the door of the EU. The experience of Hungary's decentralized government system in the last decade of the twentieth century proved the merit of democratically elected and cautious autonomous local governments, as well as the effectiveness of local initiatives. The historic events of the 1990s—correction measures, fiscal squeeze, and growing local management expertise—are good reasons for an assessment of Hungary's subnational system to identify major challenges and the best way to implement modernization over the next 10 years.

Reformers should continue the restructuring of the public sector and local governments; further support the autonomy of local governments; assure balanced and equitable development, and meet the requirements of the EU. Further steps need be taken for providing services efficiently and effectively; for strengthening the capacity and base for local revenue generation; and securing adequate financial resources. Finally it is vital to enhance the legal and institutional framework for subnational finance; reduce demand-side impediments for municipal access to private finance; and enhance financial intermediation and instruments to subnational entities.

The above issues will be discussed in the following three sections, first looking at how to further modernize the intergovernmental finances; then how to strengthen local

management capacity; and last but not least, how to develop a competitive subnational finance market.

Modernizing the Intergovernmental Finance System

The overall framework for intergovernmental finance creates the context in which localities operate and to a great extent determines the incentives for local government behavior. A stable and predictable intergovernmental finance system greatly facilitates effective strengthening of local government capacity and the development of a competitive subnational financial market. Although Hungary has made good progress, the system needs to adapt to changing circumstances and improve service delivery. The components of the system are highly interrelated and are particularly influenced by political and institutional factors. Making changes to one part of the system invariably has an impact, intended or unintended, on other areas.

Institutional, Legal, and Regulatory Framework

The institutional, legal, and regulatory framework for fiscal federalism defines the structure of government and shapes the context and incentives for interaction between levels of government. An effective intergovernmental finance system requires that levels of government be clearly defined and that institutions encourage transparent, predictable, and responsive decision-making at each level. Accountability at each level is essential; without it, the gains from decentralization are unlikely to materialize. The fragmented system of municipalities and public services has coincided with unclear roles and the vague legal and financial status of intermediate governments. Three areas need further work to improve accountability and incentives: (a) resolving the lack of clarity over the intermediate levels of government, (b) making central and sectoral legislation more consistent, and (c) strengthening the legal and regulatory framework for contracting out the provision of public services.

Reducing Fragmentation and Steps toward a Multilayer Subnational System

Clarifying the role of intermediate levels of government and choosing a path are important aspects of improving the system. Evolving legislation has tried to address fragmentation and efficient service delivery by strengthening the role of intermediate governments (for example, by establishing county and regional development councils) and by fostering municipal associations and other forms of corporations. Existing legislation, however, is unclear about the functions of these levels of government and how they relate to each other. In addition, with undetermined legal status, the intermediate levels cannot develop own sources of revenues, and most do not have the authority to recover costs, to receive grants independently, or to borrow. These constraints limit their accountability and ability to provide services.

Many analysts believe that merging micro-municipalities to reduce their number (from 3,200 to, say, 150) is politically impossible. Thus one option is for the central government to mandate a specific intermediate level, by amalgamating the old structures, formalizing regional councils, or creating new administrative units. Such a route may also be politically difficult and would take several years to develop, consolidate, and implement. A second option is for the government to support the ongoing evolution of associations, either to deliver specific services (for example, education, like school districts in the United States) or to provide a range of activities.

Generally, integration is pursued on the basis of the appropriate economic scale (Davey and Péteri 1998a) for a given function and can be referred to as functional integration or functional regionalism. The grant structure provides incentives for cities to request funds as part of an association. More could be done to help such associations by providing a proper legal definition and giving them the capacity to act as entities to receive grants from the government, raise their own resources through user fees, or borrow. Although the evolution of such associations is well under way (Kusztosné-Nyitrai 1998), implementation of this option requires improving incentives and clarifying their legal status.

Both approaches have advantages and disadvantages. Formal mandating of an intermediate level is stronger than functional integration in meeting equity, fairness, and macro stabilization objectives, but weaker in addressing political accountability issues. In terms of administrative efficiency, the first option lends itself to clearer accountability and assignments of responsibilities and to more comprehensive and integrated policies. Functional integration, by contrast, has greater flexibility, may help promote greater competition and responses that are more tailored to specific needs, and lends itself better to the tradition of citizen participation, which has become increasingly important during the transition.

Overwhelming Sectoral Regulation and Decentralization Challenges

An important aspect of improving intergovernmental finance is to consider how the objectives fit with the central and sectoral laws. The Act on Local Government provides substantial autonomy to municipalities in service delivery and standards. In practice, however, many sectoral laws constrain that autonomy by defining a host of specific terms and conditions under which localities must operate. Clearly, central government sectoral laws have a role in setting nationwide standards, normatives, and a general regulatory framework (Pálné-Kovács 1998).

Sectoral laws often go far beyond their core mission to enforce national standards and support priorities. They may (a) allow too much micromanagement of localities, (b) undermine effective intergovernmental finance by separating decision-making authority from available local resources and pushing the system toward reliance on normative grants, and (c) make local governments less responsible for their decisions and their performance. If decentralization is to be meaningful, then such laws must leave decision-making authority in the hands of the appropriate level of government.

Alternative Methods in Service Delivery and Regulatory Challenges

An issue of equal importance to appropriate government structure and a consistent legislative framework is an environment that effectively supports alternative methods of service delivery, including outsourcing and development of public–private partnerships. Local governments are open to public–private partnerships. Typically, local governments outsource solid waste disposal, park and street maintenance services, (in some cases) water, and (more recently) district heating supply. Such activities will likely increase given that private participation is often needed to finance capital improvements. Public–private partnerships, however, often overvalue the benefits and underestimate the risks and regulatory challenges (Baar 1999a). The government should consider three measures to strengthen the environment for outsourcing and public–private partnerships:

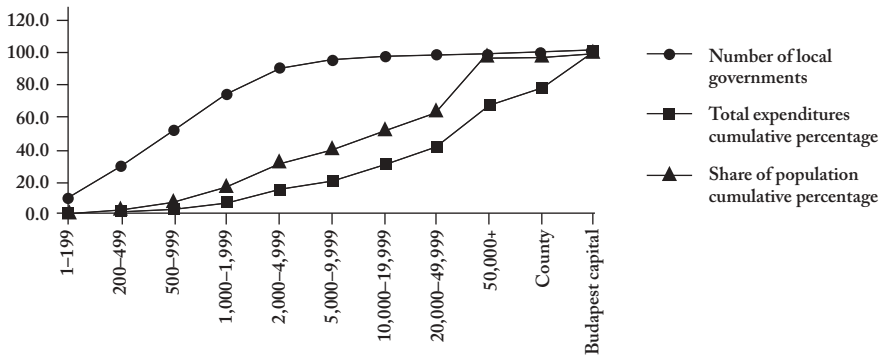
- *Review and revise exemptions to the Act on Public Procurement.* The concept that an exemption or less stringent rule is needed, because the payment for a public service comes directly from the private users rather than from public funds, or that the service goes directly from a private company to the user, is misguided. The interests of the citizen in securing the benefits of the Act on Public Procurement are the same whether the service, or payment for the service or both are directly between the government agency and the citizen or via the contracting party.
- *Make information on public procurement contracts and the basis for pricing accessible.* This disclosure is necessary to establish transparency, stronger competition, and the basic information required for accountability. It also helps communities to develop independent expertise in contracting and pricing and to make informed price decisions.
- *Help localities develop the expertise to enter into and implement service delivery contracts.* In light of the small size of many communities, as well as budget limitations, the government may want to develop, at either the national or regional level, a unit to assist local governments with expertise on public procurement, contracting, pricing, and so forth.

Service Delivery Provisions and Expenditure Assignments

Clear and consistent expenditure assignments that lay out the responsibilities of the levels of government are fundamental for effective intergovernmental finance. Conceptually, expenditure assignments are based on the following five factors:

- *The distinction between private and public goods.* Some important services, such as defense and street lighting, cannot be limited to a single individual, and the benefits of the service accrue to the whole community. The private sector alone would typically under-provide such services, so the public sector must play a role at some level.
- *The scope of the benefits or costs of providing a given service.* Some public goods may be national in scope, some may be regional, and some may be local. Ideally, the aim in expenditure assignment is to match responsibility to the level of government that corresponds most closely to the scope of service delivery.

Figure 2.1 Distributions of Municipalities by Size, Expenditure, and Population (in Percent)



Source: Ministry of Interior data.

Table 2.1 Local Expenditure Assignments

| Expenditure | Nordic countries | Southern Europe ^a | Hungary |
|----------------------|------------------|------------------------------|----------------|
| Kindergartens | X | | X ^b |
| Primary education | X | | X ^b |
| Secondary education | X | | X |
| Daily child care | X | | X ^b |
| Health | X | | X ^b |
| Social welfare | X | | X ^b |
| Public safety | X | | X |
| Public lighting | X | X | X ^b |
| Roads | X | X | X ^b |
| Water | X | X | X ^b |
| Sewerage | X | X | X |
| Garbage collection | X | X | X |
| Fire protection | X | | X |
| Parks and recreation | X | | X |
| Cemeteries | X | X | X ^b |
| Housing | X | X | X |
| Minority rights | | | X ^b |

Notes: a. For municipalities that have a population 5,000 or fewer.
b. Mandatory.

Sources: Gibson and Battery 1993; Hermann and others 1998.

- *The economy of scale that may be inherent in the delivery of a service* (Hegedüs 1998; Hermann and others 1998). Some services can be provided much more cost-effectively

for 10,000 people than for 200, and this economy of scale should be a factor in determining which level of government is responsible.

- *The government's redistribution objectives for improving equity within a country.* Typically, redistribution expenditures should be managed by the central government to assure consistency with other policies (tax policies, for example) and coherence across the regions and municipalities.
- *The political accountability and administrative efficiency.* These factors also play an important role in determining the most appropriate service provision level.

The Act on Local Government defines a wide range of potential local government functions. Hungary combines the system of the Nordic countries with the dispersed municipalities typical in southern Europe (Kopányi 1998). In Hungary, 74 percent of the municipalities represent 17 percent of the population and 8 percent of municipal expenditures (figure 2.1). These contradictions result in further efficiency losses. In addition, some services are mandatory, including potable water, kindergartens, primary education and daily child care, health care, welfare, public lighting, local roads, cemeteries, and protecting the rights of national and ethnic minorities (table 2.1). In practice, most municipalities provide voluntary services, but they omit or transfer to the county some mandatory services. Even mandatory services are financed only partially by the center, making it easy to cite insufficient transfers and local resources, or, simply, insufficient demand (box 2.1).

Service Delivery and Expenditure Assignments to be Enhanced

The following two measures can contribute to improved expenditure assignment.

- *Reduce the discretionary nature of the intergovernmental system that allows municipalities to decide whether they will undertake certain activities.* As we previously stated, several services are not mandatory for localities, so some discretion exists between levels of government. In addition, municipalities have the option to take over some activities from county governments or to transfer to county governments activities they cannot manage. Although this discretion is intended to provide a degree of flexibility, the effect is to reduce the clarity and predictability of the system. Determining which level of government is accountable for the delivery of a given service and whether a service is being delivered economically is much more difficult (box 2.2).
- *Assign expenditure functions to the level of government that can provide the service most efficiently and effectively.* Municipal tasks are of four major types: public administration; provision of human infrastructure (education, health, social assistance); provision of physical infrastructure (water and sewerage, solid waste management); and economic and regional development. The government needs to consider the characteristics of each service when determining the appropriate level for delivery. For example, solid waste management is assigned to local government, even though economies of scale in the industry suggest that it might be more effectively provided at the county level.

Box 2.1 Inconsistent Decentralization in Health Care?

In 1990 local governments became not only the owners of municipal hospitals, outpatient clinics, and general practitioners' offices, but also the employers of the health care staffs. By law, local governments are responsible for providing virtually all kinds of public health care services. A new health insurance framework replaced the old tax-financed health system. Subsequently, the central government established an "autonomous" health insurance fund to cover the recurrent expenditures of health service providers based on output and case mix Diagnostics Related Groups (DRG) normatives. Since 1990 local governments have been responsible for financing capital expenditures from their own budget, including earmarked capital grants and general purpose transfers. Local health service providers are usually legally independent municipal institutions that have considerable managerial autonomy.

Expenditures entail three clusters of costs: current expenditures, for example, wages, medicines, supplementary materials, heating, and electricity; capital expenditures on equipment, for example, purchasing electrical, computer, and medical equipment; and capital expenditures on real estate, building, and renewal. The local government owners of the respective service units (such as hospitals) finance all kinds of expenditures, so the local government must ultimately bear the costs in case of default. Service unit management is delegated to the appointed unit managers, for example, senior doctors, who act with full authority on behalf of the local government. In practice, however, managing the above mentioned three financing tracks is beyond the control of the local governments and leaves them facing a number of sober governance and game theory challenges.

Current expenditures are financed, mainly though not exclusively, by the health insurance fund through monthly reimbursement of DRG transfers. Five factors distort this expenditure. First, hospitals tend to report the most complicated version of a given illness to maximize revenues. In response, the Health Insurance Fund devalues the DRG unit transfers to maintain its monthly budget cap. Second, key cost factors (for example, wages) change beyond the control of hospital management and local government. Health care staffs are public servants employed by the local government and hence are difficult to lay off, and their compensation is negotiated at the national level, even though the resulting cost is covered locally. Third, although service providers reduce services that have a low grant-to-cost ratio, high grant-to-cost ratios encourage overuse of expensive services (such as CT scans), sometimes in outsource form (called functional privatization), to maximize the received transfers to the detriment of other hospitals. Fourth, manufacturers' agents encourage doctors to use new, and sometimes disproportionately expensive, treatments and medicines. Finally, cost overruns are temporarily rolled over through regular or forced credit, or in the case of default, the owner's local government must assume the added expense. By the end of 1999 a dozen hospitals had defaulted. Localities managed to resolve most of the cases, but municipalities handed over three troubled hospitals to the counties to minimize rather than resolve the problems.

Capital expenditures on machinery and equipment are financed mainly through addressed and targeted grants, but private foundations and local governments play a growing role. Municipalities have constitutional rights to apply for targeted grants, though they often do not receive them. In 1999 the Ministry of Health allocated about Ft 6 billion in grants targeted directly at the health institutions, and local resources financed about Ft 24 billion, at least half of which came as earmarked or general purpose grants also from the state. This system of distributing investment funds is the most powerful control the Ministry of Health has over the health sector. Below the surface of earmarked financing is a quasi-feudal system of discretionary support where directors are dependent on the Ministry of Health. If a local official is on bad terms with the ministry, his or her hospital might not receive even the necessary replenishments. If relations are good, however, he or she might receive a brand new CT scanner even if a hospital across the street already has two. So one can say that the Ministry of Health either approves investments on the basis of real needs or its decisions reflect political relations.

Capital expenditures on real estate renewal and development for health care facilities are financed either by the state through addressed subsidies or by the localities from local revenues, but often these expenditures are omitted or postponed.

In sum, local governments have only limited control over financing one of their most important mandatory services. Financing health services is particularly problematic in institutions that have excessive regional service responsibility because current expenditures are mostly, but not fully, covered by central transfers. Hence the owner municipality bears a significant cost while its neighbors get a free ride. Enhancing decentralization by vertical service reallocation and a combination of local and regional service system with respective finances would be a better way to meet these challenges.

Box 2.2 Decentralized Social Assistance for the Poorest?

Hungary has four major clusters of social assistance. First, people who are eligible and easy to identify receive universal benefits. The central government by law finances cash benefits (for example, unemployment insurance, maternity and child-care benefit, and family allowance) from the central budget through deconcentrated state agencies. Second, local governments by law provide mandatory local social assistance (with earmarked and normative grants) when accurate information for means testing is locally accessible. Earmarked matching funds support a few important social services when localities act on behalf of the state (for example, cash benefits for 160,000 long-term unemployed, child-care support, and allowances for seniors). Third, normative grants are transferred to the local governments to support dozens of mandatory social services, which are financed from the local budget. For example, regular social assistance is paid to thousands of people whose eligibility for long-term unemployment benefits has expired, and regular child protection benefits are paid for about 900,000 children because their families' per capita income is less than the minimal pension insurance benefit. Fourth, voluntary local social services often supplement the mandatory services.

Universal benefits and earmarked-fund-supported local assistance are services of the highest national priority. Earmarking aims to ensure maximum accessibility, whereas shared financing, with, say, a 25 percent local contribution, is an appropriate tool to reduce moral hazard, that is, to ensure that localities properly identify eligibility (which is otherwise not easy to measure) and hence do not incur unnecessary costs. These social services are performing well in Hungary.

Normative transfers support services when measuring the eligibility, the magnitude, and the nature of social assistance is complicated. Hence local information, priorities, and considerations are crucial. Normative grants assume a higher (for example, 50 percent or more) local financial contribution but do not imply, however, tight spending obligations, and thus they are similar to general purpose grants. Therefore, if a local government values some sectors (for example, education) more than social assistance, it is free to reallocate funds accordingly. A recent survey shows that some localities spend 40 percent more on social assistance than the received normative grant, whereas others redistribute as much as 90 percent of the received social normative grants to other services (König 1998).

Non-mandatory local social assistance has been growing. Some localities offer additional assistance, but others offer nothing or only a few benefits. For example, Ózd, a small town in northeast Hungary, offers nine major types of social protection benefits, whereas the Ferencváros district of Budapest offers 20 different kinds of assistance for the poorest people (for example, for housing maintenance, public burial, and public health insurance). On the one hand, the voluntary social services administered and financed locally further increase differences in social assistance across municipalities. On the other hand, they represent local interests and priorities in fighting poverty and, hence, are important supplementary elements of every social assistance system.

Several dilemmas arise. Because of their small size and budget, a large group of local governments seems to be financially and professionally unprepared to provide social services to take care of the poorest people. Financing social programs from general purpose grants leads to inconsistent poverty alleviation across the country, because of high variations in payment levels both from one case to another and from one local authority to another. Taking good care of the poorest social groups is a key moral obligation of local governments. A few steps could be taken to: (a) enhance the incentives when social normative transfers are used for social purposes, and (b) ensure some minimal social services for the poorest, even when the local budget is tight. Local governments may need to transfer some assistance from the normative to the earmarked group (WDR 1999), even though doing so may add a significant burden to the central budget. Local civic organizations could also play an important role in articulating and representing the interest of the poorest, who have little lobbying power.

Data on expenditures by size of locality indicate that a majority of small governments allocates a relatively small share of resources (figure 2.1). The data suggest that administrative expenditures are disproportionately higher in small governments than in larger

ones. The evidence on economies of scale also indicates that local expenditure for public infrastructure is carried out at a level that is not economically efficient. All these point to the need to promote a further degree of integration for delivery of key services. Such integration is linked to the approach that the central government pursues toward intermediate levels of government (box 2.2).

Intergovernmental Resource Allocation

Because the central and local governments are equal parts of the public finance system, equity and efficiency might be the key factors in deciding where to collect, how to reallocate, and in what channel to collect public revenues. In this respect, local taxes are alternatives to intergovernmental transfers; they are also alternatives (not supplements) to central taxes. In a decentralized world, local revenues (taxes, fees, and general transfers) represent a large share of public resources. As opposed to earmarked subsidies and discretionary transfers, taxes and general transfers represent one means of fiscal decentralization. The level of decentralization, however, is better signaled by the share of fees and taxes administered locally, although they may still be collected centrally. Hungary's decentralized municipal system contradicts this, with low local revenues and high intergovernmental transfers.

Increase Local Revenues

A key building block of intergovernmental finance is a system of revenue raising that helps localities finance services that are assigned to them. Many Hungarians believe that the local tax situation is unsatisfactory—yields are low in comparison with other countries and local autonomy over taxation is limited. Some analysts are also concerned about high overall levels of taxation and the need to reduce them to be competitive globally and within the EU. The situation has two dimensions:

- *The fiscal argument.* Given the tight fiscal squeeze of recent years and efforts to reduce the deficit, some people believe that higher local tax revenue might reduce the burden of local expenditures on the state budget and, therefore, help support the contraction.
- *The accountability argument.* Others argue that local governments do not take enough responsibility in raising the resources they spend and, therefore, do not spend wisely. The quality and efficiency of financial management would be improved if mayors and councils had to make the more difficult decisions over revenue generation and had to answer directly to taxpayers for the use of a higher proportion of the budget (Bahl 1999).

The fiscal argument implies that reforms should not increase the overall level of local taxation (although any increase in the local tax burden would be offset by a reduction in central government taxes). Tax increases could be avoided in a number of ways. One is to encourage local authorities to exploit existing local sources by levying taxes that they

currently ignore, by increasing designated tax rates, and by improving assessment and collection. Because overall tax levels are high, particularly direct taxes on individuals and businesses (the latter exacerbated by social security taxes), any additional taxation should preferably be on consumption rather than on income and profits, and direct taxation should be selective and progressive in its implementation.

Meeting the accountability objective requires a shift in responsibility for determining tax rates from the central to the local government. Transferring taxes or reducing the rates of some national taxes and allowing a local surcharge would facilitate this shift. To improve accountability, the amount of revenue subject to local discretion cannot be insignificant. Taxes selected for transfer to localities or for a surcharge must: (a) raise substantial revenues, preferably 1 percent of gross domestic product (GDP) or more, and (b) be subject to local rate variations; that is, tax administrators must be able to locate the payer and apply a variable rate whose consequences do not distort the tax base. People within the jurisdiction should bear the impact of the local decisions; that impact should not be exported to consumers or shareholders elsewhere.

Shift from Central to Local Taxation

Hungary's introduction of the kind of tax system that is common in developed countries has been progressive, but major technical and political impediments have prevented enforcement of the tax rules. The challenges of EU accession and the lessons learned from the systemic inefficiencies in the intergovernmental transfer system suggest that greater emphasis be placed on measuring local tax revenues. Three measures are likely to have the greatest impact on local government revenue: the value-based property tax, motor vehicle tax, and the personal income tax (PIT) surcharge.

- Implementation of a value-based local property tax has the potential to be a much stronger source of local revenue (Balás and Kovács 1999; Lados 1994). The property tax yield is very low in comparison with other countries, which suggest that a target of about 0.8 percent of GDP might be attainable. At that level, the tax could raise up to 7 percent of local government budgets. Implementation of a value-based property tax, however, would necessitate a major change in assessments and administrative support (Garzon 1998). The current system of flat rates per square meter, varying only by land use and neighborhood, does not adequately reflect differences in the market or rental value of real estate to bear higher rates of taxation. The potential exists for improving information organization and implementing mass assessment that could make a value-based property tax feasible. Reformers must also consider the notion of deducting local property taxes from national income taxation.
- Increasing revenues from the motor vehicle tax has possibilities. Based on comparisons with western European countries, some analysts make a case for a gradual upward revision of minimum rates on large international freight vehicles, which will face the pressure of EU directives, and on larger cars in the interest of progressive augmentation

of local revenues. The government may also want to consider allocating a greater share, and perhaps all, of this tax to local governments.

- To improve local government accountability, the government may want to implement a PIT surcharge (Davey and Péteri 1998b). A change from PIT sharing to a local surcharge would not require a major modification of procedure, and the existing tax administration seems capable of managing any changes. The main administrative burden would be on employers, who would have to apply various withholding tax rates. Introducing a surcharge would be easier if the impact on both taxpayers and municipalities is neutral at a given standard rate. Setting this standard would mean reducing the national level of PIT taxation and imposing a flat percentage municipal surcharge on all PIT obligations. Municipalities would be free to impose rates above or below the standard, with consequent gains or losses to their budgets. This discretion might be total or within a prescribed range either side of the standard rate. A shift to the PIT surcharge would: (a) increase local accountability, raising the percentage of revenues subject to local discretion from 28 percent to near 36 percent; (b) stabilize local governments' share of PIT yields; and (c) avoid the uncertainty and contention that surround the system of annual negotiation and decision.

Shift from Transfers to Own-source Revenues

Transfers between levels of government help to address: (a) vertical imbalance from a mismatch between local expenditure responsibilities and revenue raising capacity, and (b) inequalities across municipalities or regions (that is, horizontal inequalities) that may result from differing economic conditions and capacities. The key aspects of transfers that influence overall intergovernmental finance are, first, their predictability and, second, the equity and efficiency incentives they create for lower levels of government.

The transfer system can be summarized as follows: very large by international standards, *ad hoc* in both aggregate size and distribution, and administratively complex (Fox 1995, 1998). The transfer structure has significant effects on local government accountability, incentives to raise local revenues, and motivations to select the best investment projects. Generally, governments are held more accountable for revenues they raise through their own sources, and thus the large role of transfers implies less accountability. Unpredictability in the amount and allocation of transfers makes planning difficult for local governments, and although transfers are calculated using a formula, that formula is complex and changes significantly from year to year.

Local governments have disincentives to raise own-source revenues:

- Small own-source revenues mean that big relative increases in local taxes have only a modest effect on total revenues. Local officials see little value in confronting the political consequences of higher taxes when the effect on local service delivery will be limited.

- Local officials may believe that transfers will fall as a result of raising revenues. This negative trade-off can occur in two ways.
 - If all local governments raise more revenues, the central government could lower the amount of transfers, leaving the local sector with no additional resources. Local governments generally are apprehensive that the central government will respond this way and use it as an excuse not to raise own-source funds.
 - Some situations result in a direct trade-off between the revenues generated by a local government and the transfers. For example, deficit grants are a disincentive for local governments to impose their own taxes. The aggregate size of deficit grants is small, but many (and perhaps most) local governments receiving them are not using their maximum capacity to levy local taxes.

Enhance Predictability of Current Transfers

With greater fiscal stability in sight, the Hungarian government might consider linking the overall size of transfers to fixed proportions of state revenues or public expenditures, preferably for several years at a time. The pool of resources available to local governments is determined annually by Parliament. These state budget decisions have no ground rules. Setting the share of local government grants as a percentage of major taxes, as is done in other countries (for example, France, Japan, and the Netherlands) would improve the stability and predictability of the system. As an illustration, the 1998 normative grants equate with 21 percent of the combined estimated yields of value-added tax, PIT, and corporate income tax (a decline from 38.6 percent in 1992). Meanwhile the proportion of central transfers in municipal revenues has hardly changed (from 74 to 68 percent).

The possibilities for improving the transfer system range from introducing block grants to improving the formula. The most extensive alteration would replace the present system of transfers with a single equalization grant designed to compensate for both vertical and horizontal imbalances, including differences in expenditure need, service costs, and revenue potential (Davey and Péteri 1998d; Horváth 1998). Under such a model, PIT shares distributed by origin would continue to be paid to municipalities (unless replaced by the income tax surcharge discussed in the previous paragraph). The rest of the current transfers (including the PIT equalization component) would be included in a block grant. The total grant would be divided by national population to yield a standard per capita allocation, which would be attributed to each municipal area after adjustment to reflect local variance in the major factors affecting local revenue capacity and expenditure needs and costs.

One advantage of such an approach is that it would simplify the system (table 2.2) by folding into the same mechanism the PIT equalization component, earmarked operating grants, and deficit grants. Additionally, this approach, which would simplify the basic grant allocation formula, could be varied either nationwide or by area to cover the introduction of districts or regional associations. For example, if five municipalities form an association, their respective adjusted per capita allocations could be divided between them and the association according to their shares of combined expenditure.

Table 2.2 Categorization of Grants

| <i>Financing Source</i> | <i>Local Control over Funds</i> | |
|-------------------------|---|--|
| | <i>Earmarked</i> | <i>Flexible</i> |
| Ad hoc | Theater Fire brigade Ethnic education normatives Centralized appropriations Most extrabudgetary funds Accumulation revenues inside the state budget Funds from budgetary institutions | Deficit grants Most normatives |
| Shared tax | Road fund | Derivation-based personal income tax Land tax Motor vehicle tax Selected normatives |

Source: Hegedüs 1998.

If more extensive change is not feasible, then the government should implement alterations to improve the current transfer system. One aspect of this is simplification of the formula, which could make revenues more predictable and reduce administrative costs. Revenues would also be more predictable if the grant formula was left in place for several years and if the factors were not changed yearly. The formula could have the basic structure of $G = r(E - R)$, where G is the grant amount, E is a limited number of expenditure needs, R is revenue capacity, and r is the amount by which the grant rises and falls with capacity. The normative system currently operates like part of the equation, where the E reflects the different normatives and r is the values assigned to each normative (Davey and Péteri 1998c). The government has introduced a measure of revenue capacity into the formula. A key difference from the existing system is that a much smaller number of expenditure-need indicators would be included in the formula.

A second moderate change involves deficit grants. Any incremental changes to the system should aim to minimize if not eliminate this type of grant, given the adverse incentives that it creates for local governments. In 1999 more than 30 percent of municipalities applied for a deficit grant, and the total amount requested quadrupled in one year. The combined system of local revenues, grants, and revenue shares should be arranged so that deficit grants are used only in the most exceptional cases and not as a regular financial transfer.

Strengthening the System of Investment Grants

The system for financing investment grants is highly fragmented, has substantial administrative costs, and creates incentives for localities to focus on obtaining grants from the center rather than increasing own-source revenues and improving budget management (Hegedüs 1996). The most extensive improvement option would be for the government to pool all the resources allocated to investment grants into a single investment grant

mechanism to which all localities would apply. Such a consolidated approach would allow more consistent selection criteria across sectors and would help assure that resources are allocated effectively. The national government should develop tighter selection criteria and more detailed review processes to ensure that selected projects are economically viable and the highest priority.

The number of applications must be reduced if the review is to be more than cursory, and tighter application criteria can be an important step in this direction. First, limitations on which local governments or projects will be considered for targeted grants could be made more stringent. Second, local financial contributions, a frequent expectation of grants, must be large enough to ensure that local governments consider the economic costs of each project. In practice the local government's matching share is often very small, so that access to national financing dominates local decisions about which projects to consider.

A more moderate, but similar, route is to continue to strengthen the implementation of the resolution on harmonizing the investment grant allocation across ministries. More is needed to improve information coordination and project evaluation. Ministries have different degrees of willingness to cooperate in the disbursement of grants. Some want an improved process and others want to maintain their independent influence. Under any reform scenario, the government will need to strengthen the capital grants monitoring system.

Enhancing Ability to Absorb EU Structural Funds

A mechanism for receiving and using EU structural grants must be put in place. Formulating an effective system for investment grant allocation and developing regional strategies are major expectations for EU entrants. To meet these requirements, Hungary has taken the initial step of forming a regional development structure (Kopányi, Inel, and Papp 1998). The structure is still in its infancy, so the responsibilities and working methods of these organizations are not fully delineated. As with domestic investment grants, good use of EU structural funds requires a method for identifying optimal projects to be funded. The existing complex, disjointed system is unlikely to lead to optimal choices. Greater reliance on local revenue sources, including user fees, stringent evaluation of projects in terms of economic viability (for example, cost-benefit analyses), and tighter application criteria (to reduce the number of applications), would enhance the prospects for receiving EU funds and increase the chance that they would be targeted to the highest priority areas and would be used for the best projects.

Paths to Further Modernization of the Intergovernmental System

The components of the intergovernmental finance system are interrelated and are influenced particularly by political and institutional factors. Making changes to one part of the system invariably has an intended or unintended impact on others. Although changing

each of these areas is possible, a more effective approach is likely to be the development of a coherent program of changes that can be implemented over four to five years.

The options for reform make up a spectrum, ranging from minimal change to extensive or more radical change. Given the number of areas and the range of possible actions in each area, the system can move ahead in a variety of ways. The government must respond to a series of choices, which in turn affect the system as a whole. Three possible alternatives are extensive change, moderate change, and minimal change (Davey and Péteri 1998d).

Extensive Change

On the extensive change path, the key starting point is determining the appropriate approach to strengthen the intermediate level of government. The government amalgamates the functions of many small cities into larger units that can deliver services more efficiently. These mergers result in precise definitions of the levels of government and specific assignment of expenditure to each level. In Hungary's case, the choice might be made to strengthen further the new regional governments developed under the Act on Regional Development (continuing the 1999 November amendment) or to reinvigorate the role of the counties. Such a change would clearly require revisiting the legislation to revise structures and responsibilities and to assure consistency between general and sectoral laws. Assignments would also need to clarify the appropriate roles of the levels of government in service delivery (for example, standards and regulation, service provision, and performance monitoring).

If new expenditure assignments are set to correspond to amalgamated localities, then adjusting revenue assignments becomes necessary. As a start, the government would need to replace the derivation-based component of the PIT tax sharing with an income tax surcharge provided to localities and, potentially, to a regional or county level. Alternatively, each level of government could have a surcharge on a different tax, for example, municipalities might have a surcharge on the PIT, counties a surcharge on the motor vehicles tax, and so forth. The important thing is that each level of government has a source of own revenue. Developing a value-based property tax may be desirable, although establishing some degree of oversight to assure that the overall tax burden does not increase is important.

Although such a system would create a better balance between the revenues and expenditures of local governments, an equalization grant would still be needed. To assure that transfers to localities remained stable, either a fixed share of overall revenue or specific taxes would be used to determine the amount of allocations through grants. The current range of grants would be consolidated into one simple equalization grant based on adjusted per capita allocations. A detailed analysis of the most appropriate indicators of expenditure need and revenue capacity could form the basis of such a system. The extensive change case would also move the system of investment grants toward a consolidated pool of funds in which grant decisions are coordinated across sectors and based on closer scrutiny and allocation to those activities with the highest rate of return.

Pursuing such a path would address the fragmentation in the system and would rebalance the revenue side of the intergovernmental system to give more weight and accountability to lower levels of government. That being said, the system would be more rigid in terms of assignments and service delivery, and amalgamating localities is likely to prove politically difficult. Nevertheless, such measures would improve both the predictability and stability of the system—important objectives for moving the system forward.

Moderate Change

In the moderate change case, a substantial number of very small localities try to increase the efficiency of service delivery by creating special districts or municipal associations, development regions, and the like. Many such associations are developing, and this process reflects what might be called a “bottom up” strategy, although the center may maintain relatively tight control over activities through regulation, monitoring, and financial support.

Such an approach requires Hungary to develop the legal and fiscal mechanisms to support cooperation among units of different sizes. Associations need to be given legal status to create and sign contracts, put up collateral for borrowing, receive grants, and under some circumstances perhaps, collect tax revenues. The legal framework must fully support the transparency of public procurement and pricing decisions so that different service providers have the information to operate effectively. This approach also requires much more flexibility in terms of expenditure assignments because different units of different sizes will deliver different services. Although this dissemination of services makes the system administratively more complex, it has the advantage of supporting greater competition and better overall resource use.

In this moderate change scenario the most important factor on the revenue side is to assure that municipal associations, special districts, and the like are in a position to have some source of own revenues. In many cases, this assurance may be accomplished through direct cost recovery. As in the extensive change alternative, however, other important considerations are implementation of an income tax surcharge, potential other surcharges, increases in the motor vehicles tax, and development of property. For municipal associations and districts to be accountable, a specific source of revenue over which they have some control is essential.

Replacing the current system of transfers with a single block grant would be possible, and transfers could then be provided to associations and the like, based on their share in provision of a given service. Alternatively, streamlining and revising the transfer system; using a simpler formula that relies more on need-based measures (rather than user-based measures); strengthening the use of revenue capacity and enabling municipal associations, special districts, and the like to receive grants directly rather than indirectly through the constituent municipalities would be necessary.

In addition associations’ direct access to investment grants must be improved. Consolidation and unification of the investment grant system are unlikely in the moderate

change case, so governments would have to make efforts to strengthen the current mechanisms, including tightening selection criteria and conducting a more detailed review of projects on the basis of economic and social criteria. To encourage associations, the government may also want to change the allocation criteria to put more emphasis on achieving economies of scale than it does now.

Pursuing this moderate path would not do much to help address the administrative complexity of the system. Units of different size and organization would provide different services, and such a system is more difficult to manage and does not improve the clarity of expenditure assignments. The flexibility of such a system, however, is likely to make it more responsive to users and, in theory, should improve overall resource allocation. Such an approach also has the important advantage that it is much more participatory and, to a certain degree, less politically difficult to implement. The key aspect of pursuing this route is to make sure that associations and districts have the legal means and fiscal resources to carry out their required functions.

Minimal Change

This route more or less preserves the status quo, with no institutional or structural changes to the system envisaged. The establishment of legal mechanisms to support the evolution of associations and voluntary regions as they now exist would be passive or reactive. Some attempt would be made to address the most egregious inconsistencies between general laws and sectoral laws. At a minimum, public procurement contracts should be made accessible to encourage transparency and further development of contracting out as a means of service delivery. In terms of expenditure assignments some attempt should be made to reconcile existing legislation and to clarify the relation between mandatory and voluntary assignments.

On the revenue side the minimal change case still envisages greater emphasis on increasing own revenues through further development of the property tax, although planners expect that the implementation of a value-based system would not be as rapid as under other scenarios. Motor vehicle taxation would also be increased to improve own revenues.

With respect to transfers, even without institutional change, the system must be simplified and the number of normatives in the formulas must be reduced. More generally, the normatives need to be reduced and better focused to lessen the administrative burden on localities. In addition, providing counties, as service units, with access to own-source revenue and supporting associations by allowing them to receive grants would be desirable. Furthermore, planners need to strengthen the allocation of investment grants into a more coherent and effective system.

Although minimal change may have some marginal impact on the system, it is unlikely to address some of the larger underlying intergovernmental finance issues, such as fragmentation, imbalance between expenditure and revenue assignments, and an *ad hoc* system for allocating investment grants. To address these underlying issues, bolder steps are required.

Strengthening Local Management Capacity

Since the early 1990s the breadth of new local government responsibilities and reduced central government funding has put heavy pressure on municipal budgets. Most local governments have managed to keep balanced budgets because they have reduced their expenditures, increased their own revenues (mainly from asset sales), privatized and contracted out services, and increased the efficiency of their operations. Some local governments have virtually eliminated budgetary surpluses, reduced capital investments, underfinanced maintenance of municipal assets, and have only partially used local taxes. The increasing role of locally administered revenues has deepened the disparities between large and small, between urban and rural municipalities, and across geographic regions. Differences are huge between innovative, progressive municipalities, on the one hand, and those that lack expertise and “enterprising” spirit among local decision-makers, on the other. These two groups of municipalities might help each other if properly organized institutions and procedures for information exchange, professional cooperation, and joint policy design were in place.

Institutional, Legal, and Regulatory Framework for Service Delivery

According to the 1990 Act on Local Government, the 3,200 municipalities are similarly mandated to provide all kinds of local services in compliance with the main democratic objective of fiscal decentralization. In practice local public services are provided by:

- The state
- Counties
- Cities with regional competency
- Regional associations of municipalities
- Municipalities—by divisions of the mayor’s office, local budgetary organizations (for example, schools and hospitals), public–private companies, private entities, and NGOs (for example, churches).

Local governments are also mandated to be the basic regulators of local services in compliance with the national legal and regulatory framework. National regulations, however, go far beyond protection of national standards and support of national priorities. They often determine the financing of input factors, while providing on average 70 percent cost coverage even for the mandatory services (known as quasi–task–financing). From the perspective of the municipalities, the legal and regulatory framework creates serious impediments to improved cost efficiency.

Inconsistency of Regulations

Efficient use of resources is limited by contradictory and overwhelming regulations concerning service delivery. Almost 67 percent of local government expenditures are dedicated to social services, such as education, health, and social care (Péteri 1999). These

services, which are provided through local budgetary organizations, are subject to national rules and regulations over which local governments have little or no control. As a result, the process of local fiscal adjustment in these sectors is contingent on numerous, sometimes conflicting, unachievable, and frequently changing sectoral rules, regulations, and policies of different ministries. For instance, the regulation on salaries dictates that local governments increase minimum public employee salaries, but does not provide incremental financial resources.

Local governments often fail to comply with the ever-increasing number of complicated government regulations on local services. This noncompliance indicates that: (a) their institutional capacity is no longer sufficient to keep up with the system, and (b) the legal process does not sufficiently take into account local needs and incentives. Housing, for instance, remains subsidized by municipal budgets because of restrictive central government regulations that prevent municipal authorities from raising rents and tariffs to recover costs. Municipalities frequently disregard some regulations under the pretext of insufficient resources. Although sectoral transfers are generally earmarked for certain services, the pressure on local governments to provide services differs because of the rigidity and enforcement of sectoral regulations. As a result, local governments frequently draw resources from less rigidly regulated sectors, such as social services or housing, to cross-subsidize the provision of politically more sensitive and more tightly regulated services, such as education.

Grant-to-Cost Ratio versus Local Needs

Local governments are assumed to follow local service priorities strictly and, if required, supplement central grants from own-source revenues. Despite some increased emphasis on local priorities, the grant system still drives local resource management and service delivery. Local authorities' economic response to changes over time in transfer allocation rules and to reduced government transfers has been mixed. On the one hand, many localities discontinued or minimized provision of services with low grant-to-cost ratios. Local capital investment is also largely driven by access to targeted grants. On the other hand, some evidence shows that, despite financial difficulties and reduced central government funding, local government spending has been on the rise in sectors of high local priority (for example, primary schools; box 2.3).

Box 2.3 Conflicting Rules in Education

In the education sector, the normative grant allocation rules prescribe the maximum number of students per class, which rises from 21 in grades 1 through 6 to 30 in grades 11 through 13 and 25 for the rest. This formula causes problems for schools, because in practice, the number of students per class drops in higher grades. The regulation particularly hurts schools in smaller settlements, which have limited possibilities to reorganize their operations or to raise extra funds. The essence of the problem is that the allocation of normative grants also follows the formula defined by the law, which in turn translates into the number of classes organized or the number of teachers hired. As a result, lower grades are consistently underfunded while higher grades are overfunded. Yet neither the schools nor the localities have the flexibility to make the needed internal adjustments.

Local governments' response to the grant allocation system can be described as optimal when they discontinue or minimize provision of services if both the grant-to-cost ratio and the local priority are low. Grant-to-cost ratios, however, can be low not only because of insufficient grant financing, but also because of over-capacity or bad management. In cases where municipalities discontinued provision of services that were badly needed by the community, but received insufficient grant financing, their economic behavior can be considered distorted. An extension of this type of distorted behavior occurs when municipalities reduce the scale or quality of important local services, typically by neglecting adequate maintenance or renovation. For example, in the early 1990s, instead of downscaling, they closed nursery schools, partly because of the lack of grant financing and partly because of a decrease in the number of eligible children.

Another form of municipal response to a low grant-to-cost ratio for certain local services has been to transfer the responsibility for delivery to the county. In principle vertical rationalization of local service delivery is a good step. In practice this measure does not comply with a regional strategy and may result in lower quality of services. First, it is a one-sided decision by a municipality aiming to get rid of an underfinanced institution. Second, a county usually has fewer disposable funds to supplement insufficient transfers received from the central government (box 2.4).

Box 2.4 Inconsistent Decisions of Local Priorities?

The city of Tatabánya transferred the operation of the hospital, two high schools, and a youth hostel to the county. Meanwhile it decided to continue operating a sports facility and the local archives and opened a new higher education college. In the city of Szentes, however, where the education services overburdened the local budget, the municipality still preferred to continue financing high schools rather than transferring them to the county.

Variation in local government response to central government transfers can be explained, at least partially, by the rigidity of grant allocation rules. From the local governments' point of view, grants can be characterized by degree of spending flexibility. The two extremes are general purpose and earmarked grants. The larger the percentage of grant distribution that falls in a formula-driven, earmarked category, the more rigid the grant allocation system and the more distorting its effect on the local resource allocation process. The period 1993 to 1998 saw a significant shift from general purpose grant allocations toward a more rigid task-financing system. Although unconditional general purpose grants accounted for 37.3 percent of all grants in 1993, their share dropped to 23 percent by 1998. As a result municipalities now have very few disposable revenues. Although the normative grants are not earmarked by law, in practice local service organizations claim their share, which is provided by the national budget.

The design of the special deficit grant program provides another example of an impediment to local fiscal adjustment. A municipality is eligible for a deficit grant if its

revenues prove insufficient to cover mandatory services. Many analysts see this program as distorted for encouraging many local governments to seek a solution to their fiscal problems by claiming “deficit grants” rather than working through local fiscal and structural reforms. Although the amount of deficit grants remains relatively small (around 0.1 percent of GDP in 1997), the number of local governments applying for these additional grants increased to almost 30 percent of all municipalities in 1999, indicating serious flaws in the design of the transfer system (see “Modernizing the Intergovernmental Finance System” and Fox 1998).

Large Disparities in Service Coverage

Although they are not statistically representative, the city case studies carried out under the Subnational Development Program (for instance, Sebók and Kovács 1999, Mészáros and Pataki 1999) indicate significant variation with respect to the coverage of services and the range of special services (table 2.3). For example, three of the six cities considered (table 2.4) cover only about one-third of the settlement with sewer services, whereas three of the cities cover three-quarters of sewer services. Coverage of gas supply and garbage collection varies, whereas all cities take care of about two-thirds or more of roads (table 2.4). Behind these figures lie three major factors: (a) inherited service networks from socialist industrialization (Szolnok, Nagykanizsa); (b) successful navigation of the web of investment grants; and (c) local priorities, including significant financial contributions from citizens to network investments (Jókay, Kálmán, and Kopányi 1998).

Table 2.3 Special Services in Sample Cities, 1998

| <i>Service</i> | <i>Nagykanizsa</i> | <i>Orosbáza</i> | <i>Püspökladány</i> | <i>Szentes</i> | <i>Szolnok</i> | <i>Tatabánya</i> |
|----------------------|--------------------|-----------------|---------------------|----------------|----------------|------------------|
| Higher education | s | s | | s | s | + |
| Swimming pool | + | + | + | | + | |
| Public transport | | | | | + | |
| Hospital | c | + | | c | c | c |
| Elderly home | + | | + | | + | |
| Elderly care | + | | + | + | + | |
| Housing allowance | + | | | | + | |
| Recreation | + | | + | + | + | + |
| Archives | | | | | | + |
| Theater | | | | | + | + |
| Community art center | + | | + | + | + | + |
| Fire-fighting | + | + | + | + | + | + |
| Library | + | | + | + | + | |
| Museum | + | | + | | | |

Note: Blank cells indicate no service or service provided beyond the city border; “s” indicates service provided by the state; “c” indicates service provided by the county; “+” indicates service provided by the city.

Source: Ministry of Interior data.

Provision of special services varies from a wide range in Nagykanizsa and Szolnok to a more limited range in other cities (table 2.4). In part these differences stem from changes in the organizational forms of local service provision that started taking place in the mid-1990s, influenced by: (a) sectoral laws that introduced new local service responsibilities, (b) tax incentives for private service providers, and (c) local lobbies advocating alternative forms of service delivery.

Table 2.4 Urban Infrastructure Service Coverage, 1996 (percent)

| <i>Service</i> | <i>Nagykanizsa</i> | <i>Oroszáza</i> | <i>Püspökladány</i> | <i>Szentes</i> | <i>Szolnok</i> | <i>Tatabánya</i> | <i>National average of cities</i> |
|--------------------|--------------------|-----------------|---------------------|----------------|----------------|------------------|-----------------------------------|
| Sewer in house | 76.2 | 32.4 | 25.9 | 33.0 | 76.3 | 81.8 | 47.4 |
| Gas supply | 100.0 | 76.7 | 52.0 | 67.7 | 80.1 | 11.5 | 60.4 |
| Covered roads | 87.0 | 60.4 | 66.7 | 81.1 | 75.9 | 94.7 | 63.7 |
| Garbage collection | 99.2 | 74.0 | 20.3 | 75.5 | 96.0 | 100.0 | 76.7 |

Note: Although the six cities selected for an SNDP study are not representative of all Hungarian cities, they provide a good spectrum of sizes, economic and social characteristics, and geographic locations. They also differ in terms of their economic policies and management capabilities. Two of them, Tatabánya and Szolnok, are county capitals with more than 70,000 inhabitants. Tatabánya, Szolnok, and Nagykanizsa also have county rights, which put them among the 23 most important cities of Hungary. The other three cities of the sample are small or medium-sized. Orosháza and Szentes have close to 35,000 inhabitants, and Püspökladány has 16,000.

Sources: Central Statistics Office County Yearbook 1997 data; National Average of Cities data; Sebők and Kovács 1999; Mészáros and Pataki 1999.

Alternative Organizational Forms in Service Delivery

Local governments have been innovative in introducing alternative forms of service delivery. This innovation has played a key role in reducing the size of the public sector while maintaining or even enlarging the scale of local service delivery. Improved cost efficiency and better quality of services are the main rationale for experimentation, but in some cases other objectives are no less important. The latter are usually driven by attempts to avoid certain government regulations (for example, public procurement rules). These regulations can be sidestepped by changing the institutional structure of the service provider. For instance, municipally-owned service providers that are budgetary organizations are subject to government cash-accounting rules and cannot obtain refunds from the value added tax. A service provider structured as an independent company can obtain a value added tax refund (20 percent cost saving) and, in general, receives a more favorable tax treatment. Such companies also enjoy greater flexibility, which enables them to avoid profit taxation through cross-subsidization of services.

New forms of service delivery include limited liability companies, foundations, and public corporations owned and controlled by the local government. These units operate

outside the local government administration and are subject to laws and regulations applicable to private companies. Their business plans are subject to approval by the local assembly, which also appoints the manager, but has no power to control the management of municipal enterprises. Typically, a limited liability company with municipal ownership serves as an umbrella organization, providing a wide range of services, including preparing proposals for fees, tariffs, and user charges (subject to approval by the municipal assembly). The main concerns with this form of local service provision are that it: (a) is frequently used for cross-subsidizing certain activities in a nontransparent way, (b) allows avoidance of profit tax, and (c) may expose the municipality to commercial risks. For example, typically the rents from nonresidential property subsidize residential rents, an arrangement that may divert the attention of the local administration from achieving cost recovery in the housing sector (box 2.5).

Box 2.5 NGOs in Service

Traditions are powerful in municipal service provision. The local governments prefer to provide services themselves, partially because this way the image of the “caring” local government lives on in the minds of citizens. In addition, their involvement directly influences the service provision itself. Therefore, local governments and their institutions tend to establish their own quasi-nonprofit forms (such as public foundations), that then are in competition for clients and donors with the other service provider NGOs. This competition presents a serious challenge for “real” NGOs locally (Ágh 1999).

Local government budgetary service organizations (for example, schools) have their own personnel policies, the right to subcontract, and the right to use municipal assets under their management in the way that they see fit. They can also seek external funding and start some entrepreneurial activities. Although the local government assembly appoints the director of such an institution, it has only vague operational control. In general, local government budgetary service organizations account for 60 to 70 percent of total local government spending, so the efficiency of local governments depends on the right incentives being given to these entities.

In their efforts to reduce the costs of local service provision, local governments also have taken advantage of competitive contracting-out opportunities. They are required to comply with the new procurement standards modeled after the EU procurement directives (Baar 1999a). In 1997, municipalities awarded Ft 135 billion in contracts through tenders, which amounts to almost 15 percent of their gross expenditures. Public service providers also awarded tenders in the amount of Ft 81 billion. In addition, an unknown amount of contracting out was done without tenders or through procedures not governed by the national procurement act. The general experience is that contracting out results in more cost-efficient delivery of local services, although usually does not allow sufficient local government control over the providers.

Privatization, build-operate-transfer or management contract arrangements are not commonly used yet, but they will increase for services that require significant capital

investments, such as refuse collection or water services. By 1997 Budapest, Szeged, and Szolnok contracted out water services, and those contracts account for about 10 percent of all water services in the country. These undertakings are being closely scrutinized by other local governments because of their somewhat mixed results. In Szeged, for instance, the problems stemmed from weak local government capacity to evaluate long-term service contracts and relatively undeveloped legislation on build-operate-transfer arrangements. Good examples of contracting out water services (for example, Kaposvár) do exist, however.

Financing the Delivery of Local Services: Local Revenues

From 1993 to 1998, local government revenues nationwide decreased in real terms by more than 20 percent. The ability of local governments to raise more resources is in many respects determined by: (a) the authority to introduce local taxes and user fees, (b) the political will to levy local taxes and increase user fees, and (c) the local government’s capability to administer taxes and fees. Furthermore, at least in the short term, local revenue generation is a function of municipal asset disposition policies.

Local Taxes

Local governments can make greater use of their taxing and rate-setting authority. Although the central government establishes local taxes and major procedural regulations with regard to user fees and charges, local governments have the discretion to use them and set the rates within the range established by the law. In this sense local governments have some degree of autonomy with regard to local taxation and rate setting. Local governments’ taxation and revenue-raising policies can vary a great deal, however: some use all of their legal authority to levy taxes and set rates; others levy no local taxes or choose tax rates well below the maximum allowed (table 2.5).

Table 2.5 Relationship between Average Tax Rates to Maximum Rates Set by the Central Government, Selected Municipalities, 1991–1997 (percent)

| <i>Local taxes</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Tax on buildings ^a | n.a. | 16.6 | 16.6 | 16.6 | 30.5 | 17.0 | 17.0 |
| Tax on plots ^a | n.a. | 10.0 | 15.5 | 15.5 | 15.5 | 7.5 | 7.5 |
| Communal tax ^b | n.a. | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Business tax ^c | 100.0 | 66.6 | 71.9 | 84.4 | 95.8 | 77.7 | 86.1 |

- Notes:*
- a. Tax on buildings and tax on plots are per square meter.
 - b. Communal tax is per employee.
 - c. Business tax is a percentage of revenues.

Source: Garzon 1999.

Despite ample room for additional local taxation, many analysts recognize that overall tax levels, particularly business taxes, are high and are becoming an impediment to business development and the creation of new jobs. Indicative of this situation is that in the last few years, the share of municipal revenues from the local business tax, levied on the net turnover, was higher than that from the PIT. Many believe that any additional taxes, including local taxation, should focus on wealth rather than on income or profits and should be selective and progressive in its incidence, falling on those best able to pay (Davey and Péteri 1998b).

Fees and Charges

Fees and charges for services that are not contracted out have been declining, and local governments will need to make a greater effort at cost recovery. From 1993 to 1998 the budgetary significance of municipal user fees and charges declined rapidly, from 61 percent of locally generated revenue to 46 percent. In the case of the six cities selected for the study, only Szolnok managed to raise the share of tariff income in local revenues from 32.4 percent to 50.3 percent (table 2.6).

*Table 2.6 Tariffs, User Fees, and Charges for Six Cities
as a Percentage of Total Locally Generated Revenue, 1993–1997 (percent)*

| <i>Year</i> | <i>Nagykanizsa</i> | <i>Oroszáza</i> | <i>Püspökladány</i> | <i>Szentes</i> | <i>Szolnok</i> | <i>Tatabánya</i> | <i>National Average</i> |
|-------------|--------------------|-----------------|---------------------|----------------|----------------|------------------|-------------------------|
| 1993 | 72.05 | 47.59 | 54.53 | 35.94 | 32.39 | 44.68 | 61.08 |
| 1994 | 70.71 | 57.87 | 41.42 | 43.56 | 49.10 | 30.19 | 58.72 |
| 1995 | 62.83 | 42.93 | 71.53 | 30.16 | 43.53 | 36.47 | 54.75 |
| 1996 | 51.95 | 36.88 | 67.66 | 24.62 | 48.75 | 30.54 | 46.13 |
| 1997 | 50.75 | 38.62 | 44.79 | 16.75 | 50.31 | 13.06 | 46.15 |

Note: The table is computed by dividing operating revenues from municipal service providers by total municipal operating revenues.

Source: Ministry of Interior data.

In contrast to their limited taxing authority, local governments in principle have full discretion to set tariffs. The process varies a good deal around the country, from no local control to limited decision-making authority. For some services, such as rentals for nonresidential space, practically no state control exists. In the case of a typical municipal company, user charges are generally agreed on by the board of directors of utilities or other public service providers in which the local government is the main owner or shareholder.

Tariffs on major municipal services have remained virtually flat in real terms, thus flagging potential problems with financing the replacement of dilapidated infrastructure and the mounting pressure on municipal budgets. Typically, municipal user charges do not cover

replacement costs, in the expectation that those costs will eventually be financed by central government grants. In Nagykanizsa, for instance, the charge for garbage collection covers operation and administrative costs, but excludes depreciation. The cost of new investment is the responsibility of the municipality. This case is not unique. Generally, utilities cover maintenance and operation costs, whereas reconstruction and capital financing remain the responsibility of the municipality (Jókay, Kálmán, and Kopányi 1998).

Although tariffs remain below the cost recovery level when capital costs are taken into account, local governments and private providers of public services enjoy an exceptional level of collection, as high as 94 percent over the last few years. Another indicator of good payment discipline is a low level of household payment arrears to service providers, which over the last five years remained relatively flat or decreased in real terms. Nevertheless, arrears continue to be an issue in low-income urban areas, where improvement in collection cannot be achieved without special programs.

Sustainability of Local Revenues

Analysis of the revenue structure of municipalities over the last five years reveals that the almost 10 percent drop in recurrent revenues between 1993 and 1998 was mostly offset by a substantial rise in capital revenues from asset sales, which started to subside in 1997. Capital revenues have become fairly important for the cities analyzed in the case studies. In 1998 Szentes and Tatabánya derived almost 26 percent to 30 percent of their total revenues from capital sources—asset management, sale of assets, targeted subsidies from the central government for capital outlays, and, in a few cases, bond issues. Reliance on sales of municipal assets is becoming less sustainable. A precipitous decline in local revenues in Püspökladány was the outcome of reduced capital revenues from asset sales. If local recurrent revenues from taxation, tariffs, and user fees remain flat, as they have been over the medium term, the continuing decline in capital revenues will soon translate into a rapid deterioration of local governments' financial performance.

Several policy implications emerge from the analysis of the local revenue structure. The situation suggests that local governments need to look for alternatives to capital financing, different from the sale of municipal assets, which is no longer sustainable. One obvious strategy is to strengthen recurrent revenue sources. This strengthening requires modernizing and making much greater use of local taxes. For instance, the property tax is based on the physical size of the properties rather than on market value. In addition, the property tax is levied on nonresidential properties only. Furthermore, the vehicle tax, which is a national tax shared with local governments, is based on weight rather than on market value. More importance should be given to user charges, fees, and benefit levies for locally provided services. To the extent that local governments are free to set such charges, they should be strongly encouraged to do so. Introduction of an income tax surcharge can also provide an important stimulus to local fiscal effort (see "Modernizing the Intergovernmental Finance System," Davey and Péteri 1998a, 1998b, and Balás and Kovács 1999).

Tax Administration Capacity

Tax administration capabilities of local governments need to be strengthened. The ability of municipal governments to raise more revenues locally is in many respects determined by their skill in identifying taxpayers, assessing taxes, collecting taxes, and enforcing the tax laws. In principle taxpayers must register and report their tax obligations to the local tax administration office. This requirement is the case for taxes on buildings, idle urban land, tourism, and business, as well as communal taxes (on private individuals and entrepreneurs). Likewise, vehicle owners are responsible for the vehicle tax. In practice self-registration is not fully effective because not all owners comply. The number of potential local taxpayers or taxable assets is generally unknown (see Szalai and Tassonyi 1999).

Tax administrators are supposed to determine the tax liabilities for every taxpayer for each local tax. Determining tax liability usually requires verification of the taxpayer's self-assessment. The tax on buildings requires verification of the size of the properties rather than their market value and must be done at least once in the field. The same applies to the tax on idle urban land, which is also based on size rather than on market value. Out of 3,200 local governments, only two municipalities—Nyíregyháza and Németskér—use market valuation data in determining local taxes on business properties.

Tax arrears, an important indicator of tax collection, fluctuate broadly from one municipality to another. In the cities surveyed, they ranged from 11 percent of current local tax revenues to 2 percent (Garzon 1999). We should note that “arrears” refers only to taxpayers who have made partial payments of their obligations, not to those who are registered but have made no payments or those who have not registered. Therefore, the potential magnitude of unpaid tax obligations is greater than the arrears reported by the cities.

In general, the sanctions for nonpayment are strict. The first is a delay fine. In principle, failure to pay after a certain period may result in immediate collection of the total tax due, and if this measure does not work, the procedure for withdrawing a business license may be initiated. For the vehicle tax, the sanction is cancellation of the registration plates. For communal and building taxes, the possible sanctions are garnishment of benefits, wages, and pensions, or confiscation of mobile assets. In cases involving large amounts of arrears, the taxpayer's property can be mortgaged or the local government can file a foreclosure request. In practice these sanctions have rarely been used in any of the studied cities.

The major constraints on local tax administrations are a shortage of qualified staff, weak computer capabilities, and a lack of tax collection expertise. In a sense, tax payments to local governments become practically voluntary. Frequently, the mayor's office seems to lack commitment to strengthen the local tax administration. Support agreements between municipalities to learn from one another's experiences do not exist. Each local tax administration develops its own collection and verification techniques. Finally, political will does not seem to be strong enough to improve collections by enforcing payment discipline. Clearly, more revenues may be mobilized through more effective tax collection and better enforcement. Local governments need greater support of their tax administrations through training staff and modernizing computer equipment.

Strengthening Management at the Local Level

Significant achievements and a steady learning curve occurred in municipal management over the last two decades. Locally managed investment programs have been carried out since the early 1980s (for example, water, telecommunications, and gas supply development associations joined the financial efforts of local governments and citizens to improve living conditions). In 1990 municipal governments became elected self-governing bodies and received full mandate and responsibility for:

- Developing and implementing local strategies (including urban development and physical planning)
- Managing local fiscal and financial issues
- Exercising ownership rights over local public assets
- Providing virtually all local public services
- Regulating and supervising local public services.

Municipal governments also serve as deconcentrated units of the public administration system. Success in improving the effectiveness of service delivery, increasing local revenues, and responding to local challenges is contingent on having the necessary local capacity to manage these activities.

Need for Local and Regional Development Strategies

The capacity to create and implement local development strategies needs to be augmented. Ideally, municipal strategies and development programs should be linked to those of the respective regions; however, these strategies have not been used in Hungary so far. Municipal strategic plans should determine key priorities and serve as a conceptual framework for medium- and short-term economic plans from which the annual budget plan can be derived. Local governments are required to produce a long-term urban development strategy and zoning regulation (Locsmándi and Baar 1999), in compliance with physical planning regulations (1997 Act on Formation and Protection of the Built Environment), as the basis for developing a four-year economic plan to be approved ideally after the municipal elections. The Act on Public Finances also requires that a “rolling” plan be prepared and approved along with the annual budget for an additional two-year period. Local governments do not use medium- and long-term plans widely or consistently.

The Act on Regional Development was adopted in 1996 as a response to the dispersed municipal system, missing intermediate layers of governments, and EU accession challenges. A system of sub-county, county, regional (NUTS2), and national regional development councils was put in place. The councils include delegates of local governments, the national government, the Chambers of Commerce, employers and employee associations, and NGOs. The regional councils were thought of as the main channel for coordinated management of local economic development. Progress toward regional planning, however,

has been insufficient. Instead the development councils limited their activities to local allocation of central funds earmarked for regional development, a very small amount of resources so far. In November 1999 amendments to the Act on Regional Development: (a) redefined the NUTS2 big regions from their statistical role to strategic development units, (b) moved the composition of the regional development councils toward a profound centralization, (c) increased the share of state representatives significantly, and (d) changed to consultative status of the council members formerly delegated by the sectoral chambers, civic organizations, and employer and employee organizations.

Local governments, particularly in the large and medium settlements, are keen to prepare and implement local initiatives, though development strategies are often sketchy, casual, and sometimes mix elements of local, regional, and national targets. For instance, although it is not a municipal task to build national freeways bypassing settlements, local governments frequently compete for such projects and are willing to make certain financial sacrifices. The most common local economic development strategies involve public investment in local infrastructure and direct marketing of locations to foreign investors. For instance, Tatabánya created an industrial park from an unused industrial area and has attracted 15 foreign investors and about US\$ 75 million capital between 1996 and 1999 (Kovács and Sebők 1999). An important element of local government strategies to attract public investments is their stand on certain “unattractive” activities, such as incinerators and landfills. Subsidies, tax holidays, municipal guarantees, or any other form of financial assistance to entrepreneurs are less common techniques.

Local goals and strategies are often distorted by the investment grant allocation system (see “Modernizing the Intergovernmental Finance System” and Jókay, Kálmán, and Kopányi 1999, and Davey 1998a). Local governments attempt to use all the means they can to influence the allocation of central grants. Such efforts frequently result in intense competition (anywhere from hundreds to a few thousand grant applications are prepared in each of the cities annually) and not always in a sensible and sound approach to economic development. In a decentralized state, local investment priorities do not always coincide with direct service provision responsibilities. The goals of local economic development differ by type of settlement, for example, direct investment in cities, with a more favorable environment for domestic or foreign investors, and job creation in rural areas hit by unemployment. Local strategies are hard to define in the 2,500 smaller municipalities; combining them into about 150–200 small regions for development and efficient service delivery purposes is inevitable.

Development programs should be financially sound and should comply with international standards. Available Poland-Hungary Assistance for Reconstruction of the Economy (PHARE) grants have been underused because of the lack of strong project proposals. Efforts to strengthen local government capacity for creating and implementing municipal and regional economic development strategies should focus on planning skills such as assessment of potential growth areas, prioritization of activities, financial management, and performance-oriented results management.

Municipal Budgeting and Financial Reporting

Closely linked to effective economic development and efficient use of public resources is the improvement of municipal budgeting and financial reporting practices. Preparation of local budgets and financial reporting are important and intricately connected parts of local fiscal management. Both processes are subject to strict national regulations and are determined by the information needs of the national budget preparation process. Line-item budgeting is used for planning expenditures by organizational units to calculate service inputs. Local government fiscal information is based on the chart of accounts for budgetary (public) organizations. Local governments determine the level of detail for local financial reporting within the general framework established by the law (box 2.6).

Box 2.6 Budgeting Rules

The annual local government budgeting procedures, their contents, and the forms of presentation and reporting are strictly regulated by the law and government decrees. Local governments must meet fixed deadlines for preparing local budget concepts (November 30), presenting budget proposals (February 15), approving budgets (within 30 days after presentation), and presenting semiannual reports (September 15) and annual reports (within 4 months).

The form of budget classification is also standardized. Budgets should be structured by organizational units and by special groups of expenditures (for example, salaries, operating expenses, welfare payments, capital expenditures) within each unit. By law, local governments must prepare a balanced budget. However, because municipal budgets are still heavily dependent on central grants and transfers—which are unstable and unpredictable (see “Modernizing the Intergovernmental Finance System”)—the opening and the closing of local budgets are usually far apart. Local government budgetary organizations follow double-entry bookkeeping and cash-based accounting. Accrual accounting is used to account for municipal budget-related activities. Special rates of depreciation for the public sector are used for tangible assets. Municipal financials consist of a balance sheet, a cash-based budget report, a report on cash reserves or savings, a profit-and-loss statement, and supplementary annexes. The latter contain several output indicators of municipal functions and services.

Overall, formal rules for budgeting and reporting procedures are properly set. Few people recognize, however, that budgeting and financial reporting are not simply a set of procedural rules for spending public money, but are also a potential building factor of modern public expenditure management. Budgeting may be used as a tool to implement policies according to local needs, and reporting might serve as an instrument to provide feedback on policy outcomes. A sectoral- or program-type approach to budgeting promotes allocation efficiency (that is, allocation of resources from lower to higher priority sectors or programs). Application of performance indicators or output measures supports operational efficiency by providing information about the cost-efficiency of the service provider units.

Although local governments have full authority to allocate resources within their budget totals, only a few of them set sectoral plans. In the absence of a strategic view, local governments use budgeting to allocate funds among existing service organizations. This traditional line-item budgeting method prevents local governments from having a broader

view of service delivery. Furthermore, input budgeting is poorly connected to the level of services or financial performance of service providers. As a result, local budgets frequently serve primarily the purpose of recording rather than directing expenditures.

In sum, local budgeting and reporting systems face the following problems: (a) lack of strategic vision in the budget preparation process, (b) lack of regional and sectoral scope, (c) inconsistent reporting and budgeting of activities of local budgetary institutions and municipal companies, (d) limited access to comparative information on municipal finances and service delivery, and (e) shortage of staff trained in modern budgeting techniques. These problems are interconnected. In the absence of a clear strategy for service delivery, the output (performance) criteria cannot be identified, and without performance indicators, no measurable service goals and standards can be quantified.

Most of these problems cannot be solved by simply introducing new regulations. Reformers should disseminate innovative approaches and methods; professionals and local practitioners should learn them. One possible option is to move away from organization- and input-based budgeting methods toward output-based budgets. An important step in this direction would be to develop and introduce key service delivery indicators and to ensure that they are presented in budget plans and annual reports and that information on outputs is fed back to the budget of the subsequent year.

A promising move is to supplement traditional budgets with functional (sectoral) or program budgets within a strategic framework. Experiments are underway to develop program- and zero-based budgeting methods. Experience from Szentes and Szolnok showed that transparent information on sectoral spending alone modified policy priorities tremendously. Program budgeting, however, would require technical assistance to train local financial officers in new budgeting methods.

A further necessary step to improve local policymaking and asset management is the presentation of current and capital expenditures and revenues as two separate statements. This separation serves only demonstration purposes, because cross-financing between current and capital budgets is allowed, but it provides useful information on the general trends in local government finances and the use of municipal assets.

Finally, a problem is publicity and accessibility of municipal fiscal data for the general public. Information on local municipal budgets and the budgets of municipally owned service providers, including balance sheets and property registration data, is collected by the local offices of the County Treasury and Information Service Office, which used to be a part of the Ministry of Interior, but which has belonged to the Ministry of Finance since 2000. Although comprehensive expenditure and revenue data are collected annually by the government for fiscal monitoring purposes, this information is kept confidential at the national level. Only the Ministry of Interior and the Ministry of Finance have access to detailed actual fiscal data on municipalities. Although some comparative averages are produced from these data for public use, they are not sufficient for any comprehensive policy evaluation purposes.

Capital Budgeting and Capital Investments

A key issue confronting local governments today is the lack of skills and knowledge with regard to capital budgeting and capital investments. Local staff and elected officials must learn new techniques in planning, appraising, negotiating, and implementing capital investments. Most municipalities have little experience in selecting and preparing investment projects, undertaking feasibility studies, and monitoring and evaluating project outputs. As a result, as suggested by the six city case studies, many local governments failed to make the best use of the privatization revenues and invested in unduly risky and ill-conceived commercial real estate development projects. During recent years, financing recurrent spending became the highest priority of local governments, and the bulk of capital expenditures fell mostly on urban areas. Hundreds of the smallest municipalities are facing major economic and managerial disadvantages in preparing and implementing investment projects.

The transformation of financing local capital investments has modified capital investment management methods and techniques. Municipal investment departments' roles changed from acting as project implementation agencies to identifying and marketing local capital investments and coordinating each stage of the investment process from tendering to monitoring a contractor's performance. They often have to work in cooperation with neighboring municipalities.

The expected development of project financing (see "Modernizing the Intergovernmental Finance System") will further modify the current relationships among local governments, operating companies, and project lenders. Although national budget grants still have a strong influence on the local choice of capital investments, municipal investment behavior will change, too, as private sources of financing gain in importance. Concession agreements and build-operate-transfer schemes will require comprehensive contractual arrangements between local governments and operating companies. On the financing side, the diminishing share of central government financing in capital investment projects will subject local governments to increasing financial scrutiny by commercial project lenders (see Kopányi and Hertelendy 1999). This scrutiny, in turn, generates a need for information on local governments' borrowing capacity, knowledge about developing investment strategies, project appraisal techniques, and comprehensive comparative fiscal data for evaluating the risk-and-return profile of municipal project sponsors (see "Developing a Competitive Subnational Finance Market").

A critical challenge ahead is the introduction of adequate investment planning and capital budgeting. Such a process will necessitate stricter and more thorough investment selection criteria and may also improve the targeting of investments, through careful project appraisal and evaluation, making municipal investment decisions subject to closer public scrutiny. An example of such an investment process, although a simplified one, can be found in Tatabánya. The municipality ranks capital investment projects according to their potential to generate external cofinancing. Projects with a sizable number of central

government grants or private equity investments are preferred. A preliminary calculation of investment returns is made before a project is approved.

Another important aspect of the current municipal capital budgeting process is the strong influence of central government objectives on local investment priorities. Based on the case studies, several distorting effects of central government investment subsidies can be outlined (Jókay, Kálmán, and Kopányi 1998). Perhaps among the most pronounced ones are overinvestment and financing capital investment projects of low local priority. Lacking own resources, many communities are forced to implement centrally funded projects only, instead of pursuing their own investment objectives. In Szentes, for instance, decisions about whether the investment project will be implemented are determined almost entirely by the availability of central government financing. Only in exceptional cases are municipal capital investment decisions influenced by the local demand for the service (see Nayar-Stone and Tönkö 1999).

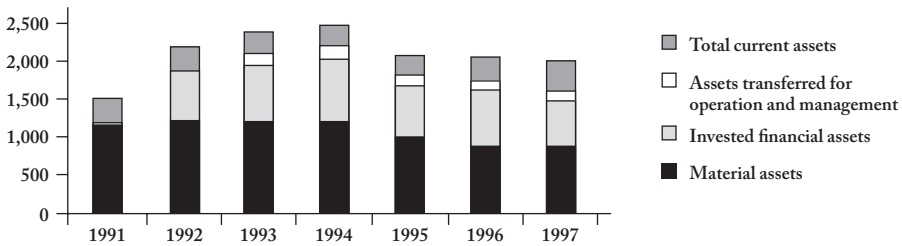
Central subsidies often encourage local governments to over-invest (that is, to build capacities that they cannot afford to operate in the long run). Also, central transfers frequently subsidize financially unhealthy investments, and that subsidization leads to operational difficulties and unjustified indebtedness. The grant application does not require precise cost calculations, and local governments do not take into account the financial costs associated with future projects. Since consumer fees in many instances do not cover increased operating costs, financing has to be provided by the municipality. Reducing over-investment should be sought not only at the municipal level, but also at the central level, because unnecessary capacity increases central costs (Hegedüs 1996). Beyond the recently tightened selection criteria and a more detailed review process, local financial contributions must be large enough to ensure that selected projects are economically viable and are the highest local priorities and that local governments consider the real costs of each project.

Managing Municipal Assets

Municipalities own a significant part of public assets. They received land, residential and commercial housing units, and assets of physical and human public services, mostly in 1990. Real estate, securities, and other shareholdings were transferred to them as compensation proceeds from privatization after 1991 (figure 2.2). Most of their present material assets are by law non-tradable because municipalities divested most of their salable land, fixed assets, and housing units, and invested in core physical and human infrastructure properties. The national aggregates of municipal assets show a rather outdated “book value” and, in fact, are assumed to be overall much bigger than accounted. A huge part of the material assets are accounted for as zero book value either because of improper accounting of depreciation and rehabilitation or because some assets (for example, land) were accounted for in the previous regime as zero value. Nonetheless, a part of invested assets is overvalued when shareholdings or securities accounted for at face values belong to enterprises that are stripped, in liquidation, or nonexistent.

Since 1994 local governments have been required to prepare annual asset ledgers and financial statements. These two sets of records are not linked. Municipal accounting regulation must be amended to provide a framework for consistent asset management (Kassó 1999). The regulation requires registration of assets' market value as well as a description of function and the physical characteristics. In practice, the required market value data are not readily available, because the valuation of certain types of property is complicated by the lack of market comparables and undeveloped valuation techniques.

Figure 2.2 Municipal Assets (Ft billion)



Source: Ministry of Interior and National Tax Office data.

Various clusters of local assets—such as cash and other liquid assets; securities and ownership stakes in non-service enterprises; land, housing, and other real estate; and assets of public services with limited marketability—require very different strategies and management. Decisions about sale or contracting out should be based on clear considerations about present and future value, options of short- and long-term costs, and benefits related to the assets in question. Fiscal managers have often ignored these kinds of considerations, overruled by political goals and short-term gains, with the aim of getting rid of management difficulties (for example, sale of housing stocks).

The usual institutional setup of local asset management follows local public administration or service supervision units. The administration offices have limited management and monitoring competency, leaving effective decisions to politicians in various committees or to the mayor and his or her deputies. Usually no institutionalized or informal relations exist between the managements of asset categories. Therefore, key asset decisions often seem to be result of *ad hoc*, politically driven, or even fraudulent decisions without accountability or personal responsibility (box 2.7).

In many cases local asset management lacks a coherent conceptual underpinning, is highly fragmented, and may be one of the most undeveloped areas of financial management. Decisions are often made by local politicians and frequently are professionally questionable. The maintenance of the assets is nobody's responsibility. Even if municipal institutions are assigned to maintain the assets, they do not have the necessary resources. At the same time, local capital expenditure for maintaining existing assets is among the lowest of budget priorities. In general, local governments have an acute shortage of asset valuation experts and professionally trained property managers.

Box 2.7 Municipal Treasuries Improve Efficiency

The overall financial outcome from improved treasury operations at the local level has been remarkably positive. Following the first quarter of operations, the municipalities that introduced independent treasuries reported that their budget deficits were reduced by 10 to 15 percent. Instances of budget overruns, frequent in the past, were reduced to a minimum, and through what some observers deemed was a better managed procurement process, the actual costs were cut by 20 percent while liquidity became more predictable. Nevertheless, despite their obvious advantages, the lack of professional staff, inadequate technical support systems, and the low level of awareness of their potential benefits currently impede the widespread introduction of independent treasuries by municipal authorities (Barati and Péteri 1998).

Local governments are passive owners of securities and other holdings even if they own majority stakes in joint ventures. Even the fully or majority-owned municipal companies are, in most respects, treated as fully independent private entities. Although the management of these entities is appointed by the local government's assembly, the latter does not exercise effective ownership control. Enterprise plans and annual reports are mostly submitted to the local government, but they are neither consolidated with nor attached to the annual report of the municipality.

Managing the core assets of human services (schools, hospitals, and homes for the elderly) is one of the biggest local management problems. Because these services are not fee-based, their assets are almost entirely non-marketable, and the services are managed as local budgetary organizations. Most of them have very high level of institutional independence. As a result teachers and medical doctors deal with the investment management to prepare grant applications, procurement, and contracts with developers. Troubles rooted in the central transfer system (see chapter 4, "The Legal and Regulatory Framework of Fiscal Decentralization") often coincide with poor financial management of local budgetary organizations.

A few municipalities have separated the professional and financial management of their budgetary organizations, whereby a financial and technical service firm provides asset management services for all operational, maintenance, and development activities of the local budgetary organizations (Kassó 1999). As a response to fiscal pressures, many municipalities have set up so-called municipal treasury organizations, whose mandates vary from cash management of budgetary organizations (simple bookkeeping, account management, and related financial analysis) to budget preparation and cost management (Barati and Péteri 1998). Since municipal treasury organizations obtain detailed financial information on municipal service providers, they have a strong incentive to improve the financial efficiency of their operations and the quality of community services.

Monitoring and Supervision of Municipal Activities

A decentralized municipal system cannot be effective if it lacks efficient monitoring that provides for economic and financial control before the commitment is made, accounting

control before payment is made, and audit after the conclusion of the action. National, local, and market institutions provide monitoring over municipalities. Only the State Audit Office, which reports directly to Parliament, can exercise direct and unlimited supervision over municipal activities. Since 1990 more and more national watchdogs have started to oversee municipalities. Line ministries monitor sectoral standards and national priorities, and regional treasury offices control and execute intergovernmental transfers in the framework of net financing. Finally, the regional public administration offices exercise legislative control.

All the major elements of local control are in place, though not performing equally well. Local government, municipal organizations, and companies are supervised by the local assembly, local committees, and internal and external audit (for cities having an annual budget over Ft 100 million). In addition NGOs' feedback is welcome, and rules provide for making documents of key public service decisions accessible to local citizens. In principle, the local assembly is the best tool for monitoring and supervising local government organizations and municipal companies. Finally, the Act on Municipal Bankruptcy serves as a key framework for exercising market control over municipal activities by private enterprises and financial entities.

The present local government monitoring and supervision system has five major problems: (a) the inability of the State Audit Office to conduct external audits efficiently; (b) the inability of the local assembly and its committees to exercise operational control and to enforce accountability and responsibility; (c) the undeveloped practice of using audits; (d) the shortage of trained local staffs; and (e) vague transparency, undefined citizen control, and biased feedback by NGOs.

Municipal plans, financial reports, and contracts for public services are, by law, in the public domain. The transparency rules, however, are often ignored, misinterpreted, or overruled for example, in the concession contract by making it confidential in a special clause (Baar 1999).

The communication between NGOs and local governments is very poor. In a few cases, NGOs successfully influence and monitor local policy through their representatives in local councils and committees (Ágh 1999).

Some analysts have suggested enlarging the State Audit Office's capacity and using the County Treasury and Information Service Office to tighten control over municipalities' financial flows. Although national institutions are easy to use, a centralized control system limits decentralization, focuses on financial input rather than performance measurement, and ignores efficiency in service provision. In parallel, improving the quality of local government audits by developing the capabilities of internal and external auditors and establishing transparent processes for their selection is crucial (for example, through chambers of auditors and local government organizations). For small local governments, regional audit services shared by several municipalities should be established.

Developing a Competitive Subnational Finance Market

Local infrastructure investment needs have been growing against a background of tight fiscal policies that constrained budgetary transfers from central to subnational levels of government. Competing claims for scarce budgetary resources led to large funding gaps for local infrastructure investments. Private capital would be required if local infrastructure services were to be brought to standards that support growing household and business demand and meet EU requirements. At the same time responsibility for the provision and financing of services is being increasingly decentralized, and local governments are assuming expanded service-provision roles. Yet, the ability of local governments to finance and deliver services is often constrained by limited institutional capacity and financial resources, which may affect the level and quality of municipal investments.

Legal and Institutional Framework for the Subnational Capital Market

The development of an orderly and efficient subnational finance market depends critically on the overall legal, regulatory, and institutional framework in which the market participants operate. The role of this enabling environment is to provide the foundation for the emergence of a market in which private investors and financial intermediaries compete to mobilize financial resources from savers, while pricing subnational credit correctly and allocating capital efficiently among subnational investments through a wide range of tailored financial products. The legal, regulatory, and supervisory environment for the subnational finance market should seek to strengthen market governance and transparency, establish and maintain a level playing field on the market, and limit moral hazard.

In a system of subnational borrowing regulated by market discipline, excessive borrowing would be prevented by rising premiums or outright exclusion of subnational borrowers by the market. Strict reliance on market discipline requires, among other things:

- *Absence of explicit or implicit government guarantee for subnational borrowing.* Growing numbers of governments are stressing that they will not issue sovereign guarantees for subsovereign transactions as a matter of sound fiscal policy and to reduce moral hazard. Although the adoption of such legislation constitutes major progress toward separating sovereign and non-sovereign risks, ensuring the credibility of the stance prohibiting government bailouts of subnational entities requires adopting additional regulations governing the treatment of creditors in case of municipal default (Jókay, Szepesi, and Szmecana 2000).
- *Openness of capital markets.* Many governments have made significant progress in liberalizing capital markets—in particular, in eliminating regulations on financial intermediaries holding government or subnational securities or both—although restrictions continue to hamper the free movement of capital, such as minimum holding requirements or regulations preventing the issuance of specific types of financing, guarantee, or hedging instruments by subnational entities.

- *Full disclosure and access to information on the financial position of subnational borrowers.* Despite progress in some countries, the mechanisms for reporting and monitoring financial information, including subnational debt, are generally absent or, when in place, remain deficient.

In a system of direct, *ex ante* administrative controls on subnational borrowing, governments could be tempted to rely on models ranging from case-by-case approval to an outright ban on borrowing. Under this system, the central government may exert control over subnational borrowing either by using a detailed approval process or restricting the sources of borrowing (for example, borrow only from the central government for special purposes) or both. Such direct controls have two drawbacks. First, they can lead to politically motivated and economically inefficient credit allocation decisions by the central government. Second, case-by-case approvals may strengthen creditors' and debtors' assumption of an implicit sovereign guarantee and make it more, rather than less, likely that the central government will have to intervene in case of default by a subnational entity.

In the middle of the spectrum lies a third, rules-based model in which the subnational capital market is allowed to play its resource mobilization and allocation role in the economy and is underpinned by a legal and institutional framework designed to maintain macroeconomic and fiscal stability and ensure market efficiency and transparency. In the following sections we summarize the key elements of a rule-based, market-conforming subnational financing system.

Prudential Framework for Subnational Borrowing

The main components of the prudential framework for subnational borrowing pertain to the definition of public debt, borrowing limits, sovereign and intermediate government guarantees, and local government bankruptcy regulations.

Definition of Public Debt

The definition of public debt includes all recourse-based direct obligations that a public entity may enter into. Consistent with EU legislation, public debt includes the liabilities of the general government (central government, social security funds, and local governments) in currency and deposits; bills; short-, medium-, and long-term bonds; and loans. Not included are guarantees and other contingent liabilities (such as promissory notes) of the central government, social security funds, and local governments. Budget regulations stipulate that guarantees and other contingent liabilities are counted as current budget expenditure by the time they are called. The yearly central government budget contains a provision against guarantees that might be called. An alternative system would consist of counting guarantees and other contingent liabilities as a specific category within public debt, subject to rating. This system would require that local rating agencies have sufficient

capacity to rate all guarantees and contingent liabilities issued by the central government, social security funds, and local governments.

Borrowing Limits

The 1995 Act on the Supplementary Budget limited the value of new medium- and long-term debt to be issued by local governments that year to 70 percent of the own adjusted current income of the local government. Adjusted own current income is the sum of current own revenues, such as local taxes and fees, minus the annual amortization payment of short- and long-term liabilities. For the purpose of calculating the borrowing limit, medium- and long-term debt includes guarantees and other contingent liabilities incurred by local governments. This borrowing limit was integrated in the legislation as an amendment to the Act on Local Government and is currently in force.

Sovereign and Intermediate Government Guarantees

The current legislation does not contain a specific limitation on sovereign guarantees to subsovereign transactions. As a matter of policy, however, the central government does not issue sovereign guarantees to subnational transactions. Exceptions to this policy can be made by the government on a case-by-case basis for loans by international financial institutions (such as the International Bank for Reconstruction and Development or the European Investment Bank). These cases are rare, generally involving projects of national importance undertaken in the capital city, and the guarantees are counted against the yearly ceiling imposed on guarantees in the annual budget law. The credibility of this policy is further reinforced by the Act on Municipal Bankruptcy. The current legislation does not contain a specific limitation to the issuance of subsovereign guarantees by local governments, frequently issued on behalf of municipal (and sometimes private) companies.

Local Government Insolvency and Bankruptcy Regulations

Hungary is the only country in the region that has introduced a regulation governing local government insolvency and bankruptcy. The 1996 Act on Municipal Bankruptcy regulates the debt clearance procedure of local governments, which may be generated by the local government and by its creditor if the local government or the budgetary organization financed by it falls behind its debt obligations by more than 60 days. Since the law entered into force in 1997, there have been 11 municipal bankruptcy cases. The causes for the bankruptcies range from investment in failed business activities to guarantees issued without the knowledge of the council to local public investment programs (linked with gas supplies) beyond the financial capacity of the municipality. No cases have occurred because of current operations, reflecting the role of deficit grants in preventing such cases. All cases have led to debt restructuring. All municipalities that have emerged from the procedure are in stable financial condition.

Policy Recommendations

Key recommended policy adjustments should seek to do the following:

- Integrate guarantees and other contingent liabilities, first by the central government and over the medium term by local governments, into general government debt
- Require full financial disclosure by local government
- Introduce an amendment to the public finance law explicitly prohibiting the use of sovereign guarantees for subnational transactions, with exception of requiring approval on a case-by-case basis by Parliament
- Over time, as market signals take hold, reassess limits on local government borrowing based on long-term debt servicing capacity.

Auditing and Collateral Issues for Subnational Borrowing

There are three major instruments applicable for enhancing subnational borrowing capacity without sophisticated legal framework and sovereign guarantee: auditing, and asset and revenue collateralization.

Auditing

The State Audit Office performs two types of local government audits. Theme audits focus on specific operations for a sample of governments (for example, public utilities or social services). Audits of financial and economic operations focus on management of targeted grants and investment subsidies.

Revenue Collateralization

The Act on Local Government limits revenue collateralization by local governments to own revenues, defined as local taxes, profits, dividend and interest income, local duties, a proportion of environmental penalties, and other revenues. Budget regulations allow for the creation of sinking funds earmarked for servicing a particular local debt.

Asset Collateralization

Asset collateralization by local governments is conditioned mainly by the registration system for real estate assets, the valuation system for real estate assets, and the designation of local government assets that can be used as collateral.

The registration system for real estate assets, developed over the last 20 years, records property ownership, quality, use, protection, and book value in the case of land. The system was up to date nationwide, with two major gaps in 1999: (a) 600,000 rural landowners from

privatization are not yet registered, and (b) Budapest had a significant backlog in recording modifications resulting from sales of property, the bulk of which was eliminated by 2000.

The valuation system for real estate assets differs for buildings and building plots, on the one hand, and for rural land, on the other. To enhance the tax regulation for buildings and building plots, a draft act on value-based property tax was prepared, but failed to receive the government support required for submission to Parliament. Thus the issue remains open and underlies the proposal for elaborating a medium-term tax reform that focuses not only on the property tax, but also on changes consistent with EU requirements. Currently no system of land valuation exists, because the absence of a land tax provides no incentive to set up a land valuation system. In addition, land values are likely to remain depressed, even following privatization, given the small size of individual property areas.

The Designation System

For real estate that can be used as collateral by local governments, the Act on Local Government distinguishes between primary and secondary assets. A local government may declare as primary assets those that serve directly its delivery of compulsory duties and its authority to enforce public rights and powers. The act also distinguishes between two types of primary assets: (a) non-saleable assets, including local public roads and their structures, squares, parks, and other assets to be designated by an act or by a decree of the local government, and (b) assets salable in a limited way, including public utilities, institutions, and public buildings, as well as real property and movables designated by the local government. Disposition of salable primary assets may be made in accordance with an act or in a decree of the local government. The Act on Local Government prohibits local governments from using primary assets as collateral.

Policy Recommendations

Key policy reforms to improve the framework for subnational borrowing would need to do the following:

- Strengthen the capacity of the State Audit Office to audit local government creditworthiness and asset and liability management
- Allow the collateralization of salable primary assets or introduce three categories of assets—primary assets (not salable, not collateralizeable), secondary assets (salable under certain regulations, collateralizeable), and tertiary assets (freely salable and collateralizeable)
- Establish a system for the valuation of buildings and building plots
- Design and implement a system of land valuation (once land registry is completed).

Financial Sector Regulatory and Supervisory Framework for Subnational Borrowing

The main components of the regulatory and supervisory framework for subnational borrowing pertain to debt issuance, registration, disclosure, and supervision rules.

Issuance

Bond issuance by local governments is authorized by the 1996 Act on Securities, which became effective on January 1, 1997. The Act on Securities conforms with EU directives, in particular the March 1979 council directive about listing securities on exchanges, as well as subsequent council directives regarding information disclosure and mutual recognition (March 1980). To make a public offering on the securities market, an issuer must publish a prospectus and announce the public offering; both the prospectus and the announcement are subject to approval by the Supervisory Commission. The act does not contain regulations regarding the public offering of securities by local governments, either in Hungary or abroad. The act also does not regulate private offering of securities by the central or local governments, although specific regulations have been introduced by the State Financial and Capital Market Supervision (now State Financial Supervision, SFS) to regulate private issues by local governments. These regulations provide that private issues must be a minimum Ft 5 million, investors must be specified in advance (since June 1998, they are required to produce a letter of intent), and local governments must use the services of a brokerage firm and produce “relevant information” to the investors.

Registration

Local government borrowing (loans, bonds) as well as guarantees and other contingent liabilities are recorded *ex post* by the local government’s department of the Ministry of Finance as part of the yearly submission of the budget execution by local governments to central Ministry of Finance. Bond issues by local governments are registered with the SFS. For public issues, the notification is part of the bond issue prior authorization process by SFS. For private issues, which do not require prior authorization by SFS, the obligation of notification has been in place since January 1, 1997. The Ministry of Interior maintains a systematic, real-time notification system for local government loans, local government guarantees, and other contingent liabilities. No system is in place for real-time notification of borrowing, guarantees, and other contingent liabilities by municipal companies.

Disclosure

For public offerings, issuers must disclose regular information on their financial and income position and operations and must provide the information in the form of annual

minute sheets and annual reports. Local governments are not required to prepare annual minute sheets. Issuers must ensure the inspection of their annual reports by investors and announce the time and place of such inspection in a national daily newspaper and the exchange journal. The annual report must be sent simultaneously to the SFS. Except for government securities, issuers must send to the SFS and publish in a daily newspaper and in the exchange journal all information directly or indirectly affecting the value or return of the securities. Save for the exemption from the obligation to prepare annual minute sheets, the Act on Securities contains no additional disclosure rules in the case of public offerings by local governments. For private offerings, the Act on Securities contains no specific disclosure rules, not even the type of information to be supplied by local governments to investors, because this information is considered to be part of the due diligence process of the investors.

Supervision

The issuance, trading, and settlement of securities are under the purview of the SFS. With few bond issues by municipalities to date, experience with supervision is limited. The SFS has so far taken a passive approach toward the supervision of public issues by local governments, limiting its overview to ensuring that issuance procedures and supporting documentation are in accordance with the law.

Policy Recommendations

Priority actions for strengthening the financial sector's legal, regulatory, and supervisory framework for subnational borrowing should provide for the following:

- The SFS should establish detailed disclosure rules for public issues by local governments, beyond the publication of the annual minute sheets.
- The SFS should strengthen its capacity to carry out both offsite and onsite supervision of local government as borrowers.
- The Ministry of Interior should establish a system of real-time notification of borrowing, guarantees, and other contingent liabilities by municipal companies.

Meeting Demand for Subnational Investment Finance in the Medium-Term Macroeconomic Framework

Following its membership in the EU, Hungary faces a considerable challenge to increase both private and public investment to support economic growth and modernize its infrastructure while maintaining internal and external macroeconomic equilibrium. Local governments and municipal companies play a critical role in this context, because they are responsible for undertaking a substantial portion of the infrastructure investments required.

The implied increase in the investment rate of local governments and municipal companies has implications for the composition of the central government's fiscal program and the structure of its financing, including the current account over the medium term.

Subnational Investment Back to its Track

In the 1990s local government investments have decreased from an average of 3 percent to less than 2 percent of GDP. The decline has been particularly noticeable since 1995. Over the 1991–1997 period, local governments financed these investments from the following sources:

- Current balances including net interest revenues (45 percent of the total)
- Investment grants from central government and capital transfers (47 percent, of which 23 percent passed on to local service companies)
- Asset sales and privatization revenues (31 percent).

Additional asset revenues allowed municipalities to retire debt incurred in the late 1980s, as shown by their negative net average borrowing (–17 percent) during the period (see table 1.1 and Kopányi and Hertelendy 1999).

As a consequence of the decrease in transfers and adverse investment incentives, local governments' investments lagged behind replacement rates in the 1990s. Strong evidence indicates that local investment decisions have been distorted by the investment grant system. The availability of capital grants has largely driven local investment decisions, while privatization revenues, borrowing, and private equity have not been adequately used (see “Modernizing the Intergovernmental Finance System” and Jókay, Kálmán, and Kopányi 1998). For example, proceeds from asset sales and privatization were often invested in government securities or bank deposits, whereas key renewals were postponed (Pálné-Kovács 1998). Privatization has often aimed at cash generation rather than rationalizing or developing public services through public–private partnership. In 1997 municipalities still owned a non-service portfolio of about 1.0 percent of GDP, including shares of manufacturing and other companies (for example, hotels and shops). This ownership was divested and used for financing service development.

During the preaccession period local government investments were well below what would be required to meet EU infrastructure standards. Because local infrastructure will be modernized, local investments in basic human and physical services are expected to increase progressively from 2.2 to 3.0 percent of GDP over the medium term. This significant increase may be attributed to two factors: core assets and market penetration. First, present regulations classify the basic elements of the human and physical infrastructure as non-marketable core assets. Therefore, development, replacement, and renewal of these assets should be financed out of municipal budgets. Second, telephone, electricity, and gas supply, which are characterized by low unit costs and are not associated with negative externalities, are well developed and have been taken over by the private sector. By contrast, sewage

and solid waste systems involve large unit costs and negative externalities. Increasing the level of service provision from around its present 20 percent level would, therefore, require considerable investments.

Shift toward Municipal Companies and Private Providers

Profound changes are anticipated in the structure of local investment finance in terms of sources of funding. Indeed private funds are expected to play a growing role, which would ease the fiscal burden, but would have an impact on the current account (see table 2.7 and figure 2.3). The current balance of municipalities is expected to remain constant over time (at 0.8 percent of GDP). The composition of the balances would change, however. First, current transfers from the central government will decline in line with the necessary changes in tax rates (see “Modernizing the Intergovernmental Finance System” and Kopányi and Hertelendy 1999). Second, local financial revenues, mainly interest income, will dry up because municipalities will no longer hold large deposits as privatization revenues decline. Third, local own revenues (taxes and fees) are expected to grow, making up for the declining current transfers and local financial revenues.

Two kinds of grants (government and EU) are now accessible for local investment purposes. The bulk of EU transfers should flow to local governments, about 1.5 out of 2.0 percent of GDP (World Bank 1999a). Furthermore, these funds will partially finance public utility investments carried out through local public–private partnerships. From the EU funds, about 0.7 percent of GDP is to be channeled to these local investments, whereas about 0.8 percent would be available to finance other service developments.

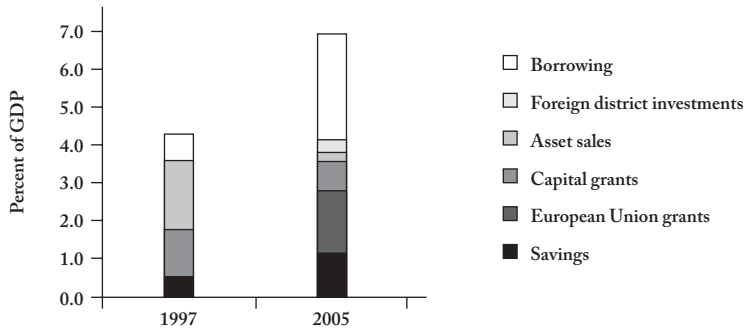
Table 2.7 Local Investment Finance 1997 and 2005 (percentage as share of GDP)

| <i>Funds</i> | <i>Local governments</i> | | <i>Public utilities</i> | |
|---|--------------------------|-------------|-------------------------|-------------|
| | <i>1997</i> | <i>2005</i> | <i>1997</i> | <i>2005</i> |
| Total investment | 2.2 | 3.0 | 1.6 | 3.2 |
| Investment financing | | | | |
| Savings (current revenue–current expenditure) | 0.8 | 0.8 | –0.3 | 0.2 |
| Financing requirement external to the sector of | 1.4 | 2.2 | 1.9 | 3.0 |
| European Union grants | 0.0 | 0.8 | 0.0 | 0.7 |
| General government capital grants | 0.5 | 0.7 | 0.6 | 0.0 |
| Asset sales | 1.6 | 0.2 | 0.0 | 0.0 |
| Foreign direct investment | 0.0 | 0.0 | 0.0 | 0.0 |
| Borrowing | –0.7 | 0.5 | 1.3 | 2.0 |

Note: 2005 data projected.

Source: Kopányi and Hertelendy 1999.

Figure 2.3 Local Investment Finance



Source: Authors' calculations based on Ministry of Finance data.

In line with a decrease in central government grants, capital transfers to local governments (including contribution to local companies) are expected to decrease from 1.1 percent of GDP in 1997 to 0.7 percent over the medium term. On the one hand, transfers from local governments to municipal companies are expected to decline. On the other hand, a significant share of local government funds will be used as the necessary matching part to EU funds (for example, an 0.8 percent of GDP EU transfer requires an 0.3 percent of GDP matching share under the present 25 percent matching rule; the matching share subsequently might be increased to 40 or 50 percent). Furthermore, proceeds from asset sales and privatization will dramatically decline (from 1.6 percent in 1997 to roughly 0.2 percent of GDP over the medium term), because the bulk of marketable assets were privatized during the 1990s. As a result, local governments would need to borrow the equivalent of about 0.5 percent of GDP over the medium term, after having been mostly net lenders in the 1990s.

Companies providing local public utility services invested on average about 1.1 percent of GDP over the 1991–1997 period. Unlike local governments, public service companies generated operating deficits (0.3 percent of GDP in 1997) because of low user fees. Hence, their investments had to be financed out of capital grants from central and local governments as well as from borrowing (see table 2.7). EU funds will primarily support infrastructure (utility) investments. Thus, close to half of the projected increase in the investment rate in the economy would be accounted for by municipal companies (1.6 percent out of the total increase of 3.5 percent of GDP) over the medium term. As a result, investments by municipal companies are projected to double (from their 1.6 percent 1997 level to about 3.2 percent) over the medium term.

These investments will be partially financed from the net operating surplus of municipal companies, which is expected to increase as a result of improved cost recovery

policies. Capital grants to municipal companies are projected to increase slightly, financed primarily by EU funds (0.7 percent of GDP by accession). As the concept of functional regionalism materializes (see “Modernizing the Intergovernmental Finance System”), a significant amount of foreign direct investment (and supplemental borrowing) should contribute to the development of the public utility sector (roughly estimated at about 0.3 percent of GDP). As a result, the net borrowing requirement of municipal companies, which amounted to 1.3 percent of GDP in 1997, is projected to increase to about 2.0 percent of GDP over the medium term.

Supply of Subnational Investment Finance

Hungary’s municipal finance markets began to emerge in the 1980s, though they remain small and lag behind the development of the financial sector as a whole. Municipal demand for medium- and long-term finance has been limited, and borrowing is concentrated mainly in a few large cities. Apart from Eurobond issues by the city of Budapest (German Mark 150 million 1998–2003), neither municipalities nor municipal companies have issued an international bond. Debt service as a share of municipal revenues has been well below the authorized limit of 70 percent of own-source revenues.

Determinants of Growth of Subnational Credit Market

Through the mid-1990s, the municipal finance market was dominated by the National Savings Bank, which had been offering short- and medium-term lending instruments for municipal clients. Municipalities held their accounts with the National Savings Bank, which also acted as underwriter for municipal bond issues. Since 1994, the National Savings Bank’s exclusive market dominance declined slightly (from 100 to 80 percent) as new private banks, such as Raiffeisen and Citibank, began to compete for market share. A small market for municipal company finance started to develop following the incorporation of municipal companies in 1991. Despite increased market competition, the range of debt instruments available to municipalities remains limited, offering no debt refinancing, bond pooling or insurance or partial risk and credit guarantee instruments. Currency hedging instruments do not extend beyond six months and have yet to be used by municipalities or municipal companies (Makay 1998).

Based on the policy changes introduced in the financial sector, the municipal credit market has the potential and scope for growth and diversification. Yet, when examining the prospects for the supply of funds to subnational entities, analysts need: (a) to assess the determinants and sources of supply, including the types of instruments offered by banks and non-banking capital market intermediaries, and (b) to address the constraints that may hamper the supply of subnational funds and to highlight mechanisms (for example, nonrecourse project finance options) and products (for example, securitization) that enhance local government ability to mobilize private resources. In this context, reformers must review the following:

- The options for local governments to access private credit in a way consistent with macroeconomic stability
- The role of local operational entities distinct from political subdivisions
- The links between local government finance and broader capital market issues
- The impediments to local government access to credit markets
- The role of specialized financial intermediaries for local government investments.

In the context of the EU integration strategy, Hungary could look at the broader European financial market as a funding source for Hungary's investments including municipal infrastructure.

Sources of Funds for Local Government Investments and Potential Need for Credit

The funding sources for municipal and municipal company investments have included local government current account savings, central government grants, and proceeds from local asset sales. The contribution of current account savings to local infrastructure finance varied significantly over time and also across municipalities by size. The ability of municipalities to increase operating savings is contingent on local capacity to generate own revenues (including tariffs adequate for cost recovery) and optimize expenditures. Investment grants, when available, represent a main source of funding for local government investments, especially for smaller municipal entities with limited asset base and marginal creditworthiness. The size and composition of investment demand has been correlated to the availability of investment grants. Proceeds from the sale of municipal assets have also provided a funding source for local government investments. This funding source is temporary, however, and has virtually come to an end as municipalities are left with nontradable core assets and participation in municipal companies that might not be easily reduced.

Should their present funding sources, in aggregate, fall short of investment requirements, local governments would need to fill the gap through market borrowing. Local government borrowing has been a central subject of the intergovernmental fiscal relations debate. A contentious issue has been the potential impact of subnational borrowing on macroeconomic stability and the conditions under which such borrowing may be consistent with macroeconomic policy objectives.

Subnational Borrowing and Macroeconomic Risks: Tax-Supported or Revenue-Based Debt

Local governments can have access to credit from a number of sources. One source has been borrowing from the central government. Local governments can also incur liabilities in running arrears to suppliers and delaying salary payments. Another, transparent, way is to borrow on private credit markets. Long-term borrowing to fund long-term assets may be appropriate to promote intergenerational equity and allow for long-dated costs

to be spread throughout the period over which long-term benefits are expected to accrue. Local government borrowing should be based on good economic and financial principles, however, which should be the focus of policy measures.

Foremost among these principles is that borrowing by local governments should be a substitute for borrowing by the central government, not an added burden to the national public debt. Borrowing should be dedicated to funding capital rather than current expenditures (a clear distinction must be made between the two expenditure categories). Borrowing may be justified to finance investments that generate rates of return above the cost of capital. Borrowing aimed at financing operational deficit should be precluded. At the time of borrowing, the parties involved should establish that debt service would be affordable when measured against local government income. Borrowing must be based on strict investment criteria, optimal financing schemes, and reliable project risk and return benchmarks.

The potential effect of local indebtedness on macroeconomic stability (moral hazard issues) should be duly assessed. In this regard, Hungary has, over the past few years, introduced laws and regulations that provide some deterrent for implicit sovereign guarantee of municipal debt. Among these is the Act on Municipal Bankruptcy, which defines debt workout procedures in case of municipal default. In assessing the potential for creating contingent liabilities at the sovereign level, a distinction must be made between two local government borrowing schemes: tax-supported and revenue-based debt. When they need to borrow, local governments should first seek budget-neutral, nonrecourse project finance options that would reduce claims on fiscal resources.

Tax-Based Financing

In tax-based financing, local government debt service would be met out of local government general revenues (Bahl 1999). This borrowing, part of local government general obligations, would be appropriate to fund investments for “public goods,” the cost of which may not be charged directly to the individual consumers. In this case, however, local governments must demonstrate that the public goods so financed would have support growth and eventually increase local tax receipts out of which the debt would have to be serviced. (For instance, borrowing based on tax increment districts has been used in some countries to fund the development of rundown areas and to service debt out of the “incremental” tax receipts brought about by improved property values.) Local government tax-based borrowing should carry no central government guarantee. Yet even without explicit guarantee, such general obligation debt may conceivably create contingent liabilities at higher government levels if creditors perceive that local government indebtedness would always entail implicit central government insurance.

Revenue-Based Financing

In revenue-based financing, local debt service would be met out of the revenues of a specific project, when such revenues are directly levied on consumers. Revenue-based financing

may be structured on a nonrecourse basis, in which private creditors' rights and claims are limited to the project's specific revenues or, at most, the project entity's assets. These revenues and assets would be segregated from all other local government assets, and creditors would have no claims to the latter. This nonrecourse finance should, all the more, extend to the sovereign level and shield the central government from implicit liabilities associated with local government debt. In addition to reducing contingent liabilities at the sovereign level, revenue-based financing can also entail credit enhancement structures that could lower the interest costs of borrowing (even conceivably below the reference cost of central government debt). A credit enhancement feature commonly used is to pledge specific project revenues on a seniority basis to creditors. To do so, revenues would be channeled through a segregated account managed by an independent trustee whose sole role is to ensure that debt holders are being paid according to priority. The corresponding debt could be secured by the dedicated income streams, to the extent these are sufficient, of such projects as water and sanitation facilities and mass transit. Municipalities are allowed to pledge future streams of income as security, although the concept of such pledges remains largely unfamiliar.

Political Jurisdictions or Operational Entities

To address the issue of a multitude of small local governments, the creation of "special purpose entities" may be an appropriate and practical solution. Local governments are political, administrative entities that play a primary role in service delivery. In some cases, however, a service clearly could be delivered more effectively by a group of such entities, for instance, to improve economies of scale and, as a result, the viability of public investments. Some countries occasionally resort to outright mergers of administrative entities to deliver services more efficiently. Other countries refrain from tampering with the political subdivisions, but encourage *ad hoc* associations for delivering services.

In terms of policy measures, the government may want to encourage the establishment, through incentives if need be, of such special purpose entities, which would be legal units vested with powers to enter into contracts and which have clear authority to borrow, to levy fees against services provided, or to levy betterment taxes against improved property values. Such a corporate entity, owned by the association of municipalities, would be dedicated to the operation of a public utility and would be able, for instance, to pledge project revenues as security for borrowing. Borrowing by special purpose entities separate from local governments is less likely to create (implicit) contingent sovereign liabilities. Finally, such entities may also be assigned credit ratings, which might be unrelated to—sometimes better than—the ratings of participating municipalities.

Local Government Finance and Broader Capital Market Issues

The framework related to municipal debt issuance is an important determiner of access to credit by local governments. Local government borrowing has been limited and largely

confined to commercial bank loans in addition to a small number of bond issues by large cities (these sometimes carry a central government guarantee). Financial institutions may hold local government securities without restrictions. Existing institutional savings can provide a potential funding pool for investments in local government projects, because debt securities issued by local government entities might fit well in the portfolios of institutional investors (insurance companies, pension funds, investment funds) seeking diversified long-term uses for their resources.

Despite an overall friendly regulatory environment, local government financial transactions need to be supported by specific regulations as well as effective instruments and institutions. When focusing on the building blocks for a resilient local government finance sector, financial policies should seek to foster the development of long-term debt instruments that can narrow the local government resources gap and meet the long-dated requirements of infrastructure investments. The broader capital market development issues, which might call for policy adjustments, relate to five factors.

- Underwriting, distribution, and market-making capabilities in secondary markets for municipal securities, which cover, among other things, prudential issues, such as capital adequacy ratios for underwriters and market makers for municipal securities
- Registration, settlement, and custody of local government securities
- Disclosure standards for financial institutions and other market players involved in local government securities
- Benchmarks for pricing debt obligations of municipal entities in reference to central government securities yield curve—the existing pricing structure in the various credit market segments (for example, government and corporate debt and financial institutions' certificates of deposit) should provide the base references for pricing local government debt obligations, although the absence of long-dated government securities would not allow straightforward results at the end of the maturity spectrum
- Credit enhancement structures (securitization, guarantees, bond insurance, bank letters of credit, convertible debt, derivative products), which confer preferential credit status on local government debt obligations, diversify and transfer risks, and increase market acceptance of local borrowing. (The nascent domestic credit rating capabilities in Hungary would provide prospective investors and creditors with a useful tool for the credit assessment of subnational borrowers.)

Impediments to Local Government Access to Credit Markets

One constraint in terms of local government infrastructure finance pertains to the limited availability of long-term lending, because loan maturities to local governments rarely exceed five years—a serious predicament given that long-dated debt instruments are required for infrastructure finance. This situation arises from concerns regarding credit and interest rate risks. In this regard, policy measures should foster an environment to reduce

both credit and interest rate risk. Credit risk could be reduced through credit enhancement mechanisms, such as: (a) lending secured by the income stream of revenue generating projects, (b) put options for bond issues, or (c) callable loans by financial institutions, which would encourage longer term commitments by potential creditors. Interest rate risks, which in a high interest rate environment deter borrowing, might be mitigated in pricing loans using an indexed, floating rate; from the investor standpoint, interest rate risk might be further mitigated through portfolio diversification techniques (for which guidelines are usually established case by case by institutional investors).

Moreover, the unpredictability and *ad hoc* nature of financial transfers between various government tiers is an added impediment to building local government capacity to attract private credit. Because securing central grants is sometimes influenced by local government lobbying, the *ad hoc* nature of the grants makes assessing local government creditworthiness, particularly for medium- and long-term funding commitments, difficult for prospective investors (see “Modernizing the Intergovernmental Finance System”).

Local Government as a Potential Borrower

In assessing the conditions for municipal finance market development, one focus should be on the factors that may impede, from the demand side, the municipal sector’s access to credit. One such impediment is the limited effective demand resulting from the weakness of small and medium local governments to structure investment proposals that meet the due diligence requirements of private lenders. When planning to access private capital markets, areas of critical importance that call for government attention and support relate to project selection and preparation, financing strategies, and financial management (which underpins creditworthiness). Local governments need to strengthen project selection processes through quantitative criteria based on economic priority, relevant return benchmarks, or least cost solutions.

Essential to the analysis would be the assessment of the affordability of fees (“capacity to pay”) that a project may have to charge to be able to service debt. Moreover, local governments need to develop financing strategies involving, in particular, project finance options on a nonrecourse basis that reduce claims on fiscal revenues. The development of multiyear investment plans would allow local governments to assess better the implications of pledging fixed assets as collateral for borrowing for a given project, because such assets may become necessary as a pledge for another project in the pipeline. Finally, local governments need to improve and optimize financial management, including current expenditure, asset and liability, and liquidity management.

As a matter of policy, all municipalities should improve financial disclosure to give investors reliable and standardized information; to this end, they must consider establishing, at the national or provincial levels, databases that have relevant indicators and ratios on local government finance (such as ratios of debt service to revenues, current revenues to current expenditures, share of local to total revenues, and share of local taxes to

total revenues). This information would also constitute a useful basis for credit rating, for which local government entities should be prepared.

Fostering competition and privately providing local infrastructure should be integral parts of city development strategies. To this end, reformers must promote closer financial partnerships between local governments and providers of services and capital—commercial banks, securities firms, institutional investors, infrastructure funds, rating agencies, utilities operators—that have complementary interests in private finance and local infrastructure investments.

Specialized Financial Intermediaries for Local Government Investments

Market borrowing by local governments may entail direct bond issues, or loans or lines of credit from commercial banks. Another way for local governments to mobilize long-term resources could be through specialized financial intermediaries that provide a vehicle for debt pooling for local investments. In the United States municipal bond markets have been a primary vehicle for local infrastructure finance through debt funding supported by the taxing power of local governments, and revenue bonds secured by project earnings. Other industrialized countries have relied more on financial institutions, including specialized financial intermediaries, to provide credit for local governments. Financial intermediation and bond markets are not mutually exclusive funding channels for local investments because they could play complementary roles in serving two segments of the local government financial market.

In Hungary having direct access to long-term credit markets is not yet feasible for a large number of small and medium-sized local government entities. Using financial intermediaries that could tap private credit markets on behalf of subnational borrowers could be one way to foster market access. Lending to municipal entities would be achieved in leveraging the intermediary's equity funds through bond issuance in the private credit markets without government guarantee.

The regulatory and institutional environment would allow a role for market-based specialized financial institutions operating within the country's competitive financial sector. Lending would be mostly to viable, revenue-generating infrastructure investments. Lending can also be done by balance sheet and directed to public goods investments if the lending intermediary can establish, and shoulder, the risk so that local borrowing entities can generate the fiscal resources needed to service debt. The built-in diversification of the intermediary's portfolio resulting from the variety of subsectors and borrowers would provide good security, strengthen the credit quality of the debt issued by the intermediary, and allow the use of credit enhancement mechanisms, such as bond insurance, which may be brought to bear only in the case of an expanded and diversified pool of debt.

Further analyses related to the feasibility assessment of specialized financial intermediaries would need to address, among other things:

- The structural and institutional arrangements needed to establish market-based financial intermediaries that would operate in a competitive environment and issue debt without government guarantee
- The main operational features in terms of product range (for example, loans, equity participation, guarantees, and underwriting) offered by the intermediary and the diversification of its portfolio between sectors and borrowers
- The main financial parameters related to the intermediary's funding, lending and product pricing policies (including credit and interest rate risk management) needed to ensure financial sustainability.

Conclusions

The present local government system mirrors the euphoria of reestablishing democracy in transition from a command to a market economy, the strong beliefs in fiscal decentralization, and the openness towards private provision of public services. This approach recognizes the right of individual communities of whatever size to retain a separate identity and a representative body, but it puts increasing pressure on them to share an administrative apparatus and run services jointly.

The studies under the subnational development program have provided a broad range of evidences of a steady learning process against the background of a deep economic recession and an inevitable fiscal squeeze in the 1990s. Hungary not only was a pioneer reformer but it has moved far ahead among transition economies in devolving central functions to the local level; and in developing an adequate legal and regulatory framework of a deeply decentralized system. Local governments have gained first experiences, *inter alia*, in asset and financial management, public-private-partnership, project preparation and implementation, and in rule-based public procurement, but also adopted the approach of cost-recovery service fees, and correspondingly tested target subsidization of the poorest social groups.

One can conclude that the first "bachelor" phase of intergovernmental reform is over and the actors at both the national and local level ought to continue modernization at a more demanding "graduate" level. Our assessment of the 1990s achievements reflects the latter perspective. Reformers at both the national and local level are facing with the following challenges and opportunities during the first period of the country's membership in the European Union:

- *Continuing the restructuring of the public sector and local governments.* Localities have adjusted to changing circumstances, but are reaching the limit of their adaptive capabilities within the intergovernmental framework. The intergovernmental finance system needs substantial changes for localities to adjust further and use their resources more effectively. Service delivery should be based on a notion of functional integration

or functional regionalism, that is, at the level that assures the most efficient use of resources.

- *Supporting the autonomy of local governments.* Because of local governments' overwhelming reliance on central transfers, economic autonomy has not matched political autonomy. Local governments have made efforts to improve accountability, transparency, and service delivery, but their success has been offset by sectoral legislation that limits local decision-making authority through unnecessary micromanagement. Economic autonomy is also limited by a grant allocation system that constrains local government initiatives.
- *Assuring balanced and equitable development.* Since 1990, changes in public resource allocation aimed at managing revenue disparities across municipalities and providing standard public services have been only partially successful. In addition, they have contributed to unpredictability, high administrative costs, and reduced incentives for local governments to strengthen local revenue bases. Reductions in inequality between small and large and between urban and rural municipalities and across geographic regions require reconsideration of the system of grant allocation and distribution.
- *Meeting the EU requirements.* Meeting EU standards in infrastructure, environment, and other areas will require a large investment, part of which will be local. One challenge will be the effective absorption of EU funds to support accession. Investment needs are so large, however, that public funds alone cannot meet them. The challenge will be to provide an intergovernmental framework that supports local government efforts to access capital markets to finance investment needs.
- *Providing services efficiently and effectively.* Three necessities challenge efficiency: (a) ensuring further reduction of the cost of services, (b) obtaining optimal scale in service delivery, and (c) exercising effective regulation and supervision over private service providers. Although local governments have been able to improve cost-efficiency, constraints block further improvements. The micromanagement by sectoral ministries and the system of transfers hinders medium-term local planning for the most cost-effective service delivery. Limited local management capacity and expertise in contracting out and pricing services greatly influence the overall quality of service delivery. Hence not only municipalities, but also ministries and national agencies that have not adjusted their functions to the new decentralized environment, are to blame for poor management practices.
- *Strengthening the capacity and base for local revenue generation.* From a policy perspective, the ability of local governments to raise revenues locally is an important indicator of their fiscal strength. Three aspects need to be considered: (a) the sustainability of revenues, (b) the ability to generate revenues through taxes or service fees, and (c) the degree to which local tax increases have been accompanied by municipal accountability to taxpayers. Local revenues are becoming increasingly important components of

Hungary's fiscal strategy even though localities still rely heavily on central grants (68.4 percent of total local government revenues in 1998) and pursue a policy of minimum local taxation.

- *Strengthening strategic planning and financial management.* Local financial management capacity, particularly current budgeting and cash management, has improved significantly, but has not kept pace with changes in the overall municipal legal framework. Suboptimal financial management, lack of trained personnel, and weak financial controls often result in misallocation of public investments. Local capacity for budgeting, financial reporting and auditing, asset and debt management, and effective use and regulation of land all must be strengthened. This effort will be critical to the effective use of resources, including EU structural funds.
- *Securing adequate financial resources.* When essential services (those not provided through private operations and concessions) cannot be funded by operating surpluses and central transfers, private borrowing must fill the gap. This gap may become significant even when EU structural funds are taken into account, because proceeds from asset sales, which have been an important source of finance, are rapidly coming to an end.
- *Enhancing the legal and institutional framework for subnational finance.* Subnational entities are ranked among the most risky borrowers in Hungary. Although the Act on Municipal Bankruptcy is a useful instrument, weaknesses remain in the financial sector regulatory and prudential framework for subnational debt and in the budgetary framework to support municipal access to private credit.
- *Reducing demand-side impediments for municipal access to private finance.* A key factor in developing a competitive and sustainable subnational market for local infrastructure finance would be to enhance local governments' ability to access capital and credit markets consistent with macroeconomic stability. Most municipalities are too small to undertake investment projects on an economically viable scale, and their size presents a major constraint, to nonrecourse finance schemes. The regional service associations of municipalities lack capital, and they are economically nonviable market entities.
- *Enhancing financial intermediation and instruments to subnational entities.* Unlike Hungary's private financial markets, the municipal credit market remains underdeveloped in terms of competitiveness, depth, and liquidity. Falling inflation and interest rates alone will not resolve the issues resulting from a lack of modern capital market financing instruments and structures and financial intermediaries to meet the projected growth in investment demand of municipalities and public service enterprises.

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PART 2.
**ISSUES OF SUBNATIONAL
DEVELOPMENT**

Section 1.
**Modernizing the
Intergovernmental
Finance System**



Local Government Size, Structures, and Competencies in the European Context

Kenneth Davey



The 1990 reforms of local government in the post-communist states shared three characteristics: (a) respect for the right of individual communities to form basic units of self-government; (b) suspicion of higher tiers of local administration; and (c) contention over their future. These reforms were essentially reactions to the period of communist rule, governed by the principle of the unity of state property and administration and the concept that local autonomy did not exist. Although communist hierarchies of national committees had embraced some practical delegation to county, town, and village levels and some limited degree of local representation, the will of the Party hierarchy could always prevail. Moreover, historical boundaries had often been ignored in forced amalgamations of settlements.

The 1990 reorganizations recognized the principles of local autonomy and reasserted historical rights and communities. The Czech, Hungarian, and Slovak laws, for example, allowed virtual freedom for any settlement to declare itself self-governing. In Hungary the number of municipalities doubled in 1990; in the Czech Republic and Slovakia the process of fragmentation continued for some years. In one Czech village nine people constituted a local government area, a population now reduced by mortality to seven.

An innate conflict arises, however, between this fragmentation and local government demands for the right to administer a wide range of competencies covering the regulation of local society and the provision of local services. This chapter discusses the approaches within the European Union to resolving this tension. It begins by comparing the range of competencies conferred on local government and goes on to examine the implications of these for the structure and organization of local authorities.

* This chapter is based on Davey 1998.

Local Government Responsibilities and Division of Competencies between Tiers

Let us first summarize the experiences in major local government competencies in 11 European Union member states: Austria, Belgium, Britain, Denmark, France, Germany, Italy, the Netherlands, Portugal, Spain, and Sweden. The list excludes functions exercised by the *Länder* in Austria and Germany and the Belgian regions, which also have federal status. It includes functions assigned to upper tiers of local government. The division of competencies between the basic and upper tiers of local government varies considerably between countries, depending to some extent on the size of the lower tier authorities.

In some countries, the separation of function between tiers is clear, with counties having the following responsibilities:

- *Britain*—primary and secondary education, all roads and public transport, social services, libraries, waste disposal (but not collection), strategic land use planning, and fire and consumer protection (in larger towns, these two are the responsibility of single tier authorities or joint boards).
- *Denmark*—hospitals, administration of social benefits, regional roads, and upper secondary schools (gymnasia).
- *Sweden*—hospitals (except in three large cities), special care for the handicapped, and special forms of technical education.

All these countries have small basic authorities that have been amalgamated, so that they are all capable of fulfilling the tasks reserved for them. In other European countries, the division between tiers is less clear. For example, French *departements* and German *Landkreise* have basic responsibility for secondary school buildings and equipment and for social assistance, but these responsibilities may be shared with the larger municipalities. In Belgium, France, and Germany, upper-tier responsibilities are either exercised in parallel to the municipal level (for example, recreational and cultural facilities) or are residual in character (for example, maintaining roads where the municipalities lack capacity).

The lack of a clear division of competencies between tiers in this second category is due partly to the varying sizes of lower-tier authorities and the survival of small municipal bodies. The upper-tier authority has to combine two roles: providing services with large catchment areas and supplementing municipal services in the smaller communities.

Uniform Responsibilities

In all 11 states, local government is responsible for the following:

- physical planning, including building and planning permission
- public health control, including waste collection and disposal

- parks and open spaces
- recreational amenities, including sports facilities, libraries, museums, and other cultural activities (these functions are not usually exclusive of any level)
- public transport (usually planning and subsidizing rather than direct operation)
- social services, including homes and other services for the elderly and childcare.

Variable Responsibilities

The division of other major competencies between central and local government and the private sector varies among the 11 countries, with local government involvement defined as follows:

- *Education*—In Britain, Denmark, and Sweden, local governments exercise full responsibility for primary and secondary education, subject to national policies for curriculum and standards. (British local authorities are required to delegate significant powers to school governing bodies in which parents are represented, and some schools are self-governing and directly funded by the government). In Austria, Belgium, France, Germany, Italy, and the Netherlands, local governments are responsible for construction, equipment, and upkeep of primary and secondary school buildings, but not for the employment or oversight of teachers. In Portugal, local governments are responsible for all these functions for primary schools, but not for secondary schools.
- *Hospitals*—Upper tiers of local government are responsible for hospital services in Denmark, Italy, and Sweden.
- *Social benefits*—State benefits are administered by local government in Denmark and Sweden. British local authorities administer housing benefits and local tax relief. Local governments provide safety net supplements to state benefits in Austria, Belgium, France, Germany, Italy, the Netherlands, and Portugal.
- *Roads*—Local governments in all countries except Portugal maintain local and regional roads. British local authorities also maintain national trunk roads (only as agents in the case of motorways).
- *Public utilities*—In Britain, water, sewerage, gas, and electricity have been privatized, but they are regulated by national legislation. In the other 10 countries, these services remain local government responsibilities, though usually franchised to companies that operate on a national or regional basis. The ownership of these companies varies widely between countries.
- *Fire protection*—This service is a local government responsibility in Austria, Belgium, Britain, Denmark, Germany, the Netherlands, and Spain.
- *Policing*—Municipal police forces responsible for traffic and bylaw enforcement operate parallel to national police forces in France, Germany, and Italy. Britain has no

national police force; county police forces are supervised by special boards representing local governments and the magistrates.

Size and Task

Decisions concerning the assignment of competencies raise basic questions about the optimal size of local authorities. The argument has several conflicting dimensions.

Catchment Areas

The first dimension of the argument relates to the match between catchment areas and territorial jurisdiction. How do municipal boundaries correspond with the area from which the clients for its services are drawn? What is the minimum area and population for which an effective service can be provided?

Some observers say that, in principle, municipal boundaries should embrace the catchment areas of their main service functions. This response raises a number of secondary questions. First, what is a minimum level of service? Is a population able to fill a medium-sized primary school sufficient for a municipality charged with educational responsibilities? Most European countries would accept that view, which results in population thresholds around 5,000. In Britain, however, a professionally dominant view has prevailed that a local education service must integrate a full range of facilities, including a choice of primary, secondary, and vocational schools, and support services, such as teacher training, specialist advisors, counseling, and inspection, an apparatus that may be economical only for populations of 100,000 or more.

The same argument can apply to any function. Does one clinic or general hospital constitute a local medical service? If not, what range of specialist facilities has to be included? Do economies of scale demand that responsibility for maintaining trunk and local roads should be shared by the same engineers using the same equipment? Is it efficient to separate bulk water supply and treatment from reticulation? Moreover, whatever catchment area is eventually agreed to be reasonable for one service is unlikely to coincide with the boundaries of another, except in the case of large towns.

Executive Capacity

The second issue concerns the size of the local authority necessary for effective management of services and exercise of regulatory duties and is principally a question of ability to recruit and employ professional staff resources, though technical equipment may be involved. Some analysts also argue that larger authorities can attract more intelligent elected members, although this assertion is difficult to verify. The associated issue of cost raises the question:

Does the overhead cost of maintaining a central administration become disproportionately heavy below a particular population threshold?

The Council of Europe has reported on a number of surveys on these issues taken by member states, including Belgium, Denmark, Italy, and the Netherlands (CoE 1994). The results are somewhat inconclusive, partly because effectiveness is hard to measure. They tend to suggest that below a population of 5,000, unit costs are substantially higher and professional capacity equally lower. Above this level, differences in cost and core administrative abilities are not consistently evident, although more specialized technical skills may be marshaled only in municipalities of 12,000 people or more. The Dutch study suggests that population size is not the only determinant of the level of professional skills deployed; whether a municipality is a regional center or part of a major conurbation is also a major consideration.

Financial Resources

Territorial fragmentation generally increases disparity between local authorities' resource bases. Two types of disparity are at issue: (a) between the general wealth and income levels of local authority areas, and (b) in the distribution of commercial and industrial undertakings contributing to local revenues.

Large jurisdictions are likely to contain a mixture of more and less affluent areas, contributing different levels of local taxation, such as shares of or surcharges on personal income tax or residential property taxation. The poorer areas may also demand higher levels of spending on social services and support (although this cost may be partially offset by higher standards of environmental services secured by richer neighborhoods). A large jurisdiction will permit some cross-subsidization between localities in the municipal budget.

Small jurisdictions may be far more uniform in degree of affluence or poverty and level of revenue generation. Indeed, when procedures allow the formation of small authorities, affluent neighborhoods have an incentive to secede from a larger territory to escape from subsidizing services elsewhere.

Large jurisdictions are likely to combine business and industrial districts with a range of residential areas. When jurisdictions proliferate, industrial and commercial development may be concentrated in one local authority, but the people they employ and serve may be scattered between several others. This diffusion will lead to gross disparities in the incidence of taxes on business premises or transactions.

The impact of these disparities on the finances of small authorities depends on the types of taxation assigned to local government and the method of their distribution. In the Czech Republic, for example, shares of personal income tax accrue to the district in which they are collected, but are distributed to individual municipalities according to population. Shares of corporate profit tax, by contrast, accrue to the municipality from which they derive. In Slovakia, shares of personal income tax are distributed to local authorities

according to population nationwide. These systems mitigate differences in local tax bases to a varying extent, although disparities in wealth and economic activity will still be reflected in nontax-revenue, such as property income.

A second financial issue concerns the role of intergovernmental transfers—grants and revenue shares—in mitigating the effects of territorial fragmentation. Reference has been made to mechanisms by which the distribution of tax shares may reduce disparities in their geographical incidence. This reduction may also extend to taxes levied by municipalities. In Denmark and Sweden, for example, the yields of the local income tax surcharges are distributed to some degree between authorities that have above and below average income tax bases; variations in expenditure need are also taken into account. A similar redistribution of business tax yields takes place in the *Ile de France* (metropolitan Paris). The British Revenue Support Grant aims to compensate fully for differences in the value of residential property on which the council tax is levied.

Grants may also compensate for mismatches between municipal boundaries and local service catchment areas. The Hungarian normative grant is based on a combination of factors, some of them general (for example, population size) and some specific to individual services (for example, the number of secondary school pupils). Specific factors have tended to increase in number and weight in order to give added support to municipalities running regional services. The Netherlands revenue-sharing system, on which municipalities depend for half of their current income, has recently been revamped to give preponderance to the needs of authorities with either high levels of social deprivation or regional center functions.

These examples show that it is possible to compensate for the disparities and mismatches to which territorial fragmentation gives rise. But costs arise in terms of local autonomy and accountability. Municipalities become less dependent on the resources directly levied on their local economy and more dependent on redistribution by the state and on transfers with a greater degree of specificity.

Moreover, encouraging fragmentation simply by compensating small municipalities for their size and excessive per capita overheads becomes a real danger. Some grant systems include a basic lump sum element which, though small overall, can be significant for tiny authorities; others, as in Hungary and Slovakia, may include an equalization fund for villages in deficit. Compensating nonviable authorities for their self-inflicted penury also presents dangers. State budget support should be an incentive to share administrative and service costs, not to continue misguided efforts to go it alone.

Political Representation

The conventional wisdom is that the design of local government structures must contend with a universal tension between the demands of political participation and economic efficiency. Services will be more effective and efficient if local jurisdictions are large, but political participation will increase if they are small.

Both suppositions are questionable though. The correlation between size and effectiveness above populations around 5,000 is inconclusive, and so is the inverse correlation between size and political participation. Again, this chapter draws on analysis by the Council of Europe of studies in Denmark, Germany, Norway, and Sweden (CoE 1994).

In two measurable respects, participation has been shown to vary inversely with size: (a) voter turnout at local elections, and (b) the extent to which individual citizens are acquainted with elected officials. Countervailing forces affecting the quality of participation are also in evidence, however. Larger jurisdictions tend to house a more vigorous civil society—a more effective combination of local media and pressure groups scrutinizing local government and articulating demands and options. Elected members of the larger authorities are more likely to be organized on party lines; this partisanship can distort the debate of local issues, but it does put some curb on faction and can (although it does not always) facilitate hard, strategic choice.

Factors other than size, of course, contribute to the quality of political participation. Electoral systems are important. Election by ward rather than at-large decreases the fear of exclusion from power by peripheral or minority communities; it can also lessen resistance to a process of amalgamation, because individual council members may be confident of keeping their places whatever the new boundaries.

Some analysts contend that the political legitimacy of a local authority depends more on its historical identity than its size. It can attach as much to a large city as to a small village. This effect has been shown in Britain, where a recent reorganization has been persuaded by public opinion to revive historical counties—such as Herefordshire and Rutland—abolished in 1974 because of supposed nonviability, and to dispense with new territories, such as Avon and Humberside, carved out in 1974 in the name of strategic capability.

Is There an Optimal Size?

The search for optimal size has proved elusive, more the pursuit of alchemy than economics or political science. Attempts to relate size objectively to efficiency, effectiveness, and participation are bedeviled by problems of measurement. Evidence tends to converge around a population threshold of 5,000, below which unit costs rise and efficiency declines. Above this level the evidence is inconclusive, because the more specialized demands for economies of scale can be met by more politically acceptable forms of cooperation and buying in (Hermann and others 1999). The pursuit of optimal size (and the belief in economies of scale) was most active in the 1960s and 1970s, when widespread amalgamations were undertaken in several European states. The number of local authorities declined by 87 percent in Sweden, 80 percent in Denmark, 78 percent in Belgium, 76 percent in Britain, and 67 percent in West Germany. Similar policies were pursued by communist regimes, but most were reversed in 1990. The policy was least effective in the Mediterranean states, where alternative strategies have been pursued, encouraging intermunicipal cooperation or strengthening intermediate tiers.

It could be argued that differences in the degree of restructuring reflect differences in the context and concept of local government. Territorial fragmentation remains greatest and amalgamation processes least effective in the Napoleonic systems in which the state maintains a major local presence through prefectorial administration and field technical services. These support, oversee, and supplement local government in the delivery of services. Local authorities have been important traditionally not so much for their capacity to provide services themselves but rather for their ability to represent local demands and interests to agencies that have the mandate and resources to do so. Conversely, attention to size has been greater and amalgamation policies more active in northern European states where the state does not maintain a major executive apparatus at local level and has depended to a far greater extent on local government to provide local services.

These contrasting traditions have converged to some degree in recent years. The Mitterand reforms in France, for example, transferred more executive tasks and apparatus to local government control, particularly at the intermediate levels, whereas postwar governments in Britain have created several parallel networks of single-purpose, non-elected authorities, in some cases taking over local government responsibilities.

Nevertheless, broad differences between northern and southern European systems remain. The paradox is that post-communist reforms in countries such as Hungary have basically created a southern European structure of multiple local authorities that have huge disparities in size and resources, but a northern European role in terms of function and self-sufficiency. The post-communist backlash also makes them particularly sensitive to attempts at rationalization.

Remedies

Most European countries have responded in some way to these challenges. No unified solution exists to improve the efficiency of service delivery, although a clear tendency has emerged to create larger service units or regions via association of municipalities through legal, organizational, and financial consolidation of service units or neighbor municipalities.

The Nordic countries and Britain have opted for amalgamation of municipalities; others preferred other alternatives that tolerate, willingly or by default, a proliferation of jurisdictions, giving equal status to large cities and a mass of tiny villages. In such cases, practical solutions must be found to the inability of many local authorities to perform even elementary duties.

Even when amalgamation policies have been pursued, some tasks are beyond the capacity of most individual local authorities. They may have exceptionally large catchment areas (for example, a school for the blind), they may demand highly specialized expertise and equipment (for example, a trading standards laboratory), or they may require strategic coordination over a very large area (for example, transportation planning in a conurbation).

Reformers have suggested many types of alternative solutions to these situations, and these solutions can be grouped into four categories: (a) amalgamation; (b) structural solutions, vesting competencies in intermediate levels of single- or multipurpose authority; (c) cooperative solutions, leaving basic local authorities with functional responsibilities exercised through cooperation, whether compulsory or voluntary; and (d) contracting solutions, leaving basic local authorities with functional responsibilities exercised by buying service provision or management.

Amalgamation

Some local government systems have been reorganized to achieve a target minimum size of basic local authority—around 5,000 people in Scandinavian countries and vastly larger in Britain.

In some cases, creating larger functional units of local government has left intact a basic village level of representation. Parish councils in Britain have no mandatory tasks, which are all assigned to county or district local governments, nor do they receive state funding. They do have the right, however, to levy a small surcharge on the local tax and to spend it on supplementing local services, to be consulted on planning applications, and to be active in representing local demands and views to any local public or private agency. Parish councilors may sit on the governing bodies of local schools, for example, even though the schools belong to higher tier authorities. In some German *Länder*, where *Grossgemeinden* (large communities) have been created by amalgamation, the constituent *Gemeinden* have retained the right to elect a mayor to represent local views and to carry out minor administrative and ceremonial functions. In these ways, some sense of local identity is preserved, even though responsibilities requiring significant finance and staffing are performed by local authorities covering a larger area and population.

Structural Solutions: Intermediate Tiers

The most frequent structural solution to inadequacies of the basic level of local government is to establish an intermediate tier of multipurpose, elected bodies. Examples are the French *departements*; the British, Danish, and Swedish *counties*; the German *Kreises*; the Romanian *judets*; and the Dutch *province*. Hungarian counties fall into this category.

Significant differences in how these middle-tier authorities function are evident. The first difference is their geographic scope. The normative model is for the whole country to be divided into these units and for their local government authorities to exercise their particular tasks everywhere within their respective boundaries.

The exceptions are many, however. Several countries follow what is known in Britain as the “doughnut” shape, within which large cities and towns are excluded from the jurisdiction of the surrounding middle-tier authority and exercise both basic and

middle-tier functions. This exclusion applies to British metropolitan boroughs and unitary authorities, German *Kreisfreistädte*, and Hungarian county-rights towns. This pattern may be nationwide or confined to exceptional cases (for example, Stockholm, Prague, and three other Czech cities).

The doughnut system has long historical roots in most cases. It harks back to days, usually mediaeval, when burgeoning cities obtained charters from the Crown to exercise a degree of autonomy over tasks performed outside their boundaries by royal delegates. This exemption from county jurisdiction is a treasured mark of local identity and autonomy and is often fiercely defended.

The exclusion of cities from middle-tier jurisdiction respects tradition and allows the integrated delivery of services, but it also causes difficulties, particularly in managing and funding services with wider catchment areas and in coordinating development planning and transportation with a city's hinterland.

A second major difference relates to the assignment of functions to the intermediate tier. In countries such as Denmark and Sweden, the functions of the middle tier are tightly defined to avoid duplication and minimize infringement on municipal competence. They tend to be confined to the management of very large or highly specialized institutions, such as hospitals or technical colleges. The functions of British county councils are wider, embracing primary and secondary education, social services, and transportation. Even in Britain, however, relationships with the lower tier are nonhierarchical and respective tasks are demarcated to avoid any suggestion of superior authority. Central government deals directly with the lower tier in respect to its field of competence.

This demarcation is not universal. In countries where the basic tier includes many tiny communities, the role of the middle tier may be more flexible. The division of responsibility between the German *Kreis* and *Gemeinde* is more varied and flexible, depending on local agreement, capability, and partnership. The *Kreis* has its distinct duties, but it also has a general role in supplementing and supporting the smaller *Gemeinde*.

Flexible solutions mean that the division of competencies between the basic and intermediate tiers does not follow a uniform pattern—the current position in Hungary. The problem is adapting the flow of financial resources, particularly because the variations in competence often apply to the most costly regional services such as schools and hospitals, which earn little direct revenue.

Intermunicipal Cooperation

The 1990 local legislation in central European countries generally made provision for municipalities to form associations for the common discharge of functions. These powers were largely voluntary, and generally, countries have been disappointed at the lack of implementation. The Hungarian legislation was an exception in that it virtually required very small neighboring municipalities to establish a common office to employ a qualified administrative notary.

Far greater experience of intermunicipal cooperation lies in those western European states that have large numbers of small municipalities. Chief among these is France, which has more than 2,000 multipurpose *syndicats de communes* maintaining roads, water supplies, and social and educational services on behalf of their members and more than 11,500 other *syndicats* providing a single service, such as water supply, schools, electricity, gas, or flood control. They are run by joint committees representing the member community councils and levy a compulsory contribution from them. The *Gemeindeverbände* play a similar role in German *Länder* (mainly in the south or east) where amalgamation of small municipalities has not been compulsory, usually providing a joint administration. Roughly 50 percent of Spanish municipalities are involved in joint authorities, half of them single-purpose and half multipurpose.

Even in countries where basic tier authorities are generally larger, joint working is common for specialized functions with significant economies of scale. In Britain the county level normally has joint authorities for fire protection, public transport, and waste disposal. In Finland smaller authorities form joint boards mainly for health care, social services, and vocational training.

The operations of these joint authorities differ significantly. First, their legal forms vary from an independent statutory authority to a joint committee or a company in which the partner municipalities hold equity. Most are governed by a board of representatives of the member authorities. They may establish their own management structures or entrust administration to one of the constituent municipalities. The British joint boards normally employ technical staff, but they use the administrative, accounting, and legal machinery of one of the member boroughs or districts.

The second difference concerns the financial base. Joint authorities typically receive directly any charges or fees pertaining to their function, but they rely on contributions from member municipal budgets for the balance of their costs. Whether these contributions are obligatory or voluntary (that is, at the discretion of the joint boards or the municipalities) depends on the statutory base of the board. In some cases, joint boards in France and Britain may levy a tax directly, normally by “precepting” on taxes raised by their members (that is, putting an additional percentage rate on the local tax base).

The third difference lies in the nature of the cooperation. Some joint authorities are voluntary creations of their member municipalities. Others are legally required, such as the metropolitan fire and public transport authorities in Britain, some (but not all) of the French *communautes urbaines*, or the common rural administrative offices in Hungary. Many lie in between these two categories, the result of vigorous arm twisting by the state. A high proportion of the French *syndicats de communes* fall into this category, being constituted by agreements brokered by prefects and backed by state grants and loans only accessible to joint authorities.

This lesson, indeed, may be the principal one of western European experience. Large municipalities may combine spontaneously to run a highly specialized function that is peripheral to their main operations and a relatively small charge on their budgets, but

small municipalities do not cooperate readily with neighbors to run a basic service such as a school or a water supply or to share administrative machinery, whatever the technical merits of such arrangement.

A high degree of legal compulsion or state manipulation lies behind the scale of intermunicipal cooperation found in countries such as France and is essential in such systems to secure service viability, particularly in rural areas. Of special interest is the French legal provision that all communes in a locality must participate in a specific “*syndicat*” established by agreement between two-thirds of the communes concerned or communes representing two-thirds of the population of the area served. Making budgetary contributions binding on member authorities and providing model formulas for the distribution of costs may also be important.

Contractual Arrangements

An alternative strategy for coping with inefficiencies of size is contracting out or buying in. Such practices may be intermunicipal or commercial. Intermunicipal arrangements consist of buying services from another local authority. This arrangement is not uncommon in central Europe, where rural and suburban authorities frequently purchase services from municipal companies owned by the core town (although the towns are normally reimbursed by direct charges on rural and suburban residents). Some newly restored unitary authorities in Britain are buying special services, such as trading standards laboratories, from the surrounding county.

A widespread alternative is contracting out service provision to a commercial company, which may operate on a national or even international basis. Again, France offers the most cases, with companies, led by *Compagnie Generale des Eaux* and *Société Lyonnaise-Dumez*, managing 75 percent of municipal water supplies with a high degree of vertical integration, including distribution, treatment, maintenance, and pipe manufacture. These companies have expanded their contracting to many other municipal services, *Generale des Eaux* being active in construction, street lighting, leisure management, car parking, telecommunications, public health, and catering. They have also expanded to other countries, taking advantage of privatization and contracting out policies in Britain, for example, and securing water supply management contracts in the Czech Republic.

British legislation requires local authorities to submit provision of many services to public tender, and the in-house organizations are allowed to compete with the private sector. This arrangement has also brought private sector companies into the management of services, such as refuse collection and leisure centers, and even into white collar services such as engineering, payroll management, and legal representation.

Contracting out enables municipal purchasers to benefit from the economies of scale offered by external suppliers, and to tap into the expertise they gain from operating on a wider scene. Some of the leisure management companies have undoubtedly brought

new flare and innovation to sporting and cultural facilities in Britain. Contracting out also potentially offers greater efficiency; compulsory competitive tendering is estimated to have resulted in overall cost savings of 6 percent in Britain, even though in-house organizations have secured around 70 percent of the contracts. But the efficiency benefits depend on the existence of genuine competition, based on alternative providers, honest and transparent procurement processes, and effective supervision. Local authorities must retain the technical expertise to design and supervise contracts or have some shared resource for doing so. This level of control poses some problems in the post-communist states, where professional skills have largely been located in the municipal companies and institutions rather than in the town halls, which tend to be staffed largely by lawyers and generalists.

Conclusions

Belief in economies of scale, which dominated the debate over local government structure and function through much of postwar Europe, resulted in major reorganizations and reductions in the numbers of local authorities in several, largely northern European, states, together with the creation of intermediate tiers for strategic purposes, mainly in conurbation. The theory of economies of scale has been echoed in much of the restructuring and “globalization” of the commercial world.

The 1980s and 1990s have witnessed something of a reaction against this trend. “Small is beautiful,” an emphasis on community, and a reversion to historical identity mark the backlash. Countries have little technical consensus or political will to drive through further amalgamations. “Buying in” is the most typical solution to the needs for shared capability.

Empirical evidence has suggested that the effectiveness of local authority services declines and unit costs rise below a municipal population threshold around 5,000. Above this level, no conclusive evidence indicates that increasing size results in either improved effectiveness or reduced participation.

The local government systems recreated since 1990 in several of the post-communist states share the major problems of disparate size and mismatch with functional requirements that inspired the northern European amalgamations of previous decades. Whether restructuring offers a feasible solution is questionable. Restructuring is out of fashion in western Europe and contrary to the post-communist mood in central and eastern Europe.

The Hungarian government’s approach—applied with extreme caution—may offer the only practical solution to the proliferation of very small municipalities. This approach recognizes the right of individual communities of whatever size to retain a separate identity and a representative body, but it puts increasing pressure on them to share an administrative apparatus and run services jointly.

This process cannot be purely voluntary. On the one hand, municipalities need legal requirements for minimum capabilities necessary for specific competencies that induce the municipalities to cooperate. On the other hand, municipalities need financial and

legal incentives to encourage cooperation—model agreements, criteria for cost sharing, improved access to state budget support, even possibly access to taxing power. Financial incentives should encourage cooperation, not costly isolation. Both sticks and carrots are essential to the process.

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The Legal and Regulatory Framework of Fiscal Decentralization

Ilona Pálné-Kovács



The new Hungarian Constitution and the 1990 Act on Local Government (ALG) formed the basic legislation of the decentralized subnational system. This initial legislation provided a broad, unified, flexible, and open framework for local competencies, responsibilities, and expenditure assignment. The legislation aimed at ensuring continuity and radical reform in local functions and services in conformity with the liberal paradigm of resource regulation and widespread local autonomy. The ALG defines mandatory and voluntary tasks, but local governments identify local needs and priorities and thus determine the level and quality of services. In this system the role of central grants is to supplement local funds rather than finance tasks. The annual Budget Act, the 1992 Act on Public Finance, and sectoral regulations have gradually supplemented the ALG and defined key conditions for its implementation.

This chapter reviews the present legislative framework of local service delivery and highlights key contradictions in the current regulation. I argue that because a clear division of competencies provides a solid basis for adequate financing schemes and quality-assuring monitoring systems, the major caveats of further progress in fiscal decentralization depend on legal and constitutional regulations and not so much on local government finance itself. I have identified several issues that must be addressed to ensure that the legal framework provides for clear expenditure assignment, stability in financing, and accountability in operation and investments.

* This chapter is based on Pálné-Kovács 1998.

Expenditure Assignment Regulations

Unlike the German and many other European legal systems, the regulation of the Hungarian system is unclear about the legal nature of centrally mandated tasks of local governments. Mandatory and voluntary (locally undertaken) tasks are not clearly distinguished and thus do not ensure clarity in financing.

Unclear Local Competencies

In principle the Constitution should set forth the services to which citizens have unique rights and specify the responsibility of the central and local governments in providing these services. Services due to all citizens (for example, elementary education, basic health care, and social services) could be considered to be unique rights and central government tasks. Provision of these tasks could still be delegated to local governments, but the central government has the full financial responsibility. At the same time local governments must comply with formal and organizational regulations and training requirements. Central government tasks or a part of them could also be outsourced from local governments to the private or nonprofit sector, as several international examples show. In quite a few countries, education and health care either are not local government tasks or are organized by special local governments (for example, Italy and Finland). Mandatory local tasks could refer to regional or local public goods provided by a dominant cluster of local governments (although not all). These services can include secondary education and vocational training, in-patient and special medical treatment, child and youth protection, care for disabled and elderly citizens, basic community services, basic library services, maintenance of public collections, and certain social services (such as family assistance or aid for the homeless). In these cases, the central government has only to supplement local resources and may regulate technical standards and quality in providing these goods. Voluntary local services could mean any kind of services; nevertheless, they should be financed exclusively from own revenues or shared taxes.

Mandatory Tasks: General versus Sectoral Regulation

The ALG, the most comprehensive regulation of local government affairs, initially did not specify clearly the mandatory local services. It mentions local government responsibilities in general in a quite inconsistent way and provides some examples headed by the term “especially” (paragraph 1, section 8). Even in the case of the latter tasks, localities have the right to decide the extent and quality of services in light of local needs and resources (paragraph 2, section 8). Therefore, these responsibilities cannot be considered to be obligatory in the sense of a public law. In addition, many of these tasks are not primarily local (for example, public safety, public transportation, and local energy supply), and the

current system provides no tools to finance them. Since 1994 local governments have had a list of mandatory services (for example, kindergarten, elementary school, basic social and health services, potable water, local roads, and public lighting; paragraph 4, section 8).

That the law provides neither sanctions for non-fulfillment of the mandatory tasks nor a monitoring system for local responsibilities and service delivery is a legal phenomenon. As a financing consequence, central government transfers (block grants and normative grants) are provided regardless of the extent or quality of services. In other countries the central government has the right to exercise professional control if services are mandated to subnational levels or to the private sector and state transfers are partially or fully withheld in case of poor quality or insufficient provision.

To complicate the system further, sectoral laws since 1990 have defined additional local government tasks. Strangely, there is an unclear legal relationship between local government tasks defined in the ALG that require a two-thirds majority to be approved and other sectoral laws approved by only a simple majority by the Parliament.

In principle the ALG provides for the financing of all obligatory tasks. This part of the law has been in the crossfire of debates since its inception. The ALG states that the Parliament, in tandem with assigning a new mandatory task to the local level, must provide adequate funding and decide the extent and form of respective central transfers (paragraph 5, section 1).

Sectoral laws that define additional tasks, however, usually do not deal with financing issues and do not adequately increase local resources. Even if the Parliament intends to provide additional resources, the most debated issue is usually whether the tasks should be covered fully or only partially from the state budget. The counterargument often is that local governments will rely on their own revenues when financing new tasks.

Although normative grants often change in tandem with the enactment of sectoral rules (or sometimes new earmarked grants are created), just as frequently funding of new tasks is integrated into an old normative, with no regard for how much the new provision may cost. General purpose grants are designated to finance tasks for which normative grants are not specified in the transfer system, but quite often general grants are referred to when the localities require additional transfers for new mandatory tasks.

Voluntary Tasks

The ALG defines the scope of voluntary tasks more clearly by saying that local government can provide any kind of local function or service not designated by law to other organizations' competency. Nevertheless, some tasks are voluntary only for certain types of local governments and obligatory for others. Tasks of regional scope (for example, secondary education) are designated to larger settlements and to counties as a mandatory task, but the ALG allows other settlements to provide them or even to take them over in accordance with local priorities. Thus the differentiation between mandatory and voluntary tasks is inconsistent in the legislation.

The central government's involvement in financing voluntary tasks is totally unregulated. Evidently, own and shared incomes serve (among other things) as funding for voluntary tasks, as do some state transfers, which the ministries allocate in a rather uncoordinated way. According to the regulation, in case of a financial crisis, local governments must maintain their obligatory tasks and cut their voluntary services first. The regulation holds a dilemma: localities must apply the same rules in downsizing voluntary and obligatory tasks, so streamlining of obligatory tasks becomes rather difficult. In addition, voluntary tasks represent maneuvering opportunities, because local governments make decisions according to local demand. Abandoning voluntary tasks from the local services would mean the loss of an essential aspect of subnational autonomy.

Fragmented Service Delivery

Differentiating expenditure assignments by size of local governments is one of the biggest problems in the subnational legislation, despite the basis provided by the ALG. The ALG acknowledges (in paragraph 1, section 6) that different tasks and competencies might occur in villages, towns, county governments, the capital city, and its districts. More obligatory tasks and competencies may be delegated to local governments of settlements that have a larger population and bigger capacity. These provisions clearly give the legislature the opportunity to decide the scope and extent of services that should be provided by a certain rank of local government.

The same paragraph of the ALG also contains an auxiliary rule that overturns the logic of the main provision and hinders implementation. The local government of a small settlement can voluntarily provide services otherwise delegated by law to municipalities that have larger population or to county governments, assuming that the small settlement is able to supply the services in its area, either by itself or in association with other local governments. In such a case the small locality is automatically eligible to receive normative transfers to finance the tasks taken over from bigger municipalities.

This rule has blocked the development of an optimal expenditure assignment and financing scheme for several reasons. First, unilateral local decisions can distort an existing and well-operating service by creating parallel capacities. As a result, the initial service provider can no longer use its own optimal capacity. Second, the central government might even reinforce irrational expenditure assignments by guaranteed funding of new tasks of smaller municipalities. This arrangement may bring bigger local governments originally mandated to perform certain tasks into a difficult financial situation, because providers receive transfers according to the number of users rather than capacities. Third, the task taken over by the government of a small settlement is often provided only to its own citizens, and it cannot be obliged to supply a bigger area. As a result the local government initially responsible for servicing a bigger area cannot simply withdraw because that would leave citizens without service.

Sectoral Regulation and Economies of Scale

The ALG states (in paragraph 3, section 8) that laws can differentiate task assignments by the size, population, or other conditions of settlements. Such differentiation rarely happened in the past; distinction was not even made between tasks of villages (say 100 citizens) and towns (say 50,000 citizens). Nevertheless, some sectoral acts aim at stimulating the use of economies of scale, such as the 1993 Act on Social Administration and Assistance, the 1996 Act on Fire Protection, and the 1998 Act on Construction.

Analyzing the regulation, one can conclude that the legislature did not want to get involved directly in forming special service districts or identifying the optimal size of service units. The sectoral laws have not regulated a clear and stable differentiation of tasks by type or size of municipalities, although these laws at least state that services should be organized by region. Municipalities are usually eligible for central support when they organize the regional task locally or form a region with a very small neighbor (say, to supply 2,000 citizens).

A set of indirect tools at hand discourages fragmented service delivery, such as applying tight service standards or inspecting suppliers' licenses and accreditation. When qualitative and quantitative conditions of service delivery have been well defined, small localities are individually unable to meet the standards. Since sectoral funds for investment grants are limited, they often serve only to demonstrate that central government support exists, but in practice, that support is not accessible for many municipalities even though they are eligible to apply for sectoral support. The interesting legal feature of this framework is that central government or ministerial decrees can substantially change the rules of service delivery without amendment of laws (that is, without Parliamentary approval).

Primary Education

The 1993 Act on Public Education does not differentiate by size of settlements, apart from tasks assigned exclusively to county governments. The act precisely defines institutional and professional requirements for local education and defines only a subsidiary role for the central government in elementary and secondary education. Institutions that have regional or national functions can be managed by the state, with approval of the minister of finance, only if the original operator proved incapable. On the positive side the act orders county governments to initiate service contracts between local governments in a given geographic area and encourages them to make a six-year development plan for public education and for the operation of their institutional network.

The act states that operational expenses are not fully covered by the central government, though the cost coverage should not be less than 80 percent. School budgets, therefore, contain contributions from the central and local governments, and maybe own revenues (for example, fees paid by the students for food or extracurricular activities). The difficulty in finding the right techniques to finance education is demonstrated by the fact that the number of normatives has increased tremendously, and now a few hundred indicators are

used to specify the content of education services. This trend, though it symbolizes the responsibility of the central government, does not encourage localities to rationalize their institutions or service delivery.

Social Assistance

The 1993 Act on Social Administration and Assistance defines basic tasks for all localities and special task assignments by size clusters of settlements (2,000, 10,000, 20,000, and 30,000 or more inhabitants). In villages with fewer than 500 inhabitants, the village manager fulfills basic social tasks.

The weakness of the regulation is that bigger settlements with special tasks are not responsible to serve beyond their own area, so citizens of a settlement that does not have a special social institution can use the county's social institutions. Citizens can also use social services in a neighboring municipality if the two localities have a contract or joint service delivery association.

Health Care

The 1997 Act on Health Care states that citizens are eligible for basic medical services and for in-patient service in their place of residence or vicinity. They are eligible for out-patient services in a place accessible by regular public transportation. This definition does not have a real normative power. In practice, because only institutions contracted by the Health Insurance Fund are able to provide services, the financing system—the annual bargaining in the framework of the capacity use agreement—essentially determines how close the service gets to the patient.

As for local governments the act presumes that basic health care services are organized on a territorial basis. As opposed to its thoroughness regarding medical standards, the act regulates the local governments' role superficially, stating only that municipalities are responsible for out-patient and in-patient care. The appendix to the act defines the number of hospital beds in advance for five years based on precise statistical indices; it also lists the institutions with national and regional functions, regardless of whether they are in central or local hands. Detailed conditions for these services and the normatives of regional financing, however, are regulated in a separate law passed in 1996.

The essence of the health finance model is that local governments are responsible for infrastructure, and operation is ensured by funding from the Health Insurance Fund. Within this framework, however, local governments and other managing agents can negotiate the capacities of their institutions. Although the owners or managers of health institutions can submit joint offers for Health Insurance Fund financing harmonized at the county level, inevitably bargaining takes place within the counties and service delivery may still remain fragmented.

Counties and Cities with County Rank

The subnational system has two particular features: (a) the subsidiary arrangement for county government tasks, and (b) the special status of cities with county rank. The latter not only worsened the conditions of optimal service provision at micro-regional and regional levels, but it also made the understanding of expenditure assignments more difficult. The allocation of tasks between city and county governments is chaotic, both in the legislation and practice. As a consequence of constant changes in assignments, asset refurbishment and investments are often neglected, and the service providers and users have no stable, long-term relationship.

County governments are mandated by law to provide public services on request for the whole or part of the county. In addition, they can be required to provide services in a settlement where most users of a service unit (for example, school dormitory) are not citizens of the municipality (managing spillover). This role of buffer or last resort could be more important, but subsequent regulations prevent municipalities and county governments from establishing a stable division of labor between them.

A municipality can obtain the right to take over and manage a service unit for at least three years if its citizens have been the primary users in the past four years. The act thus allows for the introduction of voluntary tasks, but a municipality can unilaterally take over service units. In addition, a municipality (alone or in association with others) has the right to establish a new service unit and take over a service provided by the county as mandatory. In such a case the ALG guarantees that the municipality receives central transfers in proportion with the task taken over. The central government, therefore, does not provide more money, but it reallocates the transfers between the county and the respective municipality. This regulation evidently puts county governments in an economically depressed position because they often must continue the service for the rest of the region, but operate with suboptimal use and smaller entry transfers when someone creates a new regional service unit.

The ALG does not specify (although it does not exclude) the possibility of joint county–municipal service delivery. The amendment of the ALG in 1994 intended to assign more, and some exclusive, tasks to the counties. The actual legal solution, however, is less than optimal. The act lists the mandatory services for counties, but it also states that municipalities may choose whether they want to provide such services. The ALG also states that municipalities can pass service units to the counties, and the counties are obliged to take them over.

Only a narrow range of tasks ultimately became mandates for counties, and a wider range of tasks remained the responsibility of municipalities. Tasks now belonging exclusively to counties are certain professional promotion and harmonization functions created by sectoral legislation in the recent years, including, for example, professional child and youth protection services, specialized social care services, museums, collections of historical documents, county library service, environmental protection supervision, tourism,

and the harmonization of employment policy. In sum, the 1994 amendment to the act brought about some positive changes, but it did not correct the major confusion in service delivery and disincentives in managing service units.

According to the ALG, cities with county rank are endowed with municipal and county tasks and competencies. The act thus states that county governments have no subsidiary role in relation to cities with county rank. These cities are obliged to carry out county level tasks in their own territory, and cannot pass their service units or tasks to the county. This model implies that cities with county rank can or must run in parallel all kinds of county-type service units. Fortunately, this parallelism has not become a practice. Instead of duplicating service units, apart from a few exceptional cases, an *ad hoc* division of labor emerged between the county and cities with county rank. How tasks are divided between the county and the cities usually depends on the situation inherited from 1990. In general, cities have more choices than the county since the latter serves also the inhabitants of the city, whereas the city with county rank is not obliged to serve the rest of the county, though it often does.

Joint Service Delivery

The 1997 Act on Associations and Cooperation of Local Governments aims at improving the quality and efficiency of service delivery, but it does not supply a remedy for fragmented service delivery. The act regulates several forms of associations, but it does not provide for advance financing of joint service delivery associations. Advanced financing requires the formation of a municipal association as a legal entity that operates as a budgetary organization. The act does not allow associations to collect taxes or own revenues, to receive direct budgetary support, or to be responsible for local services. The law is obscure regarding liabilities and property rights of associations. The details of financing associations for multiple services or maintaining several institutions have not been regulated.

The act defines various forms of associations, but eligibility for central transfers is regulated case by case in the annual budget laws. The members of associations can decide on the volume of their contributions to the joint task, and their agreement is necessary for all issues concerning the association budget. Since the law's enactment, analysts have realized that without positive incentives the mere clarification and refinement is not sufficient to promote a more intensive establishment of municipal associations. Introduction of obligatory associations for service delivery must be addressed sooner or later.

Local government finances contain some incentives for joint service delivery. Nevertheless, they change constantly and have not played a significant role. The central government has been promoting joint notary services since 1990, although the volume and conditions of transfers, and sometimes their form, have changed. Since 1998, associations receive extra financial support if the member local governments can prove they cut costs by providing services through the association. Eligibility for a deficit grant is also conditioned

on local governments' attempts to cut expenses through service delivery in associations. I should note that a precise monitoring of association service delivery attempts is hardly possible.

Furthermore, the 1992 Act on Addressed and Targeted Grants also stimulate establishment of associations. Joint investments of municipalities receive a 10 percent extra investment grant, and the extra support is 20 percent for associations of villages smaller than 1,000 inhabitants. In addition, villages with fewer than 2,000 inhabitants can access investment grants for certain purposes (for example, a regional solid waste deposit or a sewage purification plant) only if they join associations.

Legal Shortcomings of Local Government Finance

The ALG introduced a new financial management philosophy, namely resource regulation. This approach defines types of local government revenues and supplements them with central government resources in line with the mandatory tasks. Under a task-financing scheme, local budgets would be derived from expenditure needs, and the central government would cover the gap between the local needs and resources. The key difference between resource regulation and task financing is that the former gives localities freedom in managing their operations on the basis of locally available resources.

Local Revenues

According to the 1992 Act on Public Finance, the Parliament decides, within the framework of the annual Budget Act, shared taxes, the entitlement and amount of normative transfers as well as the targeted grants and their distribution. The annual budget law obviously plays an important role in the transfer mechanism, since the values and priorities of the legislators reflect the government's concerns and determine the financial conditions for local governments—that is, state transfers and contributions, the volume of shared taxes, the payment obligations of local governments, and the rules of financial management of local governments.

These rules enable the central government to redistribute resources annually. In practice the annual Budget Act modifies the local government finance system every year. These annual revisions make local governments dependent on the volume of state transfers and the shared revenues from the state budget (such as personal income taxes [PIT], environmental fines, and vehicle taxes). Not only the volume, but also the entitlements for transfers, change year by year, and these changes make local expenditure planning and revenue forecasting very difficult. The number of state normatives has been mushrooming continuously. Table 4.1 summarizes the most essential changes introduced between 1990 and 1998.

The annual Budget Act, which also determines state general rules and regulations related to budget implementation, contains provisions to amend other acts for the sake of implementation of the Budget Act. The rules and institutions of public finance management as well as the relationship among the general government subsystems (that is, the division of labor and organizational setup) have not stabilized. Key properties of the system are reshaped within the framework of the annual budget, bearing the disadvantages of its temporary and often *ad hoc* character.

Implementation of the annual Budget Act is very difficult, and the text is incomprehensible for several reasons. First, the act regulates a wider range of issues than usual; as a consequence, it affects a period beyond the actual fiscal year. Second, several issues are re-regulated every year. Third, the structure of budgets is not consistent, and that inconsistency makes comparisons among various years rather difficult. Fourth, the acts and institutions of public finance management were created in vain, because their rules are subject to constant changes during the approval of the annual Budget Act.

As table 4.1 shows, local government finance has been shifting gradually toward task financing. This shift is an issue not only because it evidently weakens the independence of local governments, but also because it decreases their interest and creativity in choosing ways of service delivery. In theory, localities must have freedom to use up current expenditure resources, whereas investment finance is tied to concrete objectives. I must emphasize that normatives are the basis for calculating and allocating central transfers, but local governments are not obliged to finance a given task strictly in accordance with the received current grant. The freedom of using recurrent grants is quite formal since in most cases central grants for mandatory tasks have to be supplemented from local own revenues.

Equalization Mechanisms

Equalization, which should be an important element in local government finance, plays an overwhelming role in Hungary. It looms large because, although the disparities in income-generating capacities across municipalities and regions are severe, the system of normative transfers alone is unsuitable to handle the differences. Equalization grants originally were built on two instruments: (a) the deficit grant, which provided for underdeveloped settlements and regions, and (b) the PIT supplement. Over time, the equalization mechanism has spilled over. The objectives of equalization dominate the normative transfers, earmarked grants, shared taxes, and investment grants. This influence makes the mechanism incomprehensible, and as a result equalization grants do not necessarily finance the most essential needs and are not channeled where they should go.

The increasing need for equalization narrows the financing model options. The resource financing model might not be adequate when financial conditions are substantially different across municipalities and the system contains a large number of mandatory tasks that are not differentiated by type of locality.

Table 4.1 Local Government Finance in the Annual Budget Laws

| <i>Year</i> | <i>Shared taxes</i> | <i>Number of normatives</i> | <i>Centralized appropriations</i> | <i>Priorities for addressed and targeted subsidies</i> |
|-------------|--|--|--|--|
| 1991 | The share of the local governments from the PIT was 50 percent, and from environmental fines 30 percent. | Total number: 25 4 available for all local governments 1 for villages 1 for the capital city and the counties 19 for individual tasks | Total number: 8 The deficit grant was the most substantial amount. | Investment priorities were water supply investments in progress, urban water base and sewage purification plant, urban hospital, homes for the elderly, primary education, secondary education, and solid waste deposit. |
| 1992 | PIT: 50 percent, Vehicle tax: 30 percent, Environmental fines: 30 percent | Total number: 24 6 available on the basis of unique rights differentiated by types of local governments 18 for individual tasks A special equalization normative was adopted to assist underdeveloped settlements. This normative, however, has not remained in the system (see 1993), because more and more special mechanisms were needed to treat differences among local governments. | Total number: 17 This increase shows that the former system of normative grants was not capable of financing tasks in municipalities that have different expenditure needs. The normative for theaters was turned into an earmarked central appropriation for theaters. | The priorities of the system of targeted grants did not change essentially. The development of dormitories appeared in the system. |
| 1993 | PIT: 30 percent, Vehicle tax: 50 percent Environmental fines: 20 percent | Total number: 23, with a few minor changes: the normative for vocational training was differentiated, a sport normative appeared as a new element in the system, and the content of the county normative changed again. | Total number: 17, but their content changed. Both deficit grant and support in case of vis major (emergency) was removed and put into a separate subsystem. | In 1993 priorities for targeted grants were not part of the annual budget law; they were put into a separate act. The state budget had only to decide upon the volume. |

Table 4.1 Local Government Finance in the Annual Budget Laws (continued)

| <i>Year</i> | <i>Shared taxes</i> | <i>Number of normatives</i> | <i>Centralized appropriations</i> | <i>Priorities for addressed and targeted subsidies</i> |
|-------------|---|---|---|---|
| 1994 | PIT: 30 percent Vehicle tax: 50 percent Environmental fines: 30 percent Privatization revenues: 50 percent to local governments; 20 percent to counties. | Total number: 27 Although the number of normatives increased only slightly, their structure and content changed again. A normative was introduced for the homeless; assistance for social institutions changed; the ethnic minority normative was differentiated; and a new element was the normative for handicapped adults separated from support to handicapped children. | Total number: 20 | The priorities of the system of targeted grants were put back into the annual budget law, because a reduction of eligibility was a declared objective. Investment priorities were drinking water, redemption of school rooms in poor technical condition and procurement of medical instruments. |
| 1995 | PIT: 35 percent, but a restrictive element was built into its use: a certain part had to be spent on long-term unemployment benefit. Vehicle tax : 50 percent Environmental fines: 30 percent | Total number: 27 again, and their content did not change. | Total number: 24 Eligibility conditions for the deficit grant become regulated in the annual budget law. | In 1995 for the first and last time, the budget separately listed the public investments of special importance. This separation made general priorities of the government more transparent. Several of these priorities directly concerned local governments (for example, sewage treatment in selected towns and several investments in the capital city). Prior to and after that year such a subchapter was not present in the state budget. The targeted grant priorities expanded sewage plants of settlements with more than 2,000 inhabitants. |

Table 4.1 Local Government Finance in the Annual Budget Laws (continued)

| | | | | |
|------|---|---|--|--|
| 1996 | <p>PIT: 36 percent, however, only 25 percent was allocated on derivation basis, and the rest was for equalization. An element stimulating the increase of the vehicle tax appeared, because 100 percent of the revenues collected beyond the lowest tax rate could remain at the levying local governments.</p> | <p>Total number: 14 Seemingly the number of normatives drastically declined, but an extremely detailed differentiation took place within the individual normatives, mostly caused by the Act on Public Education. The stimulation of the joint provision of services appeared within the normatives too, for example, at the normative for vocational schools. New tasks were “glued” to the county normative, for example, administration of public defense, operation of pedagogical institutions.</p> | <p>Total number: 24 The deficit grant was re-regulated.</p> | <p>The number of priority areas for targeted grants grew again. Construction of solid waste deposits was supported again.</p> |
| 1997 | <p>PIT: 38 percent, of which 22 percent remained at municipalities on derivation basis. The rest of the PIT revenue was allocated to municipalities and county governments for concrete tasks on a per capita basis. In other words, a part of the PIT was transformed into normative transfers.</p> | <p>Total number: 20 If we add the subspecies of the basic normatives, this number is 42. The former equalization normative for distressed settlements was eliminated, and the new decentralized mechanism of regional development resources was established after the enactment of the Act on Regional Development. A new normative for crèches was introduced. The county normative was abolished. Village and town governments that formed associations maintaining institutions of public education were eligible for extra transfers.</p> | <p>Total number: 20, of which several were connected to the Act on Public Education. On the other hand, several old earmarked provisions ceased to exist, such as supports for ferries, harbors, fire-oil supplied for households, support of wage policy, and urban public transportation. The support to minority local governments and the supplementary transfers for minority institutions were transformed into central appropriation. Eligibility conditions for deficit grant were re-regulated.</p> | <p>Targeted grant priorities did not change, except drinking water which was excluded. A special form of support was established for regional development, but this support could be used as the matching part required in case of targeted grants. As a consequence, regional development finance and local government investment finance became closely intertwined.</p> |

Table 4.1 Local Government Finance in the Annual Budget Laws (continued)

| <i>Year</i> | <i>Shared taxes</i> | <i>Number of normatives</i> | <i>Centralized appropriations</i> | <i>Priorities for addressed and targeted subsidies</i> |
|-------------|--|--|--|--|
| 1998 | PIT: 40 percent, of which 20 percent was allocated on derivation basis and 20 percent for equalization. A new shared tax—tax on land leasing—appeared, and the state budget let 100 percent of it remain at the local governments. | Total number: 46 The structure of normatives changed again. The amount of the administrative communal normative tripled. A new normative for regional administrative tasks was introduced which finances new tasks created by the Act on Child Protection and the Act on Construction. The county normative appeared again, for administrative and sport tasks coming from the Act on Sport and the Act on Regional Development. Tasks of public collection are for the first time financed by a specified normative, as an effect of the sectoral act. | Total number: 23 Some of them were clearly targeted investment grants, and it is difficult to understand why they were put among central appropriation (for example, South Buda–Rákospalota underground line). Joint notaries were supported through a central appropriation. | The targeted grant priorities were intact. |

Source: Author's compilation.

The ALG provides that local governments have a basic right to receive a supplementary state transfer, called a deficit grant, if they are in an economically depressed situation because of circumstances beyond their control (“without fault”). This type of grant was originally designed to moderate a lack of current resources in extreme situations. Because the law is unclear about the meaning of mandatory local tasks, however, it is also ambiguous about what factors indicate that a municipality is economically depressed “without fault.” These questions remain unanswered; thus the deficit grant system amounts to nothing but bargaining about resources without firm bases.

The role of the PIT supplement reveals that it is quite sensitive to the development gaps across regions and settlements. Sharing other types of taxes would be more beneficial for subnational finances. In addition, because of the strong disparities in local tax revenues, especially the business tax, the necessity of equalization connected to local taxes has led to the introduction of a new indicator called “local tax capacity” to allocate equalization grants.

The equalization system is made more unstable by the central government’s authority to create a list of settlements that are economically depressed because of socioeconomic and infrastructure disadvantages. Such areas will be the beneficiaries of regional development grants and are eligible for most of the equalization grants. Experience shows that, although the Parliament has defined principles of calculating the degree of underdevelopment on the basis of statistical indexes, the list of supported settlements changes constantly. These changes are fair since the selection should reflect the current situation; some settlements might recover and others might need a chance to get into the system. By contrast, when planning medium- to long-term development strategies and project resources, the year-by-year definition of eligibility for support creates uncertainty.

Local Investments

Although allocation of current grants is based on normatives, the investment finance system is multi-channel and has many discretionary elements. Investment grants are allocated through a centralized tendering process, although steps toward decentralization have been taken. The major sources of local investment are the targeted and addressed grants meant to support national priorities, but a significant part of investment is financed by grants from sectoral ministries, which have a wide range of discretion.

The 1992 Act on Addressed and Targeted Grants took over the regulation of these grants, and they are no longer subject to the annual Budget Act. The lack of financial resources, however, makes year-by-year ranking of national priorities necessary and, with it, the re-regulation—usually restriction—of eligibility conditions. As a result, the annual Budget Act still effectively regulates the targeted grants and makes ministers responsible for regulating the allocation of investment funds they will grant. Thus each type of support is regulated by separate government decree year after year.

As a consequence, investment resources become fragmented and lack comprehensive regulation. Coordination among channels and sectors seems problematic. Local actors continuously apply for investment grants despite the management and administrative requirements, which seem to be exaggerated, especially compared to the resources available.

Based on the pressure of international assessment, the government passed a decree on coordination of the use of sectoral and budgetary fund resources (no. 263/1997, which was replaced by the government decree no. 217/1998) aimed at harmonizing territorial efficiency with central, regional, and sectoral objectives. The decree prescribed only a soft mechanism for coordination among the central organs responsible for disposing investment grants. They are now obliged to share information about deadlines for tender invitations, evaluation of applications, and preliminary opinions. The decree does not stipulate rules or mechanisms that would force decision-makers to assemble resources nor has it yet defined the organizations, mechanisms, and competencies, which could become elements of a single monitoring system.

In principle, localities have unique rights for targeted grants, so any local government could apply for an investment grant and expect central government support to implement its project based on specified national priorities. If an application is rejected one year, the municipality could automatically submit it the following year. Nevertheless, the regulation on rejected applications has also changed several times. Because the supply of funds has always been less than the demand, the original characteristics of the system have changed, despite strict eligibility conditions. Many local governments have not had access to investment grants for years, so their unique right is quite limited.

According to the cofinancing principle, central investment grants must be supplemented with local funds, including borrowings. Because of the shortage of own revenues, local investment decisions are driven by central priorities, and investments for other purposes rarely take place. The own-resource requirement has not led to improved local financial responsibility or to precise evaluation of investment decisions and subsequent operational expenses, because the local contribution to a given investment is often obtained from another central fund (for example, the sectoral ministry's grant), and the municipality does not risk its own resources when it makes an investment decision.

Because of annual changes in central government objectives and the resources available as targeted grants, systematic adaptation of local governments is impossible. Local governments cannot rely on resources from the central government and are therefore unable to prepare to provide their own resources and to use up the grant they may have obtained. This situation makes local public investment obscure. In 1996, for example, the State Audit Office reported that 46 percent of targeted grants were unused.

State Audit Office investigations revealed that fragmentation has become a characteristic not only of existing capacities, but also of new investments as well. This trend occurred partly because of lack of clarity in regulating high-cost investments until 1997.

Since the amendment of the act, only investments of more than Ft 200 million are eligible for targeted grants.

Regional Development

The 1996 Act on Regional Development and Spatial Planning (ARD) aimed at decentralizing regional policy and correcting distortions caused by the policy of the previous regime. The ARD defined big (NUTS2) and small (NUTS3) regions as statistical districts which subsequently received a planning and development role. ARD also introduced national, regional, and county development councils with the authority to distribute the decentralized funds.

The ARD provides for resources and financial tools of regional development and allows expansion of the range of these tools. The act contains an earmarked provision for regional development and a distribution rule stating that the central government cannot dispose of more than 50 percent of the development fund. Furthermore, the law lists funds to be obtained by local governments from extrabudgetary funds and from addressed and targeted grants. Finally, the ARD includes the regional equalization fund, which was introduced several years prior to promote local infrastructure development.

I must emphasize that the act has not led to full decentralization of regional development funds. First, central and regional organs have shared rights to dispose of regional development resources. Second, the decentralized funds are not integrated into municipal budgets partly because private entrepreneurs and nongovernmental organizations also can receive support from these funds. Third, the regional development councils are independent of local governments. In sum, the fact that decentralization of resource distribution has started is a significant achievement. Although amounts are small, the new system improves the efficiency of decision-making by placing the decisions closer to the questions and the local information.

The biggest issue of regional development is to find the appropriate level of decision-making. The ARD empowers county councils with allocation rights. Regional development resources, however, have been used almost exclusively to finance programs in small regions (or microregions), special purpose associations, and municipalities. Evidently, these bodies strongly determine the content of the subsidized projects, their regional efficiency, and range of effects.

The future of the microregions is uncertain despite the fact that they seem to be revitalized within the institutional framework of the regional development. In a legal sense the microregions as statistical districts are only fictions because municipalities can easily establish special service delivery districts and associations. Some microregions are functioning well, partly because regional development programs are relevant to these units, and they form the statistical basis for allocating regional equalization resources. The ALG provides a legal basis for creating joint service delivery units or regional organization of

services, stating that bigger settlements can be forced to accept more tasks. The sectoral regulations so far do not support creation of bigger service delivery units, however. I should note that the analysis in this chapter does not deal with the capital city, although its role in the financing system is clearly significant. Analysts must take into consideration, however, that the financing of the capital city is different from the general regulation in many respects and is worth a separate analysis.

A change in the tendency of using regional development resources for investments at the municipal level can be expected only if big regions have a key role in regional resource allocation or if the appropriation of central resources especially supports large regions. For either of these conditions to occur, significant regulatory prerequisites must be met. In addition to defining the borders of big regions, regional development councils are still to be established with strong and clear competencies. In principle, regions could provide a good basis for decentralization in several sectors. In parallel with decentralization, functional regions are under preparation on sectoral basis with different regional borders and competencies.

The ARD suggests that the county regional development councils cannot only decide on the distribution of central resources, but they also can dispose of additional resources they may gather for implementation of their development programs. In practice, however, the councils have been limited to the disposal of central resources. No mechanisms are yet in place to channel resources for regional development purposes from the private or municipal sectors. The county regional development councils have not yet financed investments on their own initiative.

As a result of the amended ARD, decentralization of investment resources has become more and more a characteristics of local government finance since 1998. In addition to the decentralized regional development resources and the regional equalization grants, the county regional development councils decide on the decentralized targeted grants and the vis-major (emergency) transfers. Municipal infrastructure development and regional development became interconnected, and the link between municipal development and regional equalization became closer. A potential disadvantage is that the blending of municipal and regional development objectives and priorities could mean that the use of resources may not be focused on priority issues.

Policy Proposals

The 10-year history of the subnational system has proven the merits of fiscal decentralization. The legislative framework changed substantially; however, a long line of functional and sectoral laws and decrees supplemented—and often distorted—the simple, very decentralized, and liberal rules defined initially in the ALG. As a result, the framework today is less consistent and gradually moving from the initial resource regulation toward task financing and micromanagement by sectoral ministries, two conditions that threaten

local autonomy. The further development of the fiscal decentralization framework depends on the following key recommendations.

- *Expenditure assignment should be radically rearranged.* The ALG must conceptually clarify the nature of the public services and the meaning of mandatory and voluntary tasks. Local government tasks should be prescribed only by law rather than by lower level regulation. Competencies should be differentiated by size of local governments. Expenditure assignment should correspond to local demand and service delivery capacity (for example, size of the service area or its population). The preferred level of decentralization in the future should be large and small regions, or an urban attraction zone.
- *Joint service delivery by municipalities should be promoted or even prescribed to abolish the present parallels and inconsistencies.* Neighbor localities organizing parallel services should be the exception rather than the rule. The ALG and the constitution should allow for obligatory association of municipalities in two cases: (a) if a small service area and a lack of professional capacity prevent localities from meeting sectoral standards, and (b) if certain tasks require special skills.
- *The annual Budget Act should regulate only the volume of funds, not the content and procedure for subnational finance.* Key rules, competencies, management, and distribution of intergovernmental transfers should be regulated in the Act on Public Finance, and they should be amended only in justifiable cases. The sectoral acts should not set up separate procedures and rules for subnational finance.
- *The present system of municipal finance must be simplified.* Purely local tasks should be financed primarily from shared taxes and own revenues. Earmarked funds should be used to finance central tasks delegated to local governments. The number of normatives should be decreased. The equalization element should be clearly separated, whenever possible, from general financing, and the various equalization resources should be integrated.
- *The allocation mechanisms for central investment resources should be transparent and should be harmonized and coordinated across central government organs.* The legislative framework should contain clear rules and procedural guarantees required for decentralized distribution of investment resources.

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Allocation of Local Government Functions: Criteria and Conditions

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Allocation of public functions and services is specified by the assignment of expenditures and responsibilities for service delivery and is not just a simple legal action of allocating public services from one level or unit of government to another. The allocation of public functions can be redesigned in many ways, and all require several external conditions. If these legal, fiscal, and institutional criteria are not met, then service delivery will not be efficient. Consequently, by changing some crucial conditions, efficiency gains can be realized, irrespective of the changes in expenditure assignment. Allocation of services cannot be designed properly unless all these conditions are harmonized. Formal changes in basic legislation on expenditure assignment are not sufficient for determining a “better” hierarchy of services. The art of expenditure assignment is to define the conditions that are needed most to improve service efficiency.

In this chapter we summarize: (a) Hungary’s experiences in the 1990s in modernizing the assignment of public functions and expenditures, decentralizing responsibilities, and measuring the effects of economies of scale in public services, and (b) the direction of further modernization and preconditions for change.

Allocation of Functions and Expenditure Assignment

Public functions can be delegated, with some limitations, to any level or unit of government, but responsibility is typically assigned to the organization that has direct contact with the consumer. This ultimate responsibility for a public service does not necessarily mean that other public entities or governments have no responsibility. Actual responsibility for public

* This chapter is based on Hermann and others 1999.

functions is usually divided among public sector actors. For expenditure assignment, the first issue is to define which services and responsibilities belong to the public sector and which belong to the private sector. When a service is regarded as public, it can be divided vertically and by activities. Technological and professional requirements of public services often necessitate joint service provision.

For example, in providing health care or water, basic services are connected strongly to other, more specific activities (for example, laboratories) or have a regional character (for example, water production). Public functions can be divided by activities when responsibilities for operation (current expenditures) and capital investments may be separated. Often, shared local and central responsibilities serve equalization purposes. Both levels of government are responsible for service delivery, but their functions are different. The higher level government guarantees access to the service, whereas local government serves as the provider.

If expenditure assignment is defined clearly, rules and regulations always control the provision of a particular service. For example, content, performance levels, and eligibility criteria can be the subject of public decisions at different levels or in several forms. Sometimes, these rules are not fixed; they might change with modification of political forces (for example, salary negotiations in the public sector).

The most important condition of allocation of public functions is how services are financed—who pays and how the funds reach the service provider. Influence over the resources for financing a function is the basic condition of real autonomy in service delivery. Intergovernmental finances can modify the functions and responsibilities of service delivery significantly.

In sum, allocation of public functions usually does not mean that service delivery responsibilities are clearly separated. These responsibilities are shared, frequently among various public actors. Direct responsibility for service provision can be identified, but many possible types of service delivery strongly influence the actual functions. We will analyze direct responsibilities for local government services. They are subject to legal regulations, despite the fact that many other conditions of service delivery are defined externally.

Reallocation of Service Responsibilities in Hungary

The transformation of the state was the primary force leading toward a new division of private and public services. The diminishing level of state-owned property, the changing role of government in production, and the lack of resources for financing the previously extended public services were important factors in this process. Because economic conditions forced government to establish new political institutions and mechanisms, the public sector's role has also changed. In most of the former communist countries public failures forced governments to redesign the basic definition of private and public goods and services.

Distinction between Private and Public Functions

The privatization and restructuring of state property, as well as the transitional recession, significantly restricted the public sector and public funds available for social interventions in Hungary since the early 1990s. As a result some formerly public functions have almost disappeared and others (for example, housing) have been taken over by private institutions. The financing mechanisms of many public services have changed drastically. For example, private sources now play a major role in utility services and transportation. Thus, in a relatively short period, public expenditures decreased by between 25 and 30 percent and reached the level of many developed economies. By 1998 general government expenditures (consolidated primary expenditures without interest payments) had fallen to 39 percent of gross domestic product from 54 percent four years earlier (MoF and MoI 1998).

Central versus Local Expenditures

Decentralization within the general government budget is the second issue that determines the character of expenditure assignment. Despite the sharp decrease in public expenditures, the ratio of local government budgets remained relatively stable (26 to 27 percent of general budget). This stability can be interpreted from both the political and the economic point of view. One political explanation is that local governments were able to keep their relative position during the years of fiscal restriction. This stable proportion of the local budget does not reflect many new mandates that were subsequently transferred to local governments, though these unfunded local functions and services are hardly quantifiable.

Economically, changes in the overall size of the public sector often lead to decentralization of taxing and spending powers. Some research has found that a higher ratio of subnational own-source revenues to total government revenues is correlated with reduced public expenditures (Ehadie 1994). Regression analysis of 30 countries suggests that savings in public expenditures can be achieved by changing the role and functions of local governments. Mechanical transfer of functions to the local level without sufficient autonomy in revenue-raising capacity, however, typically does not lead to lower public expenditures.

The Intermediate Level

The role of the central government determines the role, if any, of the intermediate level. The issue of expenditure assignment is crucial in the countries of central and eastern Europe, because the intermediate level was the transmitting organization between the national and municipal levels. Thus the intermediate level has typically been the focus of ideological, political, and professional discussions (Horváth 1996a; Vági 1982).

In Hungary, starting from the early 1970s, the intermediate (county) level of government was a subnational counterpoint to national administration, organized by sectoral

ministries or departments (Balázs 1998). Widening county government functions was the first step toward more advanced decentralization, because strong counties were able to integrate local (regional) interests and policies. Over two decades they proved that service and public functions can be managed locally. This long learning process was missing in many central and eastern European countries, and that lack explains why several of them still have a dual structure of local governments and territorial administration. These state offices often provide local services, but have poor public control and little influence over elected bodies.

Several types of functions are transferred to the intermediate level: (a) regional services, that is, functions of large catchments areas or rarely used services or both (for example, utilities, special education, or fire service); and (b) intermunicipal services, such as roads and water (Horváth and Péteri 1997). Only roads present an expenditure assignment problem. Water service depends on the institutional, fiscal, and regulatory environment of local cooperation and joint service delivery.

Reallocation across Municipalities

The primary goal of the transition at the local level was to ensure equal status for all types of local governments. To avoid hidden subordination among different local governments (especially between counties, cities, and village municipalities), all local governments received identical legal status. This political requirement was challenged, however, by differences in administrative and fiscal capacity.

During the period of decentralization, legal status was crucial for establishing strong and autonomous local governments. Later, more rigid allocation rules were needed, mainly because of issues with the administrative feasibility of financing services. During the reassessment of local government functions, an important issue was whether local governments that have different capacities can manage the same functions and competencies. This typical question, which is related to the vertical balance of local government functions and revenues, was not clearly answered.

Mandatory local government services were defined as core services on a basic level. Then, conditions were set for managing local government functions, and responsibility for public services was transferred to individual local governments. Regulation was based on the principle that if a municipality does not provide services beyond the basic mandatory ones, then county government should take over the provision of nonmandatory services. This principle resulted in a flexible allocation of local functions, because with some limitations municipalities can operate almost any local service. For example, a secondary school or a hospital can be operated and managed by a county, a large city, or a smaller town.

Large Cities

Large cities, especially the capital city, have always been the exceptions. The “cities with county rank” are not part of the county: they are independent politically, in public administration, and in service provision. The relationship between the capital city and its districts is a critical problem. During the 1990s allocation of functions and competencies has been characterized by a gradual move from a decentralized structure toward a stronger role for the capital city.

The administrative rationale behind these changes is that the city functions as an urban entity, so the districts are closely interrelated. Technically, the relations between the two levels within the capital are regulated partly by general local government legislation and partly by specific acts for the capital city. The problem of large cities and their agglomerations is always a separate issue for expenditure assignment.

Methods for Allocating Functions

Public functions and service are allocated in various ways. Responsibility for service and the conditions under which functions are transferred are important. There are three different forms or levels of decentralization denoting the three typical ways to assign functions to a lower level of government such as deconcentration, delegation, and devolution. These terms mean that some functions are taken away from the center and transferred to other units of government. Those terms are defined as follows:

- *Deconcentration* means simply the allocation of a function, primarily for administrative reasons. In these cases local governments serve general public functions, because they are close to citizens (for example, registry of inhabitants), but they do so on behalf of the central government and have no decision-making authority.
- *Delegation of public functions* is used when national priorities should be followed in providing a service. Unified national legislation should set the rules for equity of services or stabilization. Several local government services, such as social services and unemployment benefits, are provided on behalf of the national government and should follow general principles, with some limited local discretion.
- *Devolution* means clear local authority for providing and managing services. “Functions of local significance” are those, such as primary education and certain urban services (street cleaning, lighting, and so forth), for which efficiency can be realized by connecting service benefits and costs.

“Expenditure assignment” refers not only to the allocation of functions by the constitution or any basic laws, but also depends on external conditions such as sectoral legislation, control, and procedures; availability of own-source revenues; property rights (degree and form of privatization); and institutional autonomy. “Sectoral legislation”

defines professional conditions for public services. Different levels of legislation set service standards and summarize performance criteria. Often, these sectoral rules are generally accepted procedures and values, which are manifested in professional codes. They frequently have important implications for local government decision-making. For example, sectoral legislation often may influence the number of teachers or health workers that can be hired or fired, even though primary education and some health functions may be local government responsibilities.

Revenue-raising capacity and benefits should be combined to realize efficiency gains of a local service. Expenditures should be balanced with available discretionary financial sources (vertical balance). Without sufficient own sources, the advantages of local service provision and management cannot be realized.

Property rights have been restructured in various ways during the process of transition. Without clear regulations on municipal and public property rights, critical aspects of service delivery cannot be identified. Fundamental issues of privatization include how state-owned property is transferred to local governments, the scale of municipal property, and local autonomy in managing available assets.

Institutional autonomy does matter. Assignment of public functions should be harmonized with regulations on organizational forms of service delivery. Without local discretion in selecting service arrangements, efficiency gains of local functions cannot be realized. Basic conditions (for example, concession regulations, public procurement procedures, and forms of joint service delivery) generally can be defined, but the service provider should have the right to select the most efficient form of production.

Decentralization of Responsibilities: Facts and Trends

After the above summary of the major criteria, aggregates, and overall tendencies in reallocation of local government functions, in this section we analyze the events and factors that determined the changes in the 1990s and summarize the major outcomes of the reform steps.

Basic Legislation

Local government functions and competencies are clearly legislated. Hierarchical legislation defines the principles of allocation and the blocks of services provided by localities. The Constitution, the primary source of regulations, provides equal basic rights for local governments. The Act on Local Government defines a wide range of potential local government functions and, within this group, the mandatory services. Local governments are responsible for 23 local public services of which 10 became mandatory in 1994 (see chapter 4).

The Constitution and the Act on Local Government set the basic conditions of local autonomy, and only laws approved by a qualified majority can modify them.

The Act on Local Government ensures flexibility in allocation of local government functions. Local duties ought to correspond to local needs; hence various types of local governments might have different functions and competencies. Larger cities often provide services for citizens of smaller municipalities. Governments have no right to refuse any demand from citizens just because they live outside the operating municipality. Under some conditions, smaller local governments are also allowed to take over the functions of larger local government with greater capacity. In this case the municipality undertaking the function gets the national budget grant.

The unified regulation covers very different scales of functions. A town of 40,000 inhabitants has more responsibility to provide public services than a village of 1,000 inhabitants. Neither the quantity nor the quality of services is equal. For example, if most pupils live in surrounding small settlements, the city will, in almost every case, insist on provision of primary education as its own function. Although the Act on Local Government says that functions are provided by municipalities, in fact, most services are delivered by special districts (for example, secondary schools, hospitals, and museums). This situation is not reflected in intergovernmental relations. The real linkages among users for different municipalities remain hidden.

During the transformation two major waves had different underlying rationale. In the early stages the political advantages of the reform were emphasized. Local accountability, higher public participation, and control were the main arguments for decentralization. Changing the relationship between county and municipal governments was supported by the allocative efficiency argument, saying that local articulation of needs and decisions on services should be more efficient.

In the second wave equalization, economies of scale, and capacity to provide a minimum level of services were the most frequent arguments for reallocating functions. More detailed sectoral legislation defining the conditions of local government functions and services followed the first set of basic constitutional regulations. Most of these sectoral laws aimed to set standards and control the contents of local services. They were passed by simple majority vote in the Parliament, sometimes in conflict with the Act on Local Government, regardless of the fact that the latter has constitutional force.

Competing concepts of local government legislation and sectoral laws characterize the history of expenditure assignment. Local government functions are allocated by basic laws, but conditions of service delivery are formulated along a different logic. The abstract values of decentralization and local autonomy are counterbalanced by the rationality of providing services. Together, these two types of legislation define the effective assignment of functions.

Gradual Reallocation of Local Services

Local expenditures as a percentage of general government expenditures remained stable (25–27 percent), though local expenditures as a percentage of gross domestic product sharply decreased, from 16.8 percent to 12 percent, between 1994 and 1998. Expenditure assignment to various types of local governments changed after the political transformation. The county governments lost many of their functions to cities and villages, and now they are responsible for 14.4 percent of local government services. The large cities with county rank increased their share of local budgets. The position of Budapest remained unchanged, but a significant decentralization between the capital city and its districts took place.

These new proportions were encouraged by changes in grant allocation schemes. Village municipalities and cities in the countryside now receive a much higher share of total local government grants than in 1989. This transformation was paid for mostly by reduced grants to Budapest, which has to finance its unchanged expenditures by increasing own-source revenues. Vertical balance of local budgets exists only in secondary cities, which have ratios of local expenditures and grants similar to 1989. County governments and villages lack own-source revenues; hence grants are disproportionately high for these local governments. Budapest and cities with county rank have better capacity to collect own revenues, so they receive less in grants than other local governments.

Needs and Services

Per capita expenditures vary considerably by the size of the city and favor bigger cities. Municipalities with fewer than 10,000 inhabitants obtain lower per-capita local expenditures than the bigger ones. Half of Hungary's population—in the countryside—absorbs only 37 percent of municipal budgets.

Budapest and the central region are in an extremely favorable position, because they account for 33 percent of local government expenditures and 28 percent of the population. The capital city is even better off (26 percent of expenditures and 18 percent of population). Three major regions are more or less in a balanced position, because their share in population and total local government expenditure is equal. The poorest regions are in the Hungarian Plain.

Half of the municipalities have fewer than 1,000 inhabitants, but taken together they account for 9 percent of the population and only 6 percent of total municipal expenditures (excluding Budapest and counties). Small local governments provide very few public services. This disparity suggests a fragmentation of local governments measured in terms of expenditure per capita. Key problems are the great variety of average settlement size and differences in urban structure.

Expenditure assignment is influenced also by grant allocation. National grants for municipalities that have populations up to 5,000 are higher than their proportion of expenditures. Smaller municipalities get proportionately more grants primarily because of

a lack of own-source revenues. In terms of regions the south Transdanubian and northern regions get higher grants compared to their populations, and they also have the highest number of small municipalities.

For larger cities, grants are proportional to expenditures, except for the largest cities (population of more than 50,000). This allotment reflects the characteristics of the grant allocation scheme, because normative grants mostly follow service functions. The more expensive service institutions are in larger cities, where per capita expenditures are 22–30 percent above the average (table 5.1).

Table 5.1 Local Expenditures by Size of Settlements

| <i>Inhabitants</i> | <i>Per capita expenditure (1996)</i> | |
|--------------------|---|---|
| | <i>Expenditure as a percentage of total</i> | <i>Capital expenditure as a percentage of total</i> |
| 199 or fewer | 68 | 112 |
| 200–499 | 54 | 62 |
| 500–999 | 72 | 61 |
| 1,000–1,999 | 76 | 81 |
| 2,000–4,999 | 74 | 87 |
| 5,000–9,999 | 83 | 95 |
| 10,000–19,999 | 124 | 126 |
| 20,000–49,999 | 130 | 119 |
| 50,000 or more | 122 | 110 |
| Total | 100 | 100 |

Source: Hermann and others 1999.

The structure of local government expenditures shows the allocation of functions among different types of local governments. In the smallest municipalities (population less than 500), administration and various economic services are the most important expenditures. These items include several different types of expenditures. Debt service might be accounted for under “administration”; various smaller costs (such as public lighting, welfare payments, and small purchases) are put on the largest functions. In municipalities that have populations of more than 500, education is the primary function of local governments (31–38 percent of local budgets). Health care and social services are significant expenditures in municipalities that have populations more than 10,000 (18–28 percent). Hospitals and costly social service institutions account for 73 percent of county governments’ expenditures. Public utilities are minor items in local budgets, because they are provided by extrabudgetary service organizations.

The present rules of expenditure assignment can be summarized by:

- declining central government participation in service provision;

- unchanged relationships among central and local governments, which do not support the realization of decentralization benefits;
- allocation of expenditure functions proportional to population ratios, so that the potential losses are not significant in the fragmented local government system;
- vertically balanced budgets, mostly in midsized municipalities, but small municipalities and especially county governments are characterized by lack of own-source revenues;
- concentration of locally owned companies as key factors in utility services and important sources of privatization revenues;
- sophisticated forms of nonprofit organizations providing services in municipalities.

Factors Influencing Further Reallocation of Local Functions

Three key factors are behind continuing changes in expenditure assignments: (a) ensuring equity and fairness, (b) economic stability, and (c) efficiency gains.

First, ensuring equity and fairness, the governments' primary function, can be achieved through income redistribution and by providing public services. This consideration is always behind the allocation of public functions, especially in countries where the minimum level of services ought to be provided. Lack of basic amenities makes a claim for strong public involvement, because government usually is the only well-organized service provider, as was the case with water service and public housing, which were crucial in the period of rapid urban growth. An even higher need for ensuring equity and fairness arises when the private sector has an increasing role. National fiscal policy is able to support this situation not only by reallocation of functions, but also by changes in taxation and modifying the income stream.

Second, economic stabilization, a basic role of central government, also affects the relationship between central and local budgets. Despite broadening responsibilities, local government revenues have remained unchanged for many years because of the national fiscal policy to control local spending and public debt. This policy was regarded as the only instrument for controlling one-quarter of public spending in a period of fiscal restrictions. Lowering government debt was the primary objective for economic stabilization.

The third factor that influences the changes in expenditure assignments is realizing efficiency gains. Under this consideration, allocation of public functions should be directed to the level of government that can provide the services at the lowest cost. This criterion is complex, because local public service delivery is influenced by economic and political factors.

Country examples have shown that assignment of public functions to levels of government not only follows different patterns, but also changes over time (see chapter 3). For example, the amalgamation process of the early 1970s in some countries (such as the United Kingdom and the Scandinavian countries), the creation of joint service delivery arrangements as part of the decentralization reforms in France, and the search for new

Table 5.2 Expenditure Assignment Criteria: Pros and Cons for Different Approaches

| <i>Assignment Criteria</i> | <i>Amalgamation</i> | | <i>Functional Integration</i> | |
|-----------------------------------|--|--|---|---|
| | <i>Pro</i> | <i>Con</i> | <i>Pro</i> | <i>Con</i> |
| <i>Economic efficiency</i> | | | | |
| Economies of scale | Achievable in technical services | Volume of savings low; questionable for labor intensive services | Flexible, following boundaries of different services | Cannot be realized if units are too small |
| Public sector competition | None | Smaller units required; loss in economic incentives | Smaller local governments support competition | None |
| Public pricing (user charges) | Manageable mostly for regional utility services | None | Cost allocation across jurisdictions feasible | None |
| <i>Equity and fairness</i> | | | | |
| Economic externalities | Spillovers are manageable | Against developed market in public utility sector | None | Intermunicipal arrangements need to be developed |
| Fiscal equalization | Adequate fiscal capacity, vertically more balanced budgets | None | None | Greater need for transfers |
| <i>Stabilization–Macrobalance</i> | | | | |
| | Macrobalances easier to manage | Potentially less cost effective, therefore contributing to higher deficits | Units tailored to specific activities imply better overall resource use | Different units for functional integration make forecasting overall balances more difficult |
| <i>Political accountability</i> | | | | |
| Access and control | None | Lower responsiveness, increasing role of political parties in local arena | Smaller units with higher responsiveness | Lower minority interest representation |
| Citizen participation | None | New forms of participation should be developed in larger units | Traditional forms of direct participation exist | None |

Table 5.2 Expenditure Assignment Criteria: Pros and Cons for Different Approaches (continued)

| <i>Assignment Criteria</i> | <i>Amalgamation</i> | | <i>Functional Integration</i> | |
|-------------------------------|------------------------------------|---|---------------------------------|------------------------------|
| | <i>Pro</i> | <i>Con</i> | <i>Pro</i> | <i>Con</i> |
| Administrative efficiency | | | | |
| Legal adequacy | Clear and stable assignment | None | None | Mixed authorities less clear |
| General purpose government | Comprehensive, integrated policies | None | Neutral to size | None |
| Intergovernmental flexibility | Increased accountability | Loss in flexibility | Higher pressure for cooperation | None |
| Geographic adequacy | None | Regional differences in urban structure ("small" and "large" have different meanings) | Natural service delivery zones | None |
| Management capacity | Greater professionalism | None | None | Lower capacity |

Source: Hermann and others 1999.

forms of representation and more inclusive mechanisms of policy design are all based on various aspects of expenditure assignment. The public sector and local governments had to respond to different external conditions, so new criteria for allocation came to the forefront.

Several equally important factors influence expenditure assignment. They supplement or sometimes compete with each other when some of them get too much priority. Balancing these allocation criteria is extremely important. The fragile results of the new local government system can be destroyed easily if one allocation factor is favored in policy. Policymakers should consider four major types of assignment criteria: (a) economic efficiency, (b) equity and fairness, (c) political accountability, and (d) administrative efficiency (see table 5.2).

Challenges and Responses

Studies suggest that the mechanism of providing services matters more than where the functions are allocated in cases where economies of scale hold (see Hermann and others 1999). Theory and empirical evidence show that out of 12 criteria only public sector competition clearly calls for smaller local governments and four criteria (economies of scale, public pricing, economic externalities, management capacity) call for large area-wide jurisdictions (ACIR 1974). Most of the factors are not related to local government size. Assignment criteria can be met by developing institutions and mechanisms in the local government system.

The most important expenditure assignment issue to be addressed in the future is how functions should follow the differences in local administrative capacity. The role of the intermediate level of government should be further clarified. From a fiscal point of view, this clarification requires new solutions for managing economic externalities and unfunded regional services. In the search for solutions the literature on expenditure assignment and the international examples suggest two basic principles. First, competing allocation criteria should be balanced in the process of reassignment. Economic, equity, political, and administrative efficiency considerations are all important factors in designing local government functions. The economies-of-scale argument is crucial in the fragmented Hungarian local government system, and the requirement can be met through various techniques of expenditure assignment.

European local government systems are able to provide efficient public services when the average size of municipalities differs greatly. The lesson drawn from the international examples is that the mechanisms of integration are what really matters. Depending on a country's traditions and political culture, expenditure assignment criteria may be met in different ways simultaneously.

Debates on the future of Hungarian local governments point up two basic models of expenditure assignment. The first one is based on the "layer cake" model, which clearly

separates functions and resources by level of government. In Hungary, because local governments are small and have minimal and diverse revenue-raising capacity, this solution would lead toward amalgamation and reallocation of functions.

The other direction is based on the results of the 1990s. According to the principles of creating a modern local government system, small autonomous municipalities remain key actors. In this “marble cake” model, however, which has flexible boundaries among different types and levels of government, new institutions should support efficient service delivery. Instead of amalgamation, the conditions of functional integration should be developed. These conditions can be identified by checking the impact of the two models on expenditure assignment.

Amalgamation or Functional Integration

The two basic models can be compared along the four groups of assignment criteria (economic efficiency, equity, accountability, and administrative efficiency). The first argument for amalgamation is to realize the benefits of larger municipalities. Research has proved that this realization of benefits can be achieved mostly in technical services, but also in primary education in Hungary. Because catchments areas of local services differ, this criterion hardly can be used for drawing the boundaries of general purpose local governments. A more flexible institutional framework is needed to provide these services efficiently. The other argument against amalgamation is that the potential savings are marginal, because the numerous small local governments make only a relatively small proportion of public expenditures.

Small local governments are more favorable for services that are not affected by economies of scale and where externalities do not exist (for example, basic welfare services and culture). Only these community-based, small units can increase incentives by matching needs and available local resources. Proper pricing practices are crucial for services that are financed mostly by user charges. This allocation criterion is not connected to any specific size because costs and benefits can be measured across municipal boundaries.

Spillovers provide the most important argument for amalgamation. Amalgamation should be accepted in many service areas. In the field of public utilities, however, with a developed private market and commercial service organizations, other forms of functional integration also work. These intermunicipal and contractual arrangements must be developed further, which will help to support the gradual transformation of the local government system.

Larger local governments probably have more complex revenue bases and thus less need for horizontal fiscal equalization. The available revenues for different types of local governments will be more balanced with their expenditures. Chances are greater that functions and municipal sources are matched. If municipal revenue-raising capacity is built into the allocation methods of intergovernmental transfers, then the problem of vertical imbalance can be managed.

Political control and influence over public decisions require different institutions and procedures under the two models. On the one hand, amalgamation will probably lower responsiveness, but organized political forces can counterbalance this loss. On the other hand, new forms of access and control might support minority interest representation in larger local governments. Traditionally, Hungary has had a relatively well-developed system of community-based citizen participation. This participation lies behind the higher community-based motivation in smaller units and would be lost by creating larger amalgamated units. New forms of participation should be developed.

Legal authority has been defined for any type of local government during the first years of transition. Besides basic rights, the model of functional integration would produce a mixture of competencies and duties. Legal adequacy can be developed more easily for large localities. The assignment of functions would be more clear and stable.

If small local governments continue to exist, the need for special-purpose governments will increase. These governments have some disadvantages over general governments from administrative and political points of view. Political mechanisms should support the control exercised by member municipalities. General governments' advantage is that they can develop comprehensive policies, following the changing needs of the constituents.

By creating clear competencies and a stable assignment of functions, the need for cooperation among levels of government will decrease and, in turn, will lessen the flexibility of the service delivery system, but increase accountability at each level. If smaller local governments continue to exist, then the pressure for cooperation will be greater.

A local government's administrative area should be large enough to determine strategies, provide sufficient revenues, and support popular control on public actions. Local governments have no optimal size, and, in Hungary, even the average size of villages and towns is very different in the two main regions. In the more densely populated Transdanubian region, villages are small and the towns have more central functions (Fürcht 1996). In the Hungarian Plain, the large villages have more functions because the network of cities is more sparse. This disparity is another reason why unified expenditure assignment by size or administrative status cannot simply be implemented. Natural service delivery zones can be followed more easily in a geographical structure with a flexible and open network of municipalities.

Management capacity is generally less in small local governments. More technical services and functions should be administered by larger municipalities. Greater professionalism in local administration and service organizations might be achieved not only by amalgamation, but also through technical assistance, developed information systems, training, and so forth.

Because arguments for and against amalgamation and functional integration are balanced, a new framework of policy proposals should be developed to solve problems of expenditure assignment. The past decades of local government development has proved that no decision can be made on the basis of political versus functional integration. Consequently, a new policy framework should be designed.

We recommend three major groups of actions:

- Cooperation among local governments should be supported by creating a new legal, fiscal, and organizational environment. New institutions and organizational forms as well as grants and revenue-sharing mechanisms should be developed.
- Functional integration of municipal services requires different techniques in sectoral regulation. Legislation on municipal functions and services should encourage and enforce integration for efficient local services.
- Reallocation of functions with changing intergovernmental fiscal relations is also needed in the future. Standard service capacity of local governments by cluster of municipalities should be redesigned. These groups of local governments should be defined by population size and administrative status. Reallocation of local functions should allow voluntary provision of any type of local services. The system of intergovernmental finances should reflect these two conditions: (a) the grant scheme must follow the standard (and not the individual) allocation of functions, and (b) greater own-source revenues should support the takeover of optional services.

The checklist for comparing the advantages and disadvantages of the two integration models has shown conflicts between the competing economic and political-administrative arguments. Because these assignment criteria are equally important, neither of them should be prioritized. Finding the conditions under which both sets of criteria can be met is more important. Most of these conditions have no direct influence on the reassignment of functions. That they provide harmonized legal and fiscal environment for functional integration and cooperation is even more important.

New Institutions for Cooperation

The first argument for amalgamation was that the present local government finance system cannot manage any economic externalities. New institutions for intermunicipal cooperation would help to solve this problem. Legal forms of cooperation have been introduced in the legislation in the 1990s (see chapter 4). The next task is to make them widely usable by providing the necessary professional, administrative, and financial conditions.

Subregional associations have been working since the establishment of the new local government system to provide different services and administrative functions (Horváth 1996b). For further development, legal forms of associations should be elaborated more carefully, and financial incentives must be improved to increase the intention to cooperate. Associations depend heavily on member municipalities for their creation and operation. To develop institutional changes, several steps must be taken.

Associations should be direct recipients of grants. If subregional associations have the right to access transfers directly, financial incentives will increase. Subregional associations

can get grants according to the tasks they perform. Apart from individual municipalities, their common organizational structures are also entitled to get subsidies.

This change requires institutional conditions. Regional audit offices should control association spending directly, especially grant allocation, as in the case of local self-governments. Regional public administrative offices have a right to control the operation. In the case of breaking rules administrative courts make decisions.

The proposed changing character of associations can be declared in the annual state budget, where subregional associations become recipients of grants. This change would be an important one structurally because it would establish a new self-government subject. Subregional associations would be able to get financial sources directly because they are legal entities. Because this change is crucial, declaration in the Act on Local Government would be a better solution. In principle the widening character of subregional associations with legal status would be a very important element of the local government system. It could mean a very strong form of integration and at the same time be an instrument for national government policies in local public service provision.

Separate budgets are needed for subregional associations. Potential revenues are normative grants, supplementary (incentive) grants, contributions from member governments, user charges and fees, private contributions, and loans. In the future, associations might get shared tax revenues from the member governments or the state budget.

Hungary has three large urban areas—the Budapest agglomeration and the Miskolc and Pécs urban areas that need to establish urban communities, a specific association for particular cities and their surrounding areas different from other towns and village self-governments. These three areas contain more than one-third of the population of the country. Each of them provides unified common services and each has an imbalance between the central city and surrounding localities. Collaboration is minimal and has no permanent institutional framework. The primary tasks of the urban communities are public transportation and coordination of public utility services, but member municipalities can agree to organize other common functions.

Clear and Stable Allocation

Stability in the local government system should be supported by gradual changes. With the exception of political changes in 1990, evolutionary reform steps have taken place. The continuity is especially important for the public sector, where the local level has a significant role. If forms of intermunicipal cooperation are developed and stabilized, then the grant system should also be harmonized with these developments. The advantages in variety of service management methods must not be eliminated just for the sake of uniformity. Local services require diverse forms of operation and management. For example, human and physical services have very different organizational and financial characteristics and cannot be forced into the same functional assignment system.

Different levels of government need specific structures. According to international experience, a multilevel structure substitutes for a neglected administrative amalgamation. Hungary should develop intermediate levels of government. Districts could be a level of territorial administration in the traditional meaning, that is, a state administrative unit or part of the self-governing system. In the latter case voters should elect a representative body.

Counties are responsible for providing specific services for more than one municipality or part or the whole territory of the county (for example, specialized hospitals, secondary dormitories, or schools for handicapped pupils). Municipal governments also can undertake these functions, so specific county functions should be defined by law. Municipalities could take over these functions only under certain circumstances.

With Hungary's full EU membership, a significant part of structural and cohesion funds will be channeled through regions. Here the term "region" has different meanings. A general development region, from a public administrative point of view, means a common framework for territorial activities between different county development councils. Creation of particular regions depends on free intentions of county organizations. These regions consist of three or four counties. A specific region conforms not to the county administrative boundaries, but also to existing social and spatial realities. In correspondence with the European Union NUTS classification (see chapter 1), a statistical region means a statistical and planning unit that conforms rigidly to the boundaries of present territorial administrative units. This configuration is important from the technical point of view of national financing. Statistical regions are not linked automatically with administrative regions.

Allocation by Size

Local government also must meet the needs of the inhabitants living in its surrounding municipalities. These local governments are separate legal entities with political autonomy. The constitutional, legal meaning, on the one hand, differs from the functional character of local government, on the other.

Municipalities that have larger capacities should be responsible for providing services for citizens living in other localities, possibly in the surrounding villages or in a homogeneous district. Urban municipalities responsible for provision of services for an area larger than their own territory should get additional resources through intergovernmental transfers.

Typical local government functions should be defined by different population categories that are designed carefully for each type of service. This task requires detailed analysis of service costs and organizational characteristics. The economies-of-scale argument is only one component in allocating functions. It influences expenditure assignment because it indicates the lowest rational level of service delivery.

The following hypothetical population size clusters can be identified for local functions:

- Villages up to 2,000 inhabitants
- Villages and towns that have 2,001–5,000 inhabitants
- Towns and cities that have 5,001–10,000 inhabitants
- Cities that have more than 10,001 inhabitants (excluding the capital districts, cities with county rank, and the capital city)
- Capital districts and cities with county rank
- Capital city
- Counties.

In these categories, typical functions should be listed and regulated by clusters. This method is different from the present logic, which guarantees the general minimum level in the Act on Local Government regardless of local capacity. Allocation of functions by size of local governments does not exclude the present optional character of functions. Mandatory tasks of a larger cluster may be taken over by a municipality in a smaller size cluster if the service conditions can be guaranteed.

Conclusion

These two competing criteria—allocation of local government functions by size and optional provision of services, regardless of legal regulations—can be met only if intergovernmental fiscal relations are adjusted to this dual condition. First of all, higher own-source revenues are a basic requirement for having sufficient funds to run services autonomously. Grant allocation schemes should be based on standard expenditures and service performance level, but differences in revenue-raising capacity should be built into the model of intergovernmental fiscal relations.

The need for fiscal equalization is a strong and valid argument for amalgamation. In Hungary, this problem is more one of the municipal finance system: the lack of significant own-source revenues (vertical imbalance) and the rigidity of the grant allocation schemes. Without changing present expenditure assignment, techniques exist to decrease the present intense need for fiscal equalization.

The increase in management capacity is the primary responsibility of the national government. Setting professional standards for service delivery, defining minimum performance levels, and establishing supportive audit practices would all help make local government operation more specialized. As part of the national government's role in developing these new practices of management and control, disseminating the information and knowledge will be crucial. Both national and local governments have joint responsibility in providing public services.

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Local Government Finance: General Issues

Kenneth Davey and Gábor Péteri



The system of intergovernmental fiscal relations is dominated by three major features: (a) the scale of local government responsibilities, (b) the importance of transfers, and (c) the lack of uniformity in the institutional framework. Over the 1990s the system has tried to cope with these characteristics within a context of national fiscal restraint. This effort has inevitably resulted in growing volatility and complexity in the transfer structure. This chapter briefly discusses these major features and the problems to which they give rise.

Responsibilities

The scale of local government functions is exceptional, not only in the post-communist states, but in Europe as a whole. Only Scandinavia matches their scope. British local authorities have most of the same responsibilities, except medical services. In Hungarian local government budgets, education (27 percent) and health care-welfare services (27 percent) are equally important functions (table 6.1). Public utilities (4 percent) and culture and sports (4 percent) are marginal expenditures, produced mostly by commercial or off-budget entities. Administrative expenditures, debt service, and other economic services make up the balance of each budget.

More than 14 percent of total local expenditures are spent by counties, mostly for health care and social services. City level expenditure (40 percent) is proportional to urban population (43 percent). Village municipalities comprise one-fifth of local government budgets.

These expenditure allocations are not likely to change. Even if some decrease were desirable, it would require an amendment to the Act on Local Government, possible only with a two-thirds majority. One can speculate over movements of responsibilities between individual municipalities and associations, or between counties and municipalities (see

* This chapter is based on Davey and Péteri 1998.

chapter 5), but significant shifts between central and local government as a whole are unlikely.

The exceptional scale of local government expenditure results primarily from responsibilities in the social sector (such as education, social welfare, health, housing, and so forth). This allocation has two major implications for intergovernmental relations. First, national policy debate places considerable emphasis on equalization, because parity of access to medical service, education, and so forth is regarded as an important goal. Second, local government expenditure depends heavily on funding by intergovernmental transfers.

The Importance of Transfers

Grants and national tax shares allocated as grants were at 71 percent of local government revenue in 1998. The reason for this dependence on transfers is simple. Local governments' heavy social sector responsibilities require access to the tax bases that can raise at least 7 percent of gross domestic product (GDP)—personal income tax (PIT), corporate income tax (CIT), value added tax (VAT), and excise tax. Of these, only the PIT can be assigned to local government without major distortions and exporting. All these sources remain in central government hands. The same situation occurs in Britain, where transfers are almost as important as they are in Hungary. Dependence on transfers is much less in Scandinavia because local governments share the PIT base with central government through a surcharging system.

Local business tax yields have been growing in major urban centers, but only by increasing approximation to VAT. The European Union poses difficulties in the form of major expansion of this tax base. Developing a value-based property tax system holds significant potential, although both political and administrative hurdles must be overcome. Since the property tax raised only 0.1 percent of GDP in 1996, yields could clearly be increased substantially in the major urban centers.

The potential of this reform must not be exaggerated, however. The most effective property taxation in Europe raises less than 1.5 percent of GDP; even if Hungarian yields could rise to this level, they would still support less than 10 percent of local government expenditure. The property tax could never become a significant replacement for the present scale of revenues from grants and PIT sharing.

Vehicle taxes (50 percent of which accrue to local government) have been rising, and further increases may be required by European Union accession. The main potential of local business, property, and vehicle taxes, however, lies in the cities and is directly related to their greater costs of providing physical infrastructure (traffic volumes, longer hauls to waste disposal, housing rehabilitation needs, and so forth). Similarly, revenues from charges might be increased in a number of cities, either by reviewing tariffs or improving collection, but these funds would go largely to the infrastructure companies rather than to the main municipal budget.

Table 6.1 Structure of Expenditures by Legal and Size Clusters of Settlements (percent)

| <i>Settlement</i> | <i>Manu- facturing</i> | <i>Economic services</i> | <i>Administration</i> | <i>Education</i> | <i>Health care, social services</i> | <i>Public utilities</i> | <i>Culture, sports</i> | <i>Miscella- neous</i> | <i>Total</i> |
|---------------------------|----------------------------|------------------------------|-----------------------|------------------|---|-----------------------------|----------------------------|----------------------------|--------------|
| Budapest | 9.8 | 23.7 | 13.8 | 20.9 | 25.0 | 2.6 | 4.0 | 0.2 | 100 |
| County | 2.5 | 3.1 | 5.5 | 10.2 | 72.6 | 0.5 | 5.6 | 0.0 | 100 |
| Cities | 8.1 | 12.9 | 14.5 | 33.7 | 21.7 | 4.1 | 4.5 | 0.5 | 100 |
| Villages | 8.2 | 13.6 | 23.0 | 33.4 | 8.6 | 9.9 | 2.4 | 0.9 | 100 |
| Municipalities | 8.1 | 13.1 | 17.3 | 33.7 | 17.4 | 6.0 | 3.8 | 0.6 | 100 |
| Total | 7.8 | 14.4 | 14.7 | 26.9 | 27.4 | 4.3 | 4.1 | 0.4 | 100 |
| <i>Size of settlement</i> | | | | | | | | | |
| 199 or fewer | 16.1 | 30.0 | 35.4 | 5.0 | 5.1 | 4.7 | 3.1 | 0.6 | 100 |
| 200–499 | 10.0 | 22.9 | 33.6 | 16.9 | 7.9 | 5.2 | 2.5 | 1.0 | 100 |
| 500–999 | 8.6 | 13.6 | 27.1 | 35.3 | 8.2 | 4.9 | 1.7 | 0.6 | 100 |
| 1,000–1,999 | 8.5 | 13.3 | 23.3 | 35.5 | 7.8 | 8.9 | 2.0 | 0.7 | 100 |
| 2,000–4,999 | 8.2 | 13.1 | 20.9 | 34.2 | 9.4 | 10.7 | 2.7 | 0.8 | 100 |
| 5,000–9,999 | 8.2 | 14.2 | 19.9 | 32.6 | 11.5 | 8.8 | 3.5 | 1.3 | 100 |
| 10,000–19,999 | 7.9 | 11.4 | 17.8 | 30.9 | 23.2 | 5.1 | 3.1 | 0.6 | 100 |
| 20,000–49,999 | 7.8 | 13.5 | 13.0 | 29.1 | 28.3 | 4.9 | 2.9 | 0.5 | 100 |
| 50,000– | 8.1 | 12.8 | 13.0 | 37.8 | 18.2 | 3.5 | 6.2 | 0.4 | 100 |
| Total | 8.1 | 13.1 | 17.3 | 33.7 | 17.4 | 6.0 | 3.8 | 0.6 | 100 |

Source: Davey and Péteri 1998.

Improving the local revenue base of property and vehicle taxes and consumer charges will help maintain physical infrastructure (and service credit for its rehabilitation). The more substantial costs of the social sector, however, will continue to fall chiefly on the combination of grants and PIT sharing (or surcharging).

One option would be to change the balance between grants and revenue sharing within this combination, increasing revenue shares and reducing the normative grants. The incentives would be psychological rather than financial. The change would not reduce dependence on transfers or increase local accountability or discretion. It might, however, reduce the feeling of dependence, giving local government a greater sense of sharing in the fruits of the local economy.

Two methods of increasing revenue sharing could be considered. The first would be a straight increase in the percentage of PIT shared by origin, which decreased from 56 percent of current collections in 1995 to 10 percent in 2000. A second method would be to assign a share of VAT to local government.

The main objection to increasing revenue sharing at the expense of normative grants would be that revenue disparities between municipalities would increase. This increase could be partially offset by increasing the PIT equalization grants but only further reductions of the normative or special normative elements could increase the PIT equalization grants. Furthermore, reducing those elements would be difficult so long as the current lack of uniformity in the assignment of competencies, particularly in the social sector, continues.

The only change in intergovernmental financial relations that would substantially reduce dependence on transfers would be the substitution of a local income tax surcharge for the present tax-sharing arrangements. The prime objective of this action, however, would be to increase local accountability rather than to generate more revenue. Its overall effect on both national and local budgets would be neutral in the first instance.

The Institutional Framework

Three features of local government structure and the assignment of competencies have a major impact on the transfer system:

- The structure is highly fragmented, and many small jurisdictions attempt to provide services without desirable economies of scale.
- The legislation has avoided a mandatory division of functions between counties and municipalities.
- Small municipalities are not obliged by law to cooperate in service provision (except for administrative and regulatory tasks).

As a result, assignment of competencies between types of local government is not uniform, and mismatches between municipal boundaries and the catchments areas of

service institutions are frequent. Joint arrangements for service delivery and regional development have grown, but they exhibit no consistent pattern.

These conditions have had two impacts on the evolution of the grant system. First, specific service-related elements in the normative grant calculation have proliferated. The goal is to target funding on the local government unit (municipality, county, or association) running a service institution. The monetary value of these elements has been declining as a percentage of the actual service costs. These specific normative grants now cover a significantly lower percentage of regional service costs. Between 1993 and 1996 grants for social institutions decreased from 51 to 40 percent as a percentage of current expenditures, and between 1993 and 1998 grants for general secondary education decreased from 94 to 45 percent. Grants for vocational training fell from 73 to 44 percent. The second impact has been a growth in the pressure on the deficit and equalization elements within the transfer system as a whole. The changes in the structure of grants clearly shows the pressure for higher equalization. Between 1994 and 1998 grants for various equalization purposes have increased by 76 percent, while the average increase of total transfers was only 38 percent all in nominal terms.

The Consequences of Fiscal Restraint

The intergovernmental finance system has had to operate within tight fiscal restraint. Between 1994 and 1998 local government expenditure decreased by 21 percent in real terms despite increases in responsibility. The changes in the structure of consolidated primary public sector expenditures also show that local governments were not able to keep their relative position.

This squeeze on local government budgets has evoked some increase in local revenue effort, and local taxes increased from 0.8 percent of GDP in 1994 to 1.2 percent in 1997. The major source of this growth has been in the local business (turnover) tax, mainly in the larger towns. Municipalities have been filling gaps by sale of capital assets (nearly 14 percent of local government revenue in 1996), but 1998 budgets exhibited a sharp decline in this source, presumably as the disposable stock contracts.

Two changes in the transfer system reflect the pressures created by this situation. First, the element devoted to equalizing PIT shares increased from 1 percent of local government revenues in 1994 to 1.6 percent in 1998. This increase brings PIT incomes up to Ft 8,000 per capita for villages and 9,800 for cities, figures that are close to the national average PIT allocation to all local governments (Ft 8,600 per capita). It is, however, the only form of transfer that does seek, systematically, to reduce disparity in local revenue bases. The consequence of the high per capita equalizing minimum is that most of the village municipalities are eligible for the grant. In practice, PIT sharing works as a grant allocation scheme for villages based on the size of the local population, although towns still benefit from above average PIT revenues per capita. Second, the numbers of applications for, and

recipients of the deficit grant have increased (in 1993, 147; in 1997, 843 local governments). Recipients fall into three categories:

- village municipalities trying to run services that are uneconomic at their size (24 percent of village municipalities qualified for deficit grant in 1996)
- towns that do not have a major PIT and business tax base to provide extensive services (for example, secondary schools and hospitals) for surrounding settlements (15 percent of towns and cities)
- counties (11 out of 19 in 1996) that have little direct revenue.

Most recipients are small municipalities, but in financial terms the problem lies equally with the counties and cities that have regional functions. Only half of the deficit grant is allocated to the villages, 22 percent to county councils, and 28 percent to cities.

Reform Objectives

The basic structure of the local government finance system is rational. Moreover, the central government has made continual efforts over the 1990s to adjust it and to increase its fairness and efficiency. Four weaknesses, however, put increasing pressures on the central government officials operating the system and on local governments trying to live with the effects on their budgets.

First, no statutory provision, beyond the annual Budget Act, determines the overall size of the resources assigned to subnational governments. This lack leads two perpetual arguments: uncertainty and suspicion (whether justified or not) that local government bears an unfair share of the total fiscal restraint.

Second, adjustments are frequent and many, increasing the complexity and uncertainty surrounding the distribution of resources among local authorities.

Third, because of the lack of uniformity in the assignment of functions, the number and complexity of the specific normative elements of the grant calculation has increased constantly. These elements are driven both by the central government's understandable desire to see that particular service standards are met and the need to route the funding to the authorities providing the service in any given locality. At the same time, these normatives have been declining as a proportion of the costs of the services. This increase in the number of specific normatives is unpopular with the municipalities, however, because of the added bureaucracy involved in establishing eligibility. They could also have an adverse effect on efficiency by encouraging municipalities to sustain unnecessary volumes of service provision simply to earn unit-based grants.

Finally, local governments increasingly call on the deficit grant is to play the equalization role in the overall intergovernmental finance system. It is ill equipped to do so, however, because its awards are based on the budget estimates of individual municipalities

without standard criteria for assessing either local revenue potential or spending need. It runs the risk, therefore, of rewarding low revenue effort and inefficient expenditure. In particular, it may run counter to central government policy by enabling small municipalities to “go it alone” in providing services instead of cooperating with their neighbors. The deficit grant was established to deal with exceptional cases, but now a majority of the counties and a quarter of the villages use it. The ministry officials allocating the grants make strenuous efforts to avoid these risks, but they are handicapped by the volume of cases to scrutinize and the lack of objective measurements to apply. Analysts generally recognize that intergovernmental financial relations need a more systematic equalization instrument, particularly in view of local governments’ social sector responsibilities.

The first experimental change in the concept of transfer allocation was implemented in 1998. The method of deficit grant allocation compares the planned expenditures of the individual municipalities with the average per capita expenditures of local governments of similar size and administrative status. A municipality’s estimated expenditure, which is the basis of deficit grant allocation, should be in the range of 80 to 140 percent of its group average. This approach helps the really poor municipalities and does not support inefficient services with extremely high unit costs. Further progress is needed because the method of calculating the estimated expenditures is still based on line-item budgeting, the revenue capacity is not measured, and discretion remains in the allocation process. This is the first attempt to introduce a new transfer allocation system.

Fixing the Total

One cannot expect local government budgets to be immune from the fiscal pressures on the national government. Indeed, between 1994 and 1998 the decline in general government expenditure (excluding social security funds) has slightly exceeded that in local government. Nevertheless, the national economy was improving, with 4–5 percent growth in GDP between 1997 and 2000, and consolidated public debt got close to the European Union target level of 60 percent of GDP. The national budget deficit (without privatization revenues) was 3.5 in 2000.

In light of this improvement, reformers pose two major arguments for protecting local government budgets from further contraction. First, the bulk of local government expenditure is on public goods, for which funding will remain a public sector responsibility, no matter how diverse service delivery is. Second, local governments remain responsible for much of the infrastructure that needs investment if they are to conform to European Union environmental standards. Even with the present fiscal pressure, local governments spend more on capital improvement than their average share in general government expenditures.

Current procedures create at least three major problems. First, the overall pool of resources available to local governments in the state budget is determined annually

by Parliament, and no basic ground rules govern that determination. Second, resource distribution between individual local governments is subject to frequent change. Third, allowance for inflation in annual budget allocations tends to underestimate the actual rise in costs.

The second problem of intermunicipal distribution concerns later chapters. At this stage, two questions arise:

- Can the overall allocation of state budget resources to local government be stabilized?
- Can local government allocations be more buoyant in relation to inflation during the budget year?

Two examples illustrate the legal guarantees of the total volume of state budget support. In France a 1994 act stipulates that the total general grant for current expenditure (*dotation globale de fonctionnement*) will be increased annually by a percentage representing the sum of the forecast annual rate of inflation and half the real percentage growth rate of GDP, if positive. In Japan the total pool of national budget funds allocated to local government through a comprehensive needs and resources equalization formula is determined by fixed percentages of certain national taxes—32 percent of PIT, CIT, and liquor tax; 25 percent of tobacco tax; and 24 percent of consumption tax (equivalent to VAT). The French and Japanese laws are intended to provide a continuing, multiyear basis for the assignment of transfers. These guarantees could, of course, be amended by Parliament, but such amendment would require a conscious decision independent of the annual budget process, involving considerable negotiation and debate.

In other countries, such as the Netherlands, the total grant pool is defined as a percentage of national revenues, fixed for a single year as part of the annual budget. In the Dutch case it is 11 percent. This level does not provide the same long-term stability as the French and Japanese laws. Nevertheless, the volume of transfers during the budget year reflects the actual collections of the taxes in question; if these taxes are buoyant, local governments are automatically compensated for continuing increases in costs. This protection has also benefited local government in the Czech Republic and Slovakia, where transfers are based mainly on annually fixed shares of PIT and CIT.

Risks as well as benefits are attached to this type of indexation. In a deflationary situation, a fixed percentage of tax yields might produce less than the budget estimate. In 1995 Japanese local authorities received only 80 percent of the amount of transfers estimated in the budget due to tax shortfalls. This situation would be unlikely in Hungary, however, until inflation falls to negligible levels.

With greater fiscal stability in sight, the Hungarian central government might consider linking the overall size of transfers (at least for current expenditure support) to fixed proportions of state revenues, preferably for several years. As an illustration, the 1998 normative grants equate with 21 percent of the combined estimated yields of VAT, PIT, and CIT, a decline from 38.6 percent in 1992.

Normative grants for local governments decreased from 6.0 to 3.3 percent of GDP between 1990 and 1998. Because GDP and the major taxes (VAT, PIT, and CIT) follow the same trend, the normative grants declined as a percentage of these taxes (in 1991, 36.5 percent; in 1998, 21.1 percent).

If the proportion of local government normative grants to total amount of major taxes were kept fixed, then the municipal grants would be stable. For example, using the 1994 percentage (29.7 percent) as a fixed ratio, by now the normative grants would be 40 percent higher—Ft 462 billion (See table 6.2)

Table 6.2 Local Government Revenues by Sources (Ft billion)

| <i>Year</i> | <i>VAT</i> | <i>PIT</i> | <i>CIT</i> | <i>Tax total</i> | <i>GDP</i> | <i>Normative grants (actual)</i> | <i>Estimates, using 1994 percentages</i> |
|-------------|------------|------------|------------|------------------|------------|--------------------------------------|--|
| 1991 | 149.5 | 183.9 | 77.3 | 410.7 | 2,498.3 | 150.1 | — |
| 1992 | 175.7 | 205.7 | 64.1 | 445.5 | 2,942.7 | 172.0 | — |
| 1993 | 265.0 | 238.4 | 54.0 | 557.4 | 3,548.3 | 209.8 | — |
| 1994 | 336.4 | 304.8 | 75.9 | 717.1 | 4,364.8 | 213.0 | — |
| 1995 | 423.9 | 383.7 | 91.0 | 898.6 | 5,562.0 | 220.1 | 266.9 |
| 1996 | 515.1 | 490.7 | 110.9 | 1116.7 | 6,845.0 | 253.7 | 331.7 |
| 1997 | 674.7 | 560.1 | 144.7 | 1379.5 | 8,370.0 | 297.3 | 409.7 |
| 1998 | 759.3 | 618.1 | 180.0 | 1557.4 | 9,855.0 | 329.0 | 462.5 |

Source: Davey and Péteri 1998.

Other Options for Reform

However the overall amount of transfers is fixed, their distribution should be optimized and their objectives should be clear. The prime aim is not to reduce the scale of national budget support, since the personal services are of great significance to ordinary citizens and demands and expectations are not diminishing. The main objectives must be to improve equity in the distribution of resources and efficiency in their use.

A radical reform might attempt to replace the whole transfer system with an equalization-based grant or revenue share of the Dutch, British, or Swedish type. These systems attempt to balance local spending needs and costs and local revenue potential comprehensively and objectively.

Radical change will bring significant losers as well as winners unless overall state budget support increases substantially, an unlikely scenario. Serious questions arise, therefore, about whether a radical change in system would be politically acceptable. The practical alternative is to retain the present overall transfer system, but adjust individual elements to meet the most serious practical needs.

Two alternative approaches to incremental change might be used. One alternative assumes that no institutional change will occur, that is, distribution of responsibilities between counties and municipalities, or between towns and their surrounding settlements will not be made uniform, and small settlements will not be compelled to associate in providing municipal services. The second alternative assumes that institutional change could be undertaken and that some form of intermunicipal cooperation becomes mandatory. This assumption also applies to changes in the assignment of competencies between local governments.

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Intergovernmental Finance: Summary and Evaluation

William F. Fox



The role that intergovernmental revenues play in local government finance differs widely throughout the world. Local governments raise much of their own revenue in the Scandinavian countries of Denmark and Sweden. A greater share is provided through transfers from the central government in Australia. Factors determining the relative size of the intergovernmental system include the extent of decentralization of expenditures and revenues, the capacity to raise revenues locally, fiscal and economic imbalances across the country, desires for equalization, and the cultural heritage of the country. Ultimately, the contribution of intergovernmental revenue is a country-specific decision, and no single share of transfers between levels is appropriate across all countries. Nonetheless, the role of intergovernmental revenues in local finance and the way that transfers are structured can affect economic efficiency, delivery of government services, equity, and other goals that a country sets for itself. As a result, design of the system is very important.

This chapter, which describes and examines the intergovernmental transfer system, has three sections. The first is an overview of the existing system, including an analysis of each type of transfer. For analytical purposes, the intergovernmental revenue structure can be categorized as derivation-based tax sharing and normative, earmarked, investment, and deficit grants. The second section provides a review of overall system performance. The final section presents some options for modifying the intergovernmental revenue system.

Intergovernmental Revenue Structure

Intergovernmental transfers from the central government to counties and local governments are summarized in table 7.1 according to the standard budget structure used by the government of Hungary. Transfers are categorized as shared revenues, accumulation

* This chapter is based on Fox 1998.

Table 7.1 Total Intergovernmental Transfers, 1993–1998 (Forint billion)

| <i>Local government revenues</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Shared revenues | | | | | | |
| PIT | 48.9 | 61.3 | 93.6 | 101.3 | 135.7 | 187.0 |
| Vehicle tax | 2.5 | 2.5 | 2.5 | 7.0 | 8.0 | 8.5 |
| Tax on land rental | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 1.0 |
| Shared revenues total | 51.4 | 63.8 | 96.1 | 108.3 | 143.7 | 196.5 |
| Accumulation revenues within the state budget | 6.5 | 15.4 | 7.4 | 11.8 | 10.0 | 9.0 |
| Accumulations revenues total | 6.5 | 15.4 | 7.4 | 11.8 | 10.0 | 9.0 |
| State transfers and grants | | | | | | |
| Normative subsidies from central budget | 214.8 | 221.6 | 232.6 | 231.7 | 255.9 | 276.1 |
| Subsidies to theaters | 2.3 | 2.4 | 2.6 | 3.4 | 4.3 | 4.8 |
| Addressed and targeted subsidies | 18.3 | 24.6 | 24.2 | 23.4 | 46.0 | 43.0 |
| PIT supplement | 6.5 | 6.5 | 0 | 0 | 0 | 0 |
| Deficit grant | 1.6 | 4.4 | 7.0 | 5.4 | 6.0 | 7.2 |
| Other subsidies (centralized appropriations) | 13.1 | 29.6 | 32.6 | 52.9 | 36.6 | 37.8 |
| Subsidies to local fire departments | 0.0 | 0.0 | 2.5 | 7.3 | 8.8 | 11.6 |
| Supplementary grants to certain public education tasks | 0.0 | 0.0 | 0.0 | 0.0 | 3.2 | 6.5 |
| Investment grants for regional equalization | 0.0 | 0.0 | 0.0 | 0.6 | 11.0 | 9.0 |
| Decentralized targeted investment grant | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 4.3 |
| Public employees wage, minimum wage | 5.3 | 9.1 | 6.3 | 0.0 | 0.0 | 0.0 |
| Other regrouped revenues | 0.2 | 1.3 | 3.9 | 2.2 | 0.0 | 0.0 |
| State transfers and grants total | 262.1 | 299.5 | 311.7 | 326.9 | 371.8 | 400.3 |

| <i>Local government revenues</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Transfers within general government | | | | | | |
| Funds from Social Security | 91.6 | 117.4 | 127.1 | 148.4 | 169.0 | 190.9 |
| Funds from extra-budgetary funds | 2.4 | 3.5 | 3.4 | 12.7 | 15.0 | 19.0 |
| Funds from budgetary (chapters) institutions | 4.8 | 6.6 | 6.0 | 7.2 | 8.0 | 8.0 |
| Budgetary supplements and refunds | 5.0 | 5.0 | 1.2 | 1.3 | 1.5 | 1.0 |
| Transfers within general government total | 103.8 | 132.5 | 137.7 | 169.6 | 193.5 | 218.9 |
| Total intergovernmental transfers | 423.8 | 511.2 | 552.9 | 616.6 | 718.9 | 824.7 |
| Government finance statistics (GFS) revenue total | 578.3 | 705.8 | 790.1 | 940.4 | 1,021.3 | 1,142.5 |
| Government finance statistics (GFS) expenditures total | 0.0 | 0.0 | 781.6 | 892.5 | 1,011.3 | 1,142.7 |
| Transfers as a percent of revenues | 73.28 | 72.43 | 69.98 | 65.57 | 70.40 | 72.18 |
| State transfers, PIT, revenues from land rental | 311.0 | 360.8 | 405.4 | 428.1 | 507.5 | 588.3 |

Source: Ministry of Finance data.

revenues, state transfers and grants, and transfers within general government. Local government non-transfer revenues have been omitted from the table. Transfers are budgeted to provide approximately Ft 825 billion in 1998 revenues, or about 72 percent of total local government non-debt revenues. They have risen at a compound annual 14.2 percent growth rate since 1993, a figure well below the 17.5 percent inflation rate during the same period. Transfers have been falling as a percentage of gross domestic product as well as in real terms. Still, the share of local government revenue provided through transfers has risen significantly since 1996, even though the percentage is lower than in the early 1990s.

Tax Sharing

Local governments receive percentages of the personal income tax (PIT) and the vehicle and property transactions taxes, representing a budgeted Ft 103 billion in 1998 or about one-sixth of local revenues. Municipalities also receive 30 percent of environmental fines. Tax sharing is a form of revenue sharing in which the amount to be transferred is determined by a percentage of collections of a national tax (or taxes) and the distribution is based on where the tax originates. Analysts of derivation-based tax sharing normally treat the revenues as intergovernmental transfers, although they have some characteristics of an intergovernmental transfer and some of a tax. The revenues are much like intergovernmental transfers since the central government determines the revenues, by setting both the tax rate (or sharing rate) and the tax base, and collects the revenues. The structure has the characteristics of a local tax system, because the revenues remain in the jurisdiction where they are collected.

Derivation-based tax sharing has two advantages:

- Administrative costs are low, because the revenues are collected at the same time as the national share of the tax.
- Revenue sources such as personal income are buoyant; whereas other tax sources that often are assigned to local governments typically grow slowly.

A number of significant disadvantages results from tax-base sharing, such as lack of accountability, if taxpayers do not understand that the shared revenues are provided to subnational governments. Problems with horizontal balance may also be a significant concern. Horizontal balance refers to the capacity of each city and municipality to finance its service delivery responsibilities.

With tax sharing in general, revenues from shared taxes are concentrated in the highest income (or other tax base) areas, because less affluent places have less capacity to meet their responsibilities. In Hungary, local governments receive widely different per capita revenues as a result of derivation-based PIT sharing. For example, in 1995 Budapest collected Ft 18,300 per capita from PIT shared revenues, but the average local government

with a population under 1,000 received less than Ft 4,300 (Fox, Melhem and Péteri 1995). Of course, horizontal balance problems arise from more than derivation-based sharing. Essentially all tax bases are heavily concentrated in the same places, so no local taxes are likely to achieve horizontal balance.

A tax-sharing system's normal structure prevents local governments from altering their revenues by changing tax rates. Tax sharing discourages effective planning and service delivery when the specific percentages to be shared are selected each year to balance local budgets. In the early years of transition these so-called "regulating taxes" were common in a number of countries (for example, Russia and Ukraine). The percentage shared has varied annually in Hungary as well.

Derivation-based tax sharing requires that rules be made concerning where revenues are derived. In Hungary PIT revenues are shared where the income earner lives as opposed to where the income is earned. Administrative problems always exist in determining the specific local government that should receive the tax revenues.

Sharing the PIT provided about 90 percent of total derivation-based revenues, or about Ft 89 billion, in 1998. These derivation-based PIT revenues represent one-half (20 percent) of the 40 percent of national PIT revenues earmarked for local governments in 1998. In 2000 only 5 percent of the 40 percent earmarked PIT remained derivation based. In 1998 PIT revenues included both the derivation-based revenues and the PIT revenues earmarked for other purposes (see table 7.1).

The actual amount of PIT revenues shared with local governments is based on tax collections from two years earlier because of the time necessary to prepare data based on point of derivation. The two-year lag causes a significant real revenue loss for local governments, given an inflation rate of greater than 17 percent. In other words, local governments' share of PIT revenues would be much greater if the distribution was based on the current year's collections. For example, local governments' total earmarked share of PIT receipts was about Ft 180 billion in 1998, but the share would be about Ft 250 billion if 40 percent of expected 1998 PIT collections were distributed.

Two other taxes are distributed by derivation. Fifty percent of the nationally established motor vehicle tax rate is distributed across local governments based on the sites of collection. Municipalities receive all of any additional revenues if they choose to impose a motor vehicle tax surcharge. Likewise, county administrative offices collect a tax on land and property transactions. Thirty percent is remitted to the municipality of origin, 35 percent stays with the county office to finance administrative expenses, and the remaining 35 percent is placed in a pool and provided to counties on a per capita basis.

Any undesired horizontal balance implications of tax sharing can be offset in a number of ways. For example, other transfers can be targeted to those areas receiving less in derivation revenues, or the PIT sharing can be distributed based on a formula. Both alternatives are used in Hungary. The PIT distribution is made more equal by guaranteeing local governments a minimum per capita amount. In 1998 villages were assured of at least Ft 8,000 per person, and towns were assured of at least Ft 9,800 per person. The minimum

amount has escalated rapidly in recent years and cost Ft 33.3 billion in 1998, up from Ft 9.9 billion in 1996. The minimum PIT distribution combined with the needs-based normatives described below provide a significant equalization component to the overall transfer system.

Normative Grants

Local governments and counties receive grants based on the value of a series of normatives (see appendix 7.1). Most of the revenue from normatives goes to towns and villages, but about Ft 9.5 billion goes to the counties. The normatives effectively create a complicated formula-based grant structure, linked mostly to expenditure needs. The total amount of normative-based revenue going to a local government is calculated by adding the amount to be received from each of approximately 50 normatives. (Analysts have given different totals for the number of normatives, depending on how normatives are counted when multiple normatives are applied to a single situation.) The revenue from the normatives is generally not earmarked and may be spent for any purpose that the recipient government deems appropriate, even though the normatives are often linked to specific mandatory services.

Five types of normative calculations are used:

- Several normatives are fixed amounts for each type of local government.
- Some normatives are per capita and have amounts multiplied by population to determine the revenues. Population can be regarded as a proxy for service needs.
- In many situations the normative amount is calculated by multiplying the number of recipients or beneficiaries of services times the per-beneficiary amount. Essentially all of these normatives are related to education or social welfare, and they give local governments an incentive to deliver some degree of service because the governments receive revenues only if there are beneficiaries.
- One normative is based on the number of beds in homeless shelters. Fortunately capacity normatives of this type are seldom used in the local government sector, because they create perverse incentives. They encourage local governments to expand capacity without necessarily improving the service quality.
- Local tourist tax revenues are matched with Ft 2 for each Ft 1 raised locally.

The notion behind the normative structure is that revenues should be provided in accordance with the varying types of expenditure needs of each local government. Local governments have some degree of flexibility on spending decisions, however, because the revenues are not earmarked. Of course, local governments often do not have the expenditure flexibility that would appear to exist because many services are mandatory, and mandates and standards in other laws effectively prescribe certain expenditures. Furthermore,

recipient governments can expect political pressure from advocates for each service to spend the revenues for the purpose on which the normatives are based.

It is tempting to think of the beneficiary normatives as cost reimbursement grants. In most cases, however, the values attached to the normatives are not based on actual expenditures and do not have consistent relationships with actual costs, as the Ministry of Social Welfare learned when it undertook a study of the costs of delivering social welfare services to use as a basis for setting normatives. Even if an effort was made to relate the normatives to costs, no clear statement defines the specific service characteristics that constitute provision of mandatory services, so associating the normatives with precise costs is not possible. Furthermore, municipalities spend much more on average for the services than the grant that is linked to the beneficiary normatives, so at best the normatives are loosely defined, partial cost reimbursement grants.

Education Normatives

At least 26 normatives are for education and are usually based on the number of students. For example, Ft 67,000 is provided for each kindergarten student and Ft 96,000 for each secondary student in grades 11 through 13. In some cases normatives are designed to provide incentives, such as when a greater amount is given for nonresident students to encourage local governments to cooperate in service delivery. The Ministry of Culture and Education estimates that the normatives provide about two-thirds of education costs, but the ministry recognizes that the values are not based on an analysis of actual costs. The idea is that the central government will finance education wages, which make up about two-thirds of total education costs. Cost estimates provided by local governments suggest that the normative values are sufficient to finance about 50 percent of kindergarten costs and about 80 percent of high school costs. The central government also provides seven pupil-based education grants for ethnic schools and programs. The ethnic normatives differ from others in that the money is earmarked for specific purposes. (The normatives are generally described in annex 3 of the annual budget, but each of the earmarked grants is contained in a separate annex. For example, the ethnic normatives are presented in annex 8.) Of course, the earmarked revenues are fungible and may have no effect at the margin on expenditure levels for ethnic programs, if the local governments were already going to spend more than the earmarked amounts for the services.

Social Welfare Normatives

Nine social welfare normatives are used. Beginning in 1998 the largest social welfare normative was split because of a concern that the range of programs was not being adequately provided. Basic social services for the general population are linked to three normatives, two of which are calculated using total population. Combined, these normatives provide about 20 percent of the revenues from the social welfare normatives.

The other major normative is also a per capita transfer to local governments varying from Ft 2,500 to Ft 12,500 per person. The amount depends on the extent of unemployment, the percentage of the population paying PTT, and the percentage of the population that is under age 18 and over age 60. The intent is to provide greater funding to municipalities that have larger expenditure responsibilities, although in a recent analysis of spending patterns the Ministry of Social Welfare found no relationship between program expenditures and factors in the formula. The specific definition of the factors used to determine the normative's value (for example, the meaning of unemployed), and the weights attached to the factors are set each year through discussions between the central government and the Parliament. These two parties may consider many issues when setting the amount for this normative, but one goal is to establish an allocation that achieves some preconceived (at least regionally) conclusion of how the revenue should be distributed. The definitions and weights appear to be set to meet these goals.

Beneficiary-based normatives are also used for social welfare purposes. Five types of beneficiaries are identified, including for homes for the elderly, homeless, handicapped, orphaned, and people who need rehabilitation.

Operation of the Normative System

The mechanisms for distributing normative revenues to individual municipalities as well as the total amount provided are determined every year through the political process. The system is complicated and detailed, giving an appearance of precision, but in fact the process is *ad hoc* and is routinely adjusted. The number of normatives used each year and the values applied to each varied radically between 1996 and 1998 (see appendix 7.1). In part this variation reflects the newness of the government structure and attempts by the government of Hungary to fine-tune the transfer system, but it also may reflect manipulation to meet political objectives. The use of more normatives is encouraged by advocates for specific programs who want to see funding linked to service characteristics. Annual changes in the major social welfare normative, for which the factors and their definitions are changed every year, provide an excellent illustration of how the structure is altered. The education normatives also have been subject to significant changes as the number of normatives and the value linked to each have been adjusted radically during the past years. One outcome is that municipalities cannot accurately anticipate their revenues from one year to the next.

Frequent changes in the normative structure complicate a system that is already confusing and administratively complex. Population normatives can be calculated easily using estimates provided by the Central Statistics Office. The beneficiary normatives, however, require careful compilation. For example, schools must follow detailed instructions on how to calculate the number of students. Many normatives, such as the number of students in class in grades 9 and 10, the number in grades 11 through 13, the number eating lunch at school, and so forth may apply to the same school, so many separate counts must

be kept. One case was observed where 23 normatives applied to a single school. Generally, these normatives are based on the average number of students each day, so daily counts (sometimes more than once per day) must be maintained. The academic year crosses two fiscal years, so schools and local governments must follow two different sets of definitions and normative values during the same academic year.

Budgeting for normative grants begins with agreement among the central government, the Parliament, and local governments on the total amount to be distributed. Simultaneously, as part of the national budget planning process, local governments provide estimates in the fall on the expected number of beneficiaries and the other factors that go into calculating the normative grants for the following year. The total number of beneficiaries is used to set an average amount (the normative's value) that is the basis for the distribution across governments. The normative values are then used to calculate the amount that each local government is to receive. The local governments do not find out how much they will get until March. Payments based on these calculations are regarded as preliminary, and actual normative payments are determined after the number of beneficiaries is determined at year's end. Local governments receive additional amounts if they underestimated the number of beneficiaries and must repay excess amounts if they overestimated beneficiaries. Interest is charged if the difference between the total estimated and total actual amount exceeds 5 percent. The State Audit Office inspects some municipalities to determine if the counts given by schools and other sources are accurate. A final reconciliation based on the audits can result in additional payments to local governments or a return of money if overpayments were made. The State Audit Office examines normative grants in about 500 municipalities per year and performs comprehensive audits in about 40 to 50 other municipalities.

Despite the administrative difficulties, the normative system offers two advantages for the intergovernmental transfer system. First, it links transfers to expenditure needs, ensuring that revenues are positively correlated with needs. Second, it provides transfers to the local governments making the expenditures. The close linkage between transfers and expenditure responsibilities is important because many services are not provided by all municipalities. For example, only about 120 municipalities operate hospitals, and most municipalities operate secondary schools. Changes in the structure should be focused on reducing the problems while retaining some aspects of these strengths.

Earmarked Operating Grants

Funds from a number of grants are earmarked for specific purposes, such as annual grants for theaters and fire protection, and the ethnic normatives mentioned above. In addition a series of earmarked grants called "centralized appropriations" (Ft 37.8 billion in 1998) have purposes that can vary from year to year. Accumulation reviews inside the state budget and funds from budgetary institutions are not categorized as centralized appropriations because

they may also be provided to entities other than local governments. In 1998 centralized appropriations were made for children's programs (Ft 9.5 billion), teachers' education (Ft 3.5 billion), textbooks (Ft 1.6 billion), severance pay for employees (Ft 1.5 billion), subsidies for public utility user fees (Ft 3.4 billion), public utility investment (Ft 2.5 billion), and elderly care (Ft 5.1 billion). Sectoral ministries also have revenues to finance delivery of specific operational programs, and some of these funds are granted to municipalities. In the budget accounts these amounts are called "funds from budgetary institutions." The total value of such programs was Ft 8 billion in 1998, the same as in 1997. The Ministry of Culture and Education, which provides grants for information technology, staff training, subsidies for school books, and other purposes, is responsible for much of these funds. The grants from centralized appropriations and funds from budgetary institutions are normally provided directly through sectoral ministries, based on guidelines that were developed according to sectoral legislation. The ministries often have considerable flexibility for making the specific allocations of these grants.

Extrabudgetary funds provide earmarked operating revenues. The largest of these revenues is the social security fund, which is used to finance health services including services provided through municipalities. Much of the revenue is distributed as reimbursement for the costs of service delivery. The labor fund, the second largest, assists municipalities in financing unemployment insurance benefits for people whose initial unemployment benefits have expired.

Investment Grants

Investment grants finance specific projects that normally are selected through competitive bidding processes. In most cases the transfer of these funds occurs as payment on the basis of invoices for actual expenditures, rather than through direct transfers to local governments. The funds are generally earmarked, because they are intended for specific projects. The projects often involve implementation across several years, so the grantors frequently make multiyear commitments. The funds remain unused in about 10 percent of the cases because local governments decide not to undertake the investment or are unable to provide their cost share.

Four categories of investment grants are made directly through the central government budget: addressed, targeted, discretionary and regional development grants. Other grants may be made through the centralized appropriations described above. For example, in 1998 an appropriation was budgeted to fund sewer systems in Budapest and the 22 cities with county rights.

Addressed and Targeted Grants

Addressed and targeted grants are the largest categories of investment grants, financing an estimated 60 percent of all local investments (Kopányi, Inel and Papp 1998). Addressed

grants generally provide 100 percent funding and are made for large projects that have significant spillover benefits. The projects are selected by the Parliament, normally on recommendations from the Ministry of Interior and the sectoral ministries.

Targeted grants are normally for smaller projects with lower spillovers and are matching grants that have an average of 50 to 60 percent national and 40 to 50 percent local financing. The grant component is increased 10 percent if the grantee is a municipal association. Between 1993 and 1995 the percentage paid by the central government varied by type of project from 90 percent for clean water projects to 30 percent for improving primary school classrooms (Urban Institute 1996). The percentages paid by the central government were lower in 1996 than in 1993–1995.

Priority areas for targeted grants are set in the annual Budget Act. The major priorities for 1998 include management of solid waste, rehabilitation of dilapidated primary schools, purchase of medical equipment, and operation of sewage and water systems that are linked together. Project applications are reviewed by the County Treasury and Information Service Office, the Ministry of Interior, and the sectoral ministries. All municipalities are entitled to apply for targeted grants, and applications that meet all criteria are automatically approved, though funding may not be available.

Other Discretionary Grants

Sectoral ministries and extrabudgetary funds make grants for investments in the same manner as they do for operational purposes. These revenues are called “accumulation revenues” within the state budget in the financial accounts and amounted to Ft 9 billion in 1998, down from Ft 10 billion in 1997. The extrabudgetary funds and sectoral ministries each have priority areas that were established by the Parliament, but each has considerable flexibility in making the grants. Local governments and nongovernmental entities can apply for grants through these programs. Some programs require that a minimum percentage of the grants be made to local governments (for example, 65 percent of water fund grants).

Three extrabudgetary funds make grants to local governments—environmental protection, roads, and water management. Each fund operates under a long-term plan approved by the Parliament. Agendas overlap to some degree, particularly between environmental protection and water management. The extrabudgetary funds are financed through a variety of means. For example, the road fund is financed mostly with an excise tax on fuel, but the portions available for grants to municipalities (less than Ft 1 billion) come from a 25 percent share of the central government’s part of the motor vehicle tax. Each fund has a separate decision-making mechanism for selecting the projects to finance. The environmental protection fund makes grants or loans for water and sewer (approximately 28 percent of the total), solid waste (about 25 percent), and air pollution. Financing for municipalities normally is in the form of grants, and is given with the expectation of 50 to 60 percent local cost sharing. The water management fund provides grants for water and sewer projects, using financing from a portion of the water consumption fees. The

road fund makes small grants to local governments to improve connector links to national roads. Grants provided by the Ministry of Social Welfare for hospital equipment are also categorized as accumulation revenues within the state budget.

Regional Development Grants

Two grant programs are administered through the county regional development councils that were formed in anticipation of European Union (EU) membership. The regional councils are not local government bodies, though they include local government officials in addition to private sector representatives and others. These grant programs allow some investment funds to be allocated based on regional rather than national priorities. Grants from both programs must be made in accordance with the counties' development plans.

The first program, regional equalization grants, is targeted toward distressed and less developed municipalities. Formally, the regional subsidies are made through the Ministry of Environment and Regional Development and the regional equalization grants are made through the Ministry of the Interior. The ministries use a scoring system (which is approved by the Parliament) to determine the distribution of revenues across counties and then allow the regional development councils to make specific allocations. The subsidy is 10 percent greater if the grantee is a municipal association. The second program, regional development targeted appropriations, is available for all purposes and for local governments and nongovernment entities. Either grants or recurrent subsidies can be given. Some private sector grants include interest subsidies. The grants are made with the requirement of at least 20 percent local funding, though no explicit mechanism ensures that local governments meet their commitments. The regional development councils normally provide grants of under Ft 200 million, and these grants are given in place of smaller targeted grants. Larger grants still must be obtained through the addressed and targeted grant structures. This financing dichotomy may provide incentives to increase or decrease the size of projects, depending on which structure offers the best terms and easiest access to grants.

Coordination of Investment Grants

Investment grants are poorly coordinated because the volume of applications is huge and the number of granting agencies is large. Municipalities often bid for every possible grant with the hope of being successful on an acceptable share. One municipality indicated that it submits as many as 1,000 applications annually, though only a small portion of these applications request significant resources. As a result, each municipality often applies for multiple grants for the same project and for grants for many different projects. Municipalities have many incentives to bid for numerous grants. Uncertainty about the overall grant system causes local governments to apply for funding now because they worry that it will not be available later. All schools or other institutions in a municipality may apply for the same grant program. Municipalities are not prohibited from simultaneously

applying for and receiving grants for the same project through many of the programs described above. For example, water and sewer projects can be funded through the addressed, targeted, environmental protection, water fund, and regional grant programs, and possibly through others.

Most grant programs receive applications for much more financing than is available. For example, the road fund annually receives about 1,000 applications, of which it can fund about 150. Furthermore, the volume of applications precludes granting agencies from undertaking comprehensive reviews of the applications. In fact, projects are seldom evaluated in terms of their economic viability. Factors such as the local government's ability to finance its share of the cost play a much greater role in the decision process than project quality, even though the fungibility of resources means little information is available on a local government's apparent financial capacity. All of these considerations increase the chance that decisions are based on grantsmanship and political criteria.

Some organizations, such as the environmental protection fund, make grants based on recommendations from interministerial committees, which allows for some coordination between grantors. Unfortunately, these committees have not resulted in a well-coordinated system. Grantors often have different application processes, filing requirements, and selection criteria.

Poor coordination results in four problems. First, project selection is likely to be sub-optimal, both for allocations across sectors and for choice of projects. Second, some projects have received grants totaling more than 100 percent of their cost. The quality of projects proposed by local governments can be seriously diminished, because the governments have little incentive to select optimal projects when the entire cost is borne externally. Third, conflicts between agencies can result in project work commencing, but never being completed, because some sources of finance fail to materialize. The different granting sources may make financing available on inconsistent schedules, particularly for multiyear projects. Finally, significant administrative burdens are created for both local governments and the central government.

Government resolution 263/1997 was adopted to allow more effective coordination of the resources managed by the ministries and the extrabudgetary funds. The resolution also allows the Treasury to monitor disbursements of grant funds from the different sources. Resolution 263 also permits the Treasury to ensure that debts owed the central government are met prior to any disbursement of funds. The system for implementing the resolution has not been fully developed, and the resolution is best characterized as laying out an objective. The expectation is for a single tender to be issued for all projects of the same type. Local governments will apply once to the institution where the largest grant is being requested. The evaluation process for all prospective grants for each project is to occur simultaneously, and the institution receiving the proposal is responsible for coordination with other potential grantors. Presumably, this arrangement will allow better overall targeting of investment funds and will reduce the possibility for excessive grants. At this time ministries have different willingness to cooperate in the disbursement of grants;

some want an improved process and others want to maintain their independent ability to influence the grant-making process.

Deficit Grants

Deficit grants are provided to assist local governments that have deficits through no fault of their own or local governments that go bankrupt. The total value of these grants was Ft 7 billion in 1998, up slightly from the 1997 level. During the year the aggregate value of deficit grants can be increased using unspent funds from the addressed and targeted grant programs. In recent years the number of applications for deficit grants has increased dramatically from only a small number to over a third of all local governments.

A series of criteria has been established by the Parliament to determine which local governments qualify for the grants. These criteria include the following:

- Municipalities must levy local taxes (in practice this requirement seems to be interpreted as meaning the business tax).
- Capital expenditures must be less than capital revenues (presumably to ensure that current revenues are not being used to finance investments).
- No deposits with duration of three months or more may be made.
- The grants are made only to assist governments in covering mandatory tasks.

Local governments must make application for deficit grants to the County Treasury and Service Information Office by April 30 and September 30 of the year in which the grant is to be made. This office analyzes the applications to determine whether the local governments qualify and reports its findings to the Ministries of Finance and Interior, which make a joint decision on whether a grant should be made and for how much. The decision is then presented to the Parliament for review.

Deficit grants create perverse incentives because local governments can increase their grant revenues through behavioral changes. As a result, local governments that appear to be in relatively good financial condition can receive deficit grants. Local governments have an incentive to raise less of their own revenues and to increase expenditures on mandatory services. Certain revenues can be shifted from covering mandatory to nonmandatory expenditures, and deposits can be held for periods just short of three months. Thus, the grant received by a municipality can depend heavily on its grantsmanship skills.

Overall Characteristics of the Grant Structure

The transfer system can be summarized as:

- very large by international standards
- *ad hoc* in aggregate size and distribution

- administratively complex
- necessary to achieve vertical balance, given the limited revenue-raising authority of local governments
- enhancing the equalization of local government revenues
- partially aimed at encouraging local governments to carry out national priorities
- distorting the efficient behavior of local governments.

Importance of Transfers in the Intergovernmental Finance Structure

The share of local revenues provided through transfers is relatively high in Hungary. Wide variation exists across Europe and the world in the percentage of revenues raised through transfers (see table 7.2). Cross-country differences in the role of transfers arise because of divergences in local government service delivery responsibilities, priorities on equalization, local own-source revenue raising capacity, political judgments, and other factors. Transfers tend to play a large role in transition countries because of limited access to local own-source taxes. The share of revenues from transfers is high in Hungary, even by the standard of the transition countries (lower than Bulgaria, but the same or higher than other transition countries). Data in table 7.2 are for 1996, when a lower percentage of revenues came from transfers than the 72 percent in 1998 (see table 7.3). The availability of privatization revenues is one explanation for lower transfers in 1996 and 1997.

Table 7.2 Percentage of Local Government Revenues from Transfers, 1996

| <i>Country</i> | <i>Percent</i> | <i>Country</i> | <i>Percent</i> |
|----------------|----------------|----------------|----------------|
| Albania | 94 | Italy | 38 |
| Austria | 35 | Netherlands | 60 |
| Belgium | 78 | Norway | 33 |
| Bulgaria | 78 | Poland | 60 |
| Czech Republic | 45 | Romania | 38 |
| Denmark | 24 | Slovakia | 39 |
| Finland | 31 | Slovenia | 67 |
| France | 26 | Sweden | 19 |
| Germany | 45 | Switzerland | 18 |
| Greece | 58 | United Kingdom | 77 |
| Hungary | 66 | | |

Source: Council of Europe 1997.

One justification given for such a large component of Hungarian local government finance coming from transfers is that local governments are responsible for health care and

Table 7.3 Intergovernmental Transfers as a Percentage of Revenues, 1993–1998 (percentage)

| <i>Local government revenues</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| Shared revenues | | | | | | |
| PIT | 8.46 | 8.69 | 11.85 | 10.77 | 13.28 | 16.37 |
| Vehicle tax | 0.43 | 0.35 | 0.31 | 0.75 | 0.78 | 0.74 |
| Tax on land rental | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.09 |
| Shared revenues total | 8.89 | 9.04 | 12.16 | 11.52 | 14.06 | 17.20 |
| Accumulation revenues within the state budget | 1.13 | 2.18 | 0.94 | 1.26 | 0.98 | 0.79 |
| Accumulations revenues total | 1.13 | 2.18 | 0.94 | 1.26 | 0.98 | 0.79 |
| State transfers and grants | | | | | | |
| Normative subsidies from central budget | 37.14 | 31.41 | 29.45 | 24.64 | 25.06 | 24.17 |
| Subsidies to theaters | 0.40 | 0.34 | 0.33 | 0.37 | 0.42 | 0.42 |
| Addressed and targeted subsidies | 3.17 | 3.48 | 3.06 | 2.49 | 4.50 | 3.76 |
| PIT supplement | 1.12 | 0.92 | 0.00 | 0.00 | 0.00 | 0.00 |
| Deficit grant | 0.27 | 0.62 | 0.89 | 0.57 | 0.59 | 0.63 |
| Other subsidies (centralized appropriations) | 2.26 | 4.19 | 4.13 | 5.62 | 3.58 | 3.31 |
| Subsidies to local fire departments | 0.00 | 0.00 | 0.32 | 0.77 | 0.86 | 1.02 |
| Supplementary grants to certain education tasks | 0.00 | 0.00 | 0.00 | 0.00 | 0.32 | 0.57 |
| Investment grants for regional equalization | 0.00 | 0.00 | 0.00 | 0.06 | 1.08 | 0.79 |
| Decentralized targeted investment grant | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.38 |
| Public employees wage, minimum wage | 0.92 | 1.30 | 0.80 | 0.00 | 0.00 | 0.00 |
| Other regrouped revenues | 0.03 | 0.18 | 0.49 | 0.23 | 0.00 | 0.00 |
| State transfers and grants total | 45.31 | 42.44 | 39.46 | 34.75 | 36.41 | 35.05 |

| <i>Local government revenues</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Transfers within general government | | | | | | |
| Funds from Social Security | 15.84 | 16.64 | 16.08 | 15.78 | 16.55 | 16.71 |
| Funds from extra-budgetary funds | 0.41 | 0.49 | 0.43 | 1.35 | 1.47 | 1.66 |
| Funds from budgetary (chapters) institutions | 0.82 | 0.94 | 0.76 | 0.77 | 0.78 | 0.70 |
| Budgetary supplements and refunds | 0.86 | 0.71 | 0.15 | 0.14 | 0.15 | 0.09 |
| Transfers within general government total | 17.93 | 18.78 | 17.43 | 18.04 | 18.95 | 19.16 |
| Total transfers | 73.26 | 72.44 | 69.98 | 65.57 | 70.40 | 72.20 |
| Revenues total | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

Source: Ministry of Finance data.

education, and many central government officials appear to believe that the wages should be financed nationally. Transfers would still be more than 50 percent of local revenues, even with these categories excluded.

Ad Hoc Grant Financing

Although a number of detailed mechanisms for determining the allocation of grants (tax sharing, the formula for normatives) are available, the implementation of the system has varied significantly from year to year, giving it an *ad hoc* nature.

The percentage of PIT allocated by derivation has varied every year, from 100 percent in 1990 to 30 percent in 1994 to 5 percent in 2000. This variation leaves localities with little certainty about what proportion of PIT collections they will retain from year to year.

The amounts used to finance other normatives and earmarked, deficit, and investment grants are determined each year through the annual Budget Act process. Normatives are regularly redefined, leading to a degree of uncertainty. *Ad hoc* transfers account for more than two-thirds of transfers to local governments.

The contribution of different grant categories to overall local finance has changed dramatically since 1993 (see table 7.3). Shared taxes, particularly the PIT, have risen markedly as a percentage of total transfers. Social security and other extrabudgetary funds have also increased their relative contribution. The normative grants, by contrast, have fallen dramatically since the early 1990s, primarily because of the way revenues are categorized in the budget rather than because of a change in the financing structure. If the normative-like grants had been recategorized from PIT sharing to normatives, the percentages would not have changed significantly (table 7.4).

Table 7.4 Categorization of Grants

| <i>Financing source</i> | <i>Local control over funds</i> | |
|-------------------------|---|--|
| | <i>Earmarked</i> | <i>Flexible</i> |
| <i>Ad hoc</i> | Theater Fire brigade Ethnic education normatives Centralized appropriations Most extrabudgetary funds Accumulation revenues inside the state budget Funds from budgetary institutions | Deficit grants Most normatives |
| Shared tax | Road fund | Derivation based personal income tax Land tax Motor vehicle tax Selected normatives |

Source: Hegedüs 1998.

Each country's central government makes political judgments on its aggregate support for the local government sector. Key differences concern whether *ad hoc* decisions are made each year or whether the central government sets a broad policy that is expected to last for a period of years. The Hungarian central government and the Parliament appear to evaluate most transfers to local governments as a package and to raise or lower the components annually to achieve intended objectives. Indeed, the implicit plan may be to determine annually the total amount of resources in the local sector. Local government officials agree that a total is negotiated annually, and one category of grants is reduced as another is raised so that the total is reached. The annual negotiations seem to center around shared taxes and most other transfers. Extrabudgetary funds and ministry programs that can be delivered through local governments or nongovernment entities are excluded. The perception that transfers are budgeted as an aggregate is reinforced through their explicit summing in the budget.

To the extent that the overall grant structure is seen as a package, sharing taxes, such as the PIT, does not have any practical influence on the total amount of revenues local governments ultimately receive. The PIT shared by derivation affects the distribution between local governments, even if not the total amount. Thus, the two-year lag for receipt of PIT revenues does not reduce the overall amount of local government revenues, though it can change their distribution across local governments. This relationship can explain why local governments do not appear to place a high priority on reducing the lag. The dominance of *ad hoc* revenues in the financing package allows for easy adjustments to offset patterns in shared revenues. For example, normative grants can be lowered to offset higher shared tax revenues. The frequent changes in the number and value of normatives certainly suggest that this offset is the intent.

Administrative Complexity

The intergovernmental finance system entails high administrative costs for the central and local governments. The complicated structure results in part from the wide range of goals that the central government is seeking to achieve. Still, the goals could be accomplished with a simpler system. The process of calculating and disbursing the normatives requires significant effort, even though the revenues are not earmarked for the expenditure categories to which they are linked. Similarly, the investment grant process is very expensive because significant effort is devoted to preparing and assessing grant applications. Administrative costs for the grant system are small, however, relative to the costs of collecting the same revenue with local government taxes.

Achieving National Objectives

No explicit statement is available on the transfer system's goals, so it must be interpreted based on: (a) its apparent objectives and (b) practices in other countries. Transfers are normally

made for one of three reasons. First, transfers are provided to enhance overall vertical balance, which exists when each level of government has access to sufficient revenues to meet its expenditure responsibilities. The notion is that the central government has access to more productive taxes (value added, corporate income, and personal income taxes) than local governments, and these revenues should be shared with local governments where much of the expenditure responsibility lies. Second, grants are used to achieve a desired degree of horizontal balance because local capacity to raise own-source revenues differs widely across areas. Third, transfers are used to encourage local governments to carry out national priorities.

Vertical Balance

Given the broad responsibility of local governments, creating vertical balance is a key role for the transfer system. Local government expenditure responsibilities are well in excess of available own-source revenues, and national revenue capacity is well above the expenditure responsibilities. Of course, an alternative approach would be to lower national taxes and transfers to local governments and to allow local governments much more authority to raise revenues from own sources. This option is considered further below.

Horizontal Balance

Wide differences exist in per capita local government revenues from the derivation-based PIT sharing and business taxes. Per capita business tax revenues vary more than PIT revenues (Ministry of Finance 1998). Ensuring local governments a minimum level of per capita PIT revenues and providing normative grants are the most significant mechanisms for reducing horizontal imbalances. Through these programs, the structure can be thought of as contributing greater revenues to places that have lower capacity (less PIT revenues) and to places that have greater expenditure needs (larger populations and more beneficiaries). Grants provided to distressed municipalities and places that have deficits through no fault of their own are also intended to reduce horizontal imbalances. Finally, some grants made through the county development councils are targeted toward the least developed areas. Despite these various programs, differences in actual expenditures remain. For example, 1995 per capita expenditures varied from Ft 52,900 in local governments that have 2,000 to 4,999 people to Ft 79,400 in places that have 20,000 to 49,999 people to Ft 123,800 in Budapest (Fox, Melhem, and Péteri 1995). The spending differences can be caused by variations in service demands, expenditure needs, or revenue capacity.

Most grant systems around the world seek to reduce imbalances, but not to achieve complete equality in spending, because a trade-off exists between giving local governments incentives for efficient behavior and equalizing local revenue capacity or spending levels. For example, local government incentives for raising revenues often are lessened by revenue equalization, though this distortion can be avoided if the capacity to raise revenues rather than the revenues is equalized.

National Priorities

The transfer system can assist in accomplishing two types of national priorities: targeting expenditures to high priorities and achieving overall macroeconomic objectives. An important reason for high national prioritization is often that some services, such as health care, transportation, and education, create externalities, meaning that people living outside the direct delivery area benefit from the services. Local governments have a tendency to underprovide these services because the governments ignore benefits for nonresidents. In these cases the central government can use the transfer system to encourage local governments to provide efficient service levels. A national policy can also provide minimum service levels in areas such as health care. The central government should finance these service mandates.

As discussed above (see table 7.3), the government of Hungary earmarks transfers for theaters, fire protection, and investment expenditures. Theaters and fire protection are unusual services to be financed with earmarked grants because the benefits are likely to be very localized and have limited geographic spillovers. Local rather than national priorities usually should set service levels in these cases. By contrast, investment expenditures are often targeted for areas, such as clean water and sewer, that may have significant spillovers and that have been high national priorities. The grants have been effective at getting local governments to select these projects.

The normative grant system appears to have an underlying theme of encouraging local governments to provide services that are national priorities. Local governments retain considerable flexibility to spend the normative grant resources on other programs, however, and at least in the case of social welfare the grants have not been spent as the Ministry of Social Welfare had hoped. Thus the normative system has not been structured to affect spending on national priorities.

The central government can also use the transfer system to accomplish macroeconomic goals. A frequent concern across the world is that the aggregate of local government fiscal trends could dampen the effects of national fiscal policies or exacerbate cyclical trends. The dominant role of transfers in local finance lessens the macroeconomic concerns because the central government can adjust local government revenues to support overall macroeconomic policies.

Effects on Efficient Local Government Behavior

The transfer structure can have a significant effect on whether local governments operate efficiently. Specifically, the grant structure can influence local governments' accountability, planning, local revenue raising, and project identification.

Accountability

A key expectation of governments is accountability to their citizens. Most analysts agree that governments are more accountable for revenues that they raise through their own efforts, at least in part because people are often unaware of revenues that are transferred from one government to another and often do not know which government to hold accountable for their efficient use. The spending government also is not required to defend taxes when services are financed using transfers. For these reasons, local governments like to finance services with transfers. Local government accountability is probably significantly hampered by the large role played by transfers.

Predictability and Planning

Governments must be able to predict their revenue flows if they are to engage in effective short-, medium-, and long-term planning. Some degree of unpredictability is inherent in all revenue structures because of the complicated relationship between revenue structures and economic growth. Developing a predictable revenue system and undertaking effective planning are particularly difficult, however, when transfers are based on annual decisions and budget negotiations. As noted above, about two-thirds of transfers are determined by annual decisions of the central government and the Parliament. The problem is exacerbated because the distribution across local governments is uncertain until well into the fiscal year.

Raising Own-source Revenues

The transfer system must be structured to encourage (or at least not discourage) the generation of local own-source revenues so that local governments can be held more accountable, can plan more effectively, and can meet local service demands. Citizen satisfaction also can be enhanced because people are better able to relate receipt of services to payment of local taxes than to payment of national taxes.

Local governments have disincentives to raise own-source revenues. One reason is that the small size of own-source revenues means that big relative increases in local taxes have only a modest effect on total revenues. Local officials see little value in confronting the political consequences of higher taxes when effects on local service delivery will be limited. Additionally, local governments have a disincentive to raise revenues if they believe that transfers will fall as a result. This decrease can occur in two ways. First, if all local governments raise more revenues, the central government can respond by lowering the amount of transfers and leaving the overall local sector with no additional resources. Local governments generally are apprehensive that the central government will respond this way and use this fear as an excuse not to raise own-source funds. Second, in some cases the trade-off between the revenues of specific local governments and their transfers is direct. For example, deficit grants are a disincentive for local governments to impose their own taxes.

The aggregate size of deficit grants is small, but many (perhaps most) local governments receiving these grants are not using their maximum capacity to levy local taxes.

National taxes can be lowered as local governments generate more of their own resources. The need for lower national taxes in combination with greater local revenue generation may be particularly significant in Hungary where the aggregate tax burden is high.

Incentives to Adopt Good Projects

A good project finance structure is one component of a system that leads to selection of optimal investment projects. Anecdotal evidence suggests that local governments select projects based on whether grant funding is available and that local government officials view receipt of grants as an important measure of their success. In some cases grants are intended to encourage local governments to select projects that are in the national interest, such as when grants are used to entice local governments to invest in projects that have large benefit spillovers. In other cases, however, local governments may simply elect to undertake projects because most of the funding is external, and the specific use of the funds may not be compelling.

Poor design of transfer programs can cause local governments to select projects that are too large, not the most important priority for local needs, or based on inappropriate technology. Grants, particularly matching grants, change the cost of projects to municipalities, so the same project selection decisions will not be made when financing is entirely local as when national funding is available. Furthermore, decisions on project characteristics can be skewed by grant requirements. For example, provisions in the application process can lead to such practices as building water or sewer projects that are too large or selecting a technology that is not the best for the particular use (see chapter 28). Additionally, local governments can be expected to opt for projects that have high initial investment costs and low operating costs to ensure that national funding plays the maximum role in financing infrastructure services.

Two methods for improving the process are obvious. First, the central government should develop tighter selection criteria and more detailed review processes to ensure that selected projects are economically viable and are of the highest priority. The government must reduce number of applications if the review is to be more than cursory, and tighter application criteria can be an important step in this direction (for example, more stringent limitations on local governments or projects considered for targeted grants). Second, local financial contributions, a frequent expectation of grants, must be large enough to ensure that local governments are forced to consider the real costs of each project. Conceptually, the local financial share of projects should equal the share of benefits received by local residents, and the national share should equal the proportion of benefits that occur as spillovers. The local government's matching share is often very small, however, causing access to national financing to dominate local decisions on which projects to consider.

Local governments should make investment decisions based on lifetime project costs, including investment, operations, and maintenance. In many cases user fees fail to cover operations and maintenance and investment costs. The best option is to increase user fees. In the event that fees are not increased, local governments may not perceive the full implications of shortfalls, depending on the financing mechanism. One possibility is for planners to view future recurrent costs as a national rather than a local responsibility, since local recurrent budgets are financed mostly through transfers. Under this scenario new investments reflect a future commitment by the central government to provide sufficient lifecycle financing. Another possibility is that transfer revenues will not rise with the recurrent costs. This possibility means local governments incur greater risks as they take on the additional operating costs associated with new investments because a means to finance the costs must be found. Local governments could reduce expenditures on other services, undermaintain the new infrastructure, or raise additional local revenues. A final possibility is for local governments to shift some expenditures to county governments to free up resources.

Options for Enhancing the Transfer System

The intergovernmental transfer system evolved rapidly during the 1990s and offers a number of positive features. Still, opportunities for further development are apparent. This section outlines some modifications that could be made and addresses changes in the context of EU membership. Changes cannot be seen in a vacuum because local government budget constraint requires that local government spending equal local own-source revenues plus intergovernmental transfers. Relationships between the three elements of the fiscal equation mean that reformers must develop the best transfer scheme in the context of the entire local government sector. The starting point should be decisions on local government service responsibilities. Then a system for financing these services, using both intergovernmental and own-source revenues, must be identified. This section examines only the intergovernmental finance component of the local government sector.

The transfer system can be modified to enhance three aspects of local government behavior: accountability, predictability, and administrative costs. These improvements can be achieved through two basic changes in the local finance system: imposition of local income tax surcharges and use of a simplified formula grant structure. Analysts of the local government sector have previously suggested both ideas.

Local Income Tax Surcharge

Reducing the shared PIT combined with allowing local governments the authority to impose PIT surtaxes would be an effective way to improve accountability. Income surtaxes are used in a number of countries including Belgium, Canada, Denmark, Sweden, and the

United States. The central government should lower national PIT rates correspondingly to maintain the share of personal income paid in taxes. Local governments would be permitted to use surtaxes as necessary (though a maximum rate could be imposed) to replace lost shared tax revenues and to expand local revenues if additional responsibilities are devolved to local governments. This set of policies would make local governments more accountable by requiring them to enact legislation to generate more of their own revenues and by allowing residents to be more aware that revenues are being spent by their local governments. Local governments also would have a greater capacity to set differential tax rates according to variations in local service demands. Of course, the resulting horizontal imbalances (which would not be very different from the current derivation-based tax sharing) are a disadvantage because the per person income tax base will differ widely between areas. The grant formula described below can reduce horizontal imbalances.

A minimum surtax rate could be imposed to limit tax competition between local governments. The minimum can be set by either continuing to have some tax sharing or enacting legislation that sets a minimum local rate, because the effects are similar. Administration of the surtaxes would not be very different from the existing shared taxes—the Tax Department would still be required to report revenues based on where people live. A significant difference is that the Tax Department would need to collect the tax revenues at surtax rates that differ between local governments. Also, local governments would place much more pressure on the Tax Department to reduce the two-year lag in distribution of PIT revenues.

Grant Formula

A simplified grant formula could make revenues more predictable and reduce administrative costs. Revenues would be more predictable if the grant formula was developed and left in place for several years. The system would also be more predictable if the factors used to determine the amount granted to each local government did not change radically from year to year. A significant reduction in the number of factors used in the grant formula would also lower administrative costs. Of course, a more limited set of normative grants, investment grants, and other grants could be retained.

Every formula has two components, one determining the total amount of grants for subnational governments and the other deciding how these grants will be distributed between them. The total amount to be transferred would be based ideally on a percentage of total central government tax revenues or of a particular tax. Grants based on a broad set of national taxes are normally preferred because local governments share in the overall capacity of the central government to raise revenues.

The distribution of revenues between local governments is intended to help provide budget balance and to give the greatest assistance to places with the least capacity to provide for their own needs. Intergovernmental transfers based on a formula that provides larger

grants as a local government's expenditure needs rise and as its revenue capacity decreases are the best means for alleviating horizontal imbalances. The formula would have the structure $G = r(E-R)$, where G is the grant amount, E is different measures of expenditure needs, R is different measures of revenue capacity, and r is the amount the grant rises with needs and falls with capacity. A different grant rate could be attached to expenditure needs and to revenue capacity. The normative system operates like part of the equation, where E is the different normatives and r is the value assigned to each normative. The main differences between the existing system and one based on the simplified grant structure are the number of normatives and the role that revenue capacity plays.

The grant formula must be based on objective measures of expenditure needs, such as the number of children of school age, to prevent local governments from altering their behavior to collect more revenues. Local governments can change their grant amount if expenditure needs are based on factors that are under their control, such as number of hospital beds or number of school classrooms. This flexibility results in inefficiencies, because local governments design service delivery to maximize revenues. A major difference from the existing normative system is that a much smaller number of need indicators would be included in the formula (population probably would remain). National priorities can be reflected through the specific expenditure needs that are chosen for the formula. Similarly, objective measures of revenue capacity, such as the amount of revenues that would be collected at average tax rates or regional measures of income, must be adopted to prevent local governments from reducing their revenues to raise their grant amount. A formula based on actual collected revenues gives local governments the incentive to raise less of their own revenues.

Accession to the European Union

Implications of the transfer system after accession to the EU are indirect. The main effects come through the role that transfers play in creating a functioning government structure. The transfer system needs to encourage efficient delivery of services, selection of the best projects, and regional equalization.

The EU expects entrants to have coordinated, effective regional development strategies. To meet this requirement, Hungary has taken the initial step of forming a regional development structure, composed both of multicounty regions and county development councils. Operation of the two infrastructure grant programs is a responsibility of the county development councils, but the multicounty development organizations are not yet operational.

Countries must also have a mechanism for receiving and using EU structural grants. The multicounty and county development organizations can ultimately serve these purposes as they become operational, effective units. The EU requires matching funds, however, and neither organization has any own-source revenue capacity. Both depend on transfers from the national or local governments for financing their grants and operational expenditures.

As noted above, governments normally make more effective decisions when some of the money comes from local contributions. So, for these development organizations to be most effective, a formalized system should be put in place for local money to serve as a counterpart fund for EU investments.

Good use of EU structural funds requires a mechanism for identifying optimal investment projects. The Parliament's allocation of funds across sectors (through the targeted grants, earmarked funds, and centralized appropriations) can serve as the mechanism for reflecting national priorities and for meeting EU objectives, but the existing complex, disjointed system for selecting projects to be funded is unlikely to lead to optimal choices. Grantsmanship and political criteria appear to play very large roles in the selection process. The steps the government has identified to fulfill resolution 263 are a step in the right direction. Greater reliance on local revenue sources including user fees, stringent evaluation of projects in terms of economic viability (cost benefit analyses and so forth), and tighter application criteria (to reduce the number of applications) would all enhance the project selection process and increase the chance that EU structural funds would be targeted to the highest priority areas and would be used for the best projects.

Appendix 7.1

Appendix 7.1 Normative and Normative-like Factors, 1996–1998 (Forint)

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|----------------------------|-----------------------------|-------------------------------------|
| PIT equalization grant | 9,940 | — | — |
| Villages | Up to 5,170 per capita | Up to 7,037 per capita | Up to 8,000 per capita |
| Cities | Up to 6,450 per capita | Up to 8,643 per capita | Up to 9,800 per capita |
| Transfer to county local governments for: | | | |
| Administration, sport, communal, roads, and bridges (based on permanent residents) | 145 per capita | 312 per capita | 450 per capita |
| Institutions operated by the county | — | 956.3 million | 10,800 per beneficiary |
| Lump-sum to counties | 65.8 million | 150 million | 210 million |
| Grants to communal, administrative, cultural and sport functions of municipalities | 1,761 per capita | 1,842 per inhabitant | — |
| Municipalities in depressed areas | — | 1,600 per inhabitant | 1,695 per capita |
| County and capital city administrative, regional, defense, cultural, and pedagogical functions | 512 per inhabitant | 360 per inhabitant | 150 per inhabitant |
| County per capital city cultural activities | — | — | 145 per capita |
| General grants for villages | 2 million per village | 2 million per village | 2 million per village |
| District tasks of municipalities | — | — | 4 million per selected municipality |
| For municipalities defined in Act 78/1997 paragraph 52 | — | — | 200 per capita |
| For municipalities defined in Act 78/1997 paragraph 53 | — | — | 70 per capita |
| Administration, sport, communal activities (based on permanent residents) | 1,637 per capita | 312 per capita | 1,200 per capita |
| Matching grant to local tax on tourism | 2 per tourism tax | 2 per tourism tax | 2 per tourism tax |
| Social welfare grants | 2,800–7,000 per inhabitant | 3,500–10,500 per inhabitant | 2,500–12,500 per inhabitant |
| Child and juvenile protection | 270,000 per beneficiary | 330,200 per beneficiary | 400,000 per beneficiary |

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|-------------------------|-------------------------|-------------------------|
| Social and child welfare | | | |
| Social and child welfare activities (social catering, home assistance, family assistance, and so forth) | — | — | 933 per capita |
| For family assistance institutions | — | — | 300 per capita |
| Municipal manager in municipalities with fewer than 2,000 inhabitants | — | — | 900,000 (total) |
| <hr/> | | | |
| Permanent and seasonal rehabilitation homes | 202,000 per beneficiary | 246,900 per beneficiary | 292,000 per beneficiary |
| Daily homes for elderly | 36,200 per beneficiary | 48,000 per beneficiary | 60,000 per beneficiary |
| Seasonal homes for homeless | 87,000 per bed | 102,200 per bed | 120,200 per bed |
| Homes for handicapped | 289,500 per beneficiary | 337,300 per beneficiary | 391,000 per beneficiary |
| Child care institutions (nursery) | — | — | 161,000 per child |
| <hr/> | | | |
| Kindergarten | 54,000 per child | 60,000 per child | 67,000 per child |
| For part-time kindergarten children | 27,000 per child | — | — |
| For municipalities with fewer than 3,000 inhabitants | 59,400 per child | — | — |
| For nonresident children | 59,400 per child | — | — |
| For joint operation of kindergarten | 62,100 per child | — | — |
| Ethnic kindergarten programs | 62,100 per child | — | — |
| <hr/> | | | |
| Primary education in classes 1–6 | 56,700 per pupil | 64,000 per pupil | 72,000 per pupil |
| Primary education in classes 7–8 | 62,100 per pupil | 68,000 per pupil | 75,000 per pupil |
| <hr/> | | | |
| Education in classes 9–10 | | | |
| Primary | 64,800 per pupil | 70,000 per pupil | 76,000 per pupil |
| Secondary school (high school and special technical schools with high school exam) | 66,200 per pupil | 70,000 per pupil | 76,000 per pupil |
| Vocational school | 45,900 per pupil | 60,000 per pupil | 68,000 per pupil |
| Special vocational school | 51,300 per pupil | 60,000 per pupil | 68,000 per pupil |

Appendix 7.1 Normative and Normative-like Factors, 1996–1998 (Forint) (continued)

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|------------------|------------------|-------------------|
| Education in classes 11-13 | | | |
| High school | 75,600 per pupil | 87,000 per pupil | 96,000 per pupil |
| Special technical schools with high school exam | 79,980 per pupil | 87,000 per pupil | 96,000 per pupil |
| Vocational school | 48,600 per pupil | 60,000 per pupil | 70,000 per pupil |
| Special vocational school | 56,700 per pupil | 60,000 per pupil | 70,000 per pupil |
| Training year after high school exam | | | |
| In special technical schools with high school exam | 86,000 per pupil | — | — |
| In vocational schools | 54,000 per pupil | — | — |
| Additional grants for training schools | | | |
| At classes 9–11 in special vocational schools | — | 20,000 per pupil | 25,000 per pupil |
| At classes 9–11 in vocational schools | — | 40,000 per pupil | 45,000 per pupil |
| Classroom training in vocational and special vocational schools | 48,600 per pupil | 70,000 per pupil | 77,000 per pupil |
| Classroom training in special technical school with high school exam | — | 90,000 per pupil | 100,000 per pupil |
| Practical training in vocational schools | — | 36,000 per pupil | 45,000 per pupil |
| Practical training in special vocational schools | 16,200 per pupil | 28,000 per pupil | 30,000 per pupil |
| Art training at basic level | 35,100 per pupil | 40,000 per pupil | 45,000 per pupil |
| Other public education grants | | | |
| For preparation of professional art examinations in special training schools | — | 28,000 per pupil | — |
| For preparation of professional art examinations in special vocational schools | — | 36,000 per pupil | — |
| For catching up programs in special training schools | — | 10,000 per pupil | — |

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|--------------------------|-------------------------|---------------------------------|
| For adjustment programs of pupils with behavioral problems | — | 3,000 per pupil | 3,200 per pupil |
| For teaching nonresident pupils | | | |
| In primary schools | 5,400 per nonres. pupil | 9,000 per nonres. pupil | 10,500 per nonresidential pupil |
| In 9–10 classes of high school and special technical schools with high school exam | 8,600 per nonres. pupil | — | — |
| In 11–13 classes of high school | 8,600 per nonres. pupil | — | — |
| In 11–13 classes of special technical schools with high school exam | 10,320 per nonres. pupil | — | — |
| For training year after high school exam in special technical schools with high school exam | 12,040 per nonres. pupil | — | — |
| In special vocational school | 5,400 per non-res. pupil | — | — |
| For practical training in special vocational schools | 2,700 per nonres. pupil | — | — |
| In vocational school | 5,400 per nonres. pupil | — | — |
| For practical training in vocational schools | 6,480 per nonres. pupil | — | — |
| Training year after high school exam in vocational schools | 7,560 per nonres. pupil | — | — |
| For joint educational service delivery | | | |
| In primary schools | 8,100 per pupil | 10,800 per pupil | 12,000 per pupil |
| In 9–10 classes of high school and special technical schools with high school exam | 10,320 per pupil | — | — |
| In 11–13 classes of high school | 10,320 per pupil | — | — |
| In 11–13 classes of special technical schools with high school exam | 12,040 per pupil | — | — |
| For training year after high school exam in special technical schools with high school exam | 13,760 per pupil | — | — |
| In special vocational school | 6,480 per pupil | — | — |

Appendix 7.1 Normative and Normative-like Factors, 1996–1998 (Forint) (continued)

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|------------------|------------------|------------------|
| For practical training in special vocational schools | 3,780 per pupil | — | — |
| In vocational school | 6,480 per pupil | — | — |
| For practical training in vocational schools | 7,560 per pupil | — | — |
| For municipalities with fewer than 3,000 inhabitants | — | — | 20,000 per pupil |
| Education in classes 1–6 | 5,400 per pupil | — | — |
| Education in classes 7–8 | 2,700 per pupil | — | — |
| Education in classes 9–10 | 2,700 per pupil | — | — |
| For municipalities with total number of inhabitants between 3,000 and 3,500 | — | 10,000 per pupil | 10,000 per pupil |
| For catering in kindergartens and schools | — | 8,800 per pupil | 13,700 per pupil |
| For afternoon programs in schools | — | 3,000 per pupil | 3,800 per pupil |
| For operation of parental boards in kindergarten, school, or dormitory | — | 100 per pupil | — |
| For operation of pupils' board | — | 200 per pupil | — |
| For sport associations within schools | — | 1,000 per pupil | — |
| For library | — | 2,000 per pupil | — |
| For bilingual schools | 18,900 per pupil | — | 19,200 per pupil |
| For ethnic minority primary school | 18,900 per pupil | — | — |
| For ethnic minority secondary school (high school and special technical school with high school exam) | 25,800 per pupil | — | — |
| For ethnic minority classes in vocational and special vocational schools | 18,900 per pupil | — | — |
| For primary school evening and correspondence courses | 21,600 per pupil | — | — |
| For secondary school evening and correspondence courses | 30,100 per pupil | — | — |

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------------|------------------------|------------------------|
| Private pupils in primary, vocational, and special vocational schools | 16,200 per pupil | — | — |
| Bilingual schools (nonethnic) | — | 10,000 per pupil | 19,200 per pupil |
| Dormitories | 123,200 per pupil | 126,000 per pupil | 135,500 per pupil |
| Special care with rehabilitation purposes | | | |
| Handicapped children's care in special institutions | 123,200 per child | 90,000 per child | 94,000 per child |
| Handicapped children's care at home | 96,800 per child | 90,000 per child | 94,000 per child |
| For handicapped children's care at home or in institutions if they do educational activity or participate in rehabilitation programs | 96,800 per child | 103,000 per child | 130,000 per child |
| For preparatory or developmental training of handicapped children | — | 103,000 per child | 130,000 per child |
| Cultural services | — | 157 per capita | 555 per capita |
| Earmarked grants | | | |
| Grants for theaters (individual allocation) | | | |
| Fire brigades | (discretionary) | | |
| Nonstop service | | | |
| For fire brigade buildings | — | 2,000 per square meter | 3,000 per square meter |
| For vehicles | — | 41 per kilometer | 50 per kilometer |
| For special supporting equipment | — | 250,000 per piece | 300,000 per piece |
| For administrative costs | — | 23,818 per employed | 27,033 per employed |
| For special equipment | — | 225,000 per piece | 250,000 per piece |
| Temporary fire brigade services | — | 1,247,912 per employed | 1,309,698 per employed |
| Personal expenses | — | 997,912 per employed | — |
| Operational expenses | — | 250,000 per employed | — |

Appendix 7.1 Normative and Normative-like Factors, 1996–1998 (Forint) (continued)

| <i>Factors</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|---|-----------------|------------------|------------------|
| Ethnic programs | | | |
| Ethnic kindergartens | — | 19,500 per pupil | 23,000 per pupil |
| For minority language | — | — | 24,500 per pupil |
| Development programs for Roma | — | 23,000 per pupil | 24,000 per pupil |
| Ethnic schools | — | 23,000 per pupil | 24,500 per pupil |
| Supplementary grant for ethnic programs for small kindergartens and schools | — | 18,000 per pupil | 20,000 per pupil |
| Bilingual ethnic schools | — | 23,000 per pupil | 27,000 per pupil |
| Dormitory for Roma children | — | — | 10,000 per pupil |
| Library for ethnic schools | — | 2,000 per pupil | 2,200 per pupil |
| Deficit grant (ÖNHIKI) | (discretionary) | (discretionary) | (discretionary) |

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8 Intergovernmental Transfers in Budapest

József Hegedüs and Gábor Balás

Budapest holds an exceptional position among Hungarian municipalities, representing 19 percent of the population and accounting for one-third of gross domestic product and capital investment. The Law on Self-Government of the Capital City Districts (1991) regulates the status of the Budapest Municipality, which comprises 23 districts and the city, altogether 24 public service units with no hierarchy between the city and the district governments. The municipality receives or collects most of its revenues as one entity. These so-called joint revenues must be allocated between the city and its districts for financing public tasks. The central government has established a general guideline for revenue flows, but made the City Council responsible for the revenue allocation system within the municipality. The districts receive a wide range of responsibility, although they have fewer rights than other local governments in the country (Ebel and Simon 1995).

This chapter analyzes the Budapest revenue-sharing system (RSS), including its procedures and effects on financing local functions and services. The significance of this case lies in the technical and political innovations to solve the problems of vertical and horizontal inequity in the intergovernmental finance system in a complex two-tier municipality.

The Legal Framework for Governments and Public Finances in Budapest

The framework for the revenue allocation system of Budapest is based on two elements: (a) the legal relationship between the municipality and its districts, and (b) the regulation of the revenue allocation. The Act on Local Government and the Law on Self-Government of the Capital City Districts stipulate the capital's government structure. The laws provide for

* This chapter is based on Hegedüs and Balás 2000.

direct election of the lord-mayor, a City General Assembly of 66 members, and 23 district governments. Each jurisdiction has its own elected legislature and mayor. No administrative hierarchy exists between the municipality and its districts, but each district is represented by one nonvoting delegate in the General Assembly.

The assignment of tasks and expenditures corresponds to the natural allocation of functions, which means that district tasks relate to neighborhood services, whereas the municipality's functions are the ones that affect the whole or a large part of the capital. In practice it means that the districts must provide kindergartens, elementary education, basic health and social care, street lighting, and local road maintenance. The municipality is further required to provide educational, artistic, sport, water, garbage collection and treatment, public transportation, social, and health services, if such services affect more than one district. One of the critical issues in the expenditure assignment is that the districts can oblige the municipal government to take over service institutions that have territorial duties. As part of the adjustment process, districts have transferred some educational and social institutions to the municipal government to get rid of financial burdens. As a result, the task and ownership (for example, of a service building) is now often separated, and that separation leads to further financing distortions.

The Act on Local Government defines a cluster of revenues to be shared between the city and the districts in accordance with the services provided or actual expenditures. The shared revenues are central government grants on the basis of inhabitants (except for administration and public education services), local taxes, shared personal income taxes, and other central government taxes. This sharing method has led to radical revenue redistribution.

The General Assembly of Budapest annually passes a municipal decree on revenue sharing that must take the districts' opinions into account. The districts receive the draft bill for comments 10 days before approval. (Before 1995 the municipality and the districts were obliged to reach a consensus on the RSS.) The law provides that the city government receives and ought to channel central government grants to districts before approval of the annual revenue-sharing decree. This political approval process has been continuously questioned by the parties, and a proposal was submitted to the Parliament in early 2000 to shift the revenue sharing approval from the General Assembly of Budapest to the Parliament, but the rules remained unchanged.

Problems in the Financing System of Budapest's Local Governments

The logic of the Budapest revenue allocation system has changed many times since 1991, but some core problems remain. The municipality runs a multilevel equalization system, which must cope with significant vertical and horizontal imbalances. "Vertical imbalance" refers to significant disparities between tasks and tools in different government tiers. In

Budapest the most important differences between the municipality and the districts come from the vertical imbalance that originates in the difference in service provision.

Expenditure assignment in Budapest basically still follows the pretransition structure. Most of the services provided previously by districts (and their budgetary enterprises) remained district responsibilities, and services provided previously by the municipal government (and its budgetary enterprises) continued to be under municipal responsibility (table 8.1). Significantly, tasks vary by nature, and this variation makes the political negotiations concerning expenditure needs at different levels very important. For instance, road maintenance generates different expenditures for the municipality and for the districts because of the different types of roads under their jurisdiction.

Table 8.1 Expenditure Assignment in Budapest, 1997

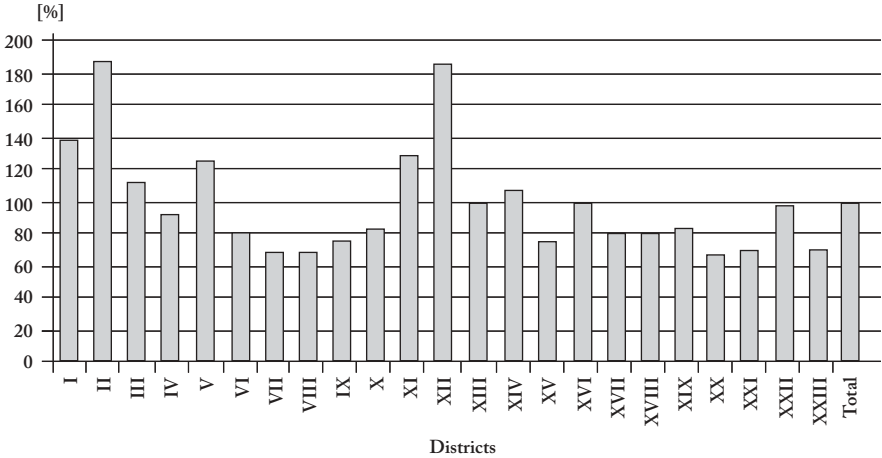
| <i>Expenditure Assignment</i> | <i>Task</i> | | <i>Shares of Costs (%)</i> | |
|--|-------------|------------------|----------------------------|------------------|
| | <i>City</i> | <i>Districts</i> | <i>City</i> | <i>Districts</i> |
| Kindergartens | X | X | 2 | 98 |
| Primary schools | X | X | 3 | 97 |
| Secondary schools | X | X | 65 | 35 |
| Dormitory | X | X | 100 | 0 |
| Basic art schools | X | X | 2 | 98 |
| Schools for handicapped children | X | X | 45 | 55 |
| Education and daily care for mentally and physically impaired children | X | X | 100 | 0 |
| Other schools | X | X | 41 | 59 |
| Day nursery | X | X | 1 | 99 |
| Daily social care | X | X | 4 | 96 |
| Institutes providing accommodation and temporary accommodation | X | X | 94 | 6 |
| Temporary accommodation for homeless people | X | X | 95 | 5 |
| Resident nursery | X | — | 100 | 0 |
| Child and youth protection | X | — | 100 | 0 |
| Attending and nursing the mentally and physically impaired at home | X | — | 100 | 0 |
| Theaters | X | — | 100 | 0 |
| Social supply without accommodation | — | X | 0 | 100 |
| Public education and sport | X | X | 55 | 45 |
| Urban management | X | X | 72 | 28 |
| Administration | X | X | 20 | 80 |
| Public transportation | X | — | 100 | 0 |
| Fire protection | X | — | 100 | 0 |
| Housing maintenance | X | X | 2 | 98 |
| Total | | | 39 | 61 |

Source: Budapest Municipality data.

With horizontal imbalance, different fiscal gaps occur between expenditure needs and revenue capacity across the districts. The lumpy urban development programs of the previous regime and historical differences have led to a dramatic increase in inequality across the districts. Although the center of Budapest is still comparable with western metropolises, some outer districts lack basic urban infrastructure, such as a water and sewage network. These inequalities result in different expenditure needs. Thus a key role of the revenue allocation system is to support a shift toward a more balanced public service structure.

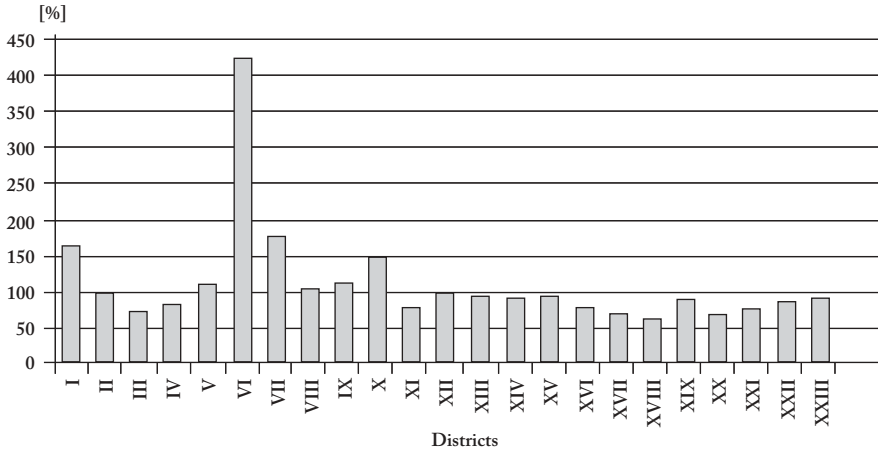
The inequalities in wealth and personal income are also significant. Budapest has its own rich and poor districts; thus, significant social and economic disparities exist across the districts (figures 8.1 and 8.2). These inequalities lead to different revenue capacity and expenditure needs that also favor the rich districts.

Figure 8.1 Personal Income Tax Per Capita by Districts of Budapest



Source: Budapest Municipality data.

Many assets were transferred from state to municipal ownership in the course of the political transition. Municipalities also inherited assets from their predecessor local councils. These assets resulted in a greater disparity across districts (for example, districts in the center and the west side of Budapest obtained more valuable real estate than the others). Moreover, these inequalities in property value were expanded by a boom in real estate prices in the late 1990s that increased the price gap in favor of the center and Buda districts. In early 2000 a four-fold difference in the residential real estate unit price separated the rich and poor districts. These factors have also increased the gap in revenue capacity across districts, although these gaps were partly counterbalanced by the need for refurbishment. Thus the RSS must cope with significant disparities.

Figure 8.2 Per Capita Revenue as a Percentage of the Average

Source: Budapest Municipality data.

The district governments have broad service responsibilities. Some of the services, such as public lighting, can be localized, but most of them are accessible by inhabitants of other districts as well. This spillover effect creates difficulties in defining local responsibilities and measuring expenditure needs, a situation that, in turn, creates other challenges for the revenue allocation system.

Analysts describe three well-known types of policy responses to cope with vertical and horizontal imbalances:

- correcting each imbalance by separate policy measures
- implementing an integrated system of equalization
- correcting only the vertical imbalances and ignoring the horizontal ones.

Revenue sharing and grants are used to reduce imbalances. Revenue sharing is a key tool to handle vertical imbalances, and grants are often used for horizontal imbalances (although revenue sharing is often combined with equalizing techniques to manage horizontal imbalance). The overall intergovernmental finance system also aims at handling both of these imbalances jointly.

The Budapest RSS offers a more radical solution in an integrated equalization system. Most of the central government transfers are channeled to the municipality as a single fiscal entity to become part of joint revenues, and additional revenues are collected directly by the districts. RSS is basically a special gap-financing scheme. The expenditure needs and revenue capacity are calculated according to a mutually accepted method. The joint revenue is then allocated to fill the gap that may occur between the expenditure need and revenue capacity in the budget of the districts and the city. In Budapest, 49 percent of the operating budget was taken into account in revenue sharing in 1998.

New Financing and Revenue Allocation System in Budapest

In January 2000 a new financing system was introduced as part of a three-year reform program to correct the imperfections of the previous revenue allocation scheme, which was established in 1995. As a first step reformers broadened the scope of the allocation system and gave the RSS additional tasks besides receiving discretionary finances. In harmony with the Act on Local Government, the main objective of RSS is to finance services provided by the district and the capital governments. The reform aims to create a system that gives inhabitants access to the same level and quality of services no matter where they live in Budapest. An implicit but more valid goal is to foster equalization (see box 8.1); the official goal was set under the pretext of introducing an equalization system. This introduction is becoming more and more important as the inequality across districts increases for various reasons. Since 1991 the share of the revenues from RSS has been continuously increasing in the budget of the poor districts and decreasing in the rich center and Buda districts (for example, districts 1, 5, and 6; see table 8.2).

Although revenue sharing should lead to a more equitable system, efficiency issues are less significant in the present scheme, albeit local bodies ought to provide public services efficiently matching their expenditure needs and tax efforts.

Table 8.2 The Share of RSS Revenues in Local Budgets (percent)

| <i>Local government</i> | <i>Share of considered revenues from RSS in the local budgets data</i> | |
|-------------------------|--|-------------|
| | <i>1993</i> | <i>1998</i> |
| I. | 47.7 | 28.9 |
| II. | 38.9 | 41.3 |
| III. | 59.3 | 56.2 |
| IV. | 63.7 | 65.4 |
| V. | 29.2 | 20.3 |
| VI. | 41.0 | 23.7 |
| VII. | 34.5 | 22.9 |
| VIII. | 52.8 | 32.5 |
| IX. | 45.8 | 37.8 |
| X. | 50.0 | 29.8 |
| XI. | 47.9 | 45.9 |
| XII. | 49.4 | 42.8 |
| XIII. | 59.6 | 48.9 |
| XIV. | 46.1 | 45.4 |
| XV. | 45.0 | 53.7 |
| XVI. | 63.9 | 56.1 |
| XVII. | 47.6 | 62.6 |

| <i>Local government</i> | <i>Share of considered revenues from RSS in the local budgets data</i> | |
|-------------------------|--|-------------|
| | <i>1993</i> | <i>1998</i> |
| XIX. | 39.5 | 49.4 |
| XX. | 60.2 | 62.9 |
| XXI. | 58.1 | 62.5 |
| XXII. | 29.7 | 51.4 |
| XXIII. | 53.4 ^a | 45.4 |
| Districts average | 48.3 | 42.9 |
| City | 46.3 | 28.2 |
| Municipality average | 47.2 | 34.3 |

Note: a. Data year 1995.

Source: Budapest Municipality data.

Box 8.1 Formulas for Equalization Transfers

Conceptually, four types of formulas describe equalization transfers (Ma 1987):

- The simplest method is a per capita transfer. It needs the least information, but the capacity for equalization is also weak. Such a transfer exists, for example, in Germany.
- The second method takes into account only the fiscal capacity, assuming that the per capita expenditure needs are the same in the different settlements.
- A third method is used when the distribution of equalization transfers is based on needs indicators. A variety of indicators can reflect the fiscal needs of a settlement such as per capita income, unemployment rate, population, density, infrastructure (for example, length of roads). This system typically ignores fiscal capacity because obtaining relevant data is difficult.
- The most complex formula takes into account both the fiscal capacity and the expenditure needs. The degree of this redistribution depends on the tasks taken into account in the revenue-sharing process.

Basic Principles of RSS

One of the basic principles of RSS is to use a transparent, clear, and fair method of calculating the share of resources to be allocated from the joint revenue of Budapest. Using normatives, RSS relies on calculating fiscal needs and revenue capacity instead of using actual historical data.

On the expenditure side, the principle is to take into account the expenditure needs corresponding to the basic tasks of the districts. Between 1990 and 2000 the system accounted for only operating expenditures, mainly those financed by central grants (in several years some form of depreciation was also included). In 2001 the system took into account depreciation and investment needs corresponding to the basic tasks.

RSS tries to handle the districts and the municipality equally, but calculates different RSS grants for services that imply noncomparable tasks for the districts and the municipality. For example, for road maintenance, the municipality must maintain the high

volume main roads and the districts must maintain secondary roads. RSS accounts for different technologies and different expenditures in districts and the municipality.

On the revenue side, RSS tries to take into account all kinds of revenues that are directly linked to expenditures. Since 2000 investment and amortization are also considered on the expenditure side; as a result almost every local revenue is now considered in the system. If the district's revenue capacity can be estimated, RSS accounts the revenue capacity instead of actual revenues.

The RSS procedure consists of the following steps:

- Expenditure needs are calculated using task indicators and expenditure normatives.
- Fiscal capacity is calculated using fiscal norms (for example, transfer norms and unit tax) and natural measurement units (for example, square meters and inhabitants).
- The basic deficit is calculated as the difference between expenditure needs and fiscal capacity.
- The transfer pool (the total amount of joint revenues that are to be shared) is divided into four parts:
 - The major part (almost 95 percent of the total pool) is shared by RSS among districts and the city in accordance with their basic deficits.
 - Four percent of the transfer pool is set aside for the correction of RSS that is required when data errors are corrected.
 - The tourism tax revenues and the central grants for tourist services are separated from the pool and included in one special revenue-sharing scheme.
 - Some small special purpose funds (for example, police support or improvement of the sewage system) are separated into another special cluster.

Expenditure Side of RSS

To begin RSS, planners determine the expenditure needs of the local governments. Before that step can be taken, however, planners must decide which expenditures to take into account in the determination. Distinguishing compulsory tasks, voluntary tasks, and the tasks fulfilled through outsourcing makes that decision difficult, since neither the cost nor the revenues of the outsourced tasks is included in the district budget.

Since the beginning RSS has taken into account operating expenditures of tasks that are supported by state normatives. Since 2000 amortization and renewal, investment and improvement, and housing have also been included. Knowing which services are not included in RSS is also important. The efficiency of the equalization system depends on the ratio between the included and excluded cost items. This ratio became much higher in the poor districts than in the rich ones. The system seems to be able to equalize the poor, but it is unable to catch the rich districts.

Expenditure needs are calculated separately, task by task, and then aggregated. RSS first calculates the municipal average cost per measurement unit, and then multiplies the average

cost (as an internal grant of Budapest) with the measurement units of the 23 districts and the city. Thus the municipal average, not the actual expenditures, determines the calculated expenditure needs for a district.

Despite the problems of this average cost method, the key stakeholders have accepted it. Conflicts arise more often when the expenditure needs for certain tasks (communal services, public administration, and since 2000, investments, amortization, and housing) are calculated by other methods. (See box 8.2.)

Box 8.2 Allocation Formulas

The basic allocation formulas—prepared by an expert team—are the following:

Formula 1 is applied when all or most of the service districts are involved in provision of the given services:

$$EN_{ij} = TC_j / \sum_i (MU_{ij}) \cdot MU_{ij} \quad i = 1, 2, \dots, 24 \quad (8.1)$$

where EN_{ij} is the expenditure needs of task j in service district i ,
 TC_j is the total cost of service j in the municipality, and
 MU_{ij} is the value of measurement unit of service j in service district i .

In cases where a service provision is concentrated in some service districts (or often the city), formula 1 is virtually the same as if the actual costs of the services were considered.

Formula 2 is applied when the cost calculation for the city services are distinguished from the calculation of the other service districts. This method is justified when the city provides a task with quite different scope or content (for example, maintaining Danube bridges or the main grid of pipe services).

$$EN_{c,j} = TC_{c,j} / MU_{c,j} \cdot MU_{c,j} \quad \text{and} \quad EN_{di,j} = TC_{dj} / MU_{dj} \cdot MU_{di,j} \quad (8.2)$$

where index c denotes city, d_i denotes district number i , and d denotes the total value for the districts.

Communal Services

The communal services include tasks such as road and park maintenance and public lighting. Before 2000 expenditure needs for these tasks were calculated differently: total cost was calculated for the city and per capita average cost was calculated for the districts (formula 2 in box 8.2). The districts argued that communal services are not proportional to the population. Moreover, the difference in the content of these tasks is much less than the disparity in the calculated expenditure needs. In 2000 the communal services were divided into three parts: road maintenance, park maintenance, and other communal services. For the first two services, average costs were calculated based on specific data (for example, the length of the roads or the area of the parks in square meters) both by districts and for the city. The third task was handled as before. This change resulted in a more realistic share of expenditure needs across districts, but it has not affected the calculation of the city needs.

Table 8.3 Calculated Expenditure Needs of the Administration Task, 1998

| <i>Local government</i> | <i>Population 1999</i> | <i>Number of officers</i> | <i>Expenditure of administration (Ft million)</i> | <i>Optimal number of officers</i> | <i>Expenditure need of administration (Ft million)</i> |
|-------------------------|------------------------|---------------------------|---|-----------------------------------|--|
| I. | 29,405 | 122 | 451 | 150 | 530 |
| II. | 91,101 | 314 | 856 | 286 | 1,011 |
| III. | 134,621 | 315 | 963 | 358 | 1,265 |
| IV. | 107,458 | 222 | 1,000 | 314 | 1,110 |
| V. | 34,735 | 254 | 1,198 | 165 | 583 |
| VI. | 49,195 | 205 | 955 | 201 | 710 |
| VII. | 69,173 | 287 | 1,109 | 245 | 866 |
| VIII. | 84,069 | 343 | 1,112 | 273 | 965 |
| IX. | 66,031 | 273 | 896 | 238 | 841 |
| X. | 82,718 | 338 | 1,082 | 271 | 958 |
| XI. | 142,419 | 424 | 1,574 | 369 | 1,304 |
| XII. | 65,308 | 285 | 930 | 237 | 838 |
| XIII. | 114,779 | 279 | 1,104 | 327 | 1,156 |
| XIV. | 122,100 | 326 | 1,469 | 338 | 1,195 |
| XV. | 87,967 | 255 | 814 | 281 | 993 |
| XVI. | 71,118 | 218 | 686 | 249 | 880 |
| XVII. | 79,914 | 288 | 691 | 266 | 940 |
| XVIII. | 98,635 | 292 | 1,294 | 299 | 1,057 |
| XIX. | 66,541 | 246 | 657 | 239 | 845 |
| XX. | 67,029 | 223 | 670 | 240 | 848 |
| XXI. | 83,485 | 224 | 650 | 272 | 961 |
| XXII. | 52,344 | 174 | 614 | 209 | 739 |
| XXIII. | 21,179 | 106 | 374 | 125 | 442 |
| Districts total | 1,821,324 | 6,013 | 21,149 | 5,952 | 21,036 |
| City | — | 1,621 | 5,464 | 1,578 | 5,578 |
| Municipality | 1,821,324 | 7,634 | 26,613 | 7,530 | 26,614 |

Source: Dóci 1999.

Public Administration

For years public administration presented the greatest number of problems. Reformers agreed that the task was similar for the city and the districts, but because of the economies of scale, different expenditure needs were justified for districts and the city. Without calculating the districts' disadvantages, the benchmark cost for the districts was determined

by a political decision each year. This cost was usually significantly less than the actual average cost in the districts, but it was higher than the unit cost of the city expenditure needs. The total cost for the city was accepted, and the resulting disparity was the biggest problem with the previous system. The method introduced in 2000 measures the expenditure needs of the administration services in the districts and the city. RSS assumes that the cost of public administration depends on two factors: the number of staff and the average labor cost. The optimal number of staff is related to economies of scale. The second factor, however, is the independent decision of the respective government.

Planners assumed that the number of staff is a power function of the population with a constant rate of return ($NB^* = b_0 P^{b_1}$, where NB^* is the optimal number of staff, P is the population of the local governments, and $b_0 = 0.426$, $b_1 = 0.57$). This function provides the optimal number of staff, and the total cost of the administration was allocated to districts and the city according to these numbers. The optimal number of staff was calculated without the city's data, because they are overwhelming, but the results apply to the city as well. The key stakeholders accept this method. (See table 8.3.)

In 2000 the renewal, investment, and housing costs were new considerations among expenditure needs. All are problems in the sense that the expenditure needs of these tasks are calculated differently from the general principle (formula 1 in box 8.2) of RSS.

Renewal

Because the renovation of real estate is essential for providing local services, the expenditure needs of such tasks are also subject to RSS. This element was built into RSS in the following way. District and city real estate was divided into the four categories: buildings, roads, parks, and bridges. The same average cost is accounted for district and city buildings (formula 1, in box 8.2), but different average costs are calculated in the other three categories (formula 2, in box 8.2). This adjustment leads to very different "grants" for the districts and the city. The city receives 1.79 times more unit grant for parks and 6.07 times more grants for road maintenance.

Housing

The inclusion of housing in RSS creates other difficulties. First, as a basic principle, RSS considers local budgets to be core data sources, but housing services in most cases are outsourced. Second, the data on housing expenditures are not standardized; hence, in some districts housing expenditures contain the cost of communal services (for example, water and heating). Of course, a corresponding amount of money appears on the revenue side as service charges. Third, the composition of the housing stock differs significantly across districts, and planners have no information on the comfort level composition, so the rent revenue normatives are inappropriate. Despite these evident data problems, the housing sector was also included in RSS 2000.

Investments

The most critical point of RSS 2000 was including the expenditure needs of investment for the first time in parallel with respective revenues. Second, investment data in the budget depend mainly on the budgeting technique. Because investment depends mainly on matching grants and other irregular revenues, some local governments plan all possible investments, and over-planning is typical. Some districts plan only those investments that are certain to be implemented and change the budget during the year if new revenues arise, so the significance of the investment in RSS is larger than the significance of this task in reality. Moreover, the draft of RSS 2000 suggested that investments of the city and the districts are different (that is, expenditure needs calculated according to the different per capita average cost for the city and districts; formula 2 in box 8.2). The calculation conveyed the message that the city had four times more investment needs than the districts altogether. Because it was politically impossible to defend, the final decision was to share the total expenditure needs on investment in a ratio 1.5 to 1 in favor of the city.

Revenue Side of RSS

The revenue side of RSS consists of two elements: the fiscal capacity calculation and the transfer pool (shared revenues).

Fiscal Capacity

As on the expenditure side, RSS tries to estimate fiscal capacity instead of using actual data in all cases in which the level of revenues depends on the decision of the local government; externally determined revenues, such as central grants, however, are accounted for in their actual amounts. Thus local tax revenues are calculated on the basis of per capita municipal average tax figures and population, and rent revenues are calculated on the basis of the total floor-space of the district's housing stock and municipal average rental unit fee. These elements of RSS 2000 are new.

RSS accounts for revenues corresponding to housing, renewal, and investment tasks (such as rents) in harmony with the expenditure structure. In the case of these particular activities, off-budget revenues, which do not appear directly in the local budget, are also included in RSS. Typical off-budget items occur because of outsourcing, such as revenues of legally independent district service enterprises or institutions (for example, housing development and maintenance units).

Shared Revenues—Transfer Pool

The difference between expenditure needs and fiscal capacity provides the basic deficit of a given local government. The transfer pool is shared in proportion to the basic deficits.

The Act on Local Government defines what revenues must be shared among the local governments of Budapest. Central government grants are reallocated on per capita basis, the shared personal income tax (5 percent of the total personal income taxes in 2000) on the basis of origin, other shared central taxes, and local taxes. The business tax is the only local tax that is channeled to the transfer pool. The districts impose different types of property taxes (communal, building, and plot tax), so these taxes cannot be shared, but they are also taken into account in RSS reallocation.

Although channeling other own revenues into the transfer pool is not legally possible, RSS practically reallocates these revenues because they are taken into account in the revenue base of the districts (especially those calculated in actual value). RSS allocates resources if a district has a basic deficit and thus needs shared revenue from the transfer pool. In 2000 RSS took into account such a wide range of own revenues, that district 5 had no basic deficit and received no resources from RSS. Hence, the district's own revenues become unrelated to RSS.

The transfer pool includes two types of revenues, both of which depend either on the state budget (shared personal income taxes, central grants, and other shared central taxes) or on the local economy and decisions. The centrally determined revenues in real terms have been declining continuously since 1991, while the locally determined revenues have been continuously increasing. The declining central sources reduce the transfer pool, but the increasing local revenues counterbalance this contraction in both nominal and real terms. This process has led the transfer pool to become virtually independent of the central government sources (see table 8.4). An economic boom would increase business tax revenues in real terms, which would reduce the conflicts in the reform of RSS in the near future.

Table 8.4 Share of Sources in the Transfer Pool

| <i>Percentage</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>1999</i> | <i>2000</i> |
|---------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Central government grants | 36.1 | 20.3 | 38.0 | 31.0 | 26.0 | 14.6 | 13.1 | 8.7 | 5.3 | 0.2 |
| Personal income tax | 63.9 | 62.4 | 45.9 | 47.1 | 49.0 | 41.5 | 41.0 | 41.4 | 39.3 | 13.8 |
| Business tax | 0.0 | 17.3 | 16.1 | 21.9 | 25.0 | 43.9 | 45.9 | 49.9 | 55.4 | 86.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Budapest Municipality data.

RSS Arithmetic

The effectiveness of the RSS highly depends on the quality of the data used, and the adequacy of the revenue and expenditure formula, while the complexity of the allocation formula largely influences its political acceptability.

The Data

The RSS uses mainly historical data; for example, RSS 1999 was calculated from the actual data of the 1998 budgets. Because the districts use different budgeting techniques, the planned and actual data could diverge significantly, resulting in many distortions. The distortions has increased significantly in 2000 and beyond, because data that are difficult to predict (for example, investment) are now included in RSS. To reduce these distortions, the RSS 2000 revenue allocation was calculated twice, in January with the preliminary data (planned 1999 budget) and in June with the actual data (closing 1999 budget).

Inaccurate or erroneous data cause additional problems. The reported data are often false or provided in an incomparable format. To solve this problem, the municipal decree on RSS stipulates an external auditor must evaluate the data before the data are submitted to RSS. Further necessary data corrections are also possible in the RSS recalculation in June. Because local governments must operate continuously, RSS revenues were due and paid between January and June as advances based on the preliminary RSS. In June the final revenue allocation was calculated and applied for the second half of the year, and a Ft 3 billion fund was retained to counterbalance the differences that occurred subsequently between the two revenue allocations.

Calculating the Revenues Provided through RSS

RSS revenue is allocated in accordance with the following formula:

$$Tr_i = TTr \cdot (EN_i - FC_i) / \underline{Sum} (EN_i - FC_i), \quad (8.3)$$

where Tr_i denotes the transfer coming from the revenue sharing process, TTr denotes the total transfer pool, EN_i denotes the expenditure needs of the service district i , FC_i denotes the fiscal capacity of the service district i , and \underline{Sum} denotes the sum of the positive deficit only.

When $\underline{Sum} (EN_i - FC_i) = TTr$, then all the services are financed equally in all service districts (the ratio of financing is 100 percent). When $TTr < \underline{Sum} (EN_i - FC_i)$, and thus the system is underfinanced, then in those districts where the basic deficit to the expenditure needs is higher, the local services are financed less than in those that have a lower ratio. If districts with higher ratios are poor, RSS has a weak equalization capacity when RSS is underfinanced (a usual case).

Calculating the Expenditure Needs in RSS

The expenditure needs for district i (EN_i) are calculated from the aggregation of the expenditure needs of the different service provisions:

$$EN_i = \sum_j (EN_{i,j}) \quad (8.4)$$

where j is the index of the services, and expenditure needs ($EN_{i,j}$) are calculated with the formula (8.1) or (8.2). (See box 8.3.)

Box 8.3 Punish Overspending!

The Budapest RSS 1999 applied a special technique in calculating expenditure needs for three reasons. First, to increase the equalization capacity of the system; second, to promote the equally distributed sectors; and third, to allocate more resources for administration costs, which appeared to be the most underfinanced task. As a result an additional factor was included into the formula to punish the positive and honor the negative difference between the districts's actual and the municipal average cost per tasks. When the unit cost of service district i was lower than the municipal average, the average cost was accounted in RSS, while the municipal average cost minus a portion of the positive difference between the district and the municipal average was accounted as relevant expenditure needs for the district that overspent.

$$UC_i = AC - \alpha \cdot (AC - AC_i) \quad \text{if } AC_i > AC \text{ and}$$

$$UC_i = AC \quad \text{if } AC_i < AC$$

where UC_i is the unit cost for service district i , AC is the average cost of the task in the municipality, AC_i is the average cost of district i , and α is a positive punishment factor. In this case the punishment factor was 20 percent.

This method was used only in 1999, because it received no political support from the stakeholders.

As we mentioned before, administration costs raise the problem of economies of scale, which means that the relationship between the expenditure need and the measurement unit is nonlinear. To resolve this problem, the measurement unit was recalculated with a formula, but the general allocation formulas were applied. The solution was the following: an exponential relationship was recognized between the population and the number of officers in Budapest's 23 districts and the city. This regression provides a measurement unit, the so-called "optimal number of officers" for the expenditure need estimation. The regression is as follows:

$$MU_i^* = 0.426 \cdot P_i^{0.57} \quad (8.5)$$

where the MU_i^* is the optimal number officers in local government i ; P_i is the population of district i (the original measurement unit).

If we build this transformation factor into the original formula (8.1) (see box 8.2), it leads to the following formula for calculating expenditure needs for administration:

$$EN_i = (TC/7,356) \cdot 0.426 \cdot P_i^{0.57} \quad (8.6)$$

The biggest problems of RSS were and are the expenditure needs of the services that are provided exclusively by the city (for example, fire protection, transportation, operating dormitories and theaters, and bridge renovation). In these cases the expenditure needs are calculated by experimental estimation.

Calculating Fiscal Capacity

The fiscal capacity of local government i (FC_i) is calculated from the aggregation of the different estimated revenues:

$$FC_i = \text{sum}(FC_{i,g}) \quad (8.7)$$

where g is the index of a given revenue.

The revenues are calculated for district i in total value (central grants and off-budget revenues) or using an average estimation formula similar to formula (8.1) in the case of property taxes and rent revenues (where the measurement unit is the basis of revenues: number of houses or total floor-space of taxed houses).

Lessons Learned in 2000

The total expenditure need considered in RSS 2000 was Ft 257.9 billion. The total revenue (with the transfer pool) was Ft 215.5 billion. RSS hence was underfinanced by Ft 42.4 billion, and the revenues covered 83.6 percent of the expenditures.

The city received 56.68 percent of the transfer pool, which represented a decline from 60.09 percent in 1999. The average shared revenue per capita was Ft 19,660, with a 130 percent relative variance, a significant increase from the 15 percent relative variance from 1999. These figures suggest that RSS 2000 implies stronger differentiation across districts than previously. Likewise, this system obtains better equalization, if the calculations match the goals.

Half of the districts agreed with the new RSS, which represents significantly higher support than before, but the other half rejected it, assuming political influence in the system. District 5 received no revenue from the transfer pool because, according to the calculations, it had no basic deficit. Hence it lost Ft 596 million in transfer resources, a 10 percent revenue decline from the previous year.

Because of the various data problems, the city council decided that RSS should be audited. Despite the fact that this decision was supported by all the political powers, three districts did not allow the auditor to check their data until June 2000.

Because the investment need is included in RSS, the districts were obliged to spend at least 50 percent of their calculated investment need on investment rather than using investment resources to finance operating costs. Since the previous years, they all spent more on investment than the defined obligation in RSS, this increase was a signal for the stakeholders rather than a strict limitation.

Considering that (a) the expenditure side was based on the 1999 data, (b) the expenditures did not decline in nominal terms for 2000, and (c) the revenue side calculations use data from 2000, RSS cannot consider all the revenue side. The equalization capacity of RSS 2000 is less than 83.6 percent because the expenditures were calculated on 1999

data, but the revenues were calculated on the 2000 basis. The same problem arises from outsourcing, when both expenditure and revenue of a service are out of the budget. Thus, the equalization capacity of RSS depends to a large degree on the off-budget revenues and expenditures (see table 8.2 and 8.3). The inhabitants of district 12 are among the wealthiest, but the local government has less revenue than some poor districts. Of course, this local government provides fewer services through its budget than the average.

Reform Steps and Challenges Ahead

Because of the criticism of the previous system, the city government assigned a group of experts to work out a program for further reform of RSS. In 1999, the group prepared a three-year program, which the city accepted. The first year was 2000, when new expenditures and revenues were included in RSS, and the principle of normatives was extended to a wider range of tasks.

A serious legal challenge of RSS is that the city government defines the revenue allocation rules, and it also receives shared revenues. The double role of the city leads to two types of conflicts between the city and the districts. First is a conflict of interest; hence districts feel that the city centralizes “their revenues” when it gets more than the average. Second, when the shares of some districts change from one year to the next, districts that are led by parties in opposition to the city government assume that politically biased allocation principles were used.

The goals of RSS ought to be clarified. The law and the politicians say that the primary objective is to share the revenues in accordance with the tasks and functions. But the ongoing reform tends to converge much more to an equalization scheme. Not surprisingly, no consensus has been reached in the measurement of system efficiency. The single indicator is the degree of political consensus, meaning how many districts support the system.

The revenue allocation system must be suitable to function in a situation of decreasing central sources. As mentioned, RSS shares only 95 percent of the revenues, whereas some special funds were separated from the transfer pool to finance special projects (for example, to improve police services, the school milk program, or to expand and renew the main sewage grid). Although political consensus supports special programs, these funds are not integrated in the overall allocation system.

In 1995 the decision-makers recognized that, although the calculations cover the operation deficit of the local governments, in the end some local governments face severe deficits, while others have significant surpluses. Analysts believe that this disparity was the result of imperfections in RSS. Hence a fund was separated from the transfer pool to adjust the deficit of the disadvantaged districts. The size of the fund, however, was insufficient to keep up with the increasing needs. Because analysts discovered that the difference between planned and actual data was the main reason for the deficits, this adjustment fund was merged into the June recalculation fund in 2000.

RSS is based on the correct principles. It is rather complex, but it handles vertical and horizontal inequalities successfully with moderate costs. Because of the complexity, the stakeholders do not understand the system well, which leads to a political distrust between the city and the districts. Moreover, in tandem with the increasing complexity, the possibilities for cheating and the chance for the stakeholders to influence the allocation is also increasing, especially for the city, which can influence the costs of services when RSS provides a higher grant to the city than to the districts in financing those services.

The problem of complexity will not be resolved and may even increase with introduction of a zero-based budgeting. Determining the investment needs in the zero-based method may lead to new political conflicts. The stakeholders must agree not only on the scope of investment to be included in RSS, but also on the timeframe and conditions concerning how these investment needs will be fulfilled. The proportion of the investments in the whole area of expenditure needs must also be debated.

The importance of the equalization has gradually been growing, but as a negative consequence the poorer districts have become more dependent on RSS. How far the conditions of local governments should be equalized is questionable. A fully equalized system would lead to the end of sovereignty of the districts.

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9 Transfers: Policy Options

Kenneth Davey and Gábor Péteri



The two major features of Hungary's local government system are the huge disparities in size and local resource bases and the broad scope of responsibility for social services when comparable standards are expected. As discussed in chapter 7, Hungary has gradually moved from a rather simple transfer system introduced in 1990 toward a detailed transfer regulation. This is often micromanaged by sectoral ministries and has a growing number of equalization factors and an increasing use of deficit grants for distressed municipalities.

Concerned with the distribution of transfers from the state budget to local governments, this chapter proposes two versions of radical change to the transfer system and also discusses options for incremental improvement. One of the radical options would replace the normative, equalization, and deficit grants with a single equalization grant (block grant) designed to compensate for both vertical and horizontal imbalance (that is, including differences in spending need, service costs, and revenue potential). It responds to the growing pressure for effective equalization mechanisms. Another radical option would convert the entire grant into a single deficit grant similar to the British and Dutch transfer system. The incremental approach discusses possible changes to the existing system, should political will be insufficient for the more radical approaches. Finally, the chapter discusses issues related to tax sharing.

Equalization through Grant Allocation

The Council of Europe has recommended that equalization systems should enable local authorities, if they wish, to provide a broadly similar range and level of services while levying similar rates of local taxation (CoE 1985). The Council's recommendation seeks complete parity between local authorities in the service levels they can provide with a

* This chapter is based on Davey and Péteri 1998d.

similar level of revenue effort. Only the British and Dutch systems attempt to achieve this parity. Others attempt partial equalization. The Danish system, for example, aims to halve the gaps between the per capita revenues of the richest local authority and those of the rest.

To achieve equalization goals, the following must be mitigated:

- disparities between the local revenue bases (that is, the potential yield of local revenues assuming a common level of effort in terms of tax rates, collection efficiency, and so forth)
- disparities in local needs for municipal services, determined by differences in, for example:
 - age structure (proportion of school age children, elderly, and so forth)
 - social structure (single parent households, unemployed, and so forth)
 - environmental and economic conditions, requiring remedial action
- disparities in the costs of providing equivalent levels of services due to factors such as:
 - differences in wage levels or the price of land
 - low population density increasing the overhead costs of institutions such as schools
 - large, high-density populations increasing unit costs of services such as refuse disposal or street maintenance.

Different approaches are possible to meet these objectives.

Options for a Single Equalization Grant

A radical departure from the present shredded equalization system would be to consolidate all equalization funds into a pool and introduce a general equalization grant allocated on the basis of selected socio-economic indicators.

A Single Grant

The most radical option would be to replace the structure of transfers (apart from the origin-based distribution of personal income tax [PIT] shares) with a single grant calculated to reduce disparities in local revenue bases and reflect differences in spending needs and service costs.

Various formulas are in use in European countries. In one category are the British and Dutch systems, which attempt full equalization and try to measure differences in need, cost, and resources comprehensively. The United Kingdom developed the revenue support grant to equalize needs and local revenue capacity. A second category, typified by the Swedish model, attempts to achieve partial equalization and uses simpler and fewer variables.

The British and Dutch formulas depend on extremely demanding data requirements. They operate in contexts that have far less fragmentation than in Hungary and where all

local authorities levy the same one or two taxes on the same base, which is nationally assessed and only the tax rates differ. Given the lack of such uniformity in Hungary, considering a simpler formula, similar to that the one used in Sweden, might be more practical.

A Simpler Grant Formula

A relatively simple model for a single equalization grant can be formulated by calculating the amount of grant allocated to each municipal area, that is, the area covered by a single municipality. The grant would be distributed among all self-government units (counties, municipalities, municipal associations, and so forth) that provide services in that area.

Using such a model, PIT shares distributed by origin would continue to be paid to municipalities just as they are now (unless they are replaced by a surcharge). The rest of the current transfers (including the PIT equalization element) would be absorbed in a block grant. The total grant would be divided by national population to yield a standard per capita allocation, which would be attributed to each municipal area.

The standard per capita allocation for each municipal area would be adjusted (without a net addition to the total state budget cost) upward or downward to reflect local variance from national norms in respect to the major factors affecting local revenue capacity and expenditure needs and costs. For example, adjustment could be made for variations in per capita PIT yields, education expenditure (measured by proportions of school age children), and health and social care expenditure (measured by proportions of elderly people, children, and the unemployed).

These adjustments to the standard per capital allocation would yield an adjusted per capita allocation for each municipal area, which would be multiplied by the municipal area's total population and allocated to local authorities as follows

- Cities with county rank: 100 percent;
- Counties and other municipalities: divided according to their overall shares of local government expenditure nationwide (excluding cities with county rank and Budapest) or in individual counties;
- Budapest capital city and districts: divided according to their respective shares of total expenditure in Budapest.

One advantage of this model is that it provides a relatively simple way of dividing the grant between levels of local government, avoiding specific normatives. Differences in service needs would be reflected in simple, uniform indicators, such as school-age population.

Another advantage of this solution is that it could be varied either nationwide or in each area to cover the introduction of districts or regional associations. For example, if five municipalities form an association, their respective adjusted per capita allocations could be divided between them and the association according to their respective shares of their combined expenditure.

Some reformers argue for using per capita PIT yields as the only basis for equalizing local revenue bases. PIT is the only revenue figure that can be compared uniformly nationwide to liability and assessment. To a certain extent, it should reflect differences in local economies that affect the potential of local revenues in general. This approach will not fully compensate for variations in the potential base of business and property taxes if they exceed the deviations in PIT. Some analysts argue that differences in business and property tax potential are matched by differences in the demands for expenditure on physical infrastructure and, therefore, should not be subjected to complete equalization.

This option provides for higher levels of revenue equalization than in the current structure. It seeks to reduce disparities in the local tax base, not in the actual local tax effort. Municipalities that make above-average revenue effort do not lose grants as a result. Therefore, the incentive to localize revenue generation is not reduced.

It would be possible, of course, to use further adjustment factors if suitable data were available to reflect relative differences in spending need or costs. Regional differences in mortality rates might be added to the calculation, for example, if they are significant. Over-complexity and the invitation to special pleading, however, should be avoided.

A comparison of the distribution of this single grant with that of the present transfer system shows that the only significant losers are municipalities that have populations of fewer than 200. This loss is probably due to the elimination of the lump-sum element of the grant to villages and could be overcome by a simple adjustment to the formula to apply a minimum multiplier in multiplying the adjusted per capita allocation by the population of the municipal area.

A radical change to this type of single grant could be phased in over a number of years to soften the impact on the losers. In a five-year transition, for example, local authorities would get 20 percent of their new grant in year 1, 40 percent in year 2, and so forth. Alternatively, the single equalization grant could be fixed as a proportion of overall transfers. For example, one-third of normative grants can be allocated using this method.

More Complex Models

A more complex model would equate with the British and Dutch transfer systems, which are sometimes described in U.S. literature as “representative revenue and expenditure systems.” Such a model would effectively convert the entire grant into a deficit grant. Each municipality would receive a grant bridging the gap between the following two elements:

- The central government’s assessment of what it should be spending (excluding capital expenditure), bearing in mind:
 - its particular range of competencies
 - standard indices of service needs (school age children, road lengths, and so forth)
 - types of local characteristics affecting service costs (for example, population density, social deprivation, labor costs)

- The product of its direct revenues, assuming it levied all permitted taxes at either an average rate or the maximum rate.

In arriving at assessments of expenditure needs and costs, such a model relies heavily on regression analysis. Regression analysis seeks to correlate actual variations in municipal expenditure patterns with differences in particular local physical, demographic, social, and economic characteristics. Such analysis would be difficult in Hungary because of the lack of uniformity in the exercise of functions (for example, management of schools, hospitals, and social care institutions) and the differences in coverage of service delivery in municipal budgets. Some municipal budgets show the full cost of a service; others may only include a net subsidy to an institution or company. By contrast, regression analysis always reflects differences in size and character more closely than simple averages. Based on the actual spending figures, planners can calculate standardized unit costs for a municipality of any size, urban character, or other factor.

Similarly, the British and Dutch systems calculate municipal revenue capacity by applying uniform standard rates to the local tax bases. This method is easy in these two countries, where local governments levy only one or two taxes on bases that are assessed uniformly. This approach, too, would be difficult in Hungary because of the lack of uniformity in the taxes levied by individual municipalities or in the assessment methods. Comparisons of nontax revenues are also difficult because in some cases those revenues are reflected in municipal budgets, but in others they are largely absorbed by institutions and companies.

Nevertheless, pilot research would be justified in seeing how far objective measurements of expenditure need, cost variation, and local revenue capacity could be developed, because these ingredients are typical of the most highly developed transfer systems.

Options for Incremental Change

Getting political and bureaucratic consensus on radical change is difficult, particularly if new legislation is required. Alternative possibilities for improving the current system involve continuing the process of incremental change that has been in progress since 1990.

Even if the present transfer system remains intact, reformers could make changes in the institutional structure, either in the assignment of competencies or in the framework of intermunicipal cooperation. Two scenarios are considered in the remainder of this chapter. The first looks at options for incremental improvement assuming no major institutional change. The second looks at the implications for transfers of the types of institutional reform that have been under discussion. Finally, possible changes in tax-sharing arrangements within the current structure are discussed.

Incremental Options without Institutional Change

The present transfer system has three bases: (a) general normative elements pertaining to types of local authority, (b) specific normative elements pertaining to particular services and payable to the authorities supplying them, and (c) limited equalization of revenue from shares of PIT.

The priority for incremental reform must focus on the present system's inadequacies that cause the most problems in practice. This focus, which means trying to eradicate (or at least severely reduce) needs for the deficit grant, is important for two reasons. First, awarding the deficit grants fairly and adequately causes the central government the most difficulty. Second, despite the absence of systematic allocation criteria, common sense suggests that the deficit grants do go to the three types of local government most likely to experience financial difficulty:

- Counties, which are increasingly taking over responsibilities for secondary education, hospitals, and social care institutions from municipalities, but which lack the municipal revenue base of local taxes, real estate, and PIT shares;
- Towns providing services for their neighbors without recompense;
- Small villages running services without efficient economies of scale.

The objective is to ensure that the combination of local revenues, grants, and revenue shares is adequate to balance the budgets of the vast majority of local governments, so that the deficit grant is needed only in the most exceptional cases. The rest of this section examines options for meeting this aim.

Normatives

The practical problems of all the deficit grant recipients would be reduced if service-related normatives were increased to meet a higher percentage of the costs of running the services covered. Although the number of normatives has been increasing in recent years, the percentage of coverage has been declining. As a result, local governments have had to contribute increasingly to the cost of these services from own revenues, general normatives, and PIT shares. But counties get neither PIT shares nor their own taxes. Regional towns get no general normatives or PIT shares in respect to nonresident users (although their regional status may enhance their business tax revenues in more prosperous areas).

Increasing the size of normatives would certainly help the counties and regional towns. Of all the possible remedies, it would also be most accurate in surmounting the lack of uniformity in service provision (that is, in assisting only those counties or towns that supply such services as hospitals and secondary schools). A 10 percent increase in grants for secondary and vocational training schools would equate with the entire deficit grant paid to counties and regional towns.

If applied to the primary school normatives, this solution would also help the small villages—although not to the same extent, because it would not cover their higher unit costs (unless the normative was weighted inversely to size or included a lump-sum overhead element).

The disadvantage of this solution might be its effect on allocation efficiency. It would further reduce local government discretion over the use of revenue and would encourage retention of surplus places in institutions, nonviable small primary schools, and the like. It would also benefit the 85 percent of towns and 75 percent of villages that do not receive the deficit grant.

If the total transfer pool is fixed by state budget policy, any increase in normatives would be at the expense of some other element. Options for cuts may be any of the following:

- A provision for deficit grants, which might become unnecessary as far as counties and regional towns are concerned
- Regular normatives allocated by the types of settlements, which would cause everyone to suffer, regardless of capacity
- PIT shares, which are logical because the biggest losers would be cities that have large PIT and business tax revenues that would gain from the increase of normatives without needing them.

Counties. What other approaches would increase county government revenues as well as—or instead of—increasing specific normatives? The options are as follows:

- Increasing the counties' general normative by 17 percent would equate with their share of the deficit grant. The general normative does not, however, relate to the scale of their actual responsibilities, which varies greatly between counties.
- Allocating to the counties the central government's 50 percent share of the vehicle taxes, roughly five times the size of the counties' share of the deficit grant. This move would simply result in some other form of transfer cut, but would introduce a new shared revenue at the county level.

The second option gives counties taxing power for accountability reasons and assumes that counties would have the same right as municipalities to increase the rates of their share of vehicle tax within prescribed limits.

Regional towns. Regional towns are municipalities that provide substantial services to residents of smaller, nearby settlements. Increasing normatives would solve part, if not all, of the problem, depending on the scale of the increase and the significance of services in their spending structure. Other options would be the following:

- Introducing a regular normative for regional service center functions
- Increasing revenue equalization, which would be logical because the more prosperous regional towns do get compensating benefits from their own tax bases. The business tax

would be the most logical base, but finding an objective statistical base for measuring potential rather than actual yield would be difficult, and the disincentive effects could outweigh the benefits.

Small villages. Increasing normatives would help if they were applied to primary schools, but this move would still fail to compensate for higher unit costs and would be particularly inefficient because it would encourage retention of unviable units. Alternative subsidies (for example, to school transportation) might be more of an incentive.

Another option to help small villages would be a larger basic lump-sum normative, regardless of population size. This normative would also benefit the 75 percent of villages that do not qualify for the deficit grant.

All these options raise the question of how much the central government wants to do to keep small village municipalities afloat and leads to a discussion of institutional change.

Conclusion. None of these suggestions is perfect; all have advantages and disadvantages. The suggestions which have the greatest advantages are the following:

- Increasing modestly the specific normatives for secondary and vocational schools (reversing the decline in these grants as a percentage of actual cost)
- Allocating to counties a share in the vehicle tax with the right to vary rates (thereby increasing revenues and accountability simultaneously).

Adjusting the scale of these two measures should eliminate the need of counties and regional towns for deficit grant aid, apart from most exceptional circumstances.

Devising solutions to the problems of deficit villages, which benefit all villages equally, however, is difficult. Although the same can be said about help for regional towns, any general increase in support to villages carries the additional disadvantage of encouraging the survival of uneconomically small service units and leads once again to a discussion of institutional change.

Incremental Options under Institutional Change

Although neither the central government nor the Parliament has reached a consensus on institutional change, the topic is under discussion. Two directions are possible if the transfer system is reformed:

- Uniform assignment of competencies for services with regional or subregional catchment areas could result in counties taking over all hospitals, social care institutions, and secondary level schools.
- To improve economies of scale, compulsory subregional associations could be formed to provide some services. This direction could include a proposal to establish multipurpose district authorities.

These two options have been discussed at the national government level. The first option was formulated as part of the changes in fiscal policy after 1995. At that time reformers believed organizing larger service delivery units by amalgamating small village municipalities and transferring regional services exclusively to an intermediate level of local governments was the most rational approach. No one evaluated the political acceptability of this option or calculated the potential savings.

The second, more evolutionary, option seems to be more realistic. The introduction and development of various flexible forms of joint service delivery organizations and associations require not only fiscal but also legal, administrative, and operational changes.

Counties. If counties and county-right towns received an exclusive mandate for certain services (for example, secondary education or hospitals), abolishing the specific norms for those competencies and incorporating the funding in a general norm would be possible. This reform might be population based, with some weighting for school-age groups and the elderly. Regional need variations could be introduced if significant differences in mortality rates, disease incidence, and so forth are found.

Subregional associations and district authorities. Predicting the financial implications of subregional association or district authorities is much more difficult because they can take many different forms. Major guidelines can only be sketched, depending on key variables. The first variable relates to the type of function undertaken by the associations and districts. If they are responsible only for public utility services, then their operating expenses would be covered by charges paid directly by consumers.

If associations and districts are responsible for tax- and grant-borne services, then they could be incorporated into the normative grant structure. If they are established uniformly with exclusive competencies, then they could receive regular norms, which would be excised from the municipal norms according to their share of previous municipal expenditure. But their regular norms could also absorb any specific norms for services they run, with appropriate spending need adjustments (for example, age group weights, and so forth). Service-related norms would have to be retained only if expenditure assignments are not uniform.

Giving associations and districts taxing power is similar to the way some British and French joint authorities function. If the governing bodies of associations and districts are elected directly or nominated by elected municipal assemblies, they could be regarded as sufficiently representative politically to exercise taxing power. The simplest way would be to allow them to piggyback on the municipal taxes. This approach assumes that constituent municipalities would be able to reduce their own tax rates because of the transfer of expenditure to the association.

If the associations and districts take over a large share of municipal responsibility, then they might be given exclusive right to levy a specific municipal tax. The business tax would

be the best candidate because of its disparate incidence within the type of peri-urban area that might typify an association's jurisdiction. Although most of the tax might be paid by businesses in a central town, most likely their staff and customers would be drawn from the wider area served by the association or district, justifying the sharing of this tax base.

The greatest obstacle to the formation of associations is their lack of access to direct revenues and consequent dependence on their constituent municipalities. Previous discussion suggests that this situation would be improved if:

- Association governing bodies were politically representative and, therefore, able to exercise taxing power, with right to the business tax base if they take over the bulk of municipal functions.
- They had the right to direct receipt of specific normatives for services they administer.

The radical changes suggested earlier would give associations and districts a share of the total transfers to their area *pro rata* to their share of local government expenditure.

Tax Sharing

Tax sharing without local decisions over tax rates (that is, without surcharging) is basically an alternative form of grant. Its impact is limited. It may stabilize local government revenue if the size of the share is fixed continuously—not the case with PIT in Hungary. Tax sharing does not enhance local discretion over taxing and spending levels. It may, however, protect local spending choices insofar as it is less susceptible than grants to overuse. It may distribute money in favor of wealthier areas, depending on the scope of equalization in the rest of the transfer system. By doing so, it affords individual local governments the psychological satisfaction of sharing in revenue produced by their local economies.

Personal Income Tax

The share of PIT distributed to municipalities by origin has declined from 100 percent in 1990 to 5 percent in 2000. Given the two-year delay in distribution in 1998, the share equated with 14.5 percent of the estimated current levels of collection. By contrast the PIT equalization grant has increased so that the minimum PIT share equals the national per capita average.

The substitution of a local surcharge for the current sharing of PIT is possible if an increase in local accountability is sufficiently desirable to warrant the administrative cost. Even without this measure, increasing the percentage of PIT distributed by origin would be possible, balanced by a proportionate increase in the minimum per capita level assured by the equalization grant.

Unless the central government decided simply to increase the total quantum of transfers, any increase in PIT shares and equalization grant would be offset by equivalent reductions in normative grants. The impact on the state budget would be neutral, but the result would be a redistribution of transfers between local governments in favor of those that have higher PIT yields.

Local government representatives frequently complain about the reduction of the local PIT share, chiefly in the context of the general fiscal squeeze they experience. Increasing PIT shares would have a highly discriminatory impact; for this reason we see it as less desirable than a general indexation of total transfers.

Value Added Tax

Another option is to share new national budget revenues with county governments and Budapest. This approach would stabilize part of the counties' transfer revenue and give them the incentive of a connection between their revenues and the commercial activities in the area. The principal candidate would be a share of value added tax (VAT), for which local government has campaigned in the past.

The geographical incidence of VAT payments is hard to determine accurately, but per capita gross domestic product, now calculated at the county level, could be a valid proxy. The percentage of VAT assigned to local government could be divided between counties on the basis of their share of gross domestic product.

We estimate that a 5 percent share of VAT distributed on this basis would contribute from 7 to 21 percent of county revenues. This degree of variation is due to differences in the size of county budgets, reflecting diversity in the functions assigned to them. Assigning a share of VAT to counties would not increase their discretion and accountability. The advantages of sharing VAT would be largely psychological.

Business Tax

The business tax has been growing both in absolute terms and as a proportion of total local government revenue. In per capita terms, major disparities occur in its incidence, mainly to the benefit of the larger urban centers. The growth and the disparity of the business tax have fueled discussion, particularly within the central government, of ways to equalize it.

Some reformers believe that the business tax base belongs to a whole urban area and its periphery, not just to the municipality where a particular firm is located. Both its customers and its employees may well reside throughout the wider metropolitan area. This view would support the kind of redistribution that takes place in Budapest between the capital city and the districts (see chapter 8). In other urban centers redistribution could take place through the operations of some form of intermunicipal association or district level body.

A national redistribution of the business tax is far less justified, however. Because the tax is not levied uniformly, it would not be easy to calculate the differences of tax potential necessary to an equalization formula. Unlike PIT, this tax is one that municipalities levy and administer themselves; redistribution could act as a disincentive to levying the tax at the higher permissible rates and assessing and collecting it strictly.

Equalization would be injurious, moreover, unless reformers make an equal effort to compare and compensate municipal expenditure needs. The centers that enjoy the highest per capita yields from this tax may well be those with exceptional needs. Larger urban centers have congestion costs (for example, greater volumes of traffic or further distances to waste disposal sites). Moreover, they frequently have the highest concentrations of social deprivation, leading to exceptional liabilities for social benefit payments and environmental rehabilitation.

Equalization or redistribution of business tax yields should not be attempted as an isolated measure. It would have a place only within a comprehensive approach to equalization which takes costs and spending needs into account equally.

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10

Local Taxation: Options for Reform

Kenneth Davey and Gábor Péteri

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In 2000 Hungarian local authorities raised 13.5 percent of their total revenue in local taxes. This amount is a significant increase over the 4.5 percent raised in 1991, but still a moderate proportion. These taxes, which are entirely within municipal discretion, are on business, property, and tourism. More unusual, each municipality decides whether to levy the tax at all, sets the tax rates (within statutory limits), and is responsible for assessment and collection.

Municipalities also receive a share of the personal income tax (PIT) collected within their boundaries (in 1998, their share was 20 percent of actual 1996 collections) and 50 percent of motor vehicle taxes. Municipalities have limited discretion over vehicle tax rates, but not PIT rates, and the percentage of PIT they receive varies radically from year to year (it fell to 5 percent in 2000).

Local governments have widely introduced various types of local taxes. The actual local tax revenues increased significantly after 1995 when severe fiscal restrictions were introduced. In 1997 a majority (81 percent) of municipalities levied at least one local tax.

Most analysts believe that this situation is unsatisfactory and that local governments are too dependent on grants and revenue shares. Citizens undoubtedly feel overtaxed. Reform must be founded on a clearer definition of the problem and future objectives. This chapter discusses core principles and options for reforming local taxation.

Current Situation

The most frequently used local taxes are the business tax and the communal tax. The business tax is a local piggyback on the centrally levied corporate income tax. Communal tax on private persons can also be regarded as a property tax because it is levied on residential property owners and renters. Communal tax on enterprises resembles a payroll tax. Tourism has been taxed for decades.

* This chapter is based on Davey and Péteri 1998.

Business Tax

The business tax is a turnover tax levied on manufacturers' and retail sales' net turnover. The law also differentiates between businesses classified as temporary activity and nontemporary activity. The maximum rate set by the central government for temporary activity is Ft 5,000 per day, and the rate for nontemporary activity is 1.4 percent (increased to 2.0 percent in 2000). The business tax may be levied on all enterprises, public and private—initially sales revenue net of the value added tax and on other consumption taxes. All businesses liable for this tax must report their annual sales to the corresponding municipality although registration and place of business can be ambiguous. Some introduced reforms address deductions from the tax base. Since 1998 the cost of materials may be deducted, but an increase in the tax rate has compensated for this reduction (Garzon 1998).

Tourism Tax

The current tax on tourism includes rents, guest nights, and summer cottages. The maximum rates established by the central government are Ft 300 per night for guests, 4 percent on the rental fee, and Ft 900 per square meter for cottages. Before the tourism tax, a local fee on tourism was collected only in resort areas. The current taxes may be levied by any local government.

Property Tax

Local governments can legally levy property taxes on privately owned building plots and buildings (for example, flats, single family houses, summer cottages, garages, storehouses, workshops, and other residential housing) and on commercial and industrial property. The tax may be levied on area size (in square meters) or on the assessed value of the property. The maximum tax rates established by the central government are Ft 900 per square meter or 3 percent of the corrected value. The corrected value is 50 percent of the assessed value as determined by the local government.

Communal Tax

This tax can be levied on household dwellings (owned or rented) and on businesses. The tax on dwellings is payable by the occupant at a maximum rate of Ft 12,000 per dwelling, regardless of the number of dwellers per household. From a revenue viewpoint, the communal tax on dwellings partially substitutes for taxes on real estate, although a property tax could be in principle more equitable than a communal tax because it could be based on the market value of property. The administration of communal tax on private persons is simple. The two other types of property taxes (on buildings and plots) produce 10 percent

of local taxes. The communal tax on enterprises is payable at a maximum rate of Ft 2,000 per employee. This approach resembles a payroll tax and makes the use of labor more costly. Its potential effect depends on the absolute amount of the tax. The gross national product per capita is about US\$ 6,730 (equivalent to Ft 1,346,000). From this perspective, the communal tax would be equivalent to less than 1 percent (0.8 percent) of the average annual income, an amount that in principle would not be expected to distort economic behavior.

Urban Land Tax

The land tax applies to urban land only and is levied on the property owners of idle (unimproved) plots. The maximum tax rate is Ft 200 per square meter or 3 percent on the corrected value of the plot. The corrected value is 50 percent of the assessed value as determined by the local government. The assessed value is supposed to reflect the actual market value of land. Publicly owned land is also taxable. The tax rate applied is Ft 15 per square meter, substantially below the maximum rate allowed. Ideally, the tax rate should be associated with the market value of land rather than the size of the plot. This rate would, in principle, make the tax more equitable and would be more likely to attain the policy objectives implicit in its design.

Objectives of Local Taxation

Conceptually, local authorities may derive revenue from local taxation by any of the following:

- Levying taxes themselves
- Imposing a locally decided surcharge on a revenue levied and collected by other levels of government
- Receiving a fixed share of national taxes collected within their jurisdiction.

Which method to exploit and apply to which tax base depends on the objectives of tax reform. One must ask precisely what is wrong with the present situation.

Presumably, the present level of local taxation is unsatisfactory for fiscal or accountability reasons (or both). The central government has been seeking to reduce a large budget deficit, and local government expenditure has been subject to a general fiscal squeeze. Higher local tax revenue might reduce the burden of local expenditure on state budget support or halt its recent decrease. For convenience, this argument will be described as the fiscal argument for enhanced local taxation.

Alternatively, some analysts argue that local governments do not take enough responsibility for raising the resources they spend and that the quality and efficiency of

financial management would improve if mayors and councils had to make harder decisions about revenue generation and answer directly to taxpayers for the use of a higher proportion of their budget. This argument will be described as the accountability argument.

The fiscal argument implies that local taxation reforms should increase the overall level of taxation either to reduce grants or increase local expenditure. It could be achieved by the following:

- Encouraging local authorities to exploit existing local tax sources more thoroughly by:
 - levying taxes they ignore at present
 - increasing rates of tax
 - improving assessment and collection
- Vesting local authorities with new tax sources
- Giving local authorities power to surcharge central government taxes within their territory.

Most analysts recognize that overall tax levels are high, particularly direct taxes on individuals and businesses. The high social security contributions penalizes employment, so any additional taxation should preferably be on consumption rather than income or profits, and any further direct taxation should be selective and progressive in its incidence, falling on those who are best able to pay more.

The accountability objective, by contrast, does not demand an increase in aggregate taxation. It needs only a shift in responsibility from central to local government for deciding tax rates or administering taxes. This shift could be achieved by: (a) transferring tax sources from central to local government, or (b) reducing rates of some national taxes and allowing local authorities to surcharge them.

The taxes subject to local decision, however, must finance a significant proportion of local budgets to make any real difference to local accountability, so they must be substantial revenue sources. Local government spends 12 percent of gross domestic product, the same percentage as in Britain and considerably more than in France (9.2 percent) or Germany (8.1 percent). This reflects wide responsibilities, particularly for education, social welfare, and health.

Thus taxes selected for transfer to or surcharge by local authorities for accountability reasons need two attributes. First, they must raise substantial revenues, at least 1 percent of gross domestic product and preferably more. Second, they must be susceptible to local variations in rates. Tax administrators should be able to identify the location of the payer and apply a variable rate, and rate variation should have no serious distortionary consequences. The impact of local decisions should fall on people within the jurisdiction and not simply be exported to consumers, shareholders, and others, elsewhere.

One tax device makes no potential contribution to either fiscal or accountability objectives: revenue sharing in which the central government determines the tax rates. Revenue sharing can meet other objectives, such as enhancing a sense of local autonomy or

guaranteeing local government a share of buoyant revenue, but it will not, of itself, increase the aggregate level of taxation or enhance the degree of local fiscal responsibility.

Fiscal Objectives

How could more revenue be raised from local taxes, thereby reducing grants or increasing local expenditure? The earlier discussion stated that any increases in overall tax burdens would have to be selective and progressive in their incidence. Comparisons suggest the following options:

- Local government discretion over levying the current taxes could be restricted. Local discretion over the tax rate is normal, but the freedom of municipalities to decide whether to impose taxes at all is most unusual. The taxes could be made mandatory and a minimum rate of tax prescribed.
- The current yield of property taxes is very low in comparison with other countries where they are levied. The potential for increases is obvious; international comparisons suggest that a target yield of around 0.8 percent of gross domestic product might be attainable and could raise up to 7 percent of local government budgets. To target increases on those most able to pay, reformers would need to make a major change in current assessment systems. The current flat rates per square meter, varying only by land use and neighborhood, do not reflect differences in the market or rental value of real estate sufficiently to bear substantially higher rates of taxation.
- Yields of local business tax have been increasing substantially. This increase has been facilitated by changes in the definition of the tax base to make it more equitable. They have also brought the tax base closer to that of value added tax, which will be subject to European Union (EU) policy restraints after accession. Competition in a single market intensifies pressures on local business taxation, and its potential for further major growth is open to question.
- The current rates of vehicle taxation are low by international standards and merit further review. EU membership may well force substantial increases in commercial vehicle tariffs. Vehicle ownership is usually related to wealth, and this form of taxation is broadly progressive as well as fair in relation to the costs of maintaining road networks.

No obvious new sources of local taxation emerge from international comparisons. The sources exploited elsewhere are already tapped by central or local government in Hungary.

Accountability Objectives

The options just discussed could raise more public revenue overall, but they would not make a fundamental difference in the balance between transfers and local revenue. Personal

income is the only potential local tax base that could support a substantial proportion of the expenditures of local authorities; 12.5 percent of the yields were distributed to local authorities by origin in 1998, but they have no share in the levy or administration of the tax. Turning this, or a larger share, into a local surcharge is probably the only way by which municipal leaders could be made substantially more responsible for the levels of their tax-borne revenue. This change would require a commensurate reduction in the basic national rates of tax to leave room for the local surcharge. Conversion into a local surcharge would also eliminate the current uncertainty and contention over the percentage share of PIT allocated to local government in the annual state budget. The major issue is whether the benefits in terms of local accountability outweigh the administrative costs.

Conclusion

The major options for increasing local taxation are: (a) introducing a value-related base for the assessment of property taxation, and (b) increasing rates of tax on motor vehicles, particularly heavy-duty commercial vehicles.

These increases will not, however, make a major difference to the overall balance between local taxation and transfers. If reformers believe that varying this ratio substantially for accountability reasons is important, the only option is to replace the current local government share of PIT with a local surcharge on PIT rates. The prime objective of such change would be to increase local discretion, rather than to raise more revenue.

Options for Reform

There are three areas where significant changes are advisable: increase of local property taxes and vehicle taxes, and introduction of a local surcharge on the personal income tax.

Local Property Tax

The most important lesson learned from the tax reforms in other countries is that property tax policy should be combined with institutional changes. Tax administration procedure should be planned ahead and each process of taxation should be executed by the most capable institution. Generally, property tax administration has five essential stages: identification, valuation, calculation of tax, billing, and collection (which includes the appeal process).

Property tax, which is a stable revenue, allows only limited tax exportation. The tax base is visible, and a rough relationship to ability to pay is maintained, at least in the case of residential property, whose value is a good indicator of the owner's wealth.

Although levied by an increasing number of local governments, property tax incidence is currently low primarily because of area-based assessments. These assessments do not differentiate adequately between the values of properties and, therefore, between the abilities of the owners to pay. Increases in the taxation of the higher value residential property could make a significant contribution to municipal revenues. Higher taxation of commercial properties is a lower priority, partly because of the technical difficulties involved and partly because their owners are also the target of local business taxes.

Property taxation is suitable as a local government levy because of the clear relationship to location and the possibility of applying local variations in tax policies and rates. Nevertheless, many national tax policy interventions are possible (for example, exemptions connected to income, compulsory categorization of properties, definition of value bands, and fixed ratios between tax rates). It would strengthen local accountability if the nationally defined property tax exemptions, which are based on social considerations, were left to local discretion.

Property tax policy design should be combined with planning the administrative environment. The current priority is to develop the valuation system.

Local governments should be encouraged and helped to adopt value-related taxation, with an immediate focus on residential property. Mass appraisal methods provide a possible compromise because of their current area-based systems. These systems could continue to use the area in square meters as a base, but could be modified by multipliers expressing differences in value arising from age, location, use, and quality. These multipliers should be derived from a regression analysis of sample assessments based on actual sales comparisons or a combination of land and construction costs (depending on the information most readily available). These costs should also be monitored continually to provide a basis for periodic indexation of the assessed values. The widely known geographic information systems should support the mass appraisal.

Central government intervention should support municipal property tax administration, especially in property identification and valuation. Economies of scale, which are needed for mass appraisal, can be achieved in the larger cities, but smaller municipalities need the services of a regional office for registration and valuation, perhaps at the county level. The local duty offices or the County Treasury and Information Service Offices could supply tax-base information.

The information needed for a mass appraisal system is available, but it is fragmented. Land offices hold the cadastre of property rights and boundaries, local government duty offices record transactions and their values, and local administrations possess the technical information on zoning, infrastructure, building size, and so forth. These three groups of information need to be made available and merged by the city or county valuation office. Municipalities should remain responsible for billing and collection and might pay a fee for the registration and valuation service.

Vehicle Tax

This section refers to possible increases in the rates of annual taxes on motor vehicles, which are shared equally between the central and local governments. It is based on a comparison made in 1994 between Hungarian tariffs and the rates applied by states in the EU (excluding the three most recent members, Austria, Finland, and Sweden). It has not been possible to obtain more recent comparative EU data.

Trucks

Trucks are taxed in the EU according to maximum loaded weight. Under an EU directive, the minimum tax rate for a fully loaded truck should be Ft 189,000. Greece, Italy, Portugal, and Spain have exemptions from the application of this directive.

In 1994 the Hungarian minimum rate was Ft 4 per kilogram of the vehicle's own weight plus 50 percent of its maximum potential load. Local government may increase this rate up to a maximum of Ft 8 per kilogram. On this basis the rate on a 38-ton articulated truck would be between Ft 102,600 and Ft 205,200. The minimum was, therefore, well below the EU directive, but the maximum is above it and in line with average EU levels.

Cars

The 1994 comparison showed huge variations between EU states in annual taxation of cars. The Hungarian rate on small cars was comparable to that in the lowest EU country, but minute in relation to EU tariffs with respect to all medium and large cars. When comparing tax liabilities on domestic transportation, taking differences in income levels into consideration is legitimate; these differences might discount the differentials in taxation of small cars, but not those of medium and large size.

An earlier survey suggested that 65 percent of local tax administrative capacity was devoted to collecting the vehicle tax (Lados 1994). Collection costs are 30 percent of the revenue collected, leaving local government with only 20 percent of the net revenue. Administrative costs for local government taxation are relatively high compared with national taxes. This disparity underlines the case for increasing the effective tax yield by reviewing the rates. It also suggests the need to examine the efficiency of the collection process.

Conclusion

The 1994 survey suggested an initial case for a gradual upward revision of minimum vehicle tax rates on the larger types of international freight vehicles, which will face the pressure of EU directives, and on larger cars. Both Hungarian and EU tariffs have changed since 1994, so a fresh comparison would be desirable.

Local Income Tax Surcharge

The two basic types of local government surcharges are: (a) a uniform addition to the national tax rates (that is, the rates on income in all brackets), or (b) a flat percentage addition to the whole of a taxpayer's national tax payment, including the rates on all brackets.

The first method applies in the Nordic countries and the second in Switzerland. In Sweden the national basic tax rate is zero, so that payers in the lowest taxable bracket pay only the local surcharge (up to 30 percent of net taxable income); the central government taxes only income in the higher brackets. The second method is easier to calculate and more progressive in its incidence on taxpayers. The second method produces greater potential disparities between the yields to individual municipalities than the first, since the surcharge applies to the higher as well as the basic rates. Applied in Hungary, however, it would only reproduce the existing disparities that arise from a flat percentage sharing of the tax collected in each municipality.

Preliminary discussions with officials in Hungary suggest a preference for the Swiss method. It would be simpler to introduce because its impacts on municipal finances can be predicted from existing tax data and a major redistribution of resources between local governments can be avoided. Further discussion in this chapter will assume choice of this method—the local surcharge will add a fixed percentage to the total amount of tax due by each taxpayer.

Local discretion to set the surcharge rate is essential to increasing local accountability. Varying degrees of discretion are possible, however. Municipalities might be free to levy the surcharge at any one of the following:

- at any rate they choose
- at any rate up to a prescribed maximum
- at or above a prescribed minimum rate
- between prescribed minimum and maximum rates.

Current legislation gives municipalities freedom not to impose the existing local taxes. The central government might not want to extend this principle to the PIT surcharge in view of the importance of PIT in the structure of municipal revenue.

We assume, as already argued, that the prime objective of introducing a local surcharge is to increase local accountability rather than tax burdens. Any surcharge would be counterbalanced by a reduction in national rates based on some estimate of the national average rates levied by municipalities. Modeling the change from sharing to surcharging would, therefore, need some assumption about a standard rate of surcharge at which the impact on taxpayers and the initial impact on municipal finances would be neutral. Municipalities that chose to levy a surcharge above this standard rate would earn a net gain in resources; those levying a lower rate would suffer a net reduction in revenue.

Setting any level for this standard rate of surcharge is theoretically possible, and the consequent gains or losses to municipalities in relation to the current PIT shares can be

adjusted against aggregate grants. A more acceptable approach, however, is to model the change on the present quantum of PIT transferred to municipalities; increasing that level of local participation in PIT and reducing grants would redistribute revenue between municipalities to the benefit of areas, such as Budapest, that have above average PIT revenues. Since this change is unlikely to be acceptable, we base our modeling on converting the existing aggregate municipal share of PIT into a standard rate of surcharge.

Multiple Levels of Local Government

More than one tier of local government can levy surcharges. In Sweden, for example, county, municipal, and parish councils all impose individual surcharges on personal income tax. The tax paid is, therefore, a composite of four rates including the national tax. The administrative burden on employers and tax authorities is clearly increased by multiple surcharges, but the process is not intrinsically more complicated.

Therefore dividing the surcharging power between the capital city and districts in Budapest would be possible. Surcharging power could also be given to county governments if analysts believed that restoring their taxing authority was appropriate.

Conclusion

Discussions with PIT officials at the national level suggest two beliefs:

- A change from PIT sharing to local surcharging would not require a major modification of existing procedures so far as the central government is concerned.
- The existing tax administration is capable of the modifications needed.

The main administrative burden would be on employers who would have to apply different rates of tax to their various withholdings. This requirement should not cause undue problems for employers that have computerized payroll systems; experience and software are both available from the Nordic countries. Municipalities, however, would need to determine their PIT surcharge rates well before the start of the tax year so that they could apply them immediately. The tax law might provide, for example, that the standard rate or the previous year's rate will apply in any given municipality unless specifically varied by the municipal assembly not less than one or two months before the beginning of the tax year.

Local surcharges would apply to income from employment and self-employment. Applying it to investment income would not be feasible.

Introducing surcharging would be easier if the impact on both taxpayers and municipal finance is neutral at a given standard rate. This neutrality would mean municipalities must impose a flat percentage surcharge on all PIT obligations (the Swiss system). On the basis of 1998 allocations the standard rate would be 17 percent and would have equivalent reductions in national rates on all brackets. Municipalities would, however, be free to impose rates below or above the standard, with consequent gains or losses to their budgets

and their taxpayers' pockets. This discretion might be total or within a prescribed range either side of the standard rate. Setting the standard rate at any other level would involve a redistribution of funds between central and local government probably involving grant structure adjustments.

In short, we have come across no insuperable administrative or fiscal obstacle to a change from PIT sharing to surcharging. Surcharging would increase local accountability, because the percentage of municipal revenues subject to local discretion would rise from 28 to nearly 36 percent. It would also stabilize local government's share of PIT yields and avoid the uncertainty and contention that surround the present system of annual negotiation and decision.

The main costs would be the added inconvenience to employers of withholding PIT at different rates and a lessening of national control over the overall tax burden. The degree of variation in PIT liabilities would be restricted by the minimum and maximum limits on the local surcharge, but the central government would still lose its control over the total level of the tax.

Surcharging PIT represents the only way of making local government directly accountable to the electorate for a substantial proportion of its revenue, given the scale of its expenditure. The advantages of this accountability and of stabilizing the division of PIT revenues between the central and local governments must be weighed in the balance against the additional administrative burden and the loss of total control over the tax level.

Extension of Local Taxing Power

Rights to levy local government taxes are limited to municipalities, which can decide which optional local taxes they want to levy and at what rates (within prescribed limits). The question arises whether this right should be extended to other local government bodies.

County Local Governments

When the 1990 Act on Local Government was debated in the Parliament, much controversy arose over the retention of a county tier. The tier was retained only on conditions that weakened county government powers; lack of taxing power is a major example.

In practice the counties have survived as self-governing units, and the number of institutions entrusted to them has grown substantially. Since 1994 they have also been governed by directly elected assemblies. Analysts see little reason to treat them differently from other self-governing units. For accountability reasons strong arguments favor giving counties some taxing power. Options include the following:

- Tax base sharing with the municipalities, as in Budapest and in France, Britain, Denmark, Sweden, and Switzerland, which would result in either reducing the municipal revenues (mainly from the business tax) or increasing tax burdens;

- Allowing counties to surcharge PIT (simpler than at municipal level);
- Allocating the central government's share of the vehicle tax and giving counties the same right as municipalities to increase the rates of their portion of the tax.

Municipal Associations

Some reformers argue that small municipalities should form associations to run services for which they individually lack financial and human resources. A Ministry of Finance proposal also promoted establishing district level self-governments to run most local services, leaving villages with minor ceremonial and representative functions. Lack of access to independent resources and dependence on contributions from member municipalities are often cited as major impediments to the formation and effective operation of such subregional bodies.

In Britain and France some intermunicipal bodies have the right to levy a surcharge on local government taxes. No inherent reason why they should be denied taxing power is evident, so long as their governing bodies are elected by the public or nominated by elected councils and representation on their governing bodies is roughly proportional to population.

If district self-governments or subregional associations exercised most municipal competencies on behalf of constituent municipalities, strong financial and political arguments for giving them substantial access to the municipal tax base would arise. The simplest way would be to allow them to piggyback on the municipal taxes. This approach would assume that constituent municipalities would be able to reduce their own tax rates because of the transfer of expenditure to the association.

If the associations and districts are: (a) are run by politically representative bodies, and (b) takeover a large share of municipal responsibility, they might be given exclusive right to levy a specific municipal tax. The business tax would be the best candidate because of its disparate incidence within the type of peri-urban area that might typify an association's jurisdiction. Although most of the tax might be paid by businesses in a central town, most likely the businesses' employees and customers would be drawn from the wider area served by the association or district, justifying the sharing of this tax base.

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11

Local Revenues in Selected Municipalities

Hernando Garzon

In light of their current and future financial situation, local governments need to strengthen their recurrent revenue sources and look for alternatives in capital financing, such as borrowing or the sale of debt instruments. Both of these options require a solid financial position to be creditworthy. The only feasible path for local governments' survival is to make much greater use of local taxes and bear the increasing political burden. This financial policy requires modernization of the system, structure, and administration of local taxes, and to attract private investors, greater transparency on local finances and financial management.

This chapter studies the fiscal situation and financial management, with special attention to tax administration and management in six medium-size municipalities: Nagykanizsa, Orosháza, Püspökladány, Szentes, Szolnok, and Tatabánya.

Revenue Sources

The Act on Local Government provides the framework for a range of revenue sources to finance local government functions. They include five local taxes, a share of the central government personal income tax, and several specific transfers. The transfers include a specific share of personal income tax allocated as equalizing transfer, normative grants, and for investment purposes, several targeted matching grants and earmarked non-matching grants (see chapters 6 and 7). In addition, local governments obtain dividends and other revenues from entrepreneurial activities, acquire proceeds from the disposition or rental of residential and commercial properties, and borrow to finance investments and to meet overdrafts or budgetary shortfalls.

* This chapter is based on Garzon 1998.

Fiscal Transfers

Central government transfers provide about two-thirds of total municipal revenues. The normative grants that primarily support current expenditures represent the largest portion of transfers. In our sample the relative weight of the normatives in local revenues ranges between 43.2 percent (Püspökladány) and 17.1 percent (Orosháza). In general, about two-thirds of normative grants cover recurrent expenditures on education. The rest of the grant is channeled to finance social services and other local activities. Other grants especially for capital expenditures (matching and non-matching) represent a very small portion of revenues (less than 5 percent); often, they do not exist.

The revenue-sharing system is another important mechanism in local finance. It includes the share in the personal income tax and vehicle tax. The 20 percent share in the personal income tax represented between 7 to 13 percent of total municipal revenues in 1998. This share may vary substantially in particular cases because it is based on the origin of the tax. Local governments retain 50 percent of the vehicle tax and transfer the difference to the central budget. Based on the current tax design, this source provides less than 1 percent of local governments' annual revenues.

Own Revenues

Own recurrent revenues include local taxes, user charges, earnings from entrepreneurial activities, and proceeds from the disposition or rental of residential and commercial properties. In this section the revenue situation of the municipalities in our sample is presented along with their options for increasing tax revenues.

Taxes

The 1990 Act on Local Government assigned five taxes to local governments: business tax, communal tax (that is, a poll tax, a payroll tax, or both), urban land tax, property tax on buildings, and tourism tax. Apart from the business tax, local governments collect the same taxes as were collected by the local councils under the previous regime (see Garzon 1998 and chapter 10).

Local governments decide, at their discretion and by resolution of their respective councils, which of these taxes they want to levy. Table 11.1 shows which taxes are levied by the reviewed municipalities. Some of our sample cities do not levy urban land taxes, the tourism tax, or the communal tax, and some (for example, Tatabánya) levy only the communal tax on businesses as a form of payroll tax. The Act on Local Government establishes some regulations on cities levying taxes:

- Two taxes may not be levied on the same object.
- Preexisting centrally mandated tax exemptions may not be restricted.
- Locally set tax rates may not exceed the centrally mandated maximum rate.

Significantly, all local taxes may be deducted as costs by individuals and businesses from the central taxes (for example, personal income and corporate tax).

Table 11.1 Local Taxes Levied in Selected Municipalities

| <i>Cities</i> | <i>Business tax</i> | <i>Communal tax</i> | <i>Urban land tax</i> | <i>Building tax</i> | <i>Tourism tax</i> |
|---------------|---------------------|---------------------|-----------------------|---------------------|--------------------|
| Nagykanizsa | Yes | Yes | No | Yes | No |
| Orosháza | Yes | Yes | No | Yes | No |
| Püspökladány | Yes | No | Yes | No | No |
| Szentes | Yes | Yes | No | No | Yes |
| Szolnok | Yes | No | No | Yes | No |
| Tatabánya | Yes | Yes | No | Yes | No |

Source: Municipalities of Nagykanizsa, Orosháza, Püspökladány, Szentes, Szolnok, and Tatabánya.

Business tax. In four of the six municipalities tax rates are below the maximum, and thus have room for adjustments. Some municipalities are considering setting the maximum rate to counterbalance future revenue losses. Municipalities that levy the maximum rate (for example, Nagykanizsa and Tatabánya) could legally increase their rates in tandem with the rise in the national maximum (for example, business tax from 1.4 to 1.7 percent in 1999). Some of them could also increase the tax base by lowering the cut-off of the yearly turnover value that makes business taxable.

Property tax on buildings. Four of the six municipalities levy a tax on buildings, three of them on residential property. Keeping residential property out of the tax base is one of the main property tax issues. Furthermore, of the two tax-base options, they use floor-space rather than market value. Püspökladány and Szentes do not levy building tax at all, and Szentes does not levy a plot tax on idle urban land. In Orosháza and Tatabánya, as in most cities, 25 square meters per dweller is exempt from floor-space tax, which leaves most housing units out of the tax base. Szolnok, in contrast, levies taxes on most housing units and does not grant the 25-square-meter exemption. Poor quality social housing units below 100 square meters are tax exempt, except in areas of tourism. Finally, properties owned by entities exempt from income tax (for example, churches, budgetary institutions, and public service organizations) are also tax exempt.

Because the floor-space-based taxation is fairly simple, but also very inequitable, most of the cities in the study want to introduce value-based property taxation. This option requires more information, however, which changes constantly. Among other things, the cities would need to develop a cadastre and update it permanently. More than 90 percent of housing units are privately owned, and market transactions occur frequently in these cities. Therefore, the information about taxable real estate is ample, particularly because sellers pay a transfer duty and the duty offices record the declared transaction price and a relevant market price. Because sellers tend to underreport real estate prices, corresponding

market values should be examined and registered for taxation and public record purposes (see chapter 13). Collecting relevant information about the local real estate markets would be fundamental in the transition from area-based to value-based taxation.

Urban land tax. Only the city of Püspökladány levies the land tax.

Tourism tax: Only the city of Szentes levies a tourism tax, at Ft 100 (US\$ 0.30) per night per guest.

User Charges

Municipalities do not directly collect user charges, such as fees for garbage collection or gas, water, and district heating supply. Under the monitoring and regulatory control of the local governments, charges are set, managed, and collected mainly by the public utilities that provide the services. Fees paid for social services are collected by the independent service institutions (for example, schools). A crucial issue is whether or not the charges recover the cost of services and, if not, how the losses are covered. Though the service providers are separate legal entities and independent of the city's administration, or owned partially or fully by private owners, the potential subsidies directly affect the local budget. Revenues from user charges are accounted as one budget item, which shows a declining trend and ranged between 0 and 3 percent of the local budgets in our sample in the 1993–1998 period. This negative trend reflects a policy to privatize or give concessions to public utilities.

Revenue Sources for Capital Finance

Capital financing that comprises revenues from asset management, sale of assets, central transfers (that is, earmarked and targeted investment grants), and in a few cases bond issuance, is fairly important for some of the cities analyzed. In 1998 capital revenues represented 26 percent and 30 percent of total revenues in Szentes and Tatabánya, respectively. In Püspökladány capital revenues represented only about 6 percent of the revenue budget in 1998.

Revenue Structure and Performance

Local government revenues generally increased in nominal terms during the 1993–1997 period, but most of the cities indicated a decline in nominal revenue in 1998. This analysis is based on actual revenues of the closing budgets, except the 1998 figures which reflect the opening budget. Revenues in constant prices deflated by the consumer price index, however, show a very different picture of the financial situation. From 1993 through 1998

local revenues in real terms fell by 40 percent in Püspökladány, mainly because of a severe decline in asset revenues. The fall in revenue was 18 percent in Szolnok in the same period. These trends suggest that the financial situation of these cities, and perhaps that of other municipalities, is approaching the critical stage.

In parallel with the decline in real value of the various local revenues, the composition of the revenue structure has changed significantly:

- Municipalities are gradually becoming less dependent on normative grants.
- The personal income tax has gained some importance in local revenues because of the greater income elasticity of the income tax. (Tatabánya is one exception to this trend.)
- Own-source revenues have gained relative importance in local finances. Szolnok has obtained about the same amount of normative grants as own-source revenues, which represent 27 and 26.8 percent of total revenues, respectively. In Püspökladány, however, revenues obtained from normative grants (43 percent) are much higher than the city's own-source revenue (17 percent).

Capital funds from own-source revenues are becoming less important. Revenues from the sale of municipal assets, particularly from privatization of housing estates, were generally growing until 1997. In 1998, however, this trend changed and the reliance on sales of municipal assets is becoming less sustainable.

Significantly, revenues from local taxes have substantially gained importance in the revenue structure (see table 11.2). Because several taxes are still levied on the basis of absolute values, and hence tend to erode with inflation, municipalities have gradually updated these tax rates during the period analyzed. Local taxes range between 5 percent and 12 percent of local government total revenues at the end of 1990s. In 1993 local taxes provided as little as less than 1 percent or at most 10 percent of total local revenues.

Table 11.2 Share of Local Taxes in the Actual Budget of the Selected Municipalities, 1993–1997 (percent)

| <i>Cities</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> |
|---------------|-------------|-------------|-------------|-------------|-------------|
| Nagykanizsa | 9.7 | 10.7 | 15.8 | 16.6 | 17.0 |
| Orosháza | 1.4 | 1.1 | 5.5 | 10.8 | 10.5 |
| Püspökladány | 0.4 | 0.3 | 1.7 | 3.1 | 2.8 |
| Szentes | 3.7 | 5.7 | 7.4 | 7.2 | 10.6 |
| Szolnok | 7.3 | 5.2 | 7.0 | 8.9 | 8.8 |
| Tatabánya | 4.9 | 4.4 | 4.2 | 4.9 | 6.0 |
| Country total | 4.4 | 4.2 | 5.1 | 7.0 | 7.2 |

Source: Authors' questionnaire and County Treasury and Information Service Office data.

Revenue Authority

This section addresses the question of whether local governments have sufficient legal autonomy to set their own revenues so that they can provide the public goods and services for which they are responsible. Adequate revenue autonomy determines how far local governments are accountable, financially and politically, for the provision of adequate local services. This section analyzes their authority to establish local taxes, set tax rates, determine user charges, and, in this context, how local governments, or their public enterprises, can recover the cost of these services is also examined.

Taxation

Local governments have the discretion to levy various local taxes, grant tax exemptions, and set tax rates subject to a maximum rate in compliance with the corresponding tax law. Despite the fact that local governments have a significant level of autonomy regarding local tax sources, most of them do not levy all legally allowed taxes. Moreover, when they levy a certain tax, they set local rates far below the maximum allowable rate. Table 11.3 shows how tax rates are set relative to the maximum rates in the selected municipalities.

Table 11.3 Relationship of Maximum and Actual Local Tax Rate in the Selected Municipalities, 1991–1998

| <i>Taxes by law and in sample cities</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <i>Tax on buildings</i> | | | | | | | | |
| Maximum by law (Ft/m ²) | 300 | 300 | 300 | 300 | 300 | 900 | 900 | 900 |
| Nagykanizsa (nonresidential %) | — | — | — | — | 100 | 33.3 | 33.3 | 33.3 |
| Orosháza (residential %) | — | 10.0 | 10.0 | 10.0 | 10.0 | 7.8 | 7.8 | 7.8 |
| Orosháza (nonresidential %) | — | 13.3 | 13.3 | 13.3 | 13.3 | 11.1 | 11.1 | 11.1 |
| Szolnok (nonresidential %) | — | 33.3 | 33.3 | 33.3 | 33.3 | 22.2 | 22.2 | 22.2 |
| Tatabánya (residential %) | — | 10.0 | 10.0 | 10.0 | 10.0 | 11.1 | 11.1 | 11.1 |
| Tatabánya (nonresidential %) | — | 16.6 | 16.6 | 16.6 | 16.6 | 16.6 | 16.6 | 17.8 |
| <i>Urban land tax</i> | | | | | | | | |
| Maximum rate by law (Ft/m ²) | 100 | 100 | 100 | 100 | 100 | 200 | 200 | 200 |
| Püspökladány (%) | — | 10.0 | 15.0 | 15.0 | 15.0 | 7.5 | 7.5 | 7.5 |
| <i>Communal tax</i> | | | | | | | | |
| Maximum rate by law (Ft/object) | 3,000 | 3,000 | 3,000 | 3,000 | 3,000 | 12,000 | 12,000 | 12,000 |
| Szentes (%) | — | — | — | — | — | 16.6 | 16.6 | 16.6 |

| <i>Taxes by law and in sample cities</i> | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-------|-------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| <i>Communal tax</i> | | | | | | | | |
| Maximum rate by law (Ft/employees) | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 |
| Nagykanizsa (%) | — | 100 | 100 | 100 | 100 | 100 | — | — |
| Orosháza (%) | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Tatabánya (%) | — | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| <i>Tax on tourism</i> | | | | | | | | |
| Maximum rate by law (Ft/guest night) | 100 | 100 | 100 | 100 | 100 | 300 | 300 | 300 |
| Szentes (%) | — | — | — | — | — | — | — | 33.3 |
| <i>Business tax</i> | | | | | | | | |
| Maximum rate by law (rate on net revenues) (%) | 0.3 | 0,3 | 0.8 | 0.8 | 0.8 | 1.2 | 1.2 | 1.4 |
| Nagykanizsa (%) | — | 66.6 | 75.0 | 100.0 | 100.0 | 66.6 | 83.3 | 100.0 |
| Orosháza ^a (%) | — | — | — | — | 100.0 | 100.0 | 100.0 | 85.7 |
| Püspökladány ^a (%) | — | — | — | — | 100.0 | 66.6 | 66.6 | 92.9 |
| Szentes (%) | — | — | 7.0 | 75.0 | 75.0 | 66.6 | 100.0 ^a | 78.6 ^a |
| Szolnok (%) | — | 33.3 | 100.0 ^a | 100.0 ^a | 100.0 ^a | 66.6 | 66.6 | 92.9 |
| Tatabánya (%) | 100.0 | 100.0 | 37.5 | 62.5 | 100.0 ^a | 100.0 ^a | 100.0 ^a | 100.0 ^a |
| <i>Business tax</i> | | | | | | | | |
| Maximum rate by law (Ft/day) | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 |
| Nagykanizsa (%) | — | — | — | — | — | 20.0 | 40.0 | 40.0 |
| Orosháza (%) | — | — | — | — | — | — | — | 100.0 |
| Püspökladány (%) | — | — | — | — | — | 10.0 | 10.0 | 100.0 ^a |
| Tatabánya (%) | 20.0 | — | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 | 60.0 |

Note: a. Rate set by different categories or different sectors.

Source: Authors' questionnaire.

User Charges and Fees

Local governments as local price regulators have sufficient autonomy to determine or control local user charges and fees. When the service providers are owned fully or mainly by the municipality, local government is represented on the board of directors; hence, the price proposal is controlled and the respective losses are covered by the municipality. In the case of services given private concession, management proposes charge adjustments, but the local government must agree to the adjustments. Though in principle local governments may recover the full cost of service provision and major price adjustments have been accomplished in the 1990s, local public services are often subsidized.

Autonomy in setting prices and the principle of cost recovery are of crucial importance in enhancing both accountability of local governments and efficiency of service providers and service allocation. From an economic efficiency viewpoint, if the beneficiaries of a local service are not charged adequately for the benefit they receive (that is, they do not pay the marginal cost of services), then one cannot expect an efficient allocation of economic resources to the provision of the particular service. Local governments have been struggling with a serious challenge to respond, in parallel, to the equity principles and subsidize several social groups, rather than the entire group of users via below-cost service fees (see chapters 25 and 26).

In principle amortization costs should be incorporated into the service price, and service provision can be handed over to the private sector under international competitive bidding. Regional companies owned by several local governments generally provide potable water and sewer services. The companies have the legal authority, through their boards of directors, to set optimal charges. The service companies cover operation and maintenance costs, but not capital financing. In Nagykanizsa, for instance, the charge for garbage collection recovers the operation and administration of the service. The fee does not include depreciation costs. A private firm provides this service, but the cost of new investment is the responsibility of the local government. The city has the autonomy to set the solid waste collection fee. In the Orosháza region, for instance, different charges apply for different settlements within the region, and fees have three categories: residential, business, and charges for local government institutions.

Tax Administration

This section examines the staffing and workload of the tax departments, the productivity of the staff, and the efficiency of the different taxes. It also analyses the four different stages of the tax administration cycle.

Staffing and Workload

Most local governments have a tax administration group that works within the economic or financial department. Only the city of Tatabánya has these functions organized at the level of a tax department. The number of staff working in tax administration across the six cities ranges between 4 and 20 employees (in Püspökladány and Tatabánya, respectively). The population of the six towns examined ranges between 17,000 and 78,000 inhabitants in 1997 (corresponding to Püspökladány and Szolnok, respectively). In general, the number of employees devoted to tax administration is directly related to the size of the municipality and the scope of their tax enforcement function. Regarding the latter, the number of staff seems low.

Tax administration workload is often measured by the magnitude of the flow of documents—between 2,000 and 28,000 tax documents per year per municipality in our sample. In Szentés, for instance, which is one of the smallest towns in our group, one tax employee handles on average 333 tax documents per year. Meanwhile, in Tatabánya, one of the large towns, an employee handles on average 1,400 tax documents per year. These numbers suggest that the tax administration staff do not seem to be overloaded. Whether the tax administration is over- or understaffed, however, depends not so much on what they do as on what they do compared to what they should be doing.

Tax Administration Cost

Each of the six towns provided estimates of the cost of administering local taxes. They included wages as well as other direct costs of tax administration and compared the actual cost with the actual tax collected to assess the efficiency of local taxes.

The magnitude of tax administrative cost as a proportion of tax revenues fluctuated between 2.8 percent and 8.7 percent in 1997 (see table 11.4), corresponding to Szolnok (largest town) and Püspökladány (smallest town), respectively. So the relative cost of tax administration tends to be lower, but the productivity of a tax official is clearly greater the larger the town. The cost of tax administration for the average town absorbs about 3 percent of tax revenues; hence local taxation seems to be fairly economical. One can see that the cost of tax administration has not been growing in tandem with the collected tax revenues, so tax efficiency has been gradually growing.

*Table 11.4 Estimated Costs of Local Tax Administration
as Share of Tax Revenues in the Selected Municipalities (percent)*

| <i>Cities</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> |
|---------------|-------------|-------------|-------------|-------------|-------------|
| Nagykanizsa | 4.2 | 4.8 | 3.9 | 3.2 | 3.0 |
| Orosháza | 29.1 | 31.2 | 7.4 | 4.6 | 3.0 |
| Püspökladány | 31.7 | 38.5 | 13.5 | 7.4 | 8.7 |
| Szentés | 8.1 | 5.3 | 3.6 | 3.6 | 3.0 |
| Szolnok | 3.7 | 5.0 | 3.8 | 3.2 | 2.8 |
| Tatabánya | 7.4 | 6.8 | 7.3 | 6.0 | 5.4 |

Source: Municipalities data.

Tax Administration Cycle

This section covers the four main phases of the tax administration cycle: identification, assessment, collection, and enforcement.

Taxpayer Identification

Taxpayers are obliged by law to report to the local tax administration their liabilities for the tax on buildings, idle urban land, communal taxes, tourism, businesses, and vehicles. In practice they often misreport or ignore their obligation. Therefore, a key task of the local administration is to identify every tax obligation. Several approaches verify how the cluster of registered taxpayers corresponds to the cluster of population that is assumed to have tax obligations. Effectiveness in tax identification, of course, varies across local taxes depending on their characteristics.

The local governments have vague information about what proportion of potential taxpayers is registered. In Nagykanizsa the registration for taxes on nonresidential buildings is above 90 percent. Tax liabilities on residential houses, however, are unknown in all the reviewed cities. In Püspökladány the only city that levies a tax on the less than two dozen idle urban land plots, every tax obligation has been identified and registered. Only the town of Szentés levies a communal tax on individuals, and about 96 percent of taxpayers are registered. Orosháza, Tatabánya, and Nagykanizsa levy a communal tax on entrepreneurs. In Nagykanizsa about 94 percent of potential taxpayers are identified, but the proportion of identification is unknown in the other two municipalities. Usually, the tax administration knows only the number of active taxpayers. Towns seldom know who should be registered. The tax on tourism is levied only by Szentés. This tax base is fairly small, and apparently all potential taxpayers have been identified. All the towns levy a business tax, and the registration rate is estimated to be between 80 and 90 percent. As for the vehicle tax, only two cities have estimates of the potential number of vehicles, and four of the six know how many are registered. The identification ratio ranges between 85 percent and 95 percent. Table 11.5 summarizes the current situation regarding tax identification in selected municipalities.

Table 11.5 Identification of Taxpayers in Selected Municipalities

| <i>Cities</i> | <i>Business tax</i> | <i>Communal tax</i> | <i>Urban land tax</i> | <i>Buildings tax</i> | <i>Tourism tax</i> |
|---------------|---------------------|---------------------|-----------------------|----------------------|--------------------|
| Nagykanizsa | 2,880 ^a | 3,060 | n.a. | 3,040 | n.a. |
| | 2,718 ^b | 2,220 | n.a. | n.a. | n.a. |
| | 94% ^c | 73% | n.a. | n.a. | n.a. |
| Püspökladány | 1,150 | n.a. | 22 | n.a. | n.a. |
| | 950 | n.a. | 21 | n.a. | n.a. |
| | 83% | n.a. | 95% | n.a. | n.a. |
| Szentés | n.a. | n.a. | n.a. | n.a. | 20 |
| | 1200 | n.a. | n.a. | n.a. | 6 |
| | n.a. | n.a. | n.a. | n.a. | 30% |
| Tatabánya | n.a. | n.a. | n.a. | n.a. | n.a. |
| | 3,323 | 3,297 | n.a. | 10,795 | n.a. |
| | n.a. | n.a. | n.a. | n.a. | n.a. |

- Notes:*
- The first line figure refers to potential (estimated) number of taxpayers.
 - The second indicates the number of active taxpayers.
 - Proportion (percent) of active to potential taxpayers.

Source: Authors' questionnaire applied in the selected municipalities.

One can conclude that for relatively small and easily identifiable tax bases (for example, urban idle land and large entrepreneurs), tax identification and registration are effective. For those tax bases that are much larger (for example, residential property), the identification of the tax base is fairly incomplete, or simply unknown. Hence, an important task for most local governments is the identification of their potential taxpayers. (See box 11.1.)

Box 11.1 The National Tax Administration Has Significantly Improved, and Benefits Are Expected to Spill over to the Local Level

In the early 1990s the rapid increase in the number of taxpayers and the introduction of a value added tax scheme overwhelmed the capacity of the central tax administration, particularly in Budapest. The agency suddenly faced a situation of being understaffed, and it had neither the expertise nor computer capacity to respond to modernization.

A tax administration modernization project, with the support of the World Bank has helped the central tax administration to overcome severe difficulties. The measures included, among other things, full computerization and rationalization of the tax declaration thresholds to reduce the number of tax returns and to make data processing and higher revenue collection cost-efficient. As a result the annual number of value added tax returns was reduced from 4.6 million to 1.3 million by shifting from monthly to quarterly returns in 1996. In addition, the tax rates were substantially reduced, improving tax morale and widening the tax base. The tightened tax administration reduced tax evasion significantly.

By the end of 1990s the central tax administration became the most modern tax administration in Eastern Europe and a model for the transition economies. An indication of its robustness and maturity is that the central tax administration was able to take over—virtually overnight—the collection of the social security contribution in 1999. The overall improvement in the national tax administration has had and is expected to have a positive effect on the local tax administration disciplines and capacity (World Bank 2000).

Tax Assessment

Tax administrators are supposed to determine the tax payment liabilities for every taxpayer on every local tax. In practice this step usually requires verification of the self-assessment submitted by a taxpayer for the particular tax. The figures in table 11.5 refer to the number of taxpayers or, equivalently, to the number of tax documents. Based on population of the sample municipalities, it seems that the workload of local tax officials should be much greater than it would seem on the basis of the mentioned number of tax documents per staff. This discrepancy may be due to the outdated management information system of these municipalities.

The taxes on buildings and plots require verification of the useful floor-space of the real estate rather than the current market value. This verification has to be done at least once onsite. Communal tax has practically no assessment, because it is the same fixed amount per dwelling. Most taxes are subject to tax exemptions granted for various reasons. Exemptions also require verification, at least once. In other cases, such as the tax on tourism, the tax assessment requires some kind of verification of the accuracy of the taxpayer's report. The

business tax also needs some form of review to determine whether the amount reported is consistent with the tax rate and the value of the tax base. Most local tax administrations' staffs are insufficient for adequate tax identification. As such, the work of local tax officials is often limited to management rather than verification of the information. In this sense tax assessments in municipalities are primarily the taxpayers' self-assessments.

Tax Collection

The business tax is the most common local tax. Businesses generally pay their taxes through bank transfers. When entrepreneurs receive a business license, they have to register with the local government. The registration list is the basis for identifying business taxpayers. The local government mails a letter to those who must pay the business tax or other tax, and the letter includes either the amount of the tax to be paid or the tax rate and the corresponding tax base so that the taxpayer can file a tax return. Tax liabilities (or the corresponding pay order) may be paid in cash or through bank transfer. Taxes are collected by taxpayers duly meeting their obligations; hence tax arrears are quite common (see table 11.6).

Table 11.6 Arrears for Selected Municipalities

| <i>Cities</i> | <i>Local tax revenues (Ft thousand)</i> | <i>Total tax arrears (Ft thousand)</i> | <i>Arrears to revenues (percent)</i> |
|---------------|---|--|--|
| Nagykanizsa | 563,498 | 42,328 | 7.5 |
| Orosháza | 516,932 | 11,334 | 2.2 |
| Püspökladány | 37,630 | 5,411 | 14.4 |
| Szentes | 292,497 | 38,540 | 13.2 |
| Szolnok | 916,987 | 60,520 | 6.6 |
| Tatabánya | 392,384 | 35,098 | 8.9 |

Source: Authors' questionnaire and County Treasury and Information Service Office data.

Tax arrears vary across municipalities and may be as high as 14 percent or as low as 2 percent of current local tax revenues (see table 11.6). Note, however, that arrears refer only to taxpayers who have made partial payments of their tax obligations. Municipalities do not account for the arrears of those who are not registered or those who registered but have not made any payments and have pending tax obligations. Therefore, the potential magnitude of the outstanding tax payment obligations is much greater than the estimated arrears.

Tax Enforcement and Penalties

Non-filers and stop-filers of tax returns are identified by comparing the list of those who have paid with the list of those registered at the local government. Of course, this

comparison is possible only when the list of taxpayers is properly updated and readily available. A second way to identify noncompliance is to compare those who have paid with the list of the registration court or, for the communal tax, with the land registry. The local tax administration notifies those whose tax returns are missing.

The first sanction on nonpayment is a delay fine. In principle failure to pay after a certain period may result in immediate collection of total tax due, and if this step does not work, the government initiates a process to withdraw the business license. For the vehicle tax the sanction is removal of the circulation license. For communal and building taxes the possible sanctions are withholding of benefits, wages, pensions, or confiscation of mobile assets (vehicles). In the case of a large amount of public debt, the taxpayer's property can be mortgaged or a foreclosure request can be filed. In practice use of these sanctions is very rare.

Constraints of Tax Administration

The major constraints are the shortage of staff and computer capacity, which reduces operational effectiveness. Another constraint is that the municipalities do not have an enforcement officer. To this extent, tax payments are practically voluntary. Furthermore, the city administration office seems to lack commitment to strengthen the local tax administration. In addition, municipalities do not support one another nor do they form agreements to learn from one another's experiences. Each local tax administration has had to develop its own collection and checking techniques. Finally, the political will of the local politicians and other decision-makers does not seem to be strong enough to levy more local taxes.

Conclusions and Policy Implications

Revenue Structure

Several policy implications emerge from the analysis of the revenue structure of the selected municipalities. First, the current financial situation suggests that local governments need to look for alternatives to capital financing other than sales of municipal assets. Two obvious sources would be financial institutions or private investors (bond issuance). Either of these two borrowing options, however, requires a solid financial position to be creditworthy. One strategy for local governments is to strengthen their recurrent revenue sources. This option, however, requires modernizing and making much greater use of local taxes.

Tax Structure and Performance

The need for modernization of local taxes and a change in tax structure is evident. First, the property tax should be levied on the basis of market value rather than physical size (floor-space). Only two municipalities in Hungary, Nyíregyháza and Németskér, currently use market values. Present legislation enables local governments to levy value-based property tax, so introducing it is a matter of local political priorities. Second, the property tax base must be expanded by including residential properties and reducing tax exemptions, particularly tax-free living space and maybe the first-owner exemption. Third, the vehicle tax should be levied on the basis of market value rather than on the weight of the vehicles.

Local governments should charge the marginal cost of service provision. This step would help provide the efficient amount of services to those willing to pay, make providing the services financially sustainable, and increase the level of political accountability and responsiveness of the local authorities toward citizens. The charge should include the cost of capital and depreciation. Compensation to social groups that cannot bear the cost-recovery service fees should be subsidized separately (see chapter 25).

Tax Administration

First, not all local governments levy all authorized taxes. Second, compliance with the taxes levied is left very much to the intention of the taxpayers to meet their obligations. Legally, sanctions and penalties penalize noncompliance, but tax enforcement is weak or nonexistent. Third, those who levy some of the taxes generally do not have enough information to levy them accurately. Local governments lack estimates regarding the potential number of taxpayers and updated records of tax registers. Fourth, without key data and adequate reporting, measuring a tax administration's performance is simply impossible.

Local governments must make greater and better use of local taxes. More revenues may be mobilized through more effective taxpayer identification, tax assessment and verification, tax collection, and enforcement. Local tax administrations need increases in staff and computer equipment. More complete and better databases for tax administration purposes are needed. New management information systems must be developed and implemented.

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12

Value-based Property Taxation: Options for Hungary

Ákos Szalai and Álmos Tassonyi



Hungary's municipal tax system and tax practice have changed radically in the 1990s. To achieve greater political popularity in the early 1990s, most municipalities terminated the previous taxes on residential properties and imposed the majority of local taxes on nonresidents. The business tax, a very conjuncture-dependent tax levied on a mobile tax base, is used by 90 percent of municipalities (see chapter 10). The need for more local revenue, however, has gradually driven many local governments to reinstate the building tax, plot tax, or communal tax, pushing property taxation into the spotlight again at the end of 1990s.

Despite the unfairness of the system, many municipalities continue to levy size-based building taxes on business properties and communal taxes on residential properties. Academic studies have suggested that the correlation between property size and the taxpayer's ability to pay (ability-to-pay principles) and between property size and the benefit from the local public services (benefit-taxation principle) are very weak. Most analysts agree, however, that local public services, education in particular, have a positive impact on property value.

This chapter highlights the rationale of value-based property taxation and seeks to establish a form that would be well suited to Hungarian circumstances. The chapter also identifies the policies necessary to enable municipalities to implement and properly administer this form of taxation.

* This chapter is based on Szalai and Tassonyi 1999.

Rationale for Property Taxation in the Context of European Union Accession

Property taxation has several well-known problems: it is unpopular because it is a visible tax burden; it is regressive; and its assessment can be complex. In many cases, property tax is the only tax that citizens directly confront because they must pay it as a lump sum periodically; other taxes are deducted from income or are hidden in the price of goods. Despite its problems, property taxation would seem to be the most appropriate local tax form. The most important positive feature of the property tax is its stability. The tax acts as a rough form of benefit charge as well: the value of real estate is strongly influenced by the level of local services (that is capitalization effect; see Inman 1999; Oates 1969), as well as location factors. Construction values and physical characteristics often are less significant as explanatory variables. Property taxation is often portrayed as a tool to influence the real estate market to encourage efficient land use (Bahl 1998; Barati and Szalai 1999; Boadway and Kitchen 1999).

An additional argument for implementing property taxation is that European Union accession requires significant changes in the Hungarian tax system, making the problems with the value added tax (VAT) system more apparent. The high rate will have to be reduced, the fiscal system must be prepared for the loss of significant VAT revenues, and alternatives must be found. The untapped property tax is an important alternative to VAT.

A reduction in VAT and an increase in property taxation require significant reforms in intergovernmental finance. VAT revenues will be withdrawn from the central budget, but property taxation will increase subnational revenues. Revenue sources will have to be reallocated. Because of the political desire not to increase the overall tax burden per household, the introduction of property taxation will require reduction of some other household taxes. One option is to reduce the local share of the national personal income tax (PIT) to make room for additional property taxation. The potential benefits are as follows:

- It would make implementing and strengthening the value-based tax possible before the VAT reduction.
- More stable revenue would be guaranteed for the municipalities.
- A shift to property taxation would broaden the range of taxpayers, so the average tax on all local taxpayers will diminish.

Moreover, the administration of the property tax carries many predictable and many unforeseeable risks. PIT was implemented more than 10 years ago, so by now the problems of income tax are known and more or less solved. The proposed shift to this form of taxation could temporarily lower administrative efficiency and tax revenues.

Major Forms of Property Taxation

Three main forms of value-based property tax are in use worldwide: (a) the bundled flat rate, (b) the land value (or graded rate), and (c) the unique English banded lump-sum tax (council tax). To analyze the type that would be most appropriate in Hungary, we first discuss two possible impacts of a property tax system.

First, the value-based property tax is not absolutely neutral. In terms of making a choice among different types of investment, a property tax may discourage the development of real properties because the net return may be decreased. All else being equal, other forms of investment (for example, bank accounts and the stock market) will be more popular, and property development may therefore be reduced.

Second, the property tax is a dynamic source of revenue: as the prices on the real estate market increase, the tax base broadens. Many experts list this buoyancy among the positive effects of the tax. (Politicians will be happy to see the increasing revenue without having to make the unpopular decision of increasing rates.) We must stress, however, the threat of this dynamism. If property values increase more quickly than incomes, the proportion of property tax in the household expenditure will increase, generating resistance to the tax. Values in the real estate market are likely to appreciate for two reasons: investors are likely to diversify their portfolios after the first collapse in the stock exchange, and European Union membership requires opening the real estate market to foreign capital. With these considerations in mind, we can compare the different forms of property taxation.

Bundled Flat or Variable Rate Tax System

This form of property taxation is the most prevalent worldwide. Land and improvements are assessed together (bundled) for a given piece of real estate, based on some method of estimating market value (see “Assessment Method” below), and their total value is taxed using the same rate. Rates and assessment methodology may vary by type of property. This form of the tax has some advantages and disadvantages. From the perspective of assessment, obtaining the total value of a property, including both land and buildings, is simpler and this total value is easier for taxpayers to understand. Municipal tax calculations are also simplified.

Tax revolts against this form, however, have occurred in many states in the United States. North American literature (O’Sullivan, Sexton, and Sheffrin 1995) explains these tax revolts as a consequence of the rate-driven characteristic of the flat rate system. In a period of economic boom, income increased and real estate prices rose with the higher rate, but municipalities did not lower their tax rates. The taxpayers objected to paying a higher share of their income to the government. In California, where the tax revolt (Proposition 13, 1978) caused the most dramatic changes, another problem arose. In 1971 and 1976, the California Supreme Court held that the use of the local property tax to finance local

schools was unconstitutional if educational opportunity was dependent on the local taxable property values. Because many taxpayers see education as the most important public service, they see the (reduced) property tax to be cost without relevant output and consequently are willing to limit taxes even at the expense of local accountability (Fischel 1998).

The state legislatures have been forced to limit the automatic increase in the tax burden caused by market conditions. They have used a variety of methods, including limits in the increase of assessed value (for example, the current year value may not be higher than the 105 percent of the previous year). Practically, this type of limitation severs the relationship between the assessed value of the properties compared to the true market value with the consequence that properties with higher-than-the-limit increases in value bear a lesser share of the cost of local services than if the assessment base fully reflected the appreciation in values.

Land Value Tax

The principal difference between the property tax system just discussed and a land value tax system is that land is taxed, but the improvement on a parcel is either absolutely exempt from tax or is taxed at a reduced rate.

The efficiency of a particular form of taxation depends on the elasticity of supply of taxed goods. The property tax base may be divided into two parts. The supply of land is fixed, but the quantity and value of improvement depends on the decision of investors. Consequently many countries (Australia, Denmark, Japan, New Zealand, and South Africa) use the land value tax. In Australia and South Africa some jurisdictions use the land tax, but others levy the bundled tax. In North America the well-known example is Pittsburgh, where a graded rate system works with tax rates on land set two times higher than the rates on improvements. Many other cities and states or provinces (for example, Washington, DC; Quebec; and Winnipeg) are studying the possibility of implementing the graded rate system. Its other advantage may be a greater equity effect. For example, the owners of condominiums in a real estate development must pay only their fraction of the value of the land parcel (one-hundredth in case of a building with one hundred flats), while the individual house owner must pay the whole tax.

In Hungary, as in many transition countries that have no long tradition of value-based taxation, taxation of land only has an administrative advantage. The required information about the land is complete in the land office, but data about the physical parameters of the improvements, although available from the municipal building authorities, are imperfect. Moreover, the duty offices assess the values of lands and buildings separately.

By contrast, when land taxation was implemented, many issues arose concerning the appropriate definition of “unimproved land,” for example, whether to include or exclude the impact of providing networks of public services such as water, sewer, gas, and electricity in the values of the tax base. In the context of a pure land tax, another problem arises from the

lower value of the aggregate tax base; namely, the lower the aggregate tax base, the higher the tax rate that is needed to raise the same revenue. Higher rates may impede efficient land use. Efficiency requires that the decision-maker be rewarded by a competitive profit or rate of return, but a high tax rate could reduce this gain significantly. Consequently, the use of a pure land tax is very rare, so the tax rate on land is limited and the necessary additional revenue must be obtained from a tax imposed on improvements. Current legislation would need significant amendment to implement land value (graded rate) taxation. The Law on Local Taxation explicitly exempts the land under the house from the urban land tax instead of allowing a higher rate on land.

Banded System (English Council Tax)

In the United Kingdom properties are classified into bands according to their capital (market) values. The assessment roll contains only the band value, not the actual assessed value for each property. The municipalities levy the same lump-sum tax on each property in the band regardless of its specific market value. This method seems to have three main advantages.

First, the threat of rate-driven taxation and its consequences—an increasing tax share of household income—is avoided. Greater tax revenue in this system requires setting a higher lump-sum tax. By contrast, municipalities could create automatic buoyancy as well. The tax decree could state that the year-to-year increasing rate is linked to inflation, to the level of increasing nominal average household income, to the average increase of real estate prices, or to a combination of the three factors. These indices seem to be far removed from the real estate market, but many property tax systems use similar indices to modify assessed values between two general assessments (for example, the consumer price index or the interest rate on government bonds), although the correlation of these indicators may not be significant with the increase in real estate values.

Second, taxpayers elsewhere seem to accept the band more easily than the current actual value. This system may reduce the number of appeals.

Third, the administrative cost of this method is likely to be lower than with a flat rate taxation system because some of the requirements of current assessment may be avoided. Reassessment may be required less frequently and may become important only when relative values among properties change significantly. In the current value-based system, reassessments must take place even if relative values have not changed, but the general value has increased. Where reassessments are avoided over longer periods, taxpayers may suffer from sticker shock when they are confronted with new assessments, particularly if rates are not flexible downward.

This form of property taxation also has its disadvantages. The lump-sum effect may result in large gains or losses when the property value is close to the border of any band. The English system cures this problem with small gaps between the tax amounts, but this factor results in a regressive scale of banded rates.

This method appears to be consistent with the current practice in Hungarian local taxation. Most municipalities levy a lump-sum communal tax on real estate, generally for reasons of administrative simplicity and cost reduction. This tax, however, yields very small amounts of revenue because of the very low rate, which is limited to Ft 12,000 (about US\$ 40) per year. The only necessary change in the local tax legislation would be to increase this limit.

In the remainder of this chapter, we assume that Hungary implements a property taxation system using the banded method, but other issues that may arise if another method is selected are also addressed.

Main Issues of Property Taxation—National Legislation

Property tax policy has three main components: (a) the definition of tax liability (who pays, on what basis, and at what rates); (b) the assessment method; and (c) mitigation issues. This chapter also summarizes the tasks of central legislation and municipalities in the policymaking and administrative process.

Tax Liability

Current legislation defines the owners of each parcel of local real estate as the taxpayer in the case of building, parcel, and tourism tax. In the case of the communal tax, the taxpayer is the private owner of the residential property or the tenant of a dwelling not owned by a private person (for example, municipal flats). Another option is also possible: the first liability would be on the occupier (tenant) in the absence of owner-occupancy, as in England, but because tenants outnumber owners, administrative costs would likely increase. We should also acknowledge that taxation based on the current taxpayer definition is functioning without any significant problems.

The choice of the base for value-based property taxation will also have to address the issue of whether to assess and tax nonresidential properties. One argument for such taxation is that similar assessment and tax treatment may encourage the most efficient land use since change in the use of property is not encouraged by higher or lower rates. Owners of nonresidential properties consume local public goods as well, so some analysts argue that they should bear some of the costs. For example, in Ontario, a rough estimate has suggested that the nonresidential sector benefits directly from approximately 40 percent of the local public services provided (Bird 1999). The counterarguments are based on the theories of tax exporting and tax competition. The owners of nonresidential properties do not vote in local elections, so they suffer “taxation without representation,” which reduces local accountability. Concerns about accountability were cited as a principal reason for the British government’s centralization of the rate setting.

Many analysts believe that tax on nonresidential properties may be exported beyond the boundaries of the municipalities through the pricing of exported goods. It is worth remembering that tax exporting is also likely with any locally levied tax, including the business turnover tax and other taxes on any local business. Generally, the nonresidential tax base is also likely to be more sensitive than the residential base to tax competition. Firms will generally seek out low-tax jurisdictions; other considerations being equal (labor force, transportation, other social infrastructure, and so forth). Tax competition is the principal reason why many legislatures consider the harmonization of nonresidential taxation across municipalities or the centralization of nonresidential taxation. This harmonization does not mean that the municipalities lose this revenue. With centrally managed rate setting and collection, the municipalities may receive back this tax on a derivation or on an equalization basis. Because of the lack of tax competition (rates that are too low), the overall revenue may be higher in this centralized case.

In Hungary local businesses pay a significant local business turnover tax, and the imposition of a local nonresidential property tax should be considered only as a replacement for this tax rather than as an additional tax. The replacement of the current, very unstable tax base with the value-based tax would be rational from the perspective of local finance. Furthermore, it would be useful to maintain the distinction in the form of property tax paid by the residential versus the nonresidential property owner. This distinction would be consistent with the current local taxation method—in many municipalities, the communal tax is paid on residential properties, and the owners of nonresidential properties pay the building tax.

As discussed above, the other main issue concerning the definition of the tax base is whether land and improvements should be treated equally, either from an assessment or from a rating perspective. If the government chooses to implement a property tax with a higher burden on the land, two main options are available: (a) the base can include the land and improvements, assessed using similar methodologies and principles, and the rates differ between them, or (b) the base can be defined differently. In the latter case, the central government should define the assessment ratios differently for land and improvements. The assessment ratio is the portion of the value on the assessment roll (subject to taxation) relative to the market value. In a banding system, the only possible solution is the second—the assessment ratio for the improvements may be 50 percent (100 percent for the land), so the tax base will be less sensitive to the value of improvements, as in the case of the graded rate system. (Zero percent for a building means a pure land tax.) In the flat rate system, actual tax rate alteration would be the better solution, because the introduction of an assessment ratio would be an unnecessary complication.

In banding, the central government would likely want to define the boundaries of the bands, as was done in England. This step may not be essential, however, because municipalities would be able to shape the bands according to the local real estate conditions. There may be room for central parameters and local flexibility here.

A significant feature of the Hungarian local tax system that will have to be confronted is the lack of a mandatory tax (for example, municipalities are not required to implement local taxes). The implementation of a mandatory tax requires defining a minimum amount (rate) for the tax. In the flat rate system, if the central government is concerned about the likelihood of assessment base value increases, it could consider measures to mitigate rate-driven taxation. As experience in U.S. jurisdictions has shown, local tax increases (caused by constant rates and assessment base growth during inflationary periods) can create a strong opposition to the property tax. Such opposition could be problematic in Hungary because of the interrelation between the proposed property tax and other taxes consonant with European Union accession. Several possible options are available, including rate capping and limits on assessment increases. A capped rate with increasing assessed value will result in significant increases in revenues. But if limits are applied only on assessment increases, the tax treatment of similar properties can be distorted. Relying on some form of revenue or rate limits may be necessary. In 1991, 30 American states limited the local property tax revenue, and in 1992, 10 limited annual assessment increases. Arizona, Nevada, and New Jersey limit both the property tax revenue and the overall revenue (ACIR 1992; O'Sullivan, Sexton, and Sheffrin 1995).

Assessment Method

Assessment or the valuation of property is the most vulnerable and often the most controversial aspect of a property tax system. The choice of assessment method is a critical issue in the implementation of value-based property taxation. International experience indicates that real estate assessment takes three main forms. Valuation can be based on: (a) market value—the probable best price of the real estate arrived at in an open market between a willing buyer and a willing seller; (b) annual rental value—the rent paid by the actual user (in case of owner-occupied property, the probable rent); or (c) acquisition value—the price at the time of purchase or construction. Having defined a methodology, the key issue is not necessarily to define the value of a property absolutely accurately but to achieve equity among similar types of property and among different classes of property.

Market Value (Capital Value)

This method of valuation is generally seen as the fairest because all property is assessed at the same time, and the valuation is done with the assumption of highest and best use. Assessors presume that the highest price comes from the bidder who will use the property in the most efficient way—the market (highest) price presupposes the best use.

Experience in many countries stresses that a simple legal declaration that market value could be applied (as in the current Hungarian legislation) is not enough. In implementing a market or capital value system, defining the valuation date of the assessment base is essential—the assessed value of properties has to be estimated with the market prices

prevailing at that time. In the absence of a declaration of this date, valuations may be inconsistent and out-of-date. In Ontario, before the assessment reform of 1998, some bases were on 1940 values and some were on 1992 values, based on historical choices by municipalities. Consequently, the assessment of similar properties even within a large single jurisdiction was often inequitable. As a matter of preference, reasonably frequent updates may avoid large shifts in assessed value and large tax impacts. Defining a status date is also important because the probable transaction has to be estimated using the condition of the real estate at this time. These two dates need not be the same as the current status of a property, and this can be reflected on an assessment roll, even if the assessed value reflects historical prices for the characteristics of the property.

Annual Rental Value

The basis of this system is defined as the notional or expected rental value of the property based on the estimated or actual amount of the annual rent. The countries that use this method tend to adopt rentals based on current use rather than highest and best use, which may somewhat reduce the total value of the assessment base (McCluskey 1999). Employing this method may also reduce the cost of assessment because the value of the rented property is known from contracts. The owners of rented properties may accept this method more readily because the actual rent is similar to the taxation of income. The one problem with this method is the exclusion of properties for which rents are subsidized or are not determined on an arm's length basis, which might lower the level of fairness more than the capital value method would. Annual rental value is used only in countries where tenancy is widespread (such as England, France, and many of the former colonies of the British Empire).

Acquisition Value

This method is used only in California, where it was introduced as a consequence of the tax revolts. From a valuation perspective, this method is simple because general reassessments are not needed. The validity of the purchase price is the main item to be confirmed. This method is quite unfair—in a period of 5 percent annual inflation, the difference in the value of two identical houses would be more than 100 percent if one of these properties was purchased 10 years before the other. Acquisition value provides protection to senior citizens and low-income households because they have tended to be immobile. By contrast, this system has provided a rather hostile welcome for new homeowners who must pay tax on the current value of the house.

Current Hungarian law defines assessment as a local task. This assignment of responsibility seems to be one of the main impediments to the implementation of value-based property taxation system. In other countries the system may be either central or regional. In the first case an agency of the central (state or provincial in North America)

government is responsible for assessing each property and transmitting the assessment roll to the municipal tax authorities. This type of arrangement is in place in Ontario, British Columbia, and many European countries (France, Germany, Sweden, and the United Kingdom). The regional solution is common in the United States and in some Canadian provinces. Agencies at a county level are the most prevalent assessment authorities (in the United States, towns and cities assess in only 14 states.). Even in states (provinces) with local assessors, some very important tasks remain with the state governments.

- The parameters and methods used to assess properties are usually regulated by the state government; training and accreditation are also usually a state responsibility.
- Many American states have had problems with the equalization system for grant and cost-sharing calculations. When equalization is based on the tax capacity of municipalities, the quality of local assessment may vary and result in misallocated grants and bias in cost sharing. If the state has accepted the results of local assessments without scrutiny, local governments would be encouraged to under-assess local properties, and the gap would be filled by state grants. The states use so-called ratio studies to monitor the quality of local assessments.
- Multi-jurisdictional infrastructure networks are usually assessed at the state level. State governments also often have retained the right to terminate a local assessment and to order a reassessment by another source in the case of permanent and uncorrected equity problems. Based on the experience of North American jurisdictions and the tradition of other European countries, it is rational to keep the assessment function under the control of the central government. This solution is also likely to be a more economical one. Economies of scale in property assessment are evident in America. Sjoquist and Walker found that a 10 percent increase in the volume of assessments reduces the average cost of assessment by approximately 6 percent in Georgia, where assessment is conducted by the counties (Sjoquist and Walker 1999). This solution is also likely to be less vulnerable to local political pressure; in many cases local assessors may face political pressure to undervalue the property of politically important owners. The centralization of this function can also provide direct information for tax-base equalization.

Ratio Studies

Ratio studies analyze the accuracy and fairness of assessments. Assessed values are compared with the real market value of a large sample of actually sold properties. These studies measure three main indices in each municipality (assessment district).

- *Assessment ratio*—the ratio of the assessed value to the sales price. This ratio can be measured as total value or at the average (median) level of the assessed and real values. This measure indicates the accuracy of the assessment.

- *Coefficient of dispersion*—the average absolute deviation expressed as a percentage of the median ratio. This average indicates the uniformity of assessment, acting as a measure of horizontal equity because if the coefficient of dispersion is greater than zero then the properties with the same market value bear a different assessed value. (The greater the coefficient of dispersion, the greater the differences.) The International Association of Assessment Officers (IAAO) standards for coefficients of dispersion are 15 percent for single-family residential properties, 10 percent in newer and fairly homogeneous areas, and 20 percent for other properties.
- *Price-related differential*—the mean of the assessment ratios for individual properties divided by the aggregate ratio. If the price-related differential is higher than 1, regressive assessment is revealed, that is, a tendency to assess low-valued properties at a relatively higher percentage of market value than higher value properties. The IAAO standard for price-related differentials is a range of 0.98 to 1.03 percent (Bell and Bowman 1997).

Mitigation Issues

One important issue concerning implementation of property taxation is mitigation. The central and local governments will need to implement some relief mechanisms for certain specific social groups or particular uses of property. Where the property tax may partly replace some other taxes (PIT, VAT), mitigation is an especially sensitive issue because the changes in the overall tax system may cause unintended shifts in tax incidence. To define a system of tax relief, three questions will need responses:

- What principles will define the social groups or property use that should be eligible for tax relief?
- How will the mitigation policy be defined in legislation?
- How much relief should be given?

The tax treatment of vacant lands (idle building plots) falls into two distinct categories. In a few cases (for example, Ontario and some Latin American countries), vacant lands are taxed at lower rates than developed properties on the theory that the absence of an occupier reduces the impact on local services. The opposite argument is that vacancy is a waste. In many cases, land is being held vacant as a form of speculation, so the imposition of a property tax should encourage development. This incentive mechanism imposes a penalty if the lands are not used in the best way. Hungarian legislation provides the option of imposing a separate urban land tax and belongs to the second category. This higher tax may be rational, but this method has a positive effect only where developed lands could meet unsatisfied needs.

Generally, properties owned by the government are exempt from taxation. In general, a subordinate level of government does not have the power to levy a tax on the property

of the upper level, and a tax on governmental properties would only be a transfer from government to government. By contract, several reasons are clear for payments or grants-in-lieu of taxes by the higher levels of government. They are appropriate if the property tax is viewed as a means of apportioning the costs of local services among properties. Second, considering land use efficiency, these properties also should be taxed. In North America, many higher level governments make payments for otherwise exempt properties. The range of lands subject to this in-lieu payment includes not only government-owned properties, but also other properties, where the activity is quasi-governmental, substantially government funded or is deemed to be worthy of encouragement (for example, churches, nonprofit organizations, educational institutions, or public hospitals).

In Hungary, if the introduction of a property taxation system is accompanied by a parallel reduction in personal income taxation, the taxpaying base will be broadened and a reduction in the tax burden on the former PIT-payers will be possible. The broadening of the base will likely include not only those who formerly managed to hide their income, but also those who do not pay income tax (or pay very little). Political acceptability will require protection for such taxpayers from significant increases in their overall tax burdens. Two methods are generally used to define eligibility for tax exemptions: (a) an exemption based on income level—households with income under a defined threshold should pay no taxes or pay a reduced amount—and (b) an exemption based on defined target groups—some taxpayers become eligible for preferential treatment regardless of their income.

In the 1990s Hungarian social policy proved that income-tested programs were not successful, primarily because of a high level of income from the black and gray economy. When the share of the gray economy decreases, Hungary could use circuit-breaker programs in which the maximum amount of property tax is defined as a percentage of household income—a portion of the tax in excess of this threshold may be deducted from the central PIT payment. The alternative criteria for preferential tax treatment would be based on some demographic or other observable characteristics, such as seniors over a defined age (not necessarily the retirement age), disabled people, families that have more than two children, and families that have at least one unemployed parent. Maintaining the current methods to solve their problems would appear to be rational. Actually, the municipalities can lower the tax or pay more social assistance for the poor based not on an income test, but on field investigation. The government could also consider providing a tax credit for property taxes paid or setting a portion of these taxes against income tax liability for certain eligible groups, thus further integrating the two systems.

Although setting an income-based limit may not be advisable, setting a property value limit would be rational. For properties that have very low value, the amount of tax forgone is likely to be minimal, but the cost of billing will approximate the average per property and the cost of collection and enforcement will likely be above the average.

In many states or provinces in North America, owner-occupied principal residences receive a partial exemption from taxation. Although the economic (distribution) effects of these practices may be questionable, politically enacting some variant of this type of

mitigation in Hungary would seem to be essential. To the extent that relief is targeted to owner-occupiers, such policies may discriminate against low-income households, who are usually tenants rather than owners. The issue of tax incidence between landlords and tenants has been debated, and the general consensus seems to be that the owner can pass through a portion of the tax to the tenant who then pays a higher rent.

Mitigation has two basic forms: (a) tax base or assessment reduction, and (b) exemption from payment. In the North American property tax system, the state or province governments define eligible groups. Municipalities receive assessment rolls for which the tax base has already been reduced, and the same tax rate is used for all reduced or non-reduced property value. Tax base reductions can cause very complex problems in the case of changes in ownership, which may affect eligibility for a tax preference. In North America, most states and provinces require annual assessment, and this frequency is able to handle these changes. The English tax payment reduction is accomplished by a less complicated method. Each property is classified according to full, non-reduced value and the exemption is linked to the taxpayer—the amount of tax is reduced in case of eligibility for relief.

Tax abatements are a special form of tax exemption when the municipality does not levy and collect tax on the higher value of property after the completion of an improvement. The old Hungarian house-tax exemption was a form of abatement, but with a very long period. The house tax was terminated in 1991. Previously, the local council could give 30-year exemptions for new houses. This practice reduced the tax base for a long time. Although this type of exemption constrains the disincentive effect on investment, it makes the system unfair because the abatements have the effect of exempting from the property tax the part of hidden income invested in real estate, and the owner does not contribute to the financing of the new infrastructure required by his or her new investment.

Tax deferral is a form of assistance frequently employed in North America. The eligible taxpayer may delay a portion of the tax payment and the deferred tax accrues on the property as a lien that increases year to year by normal or market interest. Tax and interest must be paid at the time of transfer of the property. Although this form of mitigation can be defined either by target group or amount, it can cause revenue uncertainty at the local level. The number of taxpayers that may apply for deferral is not predictable, especially in the first year of a program. In general, the take-up rate in North American jurisdictions is low. Eligibility can be restricted to a narrowly defined group, such as seniors and the disabled. The limitation of the value of the deferral is worth considering, for example, setting the upper limit of this lien as a portion of the property value. If the citizen reaches this limit, he or she should start to pay the lien.

If the central government declares the value-based property tax to be mandatory and other taxes are reduced to create tax room or an ability to pay for this tax, then some national tax relief policy must be enacted as well. Such a central policy will be essential for Parliament to accept the new tax structure. The failure of previous value-based property tax proposals submitted to Parliament in Hungary can be explained partly by the fact that neither the issue of a national mitigation system nor the issue of reducing other taxes was addressed.

Local Tax Administration

One of the main impediments to the implementation of a local property tax system in Hungary is that the local tax administration is not ready. Some of the problems stem from gaps in the legislation and others from the lack of experience in property taxation. Some of the most important constraints and the possible remedies for them are outlined below.

The current legislation defines assessment as the function of local governments. The municipalities, however, do not have enough experts to appraise the value of all properties in their districts. Moreover, the central government currently does not provide municipalities with enough information or legislative authority to make these assessments. In Hungarian legislation, the term “market value” is not a proper basis for mass and correct assessment for the following two reasons:

- Market value may change from month to month, and the base date is not defined. In a flat rate system, the main issue related to the base date definition is the frequency of reassessment. If the assessment cycle is too long, the increase in assessed value can be enormous from one assessment to another, so the flat rate system requires frequent reassessments—the best option is annual assessment. The banding system does not need such frequency because the tax does not depend on the current value, but on the relative value, which is likely to be more stable than the market price.
- The Law on Duty requires that valuation be based on the sales comparison method, but Hungary has no tradition of property taxation and thus lacks an understanding of the main technical issues of making comparisons.

The administration of all taxes is regulated in a single law that has been designed to suit the administration of other forms of taxation, especially income and sales taxation. The key implication of the applicability of this statute is the legal requirement that each tax process is based solely on the information collected from the taxpayer’s tax returns. As long as self-assessment is the only way to establish the tax base (that is, the value of property), potential tax revenue will remain below its possible level as a result of the tax evasive strategies of the landowners. Because higher property value (that is, a higher tax base) translates to a higher tax for the landowner, when self-assessment is used, all citizens will be encouraged to undervalue their properties. The Law on Tax Administration should be changed, or an independent Law on Assessment should be created, to make governmental assessment possible.

Given the lack of a governmental inventory process, citizens should be required to provide information about the physical parameters of real estate, but it is unlikely that each citizen will be able to correctly complete a very detailed tax return containing detailed questions.

The Law on Duty requires that assessment be based on a comparison of sale prices, but the duty office may not provide the municipalities with precise information on the actual

prices because of confidentiality provisions. The legislation should be changed to require that the duty office provide the municipality with sale prices from recent transactions in the area, and the assessors in the duty office should participate in the valuation. Communication between the land offices and the municipalities varies significantly from city to city. Legislation should require that the land offices give complete lists of the local properties and their owners to municipalities at the time of valuations and in a computerized format, should this be requested. Property records should also be forwarded to the local tax administration in cases of changes in ownership.

In addition, municipalities have very little information that can serve as the basis for picking out false and suspicious tax returns. Although as part of building permit documentation the building office has collected the main parameters of each building that has been built or renovated since January 1, 1998, these data have three important problems—they have not been stored in a computerized database, the older information is incomplete, and the older information is not readily available.

Central legislation should allow the municipality to publish the assessment roll as a cadastre of local properties. This cadastre should show: (a) the name of owner, (b) the physical parameters, and (c) the band of value of properties. Publicity is essential to appraise the fairness of the assessment and to impede undervaluation in the self-assessment process.

When the assessment roll prepared by governments, some taxpayers may have an incentive to appeal against the stated value. A large number of appeals may result, unless the filing of frivolous appeals has some negative consequences. The main forms of penalty should be that: (a) the assessed value reflects the real market price of property, for example, through the so-called golf course rule (that is, the owner has to sell the property to the municipality for the assessed price), or (b) the appeal process may impose a penalty in the case of obvious nuisance appeals. By contrast, the appeal practices indicate that a minimum of three levels of appeal should be defined. The first phase should be an informal negotiation between the taxpayer and the assessor. The problems not resolved in this process may be appealed to the specific assessment review board—such a tribunal is lacking in the current system. This board should be the final level considering the question of quantum of assessment. The judicial, or third, level should deal only with questions of law. Only two cities (Nyíregyháza and Némethkér) base the property tax on current value. This levy is only on nonresidential properties. In these two cities, negotiation (the first phase) was the final point of appeal: the tax returns were reconsidered with the owners. The disputes had to finish at this level because of the absence of an appeal mechanism. Effectively, the taxable value is determined in a negotiation between the taxpayers and the municipality.

Enforcement remains a problem. A large percentage of the unpaid taxes are from local businesses. This fact should make enforcement easier because the companies are required to inform the tax administration of their bank practices, and in many cases they have assets such as vehicles that can be seized. The administration has the right to stop payment from this account until the business pays the tax. Non-businesses, however, do not have to register their bank accounts with the tax administration and do not always have high-value,

movable properties to be seized. The seizure of the movable and immovable properties of non-payers, either physically or by securing a lien, should serve as an adequate enforcement mechanism. The seizure of movable properties is a well-functioning tool, especially in case of vehicles. Garnishing from personal income should be made easier, and the municipalities should get information about the employer of the taxpayers from the social contribution databases at the Central Tax Office. Stopping PIT-repayment could also be employed. Stopping the company tax repayment is a well-functioning method to collect the unpaid business receipts tax.

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13

Value-based Property Taxation: A Policy and Impact Analysis

Gábor Balás and Róbert Kovács



Over the 1990s central transfers have decreased significantly in real terms in tandem with the steady growth of local own revenues. This trend, which is likely to continue for the foreseeable future, is desirable because local revenues also motivate more citizen control over local financial management. Restructuring the present taxation system, introducing new taxes, and further increasing local revenues are key challenges during the first period of the country's membership in the European Union (EU). For the vast majority of municipalities, one possible alternative is the introduction of a value-based property tax, which has been legally available since 1990. Only two local governments have introduced it till 2000.

This chapter examines the conditions of and arguments for the introduction of value-based property taxation, which is both a realistic and desirable alternative for local governments. The chapter considers policy alternatives and challenges to show how a value-based property tax may be introduced, what problems the local governments might face in the present legal framework, and what remedies may be available. The chapter presents an appraisal method based on calculated value that can be introduced within the confines of current legal regulation and that would make appraising properties at relatively low cost possible. Based on the current data from Püspökladány, a secondary city, the chapter also presents an impact analysis on efficiency, fairness, and equity factors to show how different valuation methods and tax exemptions would influence various social groups, the tax revenue envelope, and tax dynamics. The study focuses on residential properties because taxing business properties is socially less sensitive and their appraisal is simple.

* This chapter is based on Balás and Kovács 1999.

Why Is Restructuring the Tax System Necessary?

At the beginning of the 1990s, newly elected local governments were reluctant to introduce local taxes for three reasons:

- Central transfers and shared taxes provided a convenient base for financing local services.
- They had received a significant amount of state assets and, hence, expected capital gains and proceeds from divestitures.
- They assumed political popularity in not levying taxes.

As a reaction to the fiscal squeeze, however, first the local governments increased asset sales to counterbalance the steadily decreasing central transfers and used privatization revenues primarily for investment and debt amortization. These measures, however, do not offer long-term solutions for financing recurrent expenditures. As a result, more than 80 percent of local governments now levy local taxes, and although these revenues more than tripled (from Ft 37 billion to 135 billion), they remained insufficient to counterbalance the Ft 400 billion drop in central transfers from 1991 through 1998.

The 1990 Law on Local Taxation stipulates that the following taxes can be levied locally: property tax (on residential and nonresidential buildings and plots), communal tax (private and corporate), tax on tourism, and business tax (see table 13.1 and chapters 10, 11, and 12). Every type of tax has advantages and disadvantages. Of concern, however, is that the business tax provides more than 80 percent of local tax revenues. Despite its disadvantages, local governments like the business tax, because they expect less resistance from entrepreneurs than from residents. This expectation is reinforced by a common view that residents are overtaxed and, hence, are unable and unwilling to pay more. Both the personal income tax and the value added tax are too high in comparison with other countries. These taxes ought to be reduced in parallel with EU membership, so Hungary's entire taxation system must be reconsidered and restructured in the near future.

Several arguments favor the value-based property tax, but the key policy challenges before a new type of tax is introduced are as follows:

- How much revenue is needed to maintain local services at a rational level?
- Which social strata should bear the burden of public expenditures, and to what extent?
- What effect may local taxes have on local businesses and employment?

In April 1999 we conducted a survey that in part forms the basis for our simulation modeling on local taxes. The survey took representative samples of 400 residents from each of the following medium-sized cities: Nagykanizsa, Orosháza, Püspökladány, Szentes, Szolnok, and Tatabánya. Experiences from our survey suggest that residents paying local taxes monitor local governments' activity more closely (for example, they attend assembly

meetings more often and are more informed). Local governments and the population have a choice between more public services and higher taxes or scaled-down public services and lower taxes.

Table 13.1 Local Taxes Levied in Hungary, 1998

| <i>Tax type</i> | <i>Number of local governments levying tax</i> | <i>Tax revenue</i> | |
|---------------------------------------|--|--------------------------------|-----------------------------|
| | | <i>Amount (Ft billion)</i> | <i>Proportion (percent)</i> |
| Property tax | | | |
| Residential buildings ^a | 215 | — | — |
| Nonresidential buildings ^a | 633 | 13.5 | 10.0 |
| Plot | 388 | 2.0 | 1.5 |
| Communal tax | | | |
| Private | 1,525 | 2.4 | 1.8 |
| Corporate | 825 | 1.2 | 0.9 |
| Tourism tax | 482 | 2.1 | 1.6 |
| Business tax | 2,527 | 113.7 | 84.3 |
| Total | 2,672 | 134.9 | 100.0 |

Note: a. The amount of taxes on residential and nonresidential buildings taken together.

Source: *Ön Kor Kép*, March 1999.

Analysts assume that local governments select a new type of tax after considering the advantages and disadvantages of the alternatives. Arguments listed in table 13.2 suggest that among all types of taxes available now, the value-based property tax has the most favorable characteristics. Only the business tax levied in prosperous industrial regions offers significant revenue capacity comparable to property taxes. Because of some of its characteristics, however, the business tax is not ideal as a primary source of revenue even in prosperous municipalities. The application of communal taxes is not justified because of the many problems they entail and because other alternatives are better. Most of the municipalities have not introduced the tourist tax or the tax on plots because of their small revenue capacity, but wherever possible these taxes can be recommended as supplementary elements of the local tax system.

When selecting one of the two types of property taxes (area-based and value-based), several factors need to be considered, such as revenue capacity, equity and fairness measures, and technical feasibility. Both value-based and area-based property tax schemes are suitable to create the necessary revenue capacity for local governments, but the revenues derived from the value-based property tax grow together with inflation in most cases, whereas the area-based tax tends to decrease in real terms, particularly in an inflationary period. Hence, given its dynamic nature, the value-based property tax is much more advantageous. The strongest argument for the value-based tax is that it is more equitable than the area-based tax.

Table 13.2 Characteristics of an Ideal Tax System

| <i>Characteristics</i> | <i>Business tax</i> | <i>Tourist tax</i> | | <i>Communal tax</i> | | <i>Property tax</i> | |
|--|---------------------|--------------------|-----------------|---------------------|--------------------|---------------------|--------------|
| | | <i>Area-based</i> | <i>Turnover</i> | <i>Corporate</i> | <i>Residential</i> | <i>Area-based</i> | <i>Value</i> |
| Paid by those who use services | | X | | | X | X | X |
| Stable tax base | | X | | | X | X | X |
| Transparent tax system | X | X | | X | X | X | X |
| Generates sufficient revenue | X | | | | | X | X |
| Equitable and affordable | X | | X | | | | X |
| Causes the lowest possible economic distortion | | X | | X | X | X | X |
| Not levied on citizens who are not part of the local community | | | | X | X | X | X |
| Simple administration | X | X | | | | | |
| Politically acceptable | X | | X | | X | X | X |
| Wide tax base and low tax rate | X | | | | X | X | X |

Source: Balás and Kovács 1999.

Based on the data of Püspökladány, a small city in southeastern Hungary, a simple simulation compared the possible impact of an area-based and a value-based property tax scheme assuming collection of the same total revenue (see table 13.3). Area-based taxation would tax the poorer strata of the population more heavily than value-based taxation would, because property value and family income have showed a higher correlation than the size of the housing units and the family income. Wealthier citizens would pay a greater portion of the tax in a value-based taxation. Moreover, reformers caution that the local government can collect more revenue with area-based taxation only by collecting more tax from the poorer clusters of residents.

Table 13.3 Comparing Area-based and Value-based Property Tax in Püspökladány

| <i>Factor</i> | <i>Type of property tax</i> | |
|---|-----------------------------|--------------------|
| | <i>Area-based</i> | <i>Value-based</i> |
| Revenue capacity | 90.0 Ft million | 89.6 Ft million |
| Tax rate | 200 Ft/m ² | 1.25% |
| <i>Percentage of total tax paid by household clusters</i> | | |
| Lower status households (37.7% of households) | 32.6 | 28.5 |
| Upper status households (24.6% of households) | 29.4 | 35.0 |

Notes: Lower and upper status households are represented by the lowest and highest quintiles.

Source: Balás and Kovács 1999.

The simulation results suggest that value-based property taxation can provide stable revenue for the local government and is more equitable than other taxation schemes. The remaining questions, then, are whether local governments are able to: (a) overcome the technical problems of levying value-based taxes, (b) meet the legal and operational requirements, and (c) develop an efficient, politically acceptable, and financially viable appraisal procedure.

Tax Policy Challenges

Should the political leadership of a municipality decide to introduce value-based property taxation, they will need to: (a) examine some legal conditions and limits, (b) appraise the market value of the properties and develop a reliable property register, and (c) analyze the revenue potential.

The Legal Conditions and Limits of Property Taxation

One of the most important questions when introducing a new tax is its expected revenue capacity. Legislation sets strict limitations for local governments in imposing the property tax. Both housing and non-housing properties can be taxed, but the range of exemptions is wide. The following are tax exempt: temporary lodgings below standard; the properties of social, health care, child care, and education institutions; the properties of budgetary organizations; properties of organizations supplying social services (for example, churches); the supplementary premises of dwellings; and agricultural storage facilities. The law defines a term “corrected market value,” which is 50 percent of the “commercial value” of the property. Another limitation is that tax exemptions granted to new housing units for 25 to 35 years before 1990 will remain in force until their expiration and will exempt about 30 to 50 percent of the housing in the country.

Although at first glance the legal framework appears to set serious restrictions, simulation results suggest that local governments have significant tax revenue potential, and the law provides them ample latitude to attain local priorities.

The Market Value of the Properties

It is easy to state but it is difficult to measure market value of properties. In this section we briefly summarize a number of methodologies and then introduce a simple method suitable for appraising market values in the Hungarian circumstances.

Options for Appraisal Methodologies

The success of value-based property taxation depends on the accuracy and recognition of the property appraisal (table 13.4). Despite the fact that owners are evidently interested in having their property appraised below market value for the tax base, self-appraisal is one of the most accessible initial solutions. Moreover it requires some generally applicable control mechanism to preserve equitable taxation and to avoid levying very different taxes on similar properties. In the long run, however, self-appraisal may lead to erosion of the real value of tax revenues because owners are not interested in appraising their property in tandem with increasing market value. In smaller settlements, however, say with a few thousand inhabitants, self-appraisal could be a long-term solution because inherent transparency and close personal contacts in small communities curb drawbacks. Self-appraisal could substitute other methods in small municipalities where tax administration capacities are limited.

External appraisal could be carried out as individual appraisal with the help of real estate experts or through a formula-based mass appraisal. The first solution is expensive and time-consuming and requires significant expert capacity and continuous training. The second method requires an appraisal formula, standardized technical and economic qualification indicators, and the average value estimate of the local properties. The legal background for this solution is underdeveloped, so the appraisal technique must be chosen with care to prevent local governments from mass appeals.

Mass appraisal based on a market-value formula seems to be suitable. It would not require a significant increase in administrative capacity and is unlikely to run into an uncontrollable number of appeals. Mass appraisal is initially also expensive, but it enables savings in financial and political costs in the long run. Private and government experts involved in developing the framework for value-based property taxation support the idea of a formula-based appraisal.

Appeals cannot be avoided by choosing either appraisal method because some taxpayers would appeal at any price. Those who appeal mass appraisal, however, will be confronted with considerable expenses and, hence, presumably will appeal only if a dramatic reduction or exemption is very likely. The number of appeals will be moderate if the formula contains a conservative estimate of the average property value and reflects a lower range of possible sale prices. The appraisal will be better accepted politically if the formula is published to allow residents to understand and review the value estimates.

The banded system, as described in chapter 12, also offers a cheap and simple solution. This method makes annual corrections simple, but distorts the relationship between property value and the level of taxation. It reduces the likelihood of appeals at the top and middle of the bands, but appeals remain likely at the bottom of the bands. Another problem is that this method is not properly legislated, though the law allows it. It might be a temporary solution for smaller settlements, say with fewer than 50,000 inhabitants.

Appraisal based on calculated value maintains property value proportions and is relatively inexpensive, but it requires an increase in administrative capacity and may distort

the equitability of the taxation system. With the current conditions, successful introduction of value-based property taxation depends to a large extent on the possibility of elaborating a calculated-value method.

Table 13.4 Comparing Appraisal Techniques

| <i>Appraisal technique</i> | <i>Advantages</i> | <i>Disadvantages</i> |
|---|--|---|
| Self-appraisal | Inexpensive No appeals | Inequitable Expensive to verify Tendency to underestimate Unstable tax base |
| Expert appraisal | Realistic value | Expensive to establish and maintain Subjective (each expert will give a different value) Encourages appeals |
| Area-based differentiated by area within the city | Inexpensive No appeals | Different from real value Inequitable Leads to segregation Annual political decision Defining areas will be a political (not a professional) decision |
| Appraisal using bands | Inexpensive Lowers number of appeals | Different from real value Inequitable Legality uncertain All at the bottom of each band may appeal Defining bands will be a political (not a professional) decision |
| Calculated value | Realistic value Objective Value-modification inexpensive Lowers number of appeals Lowers chances of successful appeals | Relatively high introduction costs (database) Does not prevent appeals |

Source: Balás and Kovács 1999.

The Legislative Framework for Appraising Market Value

The Law on Local Taxation and the 1990 Law on Duty create the legislative framework for a value-based property taxation. The Law on Local Taxation vaguely states that property tax can be levied on the basis of adjusted market value of the properties (section b, article 15 of the law). In principle this provision allows both individual and mass appraisal of fair market value. The Law on Local Taxation further refers to the Law on Duty, however, saying that the adjusted market value is equal to the 50 percent of the market value appraised in compliance with the Law on Duty (paragraph 13, article 52 of Law on Local Taxation). The latter stipulates that the market value is appraised and registered by the duty offices on the basis of the filed sale contract. Duty files, in principle, reflect fair market value, recorded on either the reported or a corrected sale price. Reported sale price is reappraised and increased to a comparative market price by the duty offices only when a qualified

underreporting is assumed. The annual maximum rate of property tax shall be 3 percent of the adjusted market value (section b, article 16 of the Law on Local Taxation).

The laws and regulations do not specify methods for property appraisal; they require only realistic valuation. Therefore, appraising property value without site inspection, based on key data about the property, is legal. Most of the properties have never been sold, or have not recently been sold, so the market value must be assessed indirectly. Another problem is that the law ties long-term commercial value to the historical sale price, subject to adjustment to a generally attainable price. In short, the current regulation does not prohibit, but clearly does not support, the use of a calculated value in appraising property.

A Suitable Method for Appraising Property Value

The method we elaborate and recommend for appraising property value is based on a linear equation formula that can be applied to all properties of a settlement with a standard procedure. The formula for appraising property value is (Balás and Kovács 1999):

$$PV = (AV + T_1 \cdot Sz_1 + \dots + T_n \cdot Sz_n) \cdot \text{Useful Area}$$

where: *PV* denotes property value

AV denotes the average value (average of actual sale price per square meter)

*T*₁ to *T*_{*n*} are factors that influence property value (location, material, age)

*Sz*₁ to *Sz*_{*n*} are factor coefficients that indicate how a given factor affects the property value (a coefficient might have a minus sign).

The average property value and the coefficients can be derived from a representative sample of local properties containing physical parameters and value estimates provided by one (or more) real estate experts (for example, location zone, status, infrastructure access, age). Calculating the formula with a multivariable regression is practical to ensure that the calculated property values are closely correlated with market prices. In elaborating the appraisal formula, identifying parameters that are relevant and easy to verify is of critical importance. This formula provides for a transparent, simple, and acceptable appraisal that is close to the real market value.

This formula makes annual reappraisal simple, because the average value is the only variable that needs annual adjustment, and a few other factors may need casual adjustment (for example, refurbishment, extension, utility development). We recommend, however, changing the correction factors and coefficients only every five years. The legislation stipulates actual market value, but the undesirable fluctuation of the tax base can also be avoided by using a three- to four-year moving average of the actual sale prices.

A reliable database could be obtained from the land cadastre and duty offices. Detailed supplementary data can be obtained from taxpayers, who should be encouraged to provide information about their own property. Taxpayers' data need cross-control, but relatively simple procedures are available for that. Land and duty offices are, for secrecy reasons,

very reluctant to share property data with local governments, although the latter, by law, must have automatic and free access to property files. In practice most local governments access this information when they need it, but their clear legal right should be stipulated by amendment to the Law on Local Taxation. Data flows across various departments within the local public administration should also be improved significantly.

Tax Revenue Potential

Local governments have a broad range of competency to: (a) introduce or modify local taxes in accordance with local priorities and political objectives, and (b) decide how much tax revenue is required, which social groups will bear major tax burden, and which ones will receive tax exemption. With the use of a simulation model, local governments can easily test these objectives, expectations, and potential effects to work out the final tax rates and other parameters (for example, exemptions).

When defining potential tax revenues, local governments must take legal limitations and residents' ability to pay into account to avoid mass appeals and enormous tax arrears. A sophisticated and sustainable system of equity-based exemptions, based on an impact analysis, is indispensable. The impact analysis can help define the tax level at which the average resident and various social groups can afford to pay. Equity-based exemptions are crucial to recognize differences. These methods are rarely used; instead, to avoid social and political tensions, local governments impose a narrow tax base and low tax rates, collecting much less than is legally allowed.

In every city in our survey, a value-based property tax levied on housing units at the highest rate would provide much higher revenue than the combined revenue collected through all local taxes today. Needless to say, taxes levied at the maximum rate, as assumed in table 13.5, would bring such an unbearable burden on citizens and amount to such huge political risks that no local government, even in prosperous municipalities, would be willing to impose such high taxes. If the taxes levied on corporate properties are added, then we see clearly that the property tax alone could provide an adequate level of local revenue and could substitute all kinds of other taxes presently collected or received as shared revenues. Because the property tax has such a high revenue potential, even within the framework of present regulation, it gives local governments a great deal of freedom in imposing tax rates.

How local revenues might change over time is a crucial feasibility indicator of any local tax scheme because resources rarely change automatically, but local expenditures follow price increases. The tax base of value-based property taxation, however, could increase dynamically for two reasons. First, the quantity of taxable properties increases over time in most municipalities. Second, the market or capitalized value of real estate increases in parallel with long-term financial market trends. The quantity grows because of new construction, expansions, refurbishment, and from the gradual phasing out of tax exemptions (a serious issue). The tax base also expands through periodic property reappraisal in accordance with local business prosperity.

Table 13.5 Property Tax Revenue Potential

| <i>City</i> | <i>Estimated property tax revenue^a</i> | <i>All local taxes combined</i> | |
|--------------------------|--|---------------------------------|------------------------------------|
| | <i>Value-based tax with 3% maximum rate (Ft billion)</i> | <i>Revenue 1998</i> | <i>Percentage of total revenue</i> |
| Nagykanizsa ^b | 967.7 | 561.6 | 7.8 |
| Orosháza | 574.2 | 517.0 | 12.2 |
| Püspökladány | 215.2 | 43.5 | 4.9 |
| Szentes | 570.7 | 270.0 | 9.2 |
| Szolnok | 1,356.3 | 1,050.0 | 10.9 |
| Tatabánya | 756.9 | 420.0 | 5.9 |

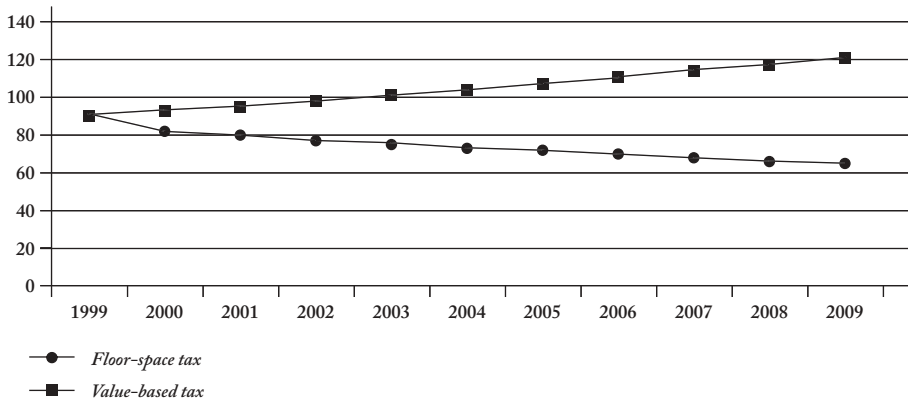
Notes: a. Revenue from residential building tax only, taxes on commercial property are excluded.
b. Nagykanizsa data are from 1997.

Source: Balás and Kovács 1999.

Although the net growth of the number of buildings is generally slow though steady, the increase in property value is far less predictable. (Because of the gradual removal of tax exemptions that had been granted since 1974, the tax base will steadily increase until 2007. In addition, by imposing consistent tax rates via reappraisal and because of the increase in the number of taxpayers, local governments can count on a dynamic increase in tax revenues without increasing tax rates, or even with lowering them.) The increase in property value depends on, among other things, general price changes, local economic conditions, and the demand for local properties. Although the relationship between the value of properties and inflation is uncertain, because real estate prices can temporarily lag behind the growth in capitalized value of other assets, experience shows that the two tend to change in tandem in the long run. Because of the economic crisis, the value of real estate dropped by 30 percent in real terms from 1992 through 1997, but real estate prices started to catch up with the inflation as long-term economic growth began in 1998. A further increase is expected because of Hungary's membership in the European Union. No country has an automatic relationship between the change in property value and tax revenue.

Foreign experiences show that adjusting the tax base or rate is one of the most difficult and politically sensitive issues. Often sufficient rate increases are not approved and the success of taxation is put at risk. These consequences should be addressed in choosing the appraisal method and drafting the local tax ordinance. We recommend a solution that does not require annual political approval. Figure 13.1 shows a projected change in tax revenue in Püspökladány, comparing area-based and value-based taxation in constant prices in a period of notable inflation. The figure shows results assuming: (a) that local governments levy either a Ft 200 per square meter area-based tax or a 1.25 percent rate value-based tax, and (b) that a 3 percent annual increase in real value of housing units occurs and inflation gradually decreases. (We assumed 8.0, 6.0, 4.0, 3.5, 3.0, 2.8, 2.6, 2.5, 2.5, and 2.5 percent inflation from 1999 through 2008, respectively.)

Figure 13.1 The Dynamics of Tax Revenues in Püspökladány—Constant Price (Ft million)



Source: Balás and Kovács, 1999.

Local governments can choose among several reappraisal methods, such as indexation, direct price adjustment, or banded value increase. Property value can be indexed to monetary indicators such as inflation or the yield of state securities. Reappraisal can be based on real estate current sale price data from previous years; meanwhile, large public investments that may affect property value should be considered. Automatic indexation is unsuitable when some extraordinary factor (for example, EU accession or war in a neighboring country) changes property values sharply up or down in the span of one year. A sharp decrease of the tax base is undesirable for the local budget, and a sharp increase may be unacceptable for taxpayers. These situations can be avoided in several ways. The local government can restrict the range of annual changes in the tax base, allowing, say, only a 15 percent annual increase and gradually dispersing a striking 50 percent change in a three-year adjustment period. As a result, property values might catch up with market value in three to four years, but local tax revenues will be less volatile than market value. Another method is to use a five-year moving average of current real estate prices. These methods lead to similar results, but the ceiling method is safer. We advise reconsidering and maybe changing appraisal schemes with a defined regularity (say five years).

Impact Analysis

The goal of an impact analysis is to: (a) measure the potential socio-economic effects of a taxation scheme; (b) estimate and test the optimal benchmarks and coefficients determining the tax base, tax rate, and tax dynamics; and (c) test tax revenue capacity and the effects of potential tax exemptions on local revenues. An impact analysis conceptually

performs a simulation in a complex taxation model based on real data available at the local administration and from a survey of citizens.

This section first summarizes the conceptual issues of an impact analysis, and then shows the major results of the analysis performed on the basis of detailed data from Püspökladány. In our simulation modeling we have addressed four important sets of issues, tested the tax affordability, measured the impact of tax exemption on various social groups and on local budget revenues, and finally drew conclusions for political decisions.

Types of Exemptions

Exemptions are granted essentially for two reasons: first, to make the tax affordable and reduce arrears and, second, to follow local political priorities.

Exemptions Based on Affordability or Fairness

Exemptions based on affordability conceptually improve equity and prevent overtaxation. Developing an affordability exemption scheme, however, is just as complicated as developing the taxation scheme itself. Instead of improving equity, exemptions may distort the basic role of property taxation, which is to tax higher wealth and bring otherwise untaxed incomes into the support of the local public burden. To improve fairness, exemptions are often tied to the income of taxpayers. About 30 percent of personal income remains hidden and is concentrated in certain social strata and professions. As a result, income-based exemptions may increase inequality. One solution could be to link a wealth test to income-based exemptions, that is, an exemption for low-income people can be granted only if the value of their properties falls below a ceiling (for example, Ft 4 million). Imposing an inheritance tax could be a solution for a critical group of single elderly people living in valuable housing with low income; however, as mentioned, this exemption would require legislative changes. Various forms of exemptions are often granted in parallel. Exemptions might be full or partial; they might be tied to household income brackets (for example, the sum of the tax cannot exceed 2 percent of household income, but up to this level even the poorest must pay); they might be temporary (for example, for the unemployed); they might be time-delayed exemptions granted to single elderly persons and often passed on to their heirs. This type of exemption is known as inheritance tax in Europe. Hungary's current legislation does not allow institution of the inheritance tax, although introducing it would be a step in the right direction.

Exemptions Based on Local Political Priorities

This sphere of exemptions is virtually boundless (for example, poor families or urban policy objectives can be supported with specific or general exemptions). When introducing such exemptions, three important points should be taken into consideration. First, will the

tax revenue collected be sufficient for the local budget after the exemptions are enacted? Second, can the desired positive effect of the exemption be effectively ensured (for example, exemptions based on the number of children may serve family policy rather than social purposes)? Third, is the tax system transparent? Hence, the number of exemptions should be limited. Because exemptions can distort each other's effects, a complicated and detailed exemption system might be less effective than restricting exemptions and applying lower tax rate.

Forms of Exemption

The form of exemption depends also on the objectives and the forms of local tax regulations. Exemptions based on affordability must be limited to those who have real difficulties, and exemptions that are too broad mean full freedom from taxation. Temporary exemptions are applicable to the unemployed because this disadvantage is temporary. When a disadvantage is long term, but a valuable property is involved, the tax can be pledged to pass the burden to the time when the property is sold or when the owner dies. These regulations allow the local government to be fair, but able to plan and receive the revenue eventually. Citizens must have the opportunity to receive exemptions anytime throughout the year when changes in life circumstances justify them.

Affordability Test in Püspökladány

Citizens are more willing to pay if they feel the local taxation is equitable. A well-prepared tax system imposes affordable taxes with the lowest possible rate, encourages citizens to pay, and generates sufficient revenue. Once the local government has decided the expected tax revenue, it should decide how to distribute this burden among residents in the fairest manner, while matching social and political goals. An impact analysis is a crucial instrument in defining a suitable and efficient taxation scheme.

Consider a hypothetical example. The local government of Püspökladány chooses to earn Ft 90 million revenue through a value-based property tax on residential real estate. The simulation shows that a 1.25 percent tax rate would enable the local government to collect Ft 89.7 million in revenue, if everyone pays. Using the method described above, we simulated the average tax payment for households in various social groups (tables 13.6, 13.7, and 13.8). The annual property tax is projected to amount to about Ft 12,000 (US\$ 40) for an average household. We estimated not only the average tax paid by households, but also the burden on their incomes. Based on simplified calculations, we show the burden by social strata in income quintiles, though attention should also be paid to indicators of income per family member.

The impact analysis shows unambiguously that the highest status group, mostly residents of large homes, would pay more tax, but the lowest status group would pay not quite half of what the best-off would pay (see table 13.6). Disparities are even wider because

of the differences between wealth (property value) and family income. As the property tax portion of family income, the poorest group would pay 10 times more than the highest status group. One reason for this is that Hungary has no social housing, and because of previously heavily subsidized home construction, families with very low income are owners of sizable and valuable houses. The analysis also revealed that the highest tax-to-income burden is put on single active and inactive (retired) people (see table 13.7). The Ft 10,000 annual tax payment (table 13.6) seems to be too high for owners in the lowest strata; hence, the tax amount ought to be mitigated. The local government ought to provide preferences according to family types, particularly large families, though this issue is not necessarily a social one. The data in table 13.7 show that large families hardly pay more than the average (just Ft 3,000 per year), while single retired people pay only Ft 4,000 less than the average and the tax represents an almost unbearable burden on their pension income.

Table 13.6 Tax Burden by Income Strata of Households in Püspökladány

| <i>Status group (from lowest to highest)</i> | <i>Property tax (Ft per year)</i> | <i>Tax per Income (percentage)</i> | <i>Number of households</i> |
|--|---------------------------------------|--|-----------------------------|
| 1. | 10,151 | 7.2 | 2,510 |
| 2. | 12,694 | 1.2 | 1,460 |
| 3. | 13,548 | 0.8 | 1,098 |
| 4. | 16,058 | 0.6 | 826 |
| 5. | 22,394 | 0.7 | 811 |
| Püspökladány average | 12,362 | 3.3 | 6,652 |

Note: Calculations are based on a 1.25 percent tax on the corrected market value of households' residential properties, and estimated annual family income.

Source: Balás and Kovács 1999.

Table 13.7 Tax Burden by Types of Households and Families in Püspökladány

| <i>Type of household</i> | <i>Tax to be paid (Ft per year)</i> | <i>Tax per Income (percentage)</i> | <i>Number of households</i> |
|---------------------------------------|---|--|-----------------------------|
| Single person, active | 13,337 | 6.4 | 512 |
| Single person, inactive | 8,342 | 5.6 | 1,271 |
| Minimum 2 working, maximum 2 children | 15,126 | 2.2 | 4,020 |
| One working, minimum 3 children | 11,000 | 0.9 | 146 |
| Minimum 2 working, minimum 3 children | 17,511 | 1.9 | 81 |
| Old couples | 13,476 | 3.6 | 622 |
| Püspökladány total | 12,362 | 3.3 | 6,652 |

Note: The tax is based on a rate of 1.25 percent of the corrected commercial value.

Source: Balás and Kovács 1999.

Household composition results in serious tax disparities consistent with the observations mentioned earlier (table 13.8). Households with an entrepreneur family member, which are usually in a better income and overall wealth position, pay on average 50 percent more tax based on their residential property. They may also have a separate property for business that is taxed according to a different ordinance. Nevertheless, the property tax will be a burden mostly for households that include one or more retired persons. Without tax mitigation, these households would pay a 4.8 percent share of their income for property taxation.

Table 13.8 Tax Burden by Household Composition in Püspökladány

| <i>Household</i> | <i>Tax to be paid (Ft per year)</i> | <i>Tax per Income (percentage)</i> | <i>Number of households</i> |
|------------------------------------|---|--|-----------------------------|
| Entrepreneur in the household | 19,548 | 2.0 | 661 |
| Unemployed person in the household | 11,304 | 1.9 | 960 |
| Retired person in the household | 12,286 | 4.8 | 3,852 |
| All Püspökladány | 12,362 | 3.3 | 6,652 |

Source: Balás and Kovács 1999.

Measuring the Effects of Tax Exemptions

Reformers should carefully analyze the tax burdens on different social groups and on various kinds of households in the course of the impact analysis of exemptions. When establishing exemptions, the size of the social group in question is a serious issue. If tax exemptions are granted to a populous group of citizens, then the local government faces a significant revenue decrease and the entire tax burden may need to be increased or put on other social groups.

Fairness-based Exemptions

Fairness exemptions are a complicated but very important part of property taxation. Among the several possible variations, reformers have examined income-based exemptions. The two key issues to be addressed in defining exemptions are how to achieve the desired goals and obtain an adequate level of revenues. Table 13.9 shows the effects of various income-based exemptions in Püspökladány. We analyzed three basic cases to estimate the impact of the exemptions on overall local revenues and on various households' clusters. We considered three possible tax limitations by family income: 1 percent, 2 percent, and 3 percent ceiling, as well as three possible limitations by value of properties: Ft 2 million (US\$ 7,000) per house, Ft 6 million (US\$ 20,000) per house, and no limitation. The effects of the two sets of limitations on tax exemption were estimated in combination.

Simulation results show that the local government of Püspökladány could lose considerable revenue (Ft 15–30 million, see column 4 in table 13.9, “no limit”) if tax

exemptions are granted without limit (that is, irrespective of the value of their housing unit) to every household when its tax would surpass 1, 2, or 3 percent of family income. Clearly, applying a property value limit (that is, easing the burden only for homes under a set value) could improve tax revenue potential significantly (see columns 2 and 3 in table 13.9). The low limit of Ft 2 million means that exemptions are granted only to poor families who not only have low income but also live in a low-value housing unit. As a result of this conservative principle in granting exemptions, the local government would only lose Ft 4–7 million (4.5–8 percent) of tax revenue, while the higher social strata would continue to bear the tax burden of the municipality. The results suggest that local governments can easily establish a limit on exemptions that makes the tax bearable to poor families, but enables them to collect sufficient tax revenue.

Table 13.9 The Effects of Income-based Exemptions on Local Revenues and on Households

| Income limit (percent) | Property value limits in exemptions (Ft million per household) | | | Income limit (percent) | Property value limits in exemptions (Ft million per household) | | |
|---------------------------|---|--------------|--------------|---------------------------|---|--------------|--------------|
| | Ft 2 million | Ft 6 million | Ft 6 million | | Ft 2 million | Ft 6 million | Ft 6 million |
| | Local government annual revenue (Ft million) | | | | Tax paid by lower status household (Ft per year) | | |
| 1.0 | 82.2 | 64.3 | 59.5 | 1.0 | 7,300 | 2,700 | 2,000 |
| 2.0 | 84.4 | 74.4 | 71.3 | 2.0 | 8,100 | 4,400 | 3,700 |
| 3.0 | 85.8 | 78.4 | 76.5 | 3.0 | 8,600 | 5,700 | 5,000 |

Source: Balás and Kovács 1999.

Simulation results summarized in table 13.10 illustrate a case in which the local government seriously considers both the need for revenue and easing the burden on the most disadvantaged households. The local government, as in our earlier example, opts for a Ft 90 million revenue from property tax that can be obtained by taxing at a flat 1.25 percent rate on property value. After an impact analysis, local politicians may decide they would like to ease the burden of the lowest income citizens, who should not use 7.2 percent of income for paying property tax (original scenario). The difference between present income and the value of real estate owned by a family might be a consequence of inherited (taxed) wealth, but often it results from misreported (untaxed) revenues. Thus, limiting tax exemptions by property value is equitable and justified because of hidden revenues.

This simulation assumes that a tax exemption can be granted only if a housing unit falls below the upper-middle price category based on the real estate files of the local public administration. If only properties under Ft 5 million value were eligible for the exemption, the local government would face a revenue gap of about Ft 20 million (scenario 2 in table 13.10). The system would be much more equitable because the tax burden of low-income households would drop from Ft 10,000 to less than Ft 4,000, and the average tax burden would decrease from 7.2 to 2.3 percent of their income.

The case can also be simulated when the local government is not able to reduce its expenditures or to collect revenues elsewhere, and so it must obtain Ft 90 million property tax revenue. Scenario 3 (in table 13.10) summarizes the simulation results assuming that the overall rate of local property tax raises from 1.25 to 1.71 percent, but tax exemptions are still granted in accordance with the scenario 2. Because of the higher tax rate, the tax payment of households in the highest income strata would grow from Ft 22,000 to 30,000; albeit their tax burden would increase negligibly from 0.7 to 0.9 percent of family income. At the same time, the tax payment of the lowest income strata would grow by only Ft 500. Such simulations reveal that the local government faces a good range of opportunities in defining the most appropriate property taxation.

Table 13.10 Optimal Exemptions and Maximum Revenue

| <i>Local government revenues</i> | <i>Scenario 1: Original taxation</i> | | <i>Scenario 2: Original rate with exemption</i> | | <i>Scenario 3: Adjusted rate with exemption</i> | |
|--|--|----------------|---|----------------|---|----------------|
| Expected revenue from residential tax (Ft million) | 89.6 | | 70.3 | | 90.1 | |
| Tax rate percentage | 1.25 | | 1.25 | | 1.71 | |
| <i>Household burden</i> | <i>Ft per year</i> | <i>percent</i> | <i>Ft per year</i> | <i>percent</i> | <i>Ft per year</i> | <i>percent</i> |
| Low-income strata | 10,200 | 7.2 | 3,700 | 2.3 | 4,200 | 2.7 |
| High-income strata | 22,400 | 0.7 | 21,900 | 0.7 | 30,000 | 0.9 |

Source: Balás and Kovács 1999.

Exemptions Based on Local Policy Preferences

Local politicians have boundless opportunities to grant partial- or full-tax exemptions for preferred groups, neighborhoods, or by property types based on policy considerations. Well-targeted exemptions not only support fairness; they can even motivate residential investments. In most cases such exemptions are harmonized with social principles, as in Hungary's present rule that "everyone has a constitutional right to 25 square meters of living space" without paying tax (Article 25, Law on Local Taxation). This principle, though very generous, leads to a very significant limitation of taxable properties because an average three-member family lives in a 60 square meter housing unit. As a result, a small number of residents would have to pay very high taxes, or the local government of Püspökladány would have to give up its expected revenue envelope.

Simulation results in table 13.11 show that poorly measured or ill-targeted exemptions could reduce revenue capacity dramatically (to 1/80 in our example). Property tax exemptions are commonly granted by area or by number of residents. The first is not recommended at all, and we have serious reservations about the second. Area-based exemptions (per dwelling, per resident, or per child) undermine the fairness of value-based

taxation, because they grant greater relief to those living in more expensive housing units. Such exemptions, which are common in Hungary, have two additional problems:

- When they are too large, they overwhelmingly reduce the number of taxpayers.
- When they are too small, they lead to the same result as a tax with a lower rate.

The calculations in table 13.11 take into consideration the desire of some local governments to drop the minimum payable tax to a certain level (in which the taxpayer would be exempt), because the administrative cost of collecting such sums is higher than the tax collected or because it would affect groups that deserve to be exempted (see table 13.11). Just as some arguments advocate forgoing taxes under a certain minimum, other arguments advocate setting a maximum limit. For example, the tax may represent the contribution to local expenditures, and thus disproportionate differentiation is unjustified. Furthermore, property taxes that are too high can scare taxpayers away from the city and negatively affect local economic development.

Table 13.11 The Effects of Local-preference-based Exemptions on Local Revenues

| <i>Area-based tax and space-based exemptions</i> | | | | <i>Exemptions by family revenue</i> | | | |
|--|--|-------------------------|--------------------------|-------------------------------------|---|-----------------------|------------------------|
| <i>Exemption per child</i> | <i>Tax-free area-based in square meter</i> | | | <i>Exemption of smallest tax</i> | <i>Maximum tax payment (Ft/household)</i> | | |
| | <i>No exemption</i> | <i>50 m²</i> | <i>100 m²</i> | | <i>20,000 Ft/year</i> | <i>50,000 Ft/year</i> | <i>100,000 Ft/year</i> |
| | <i>Tax due Ft</i> | | | | <i>Tax due Ft</i> | | |
| 10 | 81,954 | 23,702 | 1,264 | 1,000 | 77,788 | 85,875 | 87,370 |
| 15 | 79,251 | 22,076 | 1,090 | 2,000 | 77,686 | 85,773 | 87,267 |
| 20 | 76,581 | 20,919 | 1,004 | 3,000 | 77,652 | 85,739 | 87,233 |

Note: The tax rate based on area-based valuation used in the tables is 250 Ft per square meter, while the value-based tax rate is 1.25 percent of corrected market value.

Source: Balás and Kovács 1999.

Impact Analysis and the Willingness to Pay

The most difficult task is to estimate in advance citizens' willingness to pay due taxes. This estimate is the most uncertain part of the impact analysis. Indirect tools are in place to study residents' willingness and resistance to pay and the reasons behind them, so a communication strategy can be designed to persuade residents to pay. In practice local governments and public service companies often build the costs of arrears into their price, so they punish those who pay instead of those who don't. When designing taxation, if the local government takes into consideration the citizens' willingness to pay, and if it designs fair exemptions for those in needs, then imposing measures against those who do not pay is important. Otherwise tax morale will deteriorate.

Political Decision Challenges: Approving the Tax Ordinance

A local tax ordinance must regulate a new taxation scheme, and the local government assembly must approve it. As mentioned, mostly political fear of the assembly, rather than the lack of technical or legal conditions, prevents the introduction of a residential property tax. Should a local government want to introduce value-based property taxation, then the local tax ordinance must cover the basic tax rules, tax dynamics, and a method of property-value appraisal. Because of the aforementioned shortcomings in the legislative framework, the local tax ordinance must define rules for estimation of market value. For instance, one can state that in tax-base appraisal, the local government first calculates an average market value for the municipality based on current real estate prices, then applies correction factors stipulated in the ordinance.

Given that appeals may challenge the appraised market values of properties, the appraisal formula and rules must be very precise. Making the formula public is also important, even if it is not part of the ordinance, given that it may not have been completed by that time. In Canada, for instance, taxpayers can use computers accessible in the mayors' offices to get tax information, ensuring that the process is open and transparent. The ordinance must clearly spell out all key issues concerning property appraisal: the annual correction method and its limits, the establishment and maintenance of the property-related information system, the upgrading of the formula every four to five years, the conditions of indexing, and the handling of unacceptably large shifts.

Recommendations

The above results support two sets of conclusions: recommendations for local governments and for central government organs responsible for changing the legal framework for local taxation.

Recommendations for Local Governments

The merits of value-based property taxation are profound, tested, and reassured in the daily practice of developed economies. Experiences in transition economies show, however, that legal and policy shortcomings, political awareness, and also historical and cultural traditions from the previous regimes have prevented the use of value-based property taxation, despite its strong revenue potential. These countries, and Hungary in particular, are more and more open to the effective use of this taxation scheme, whose success depends greatly on defining a simple, equitable, transparent, and well-communicated system.

- The local assembly or local political leadership ought to determine the expected amount of tax revenue, while taking into account the socio-economic priorities, the acceptable tax burden, and tax preferences.

- The calculated property value, based on a simple mass appraisal formula (presented in this chapter) could be a useful tool in appraising property. The formula and the process of appraisal must be well articulated and transparent to receive public recognition and support, which is also critical to reduce the likelihood of successful appeals and mass reduction of announced due taxes.
- An impact analysis based on simulation modeling is instrumental to define a suitable appraisal formula; to test the parameters of a fair and affordable taxation; to test the potential effects on various social groups, and to define the principles, target groups, and methods of tax preferences and exemptions. These procedures are time-consuming; hence, the new tax could be successful only if preparations begin at least one year before the planned introduction.

Recommendations for Changing the Legal Framework

Although current regulations allow for the introduction of value-based property taxation, several modifications of the legislative framework would increase local governments' ability and willingness to introduce this form of taxation.

- The law must define the term “market value” more precisely to allow the use of mass appraisal and formula-based calculated value. Current legislation conceptually allows these, saying that market value should be estimated in compliance with the rules of the Law on Duty. The latter evidently prescribes a market-conforming estimation, but the present cross-reference might be insufficient to prevent mass appeals and to maintain maximum flexibility for local governments. The law should state that the elaboration of an appraisal formula is the right of the local governments. Self-appraisal should be stipulated as a supplementary method. This method could be instrumental in small settlements that lack appraisal capacity but have greater local control.
- The law should enable and force the land cadastre, the duty offices, and the local public administration (for example, building authority) to share their datasets about local real estate (see also chapters 16 and 21) for taxation purposes, among other things.
- The legal framework of an inheritance tax should be introduced. Elderly people living in valuable housing units represent a critical group in property taxation. Countries with developed property tax systems have solved this problem by creating the inheritance tax category, so instead of granting tax exemptions, they defer the tax obligations to the heirs or new owners.
- Collection of local taxes should be made more even. Currently, local taxes are due twice a year (March 15 and September 15), and these payments are often simultaneous with other tax payments (for example, mandatory insurance). Adjusting the law to make possible a more even distribution of tax payments would make it easier to collect and increase local tax revenues.

- The central government, as a matter of policy, needs to support increased autonomy in local income generation. Local taxes need to be well positioned in the overall taxation framework. For example, the central government should seriously consider reducing several central taxes, such as the personal income tax and the value added tax, the latter unavoidable on membership in the EU.

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PART 2.
**ISSUES OF SUBNATIONAL
DEVELOPMENT**

Section 2.
**Local Management
—Structural Adjustment and
Future Challenges**



14

Delivering Municipal Services

Kenneth Davey

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A strong tradition of public provision of services has remained the last resort of public ownership during and after the political system transition in eastern Europe. The inherited views about the nature, role, organizational setup, and financing of public services have served as theoretical and political underpinnings for the policies to keep the provision of these services under municipal or state ownership and strong central control. Far ahead of its neighbors, Hungary has decentralized and transferred to mixed or private ownership the vast majority of public services, but numerous challenges remain.

This chapter summarizes the conceptual framework for modern service provision. Although no sole optimal solution exists, following the principle to provide services in the most efficient organizational, ownership, management, financing, and regulatory framework is crucial.

Issues and Choices

In dismantling the socialist state in Hungary, both the central and local governments had to decide what types of activity should remain in the public sector (that is, they had to distinguish between those that involve an element of public service and those that are truly commercial). The general principle of a mixed economy is that government should be involved in managing a service only if some public interest is at stake.

* This chapter is based on Davey 1998c.

Local Public Services

Reformers are tempted to hold onto public ownership of a purely commercial enterprise because it is profitable, but doing so presents at least two dangers: first, that the enterprise will compete unfairly with the private sector (because, for example, it gets some overhead services free) and, second, that its profits come at the expense of poor service or high costs to its customers. The general principle in Europe is that municipalities should not engage in commercial activity, except when it is ancillary to a genuinely public service (for example, a snack bar at a swimming pool).

The first question, therefore, is whether a task or a service should remain within the public sector. What is a public service? Most analysts agree that public services fall into four, often overlapping, categories:

- Services that benefit everyone indiscriminately, so that charging is impossible, for example, policing, fire protection, roads and street lighting (except when access can be restricted to payers), parks, and environmental health control
- Services that are provided to individuals, but that have wider benefits to society, for example, education, medical care (for disease protection purposes), sewerage, waste disposal, and in some circumstances, public transportation
- Services that are essential to quality of life and require such heavy investment that monopoly provision is likely, and for which people can be exploited because they depend on the service and have no choice of supplier—piped water supply is the prime example
- Services that are essential to the quality of life but that are too expensive for low-income groups if left purely to market provision—public transportation to work or schooling and recreational facilities may be examples.

Although these principles are clear, their precise application is not. Whether a service has a wider benefit to society or is essential to the quality of life is a matter of judgment. Sometimes these judgments are made at the national level, sometimes locally. Parliament may stipulate a national entitlement to basic and secondary education, but each municipality may decide how far nursery education constitutes a public service.

Public Service Provision

If a municipality defines a service as public that service lies within the municipal competence, the next question is how best to provide it. Traditionally, municipal budgetary organizations have carried out most local public services. Many Hungarian municipalities, however, are now transferring service functions to different types of companies that are being established with varying degrees of municipal ownership and control.

Although municipalities are responsible for ensuring that a service is provided, they do not need to provide it through organizations they own or control directly. Private

enterprises, some of them under foreign ownership, are becoming involved in the provision of local public services, sometimes as partners in a joint venture, sometimes as contractors. Nonprofit organizations offer further options for the management of educational, cultural, and social services; the growth of nongovernmental organizations is increasingly providing municipalities with scope for new partnerships in these spheres of activity.

Using private organizations to deliver public services has one major theoretical advantage. If a municipality provides a service through its own organization, it is faced with a conflict between its duty to provide a satisfactory level of public services at a reasonable cost and its interests as owner of the assets and employer (directly or indirectly) of the staff involved. Municipalities can avoid this conflict of interest completely only if services are delivered by external organizations and the municipality restricts its role to regulating, monitoring, and when necessary, subsidizing their activity. Involving more than one supplier of a service also has potential advantages because competition gives consumers some choice between alternatives.

This situation is, however, the ideal one. Its success depends on conditions that may be hard to achieve or may take time to develop. These include, critically, the following:

- The existence of private organizations—commercial or nonprofit—willing and able to undertake delivery of public services, preferably in competition with each other
- The capacity of the municipality to award contracts and regulate and monitor the performance of external organizations in an effective and transparent manner.

Municipalities may need to consider a range of alternative forms of organization for their services, including municipal subsidiaries, commercial companies, and nonprofit organizations.

Organizational Choices

This section discusses the way in which choices between types of organization and legal relationship can best preserve the public interest. The discussion is divided into two parts. The first part looks at provision of services under direct municipal control and discusses the respective advantages of: (a) municipal organizations (departments and budgetary institutions) and (b) municipally owned companies. The second part discusses the choice between municipally controlled organizations (that is, companies in which municipalities have few or no shares) and external organizations (that is, nonprofit organizations).

Choices between Municipal Organizations and Municipal Companies

Assuming that a municipality wants to maintain provision of a public service within its direct control, is it preferable to delegate it to an internal municipal organization (department or budgetary organization) or to a municipally owned company?

The biggest practical differences between companies and budgetary organizations lie in employment, property ownership, and investment. Companies are not subject to any special restrictions on the terms and conditions they offer to staff and can, therefore, compete in the market for technical, managerial, and professional skills. As with all potential advantages, this feature carries a corresponding risk of nepotism. Higher remuneration for a company's staff can simply push up its costs, leading to higher tariffs, poorer services, or both.

Responsibility for the maintenance and renewal of assets is more clearly defined when a municipality entrusts a service to a company. Municipal assets used in a service undertaken by a company must either be transferred or leased to it by a formal agreement that provides for the payment of rent and defines responsibility for maintenance and repair. (This requirement for transfer or lease does not necessarily apply to a purely management contract, in which the company does not retain the operating revenue.)

Delegation to a company potentially improves the prospects of investment. A company is free to raise capital for the expansion or improvement of the assets, although at some risk to the municipality if the municipality's assets are pledged as collateral or if it is used as a guarantor. Bringing in private entrepreneurs either as joint or sole owners may also attract investment capital, a major reason for the prevalence of joint ventures in the field of waste management.

Company management also provides a framework for achieving greater economies of scale. This consideration is important given the wide variation in the size of municipalities. Several options exist. Joint ownership by several municipalities allows a single operation to serve a wider catchment area. A company owned by one municipality can be contracted to serve or manage the facilities of smaller, neighboring jurisdictions.

Quite apart from their legal and technical characteristics, companies have a more entrepreneurial ethos. This ethos derives not only from their greater freedom in recruiting and rewarding staff, but also from their popular association with the world of business. This can encourage greater efficiency, a sense of self-dependence, a willingness to innovate, and a more positive attitude toward their customers.

Again, however, these potential advantages carry corresponding risks. Companies may lose a sense of public service. They may focus too much attention on the consumers who provide the most revenue and neglect others. Bus companies may neglect unprofitable, often rural, routes; utility suppliers may be slow in connecting or repairing services to low-revenue or remote consumers. Monopoly may encourage insensitivity and inefficiency.

Risks of corruption and nepotism arise if the ownership of a company is predominantly municipal and its direction is concentrated in the hands of the political leadership. The relative autonomy of the company may simply allow its board members and directors to avoid the transparent scrutiny under which the more direct forms of municipal organization must operate.

These dangers can be overcome if municipalities make companies accountable for clearly defined outputs and standards. External participation in ownership can dilute the

opportunities for nepotism. Direction and board membership can be entrusted to persons independent of the political leadership. Competition, when possible, can help to maintain both efficiency and quality. When necessary, municipalities can ensure that citizens get equal access to services by providing targeted subsidies solely for serving disadvantaged customers. But all these processes require that the municipal office has the executive capacity to specify and enforce effective contractual relationships with the companies.

Two additional risks attached to the establishment of companies are redundancy (outliving their original purpose) and insolvency. Closing down a company when it is mismanaged, bankrupt, or simply no longer necessary takes time and effort, particularly in the case of a joint stock company. Municipal organizations can be abolished overnight.

If a company is at risk of bankruptcy, a founding municipality may stand to lose the physical assets it contributed to the capital. This situation illustrates that contributing cash or know-how as initial capital is preferable to providing physical assets, which the municipality can instead lease to the company. This arrangement may not be possible when the company involves partnership with an external investor, and the municipality needs to contribute the physical assets to secure a controlling share of the equity. This situation may simply provide an additional argument for a municipality choosing to contract and lease assets to an essentially private company rather than retain ownership.

Choices between Municipal and External Providers

The second choice is between provision by municipally owned organizations or by external providers. The latter includes commercial companies and nonprofit organizations and may include companies in which a municipality has a minority shareholding. External providers may provide services through service contracts, management contracts, leases, concessions, licenses, or unregulated operation.

The Role of Market Mechanisms

Underlying these choices is whether the public interest can best be served by administrative or market mechanisms. Direct provision by municipally managed organizations relies on traditional bureaucratic processes for making policies, supervising staff, and controlling costs. The alternatives assume that market mechanisms of competition and choice will, at least in part, secure efficiency and effectiveness.

Reliance on market mechanisms is not confined to private sector involvement. Municipally owned schools may compete with each other for pupils. Apartment owners may be able to choose between municipally and privately owned companies for estate management or central heating. In Britain municipal organizations compete with privately owned companies for service contracts to collect refuse, repair streets, maintain parks, and run sports centers.

The Public Interest

This chapter starts from the assumption that a municipality's duty to the public comes first, above its interest as an owner of property and an employer of staff. The relative merits of direct and market provision in relation to the protection of the public interest should guide the choice of how to organize and manage public services. Five aspects of public service (access and coverage, price, quality, environmental impact, and service development) are discussed below. Each discussion begins with an italicized definition of the public interest.

Access and coverage—Essential public services should be adequate to meet demand and should be accessible to the whole population (for example, public transportation should not be confined to profitable routes, libraries and sports facilities should be open beyond general working hours, and recreational facilities should make provision for the disabled).

In theory, these objectives should best be served by direct municipal provision for two reasons. The first is its direct accountability to the public. The second is the absence of profit motive; a municipal organization should not be deterred from providing service, such as those noted above, to customers who cannot afford to pay the full cost or whose needs are particularly expensive.

In practice, an external provider may improve service coverage simply through greater efficiency, making resources go further. A municipality can insist on equality of access to services by a mixture of contract specifications and targeted subsidies (or cross-subsidies). Certain types of service, particularly to socially and ethnically deprived groups, may reach their intended consumers only if provided through nongovernmental organizations that can develop acceptance and trust.

Price—Inefficiency and overpricing because of monopoly provision should be avoided. Costs to consumers or taxpayers should be affordable and reasonable. Subsidies should be confined to cases of genuine individual need or wider public interest.

The discussion of quality will cover ways of making direct municipal provision more efficient. These methods include benchmarking to compare municipal costs with those of other providers, and delegation to cost centers, such as budgetary organizations or companies that have some freedom and incentive to deploy resources efficiently.

Market competition through tendering and franchising should be a better guarantee of efficiency. In the social and cultural service field, choosing nonprofit organizations to provide services may also reduce cost, simply through the use of unpaid volunteers, either in service delivery or management.

The efficiency of external contracting and franchising does depend, however, on the existence of genuine competition. Genuine competition means the presence of alternative providers in the external market, and an absence of nepotism in the award and supervision of contracts and franchises.

Quality—Services should be of an acceptable standard defined either by law or deliberate political choice. Performance should be monitored. Standards should apply both to the physical character of the service and the behavior of the staff providing it.

Direct accountability to the public and the absence of the profit motive should again help to ensure the quality of direct municipal provision. The additional danger that contractors will reduce quality to keep their prices competitive and maximize profit is always present.

In practice, external provision may be just as conducive to quality. Provision under contract or license will usually involve the specification and monitoring of performance standards, which are often absent from direct municipal provision. Competition may also offer the public a choice of provider, offering both an incentive to performance and an opportunity to provide variety of service for different needs and tastes.

When services are contracted to companies or nonprofit organizations operating regionally or nationally, they may also gain from experience and expertise that is not available to a purely local organization. Companies may bring innovation and new technology to services such as waste or leisure management, and nongovernmental organizations may bring newer, more effective methods to the care of the disabled or the treatment of drug addiction and alcoholism.

Environmental impact—Individual public services have an impact on the general quality of life and on a municipality's economic competitiveness; improvements in public transportation, recreational facilities, or cleanliness may, for example, be critical to the attraction of new private investment.

That external contractors will ignore environmental standards to cut costs and increase profits—particularly in sensitive fields such as waste management—is clearly a risk. This risk can be avoided by strict specification and monitoring of standards, but such standards can be undermined by collusion between municipal officials and contractors.

Direct municipal provision does not necessarily avoid these risks because municipalities may have difficulty disciplining its own operations. Environmental regulators may more easily apply sanctions to an external organization than to their own employer. In either case the vigilance of public opinion is the best safeguard.

Service development—Public services should not stand still. Development of technical methods and human skills should be constant to reflect changes in demand (such as local age structure or economic activity), technology, and experience.

Changes in demand and potential supply have contradictory implications for the organization of local services. On the one hand, they favor the use of specialized external organizations, through contracting, concessions, or licensing. Such organizations can operate widely enough to accumulate and disseminate professional experience in fast-moving markets such as waste or leisure management in ways rarely possible for an in-house agency rooted in a single town or subregion. On the other hand, contracts and

concessions can lock a municipality and its providers into an inflexible pattern of services and costs enshrined in the basic agreements.

Only a few broad recommendations are possible in these respects. The first is the need to incorporate flexible provision for variations in the contractual agreements between municipalities and service organizations. Types, quantities, and standards of provision should be clearly specified, but procedures for amending them to fit new demands or methods should not be an obstacle.

Second, professional networks are extremely important. Municipalities need national or regional networks of specialists involved in the oversight of particular types of service and who inform one another of changes and innovations. These networks might be organized through associations of municipalities or through professionals working for local government. Service providers, whether municipal or commercial, also need networks, either at the level of the organizations or of the professionals working within them.

Nonprofit Organizations

The use of foundations and other nonprofit organizations has clear financial advantages in terms of their tax exemption and their ability to involve people who are willing to give services free or significantly below market rates. Foundations operating nationally may well provide economies of scale and a focus of expertise, particularly in very specialized fields such as care of the disabled.

Risks are also present. Leaders of nonprofit organizations are very committed people who have strong opinions that can weaken their accountability to the municipality, particularly if they are giving their personal services without charge. They can be committed to types and standards of provision that the municipality cannot afford or that differ from majority preference. Partnerships with nonprofit organizations may be highly beneficial, but dogged by controversy.

Financial Relationship

The financial aspects of local public service provision are just as important, and sometimes even more important, than their technical conditionalities. There are four major areas of concern: whether municipal taxpayers or the consumers of services should cover the cost; how to account for various cost elements such as overhead, capital and financial costs; how to ensure efficiency through cost allocation and control; and how to regulate the size and changes of tariffs.

Taxpayers and Consumers

The descriptions in the previous sections reveal many differences in the financial relations between municipalities and the organizations delivering local public services. At the heart

of these differences lies the apportionment of cost between the taxpayer—met through the municipal budget—and the consumer—met through service charges and fees. At one end of the spectrum, all the service costs are met by the taxpayer. This relationship would be typical of a municipal department or a budgetary organization and would apply to services such as education, for which the municipal budget meets the entire cost (including revenue from government grant) and the service is free to the pupil. At the other end of the spectrum are services such as car parking, for which consumers pay all the costs. These services are usually undertaken by companies, and the revenue may even subsidize other services. In the middle of the range are services for which subsidies from the municipal budget augment consumer charges, often the case with public transportation or waste management (that is, when costs are shared in varying proportions between taxpayers and consumers).

Who should pay for a particular service, taxpayer or consumer? This issue is basic. Of course, most consumers are also taxpayers. In which capacity they pay determines their share of the cost. If they pay for refuse collection through charges, their liability depends on the amount of refuse they produce. If they pay through municipal subsidy, their contribution depends on how much tax they pay, which depends in turn on the size of their income, the scale of their property, even perhaps the amount of beer they drink.

In distinguishing between the duties of consumers and taxpayers, two factors are basic: equity and efficiency. Starting with equity, analysts normally categorize public services as private or public goods.

A service is classified as a private good if it is possible to identify how much each consumer benefits from it, so the amount of individual consumption must be measurable and exclusive (that is, others are excluded from any benefit). A domestic telephone can be called a private good because it is possible to measure and cost its use precisely and no one but the household has access to it.

A public good benefits the public collectively and indiscriminately. Even if it can be broken down into individually costed units of service, the consumers cannot be identified accurately because it is difficult to exclude anyone from benefit. Streets are a public good because anyone can walk or drive on them. Thus, a private good should be charged to the consumer, and a public good should be funded by taxes.

These principles are easier to state than to apply, however. For some services individual consumption can be measured and costed, but those services also confer some wider benefit on society. Having a literate population and people with specific skills is in the public interest, so education is publicly funded. Other services are individually consumed but may be regarded as essential human needs of which individuals should not be deprived through poverty, so housing for those unable to meet its full costs is publicly subsidized. Still other services have a degree of subsidy that is primarily aimed to encourage consumption; public transportation is a prime example.

Efficiency is the second important consideration. A correct balance between individual and collective payment for a service is essential to ensure the best use of resources. Some services require individual charging to discipline consumption of an expensive resource,

so supplies of water and heating are individually metered and charged. In some cases, however, some subsidy may be needed to ensure that individuals use a service sufficiently for the wider public interest. Public transportation may be subsidized from taxes to attract passengers who would otherwise add to pollution and congestion by using cars.

These principles lead to a range of practices:

- Full funding by the municipal budget when the benefits of a service are entirely collective (for example, street lighting or environmental health)
- Full charging to consumers when the benefit is entirely private (which might involve charging above direct costs when individual use needs to be discouraged in the public interest, city center parking being a prime example)
- A combination of budget subsidies and consumer charges when the balance of individual and collective benefits depends on the respective strength of public and private interest and the need to encourage or restrain consumption
- Consumer charging but with targeted subsidies when benefits are individual but essential to basic human need.

The Calculation of Costs

Apportioning costs fairly and efficiently between taxpayers and consumers (and between individual consumers) depends on measuring them accurately and comprehensively. This requirement raises three major issues: (a) the charging of overhead and common service costs, (b) the treatment of capital costs, and (c) the difference between the average cost of a service and that of individual units.

Overhead and Common Service Costs

Many service organizations provide several services. Their budgets may show the costs of individual sections dealing with specific services, but certain expenses may be pooled. These pooled expenses are likely to include the costs of central management, shared inputs such as energy or telephones, and common services, such as vehicle maintenance, stores, or accounting. The costs of individual services cannot be accurately identified unless the shared costs are divided between them.

The simplest solution is to apportion the central service costs to individual activities in proportion to their share of total expenditure. A more accurate solution is to apportion the costs according to each activity's use of the central services. For example, the costs of the finance department should be apportioned according to the total of each activity's revenue as well as expenditure, because it probably devotes as much attention to revenue transactions as to expenditure.

The Costs of Capital

The second issue is whether capital investment costs are included and, if so, on what basis. Service organizations may not reflect capital costs in their budgets and accounts (and consequently in their consumer charges) because these costs have been met (usually from general revenue) by the parent municipality or from loans that have been discharged. Any true calculation of costs, however, should include the capital costs of assets employed; even if these costs have been fully discharged, making provision for their depreciation and replacement is wise.

Capital costs may be calculated in a number of ways, including:

- *Debt amortization*—which reflects the actual annual costs of repayment of loans taken to finance construction or purchase of assets together with interest charges
- *Depreciation*—in which the value of the assets is reduced in the accounts by annual installments over their estimated life, the notional cost being charged as an expenditure
- *Asset rental*—by which the service budget is charged with an annual payment of rent to the owner of the assets employed (normally the municipality); the rent would usually be calculated on the basis of a market rate of return on the asset value.

One major issue is whether the annual charging of capital costs of assets should be based on their historical costs or current replacement costs. Charging amortization, depreciation, or asset rental on the basis of the historical costs may reimburse the municipality for its actual cash outlay, but it does not prepare the ground for the renewal of assets when necessary. Regular charging on the basis of current replacement costs has two advantages: it builds reserves to help finance, and it avoids a radical increase in annual costs and charges when renewal takes place.

Pooled or Individual Service Costs

The third issue is whether costs are calculated according to the actual expense of a unit of service or as a pooled average. The actual costs of an identical level of service may vary considerably. Amortization of capital costs will vary with the age of the asset and interest rates prevailing at the time of construction. Supplying heating to outlying areas will cost more because of transmission costs (length of mains, leakage, pumping, and so forth). A small school will probably have higher overhead costs per pupil. A half-empty bus serving a sparsely populated area will cost almost as much to run as a crowded one in the city center; depreciation and labor costs may be almost constant, and fuel consumption will not be proportionately lower.

Should these differences in unit costs be reflected in the calculation of costs and the consequent charges to users? Conflicting arguments arise. If a service is a purely private

good, some analysts argue in favor of charging each user the full cost of provision to him or her specifically. If a factory chooses to locate in a remote and hilly place with excessive water pumping costs, these costs should be included in its water charges; the consequence may encourage it to locate in a cheaper place to supply. The opposing argument is that the circumstances which increase the cost of a service may not be of the consumer's making. If they involve an essential service, a consumer should not be penalized if the costs are above average in his or her case. Poorer people driven to the outskirts of a town by land and housing costs should not have to pay extra fares for transportation to work or school.

Municipalities have generally chosen to charge uniformly: a single bus or metro fare for a whole city, a flat rent per square meter of apartment, a uniform charge per cubic meter of water. This uniformity may not be justified, however, when people or businesses voluntarily choose high-cost or low-density locations because it could involve cross-subsidization by consumers in less favorable environments.

Cost and Efficiency

A municipality should be concerned that a public service is run efficiently (that is, that the public gets the best possible value for the money it spends on a service, whether through taxes or charges). This goal may be reached by three possible means: (a) competition, (b) improved budgetary management, and (c) comparative performance measurement.

Competition

Inviting tenders to provide a service should ideally determine its market price. Competing companies (which can include those owned by municipalities) will vie with each other to offer either the cheapest service or the best combination of price and quality. This incentive to efficiency will apply also in cases in which companies undertake a management contract on a profit-sharing basis.

Whether public tendering actually secures efficiency depends on genuine competition. The market must have alternative providers, each capable of undertaking the work and willing to compete for it. The process of awarding the contract must be transparent, and the municipality must have the technical capacity to monitor performance and enforce its provisions. The municipality may also face dangers that quality will suffer in the effort to keep costs down. This risk underlines the importance of specifying quality standards in the tender and monitoring delivery.

Improved Budgetary Management

If no competitive process is in place, cost efficiency will depend on the system of budgeting and budgetary control. The system has at least four aspects that affect efficiency. Each is described below.

Discretion given to the service organizations—Does the municipality control its expenditure by line item? Does it determine how much it can spend on salaries, transportation, energy, equipment, and so forth? Or does it provide a lump sum that the organization can allocate between cost elements at its own discretion? (If lump-sum provision is made, organizations may still have to present line item estimates to justify the total amount.)

Line-item control may be useful in avoiding unnecessary expenditure on aspects attractive to service managers (for example, staffing, hospitality, furniture). Experience generally suggests, however, that lump-sum provision increases overall efficiency, partly because operating managers know best where savings can be made and because they have an incentive to make compensating savings in cases where overruns are inevitable for a particular item. They may, for example, defer some non-urgent repairs if a severe winter increases heating costs. Lump-sum provision can still be accompanied by some controls over detail, such as the need to secure municipal approval to increasing staffing levels or bonus payments.

Determination of annual increases in budgeted expenditure—Traditionally, public authorities take an incremental approach to annual budgeting. They take the previous year's budget as the baseline and apply all the scrutiny to the margin of increase (rate of inflation, proposed growth in items such as staffing, and so forth). The municipality determines its growth items in a bargaining process in which it juggles with its revenue forecasts, on the one hand, and the competing demands of different service organizations, on the other.

The incremental approach presents several problems. Final allocations depend heavily on the political weight of the individual organizations within the municipality. They do not reflect the service outputs required by public demand (for example, how far the percentage increase in waste management costs corresponds with the percentage increase in refuse collected). Funds are allocated basically on the basis of what was done last year, not on what is needed now. Service provision becomes stale and inefficient because providers have no incentive to control costs or improve working practices.

The alternative is some form of zero-based budgeting. Budget planners ignore previous provisions and construct a fresh budget on the basis of the current demand for a service, the resultant output, and its cost. A zero-based system is valuable in establishing a new budget baseline. It is a time consuming process, however, involving complex data analysis and argument over levels of demand and response. Two intermediate approaches to budgeting are possible. One generally uses the incremental approach, but applies zero-base analysis selectively, perhaps taking a few areas of expenditure each year. The second approach also uses the incremental base but adds a few output and unit-cost measures to compare the growth of expenditure with service performed (for example, the number of library books purchased or loaned, the number and unit cost of swimming pool admissions). This method would highlight areas in which costs were growing without commensurate increases in workload.

Treatment of year end balances—If an organization underspends its budget, can the balances be carried over to the next year? Without some system of retention, service providers have no incentive for efficiency; organizations are encouraged to spend unused funds on low-priority objects at the end of the budget year. Discretion to retain and use such balances usually enhances efficiency, but subject to two restrictions. First, the right to award staff benefits (bonuses and so forth) needs to be restricted or staff will be encouraged to reduce service to the public to benefit themselves. Second, one-off savings should not be used to finance expenditure that would increase regular commitments (extra staff, for example).

Distributing funds between parallel organizations—This situation arises particularly in the case of schools, but in larger towns it could apply to other institutions, such as housing estate maintenance, social care homes, or leisure centers. The question is whether allocation to individual institutions is based on historical costs or some formula.

If historical costs are used, the treatment of individual institutions may be inequitable. One school is able to offer more activities and facilities than another simply because it has always been treated more favorably, its parents are more influential, or its director is better connected politically. Using a formula has an advantage because a formula basically distributes funds between institutions on the basis of their clientele—the number of pupils in schools, residents in social care homes, and so forth. Planners would have to take care, however, to compensate for genuine and objective differences in running costs, for example, variations in energy and repair cost due to the age and construction type of building.

Substituting formula distribution for an historical base may involve a substantial redistribution of funding between institutions, which in turn may call for a transitional system to phase in the changes over a number of years, so the losers are allowed to adjust their expenditure gradually. Some form of limit, say 5 percent, might be applied to the gains and losses of an individual unit in a single budget year.

Formula funding can leave small units in a financially weak position because of their relatively high overhead costs. If a municipality is making deliberate policy to retain the smaller units—village schools, for example—the formula might contain two elements: a fixed lump-sum to cover overheads and a variable addition depending on clientele.

Comparative Measurement

A further instrument in promoting cost efficiency is benchmarking. This procedure involves comparing the costs of similar services as provided by different municipalities. These costs are usually compiled per unit (for example, cost per ton of refuse collected, per kilometer of road or hectare of park maintained, per cubic meter of water supplied, and so forth). Such comparisons may well direct attention to particular services in particular municipalities that are run at costs significantly above average.

Benchmarking has two problems. The first is securing comparable data. For reasons discussed above, service-cost records of different municipal organizations may vary extensively in the extent to which they reflect the costs of capital or of overhead and central services. Second, higher costs may reflect greater quality rather than inefficiency. Introducing cost comparisons will require efforts to achieve greater uniformity in accounting standards. Variations in costs also need to be investigated to distinguish between differences in provision and in working practices.

Such comparisons and investigations have been the basis of the many studies of value for money and good practice published by the British Audit Commission. Its experience has shown that benchmarking can lead to substantial improvements in working practice, but only on the basis of careful comparative analysis.

Tariff Regulation

An earlier section argued that consumer charges should pay for services that benefit individuals exclusively, so long as their individual consumption can be measured. The general rule, therefore, would be that tariffs should be set at a level sufficient to meet all costs, both capital and operating.

Municipal Subsidy

Exceptions to the principle of full cost recovery would arise when the following conditions occur:

- Individual consumption carries wider public benefit, as in the case of education or, sometimes, public transportation
- Poorer people would be unable to meet the full costs of a service that is a basic human necessity, such as housing.

In the first case, contributing to service costs from general municipal revenues is logical so that all consumers enjoy the reduction in charges. In some cases, such as schooling, taxes might fund the service in full. In others, the tariff might be set low enough to enable and encourage everyone to use the service.

In the second case, a general reduction in tariffs would not be justified and municipal subsidy would be restricted to the specific cases of need. These cases would basically assist poorer sections of society, but subsidies might also be targeted to communities where services were exceptionally costly for reasons beyond their control.

In the case of bus services, for example, a municipality might want to subsidize the following:

- Services to and from a particular area (for example, certain villages outside a main town)

- Services at particular times (for example, early morning services for people traveling to town for work or school)
- Services for particular clients (for example, reduced fares for the elderly or school-children).

Bus companies would be expected to charge for other services at full cost, but would be invited to tender for the amount of subsidy they would need to operate these particular loss-making services.

Capital Costs

Municipalities frequently subsidize a service by meeting capital investment costs directly through the municipal budget and leaving the service organization to fund operation and maintenance from charges. This arrangement creates two problems. First, it may impose a very large and lumpy cost on the municipal budget in one year. Second, the relief from capital costs will be enjoyed by all consumers, whether they can afford them or not.

A better method is for capital costs to be charged to the service organization either directly or through an asset rent or depreciation charge paid to the municipality. The latter will help the municipality amortize any loan it may have used to fund the investment. If capital costs result in an unaffordable user charge, the municipality may reduce it through an operating subsidy. But this approach will provide an opportunity to target the subsidy more fairly and efficiently.

Charging Above Cost

In some cases setting tariffs above the level necessary to recover the capital and operating costs of service is justifiable. The first case would be if the municipality wanted to discourage consumption of a service because of its indirect costs or to restrain consumption levels. An example might be town center car parking. The tariff variation must meet its objective. Some car parking tariffs, for example, penalize only long-term parking; high charges for duration over, say, five hours discourage people commuting to work by car at peak hours without discouraging others who visit the town center for shorter midday or evening periods for shopping or entertainment.

A second case arises when a municipality is selling an essentially commercial service that is also available from the private sector. Generally speaking, municipal organizations should not compete for purely commercial activity, but such services may be ancillary to a public service, such as the café at a sports center. They have every reason to charge what the market can bear, and undercutting private competitors simply because capital or overhead costs have been met by other means would be wrong.

Tariff Adjustment

The health of a municipal service requires that its tariffs be adjusted regularly to take account of inflation and other cost variations. If tariffs remain unchanged for several years, service funding deteriorates and, with it, service quality. Major increases are then necessary, but are politically unpopular both because of their scale and because of the poor standard of service.

Conclusions

The arguments in the previous paragraphs generally favor either of the following:

- External provision of local public services under contract or concession or
- A mixed economy in which municipal and private organizations provide services in some form of competition (that is, in parallel offering public choice or competitive tender).

In both cases, the municipality retains a clear responsibility to set standards, monitor performance, and subsidize service operators when justified by the general public interest or social justice.

The potential advantages of external provision or a mixed economy lie in: (a) competition, (b) specification of outputs and standards, (c) transparent arm's length regulation of performance, and (d) access to external experience and expertise. These advantages can be realized only under favorable circumstances, however, such as the following:

- Competition depends on the existence of alternative providers in the market and an absence of collusion and nepotism influencing municipal choices.
- Specification of outputs and standards requires expertise within the municipal office or access to independent external advice in drawing up tenders, concessions, and so forth
- Regulation of performance requires skills and integrity on the part of municipal office staff, or professional assistance from an independent source.
- Access to external experience and expertise assumes that private companies, non-governmental organizations, and so forth that have accumulated experience in running specific services are available.

When these conditions are absent, direct provision by municipal organizations without competition may continue to be the only effective option open to a municipality. Even so, developing a formal contractual relationship between the municipality and the institution or municipal company providing its services has advantages. These advantages would be based on contracts or service agreements that specify outputs, standards, and the conditions for any subsidy, similar to those governing an external provider. Performance would be monitored by municipal office staff or independent professional advisors and auditors.

Delegation does not mean abdication of responsibility, however. Key roles remain for the municipality, at the levels both of the City General Assembly and the mayor's office.

First, municipalities must make choices about the type, level, and standard of service the delegated organization is expected to give. These choices are political, and an effective process by which elected officials consider them must be in place. The professional staff who supervises the services, however, must also have an opportunity to give their opinions and advice.

Second, in most cases, municipalities must make choices about the financing of the service and how costs are to be divided between customer and taxpayer (that is, about the levels of consumer tariffs and municipal budget subsidies, if any). These decisions are financial and require careful analysis, but they are also political since they interact with the choices over levels and standards of services, and tariffs are always politically sensitive.

Third, the mayor's office must have the professional capability to specify what is expected of the service providers and to supervise their performance. This oversight can be difficult if the technical expertise is concentrated in the service organizations themselves, provides an added argument for cooperation between smaller municipalities in the delivery of services, and suggests a growing role for the provision of advisory services by associations of local governments and of professionals serving local government.

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15

Contracting Out Municipal Services: Transparency, Procurement, and Price-setting Issues

Kenneth K. Baar



In recent decades, as a part of the trend toward the incorporation of cost concepts and competitive market principles into the provision of public services, a movement has been underway throughout the world to contract out more government services on a competitive basis. Almost every type of public service has been contracted out, including utilities, schools, prisons, and cemeteries.

This chapter addresses transparency, procurement, and price-setting issues related to contracting out public services from both a policy and practice perspective. Numerous interviews with local officials form part of this study, and are central to its analysis. We refer only to the case of Eger because the purpose of this chapter is to address overall policy issues rather than to provide critical analysis of the practices of particular cities. Brief comparative information is provided on European and U.S. experiences (see also Baar 1998).

Principles of Contracting Out

A principal theory behind contracting out is that it decreases the cost and increases the quality of public services. Since government services involve large portions of national and local economies and employment, the pros and cons of contracting out have been the subject of a large body of literature. The switch from government provision to contracting out places local government in the role of regulator of the price and quality of services. When services are contracted out for a substantial period, price adjustments are required.

* This chapter is based on Baar 1999.

Contracting out has been actively advocated by international finance organizations, including the World Bank, the Organization for Economic Cooperation and Development, the International Monetary Fund, and national governments, especially Great Britain, on the basis that it reduces the cost and increases the efficiency of public services, and helps develop the private sector (Silanes, Shleifer, and Vishny 1997). By contrast, some scholars have reached mixed conclusions or have concluded that contracting out is no more efficient than in-house provision of public services (Ascher 1987). Others have concluded that contracting out public services may serve other purposes, such as avoiding the constraints or rigidities associated with public provision of a service or decentralizing the blame for failures (Perry and Kendall 1997).

In fact, each type of public service has its own characteristics and demands its own set of strategies and institutions, which should be explored before contracting out is undertaken. For example, some services may be contracted out on a short-term competitive basis, but others require long-term contracts with price adjustments based on cost reviews. Contracting out has worked much better for some types of services than for others. Furthermore, the national and local institutional circumstances of various public services, relating to their level of efficiency and corruption, differ greatly.

Although much of the literature cites the savings, substantial differences are evident between contracting out public services that can be provided on a competitive basis, with periodic renewal of competition, and those services that require longer term monopoly provision. As a United Nations report notes: “The transfer of a public monopoly into private hands is not an ideal solution, as efficiency gains might not be transferred to customers, but retained by the operator in the form of monopoly profits” (UN 1995: 156). In this light, unbundling the various aspects of service provision and contracting out the portions that can be provided on a competitive basis make sense. Typically those portions are less capital intensive.

In the course of their efforts, various international organizations (for example, United Nations, the World Bank, and the Organization for Economic Cooperation and Development) have compiled lists of best practices in implementing contracting out policies. (See Caseates 1993; Council of State Governments 1993; OECD 1997; UN 1995; U.S. GAO 1997.) The following is a composite of criteria and procedural prerequisites based on criteria set forth in these reports.

- Secure top management and encourage reevaluation of tasks and processes.
- Focus on staff issues and consult with current employees.
- Specify service requirements in terms of outcomes or outputs.
- Monitor performance and foster cooperative relationships.
- Ensure valid comparisons, by considering all of the real costs and benefits of contracting out.
- Evaluate in-house bids according to the same criteria as outside bids.

- Foster competitive markets by selecting the appropriate size of contracts.
 - Develop and maintain the necessary skills to oversee contracting out.
 - Use competitive public procurement procedures.
 - Establish an independent and competent review and regulatory mechanisms before privatizing.
 - Establish transparent procedures for public action.

Contracting Out by Local Governments

During the socialist era, local governments served almost solely as agents of the central government with very little local revenue and discretion. The 1990 Act on Local Government granted substantial power and responsibility to local governments. Now, they are in a particularly difficult position in regard to the provision of public services. They must charge for services that were provided without charge for decades, upgrade service quality, and usually are required to make up for decades of deferred investment. These steps need to be taken within the context of severe budget constraints (see chapter 7). Furthermore, a significant portion of the population cannot afford to pay for services, trapping the service provider between cost recovery and welfare functions. The most extreme example is the case of low income and retired households served by district heating, which commonly costs more than half of household income in winter months.

Contracting Out Practices

Frequently local governments services contract out to private firms on a competitive basis, for example, solid waste disposal, park and street maintenance, parking fee collection, and water provision. In addition, some cities have entered into long-term concession contracts (in the range of 20 years) for the operation of district heating. Most likely, contracting out will increase in the coming years because private firms are often needed to obtain financing for capital improvements, which are necessary to maintain public services. Although contracting out to private firms may be new in Hungary, outsourcing of many public services to semiautonomous publicly owned corporations has been a tradition.

Typically park maintenance services are divided into sections of the city and sub-contracted out by section, resulting in numerous subcontractors for this service. (The typical length of such contracts is 3 to 5 years). Refuse collection services are commonly contracted out to foreign firms when significant capital investments are required to create new disposal sites. In such cases, 15- to 25-year contracts are common, and about 10 percent of all water services are contracted out to private investors. Interviewees commonly indicated that contracting out led to more efficient provision of services, and under the

threat of organizational or ownership changes, municipally owned service providers operated in a more efficient manner.

Institutional Incentives for Contracting Out

Although much of the world institutional and theoretical support for contracting out is based on the concept that such an approach is in itself more efficient, in Hungary regulatory factors provide major economic incentives for contracting out. First, private enterprises can employ labor far more cheaply than public entities. Second, companies, unlike public entities, may be able to subcontract a substantial portion of their labor tasks to independent contractors and thus avoid social security payment requirements, which constitute about 42 percent of wages. Depending on their bargaining power, workers at an independent contracting firm may require that some of these savings be passed through to them. Such subcontractors are subject to the social security taxes that are not paid by their firm, but can deduct business expense before calculating the tax. Unlike employers, independent contracting firms can decide whether they will make social security contributions. Third, the independent contractor arrangements enable firms to terminate their subcontractors at will. Fourth, companies may obtain refunds of their value added tax payments, but government entities cannot obtain a refund. This tax adds about 20 percent to the cost of local services.

Procurement Standards and Practice—Public Services Contracts

Hungarian versus European Union Public Procurement Standards

Hungary has adopted detailed legislation on procurement standards, the 1995 Act on Public Procurement, modeled after the standards set forth in European Union (EU) procurement directives. In keeping with the price differences between Hungary and western Europe, however, the contract sums that trigger coverage by the procurement law (thresholds) are far lower in Hungary (see table 15.1). In accordance with the Act on Public Procurement, the Hungarian thresholds are set forth in the annual Budget Act.

The Council on Public Procurement indicated that it has discussed raising the thresholds to EU levels. Although such a step may be literally consistent with EU policy, in practice it would exempt a segment of public services that are covered in the rest of the EU.

In addition, two other laws govern public procurements: section 4–10 of the 1991 Act on Concessions, which includes in its coverage contracts for the operation of local public utilities (section 1(d)) and section 11 of the 1995 Act on Water Management. Both of these acts contain additional tendering standards beyond those set forth in the Act on Public Procurement.

Table 15.1 Coverage of the Act on Public Procurement

| <i>Type of Contract</i> | <i>Thresholds for coverage by procurement law, 1999</i> | | |
|-------------------------|---|-------------|--------------------|
| | <i>Hungarian standard</i> | | <i>EU standard</i> |
| | <i>Ft million</i> | <i>EURO</i> | <i>EURO</i> |
| Goods | 16 | 62,600 | 400,000 |
| Public services | 8 | 31,300 | 600,000 |
| Public works | 32 | 125,200 | 5,000,000 |

Source: Council on Public Procurement data.

The Extent of Tendering Out

The Council on Public Procurement prepares reports on the volume of tendering by public agencies. Overall in 1997, tendered contracts equaled approximately 7 percent of government expenditures (Ft 291 billion of Ft 4,166 billion; see table 15.2). In the case of local governments tendered contracts equaled about 15 percent of total expenditures (Ft 135 billion of Ft 914 billion total municipal budget).

Table 15.2 Public Procurement Contracts, 1997

| <i>Tendered contracts</i> | <i>Amount of contracts awarded</i> | |
|---------------------------------|------------------------------------|---------------------|
| | <i>Ft billion</i> | <i>US\$ million</i> |
| <i>Type of tender procedure</i> | | |
| Open procedures | 209 | 1,000 |
| Invitation procedures | 11 | 55 |
| Negotiated procedures | 74 | 350 |
| <i>Level of government</i> | | |
| Municipalities | 135 | 675 |
| Public service providers | 81 | 405 |
| Central budgetary organizations | 55 | 275 |
| Other | 20 | 100 |
| <i>Type of contract</i> | | |
| Products | 108 | 540 |
| Construction | 135 | 675 |
| Services | 48 | 240 |

Note: The totals in the tables differ slightly due to rounding.

Source: Council on Public Procurement, database.

The Council on Public Procurement

The act (in part II, sections 11–23) provides for a Council on Public Procurement which monitors the implementation of the law by local and national agencies. The council has a staff of 12 full-time arbitrators, who review complaints. The arbitration committee received 267 complaints in 1997. According to council staff, most of the complaints involved claims that a local government failed to follow its own criteria in awarding a contract.

In a recent report the council commented that in Hungary—and such is the case in the other countries in the region—budget entities particularly lack the trained staff needed for a professional management of public procurement. This is particularly relevant in the case of small local governments and smaller budgetary institutions (Council on Public Procurement 1998).

Public Services Contracts—Exemptions from the Act on Public Procurement

Although the act applies to public procurement generally, several key information sources indicated that commonly it is not applied to contracts for the provision of services that are supported solely by user fees (see section 9(1)). The exemption is based on the concept that the contracting public agency does not provide any consideration for the service; instead, the service is paid for by private citizens.

In reality the principal exemptions created by this provision are for solid waste services supported solely by user fees. (If the service is partly paid for from user fees and partly subsidized, it is covered by the procurement act.) Furthermore, although a contract with a private company to provide user-fee-funded services is exempted from the procurement law, purchase activities of that private company (for example, the purchase of trucks by a waste disposal company pursuant to the performance of public service) is covered. A separate act covers contracting out of refuse collection and chimney services (Act on Refuse Collection and Chimney Services 1995), but it does not set forth standards for these tenders.

In some interviews directors of municipally owned companies indicated that the activities of their companies were not covered by the procurement legislation and that their subcontracting for public services was not subject to the procurement act. Other knowledgeable sources indicated that localities were claiming exemptions on the basis that under the Act on Public Procurement “public service providing activity” covers only activities “qualified ...by-law as public service, activity provided by an institution in the public service, public utility or communal service” (Act on Public Procurement, section 10(e)). One procurement expert indicated that the central and local governments commonly conclude that transfers of public services to private not-for-profit organizations are not subject to procurement requirements based on the concept that the service is for a third party rather than for the government. Therefore, under this concept, the contracts do not involve public purchases of products or services (the government agency is giving a quasi donation to the not-for-profit organization rather than paying for its service).

In our opinion, exemptions for public service contracts from procurement requirements are contrary to the purposes of the procurement legislation which include “...establishing the transparency of the use of public funds and its wide-ranging public controllability; furthermore, providing for the purity of competition in the course of public procurement...” (Act on Public Procurement; “Introduction”). The concept that there should be an exemption or a less stringent procurement rule because the payment for a public service comes directly from the private users rather than with public funds or that the service goes directly from the private company to the user exalts form over substance. Funds for all services come from taxes or fees paid by private individuals. Furthermore, in the case of a public service performed by a private contractor, the latter has received a monopoly position from the public sector with economic value which certainly implies a form of consideration. The interests of the public in securing the benefits of the procurement act are the same whether the service or the payment for the public service is directly from the citizen to the service provider or via a government agency.

In contrast to the Hungarian practices, the EU directives regarding the applicability of procurement regulations contain broad definitions of “public authorities” and “public undertakings” which include authorities that are effectively controlled by public entities (box 15.1). This coverage includes entities that “operate on the basis of special or exclusive rights granted by a competent authority of a Member state” (title I, article 2, section 1(b)).

*Box 15.1 The European Community Definitions of
“Public Authorities” and “Public Undertakings”*

Public authorities—shall mean the State, regional, or local authorities; bodies governed by public law; or associations formed by one or more of the authorities or bodies governed by public law.

Public undertaking—shall mean any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it. A dominant influence on the part of the public authorities shall be presumed when these authorities, directly or indirectly, in relation to an undertaking:

- hold the majority of the undertaking’s subscribed capital, or
- control the majority of the votes attaching to shares issued by the undertaking, or
- can appoint more than half of the members of the undertaking’s administrative, managerial, or supervisory body.

Source: European Commission directive 93/38/EEC, title I, article 1; 1993.

In the course of interviews, we found substantially differing opinions about the scope of the Act on Public Procurement and heard statements that the law clearly did not allow for some of the interpretations that other experts claimed were common. Further clarification and possibly simplification, which obviates the need for substantial cross-referencing to other legislation, might bring about greater uniformity of interpretation.

EU Conclusions about Hungary's Public Procurement Standards and Plans for Future Amendments to the Procurement Act

The European Community (EC) Commission, while commenting that “Hungarian legislation on public procurement is largely compatible with EC directives in this field,” has noted that: “... the Hungarian legislation does not meet all the requirements of EC directives regarding the utilities sectors (namely energy, telecommunications, water, and transport)” (European Community 1997: 36). Interviewees from the Ministry of Justice and the Council on Public Procurement indicated that plans were underway to take the steps necessary to bring the Hungarian standards in conformity with the EU standards. Interviewees expressed differences of opinion, however, about the extent of diversion between the EU standards and Hungarian law.

Interim Preferences for Hungarian Companies

Under the current law, a public agency may prescribe that the tender will be awarded to residents of Hungary, or that the Hungarian bidder will be favored if its bid is not more than 10 percent above a foreign competing bid (Act on Public Procurement, sections 26(3) and 59(2) and (3)). In accordance with EU accession agreements, these preferences have been phased out.

Enforcement and Implementation of the Act on Public Procurement Standards

Staff of the Council on Public Procurement stated that most noncompliance was not intentional and that the most serious problems result from a lack of understanding of the law. It indicated that frequently local agencies draft implementation regulations that are not consistent with law. The council is considering preparing a procurement package for localities. Several interviewees noted that bidders are hesitant to complain about violations of the rules out of fear of retaliation in future tender evaluations. In a study extending to the end of 1996, the State Audit Office concluded that “a considerable part of public procurement procedures were conducted in deviation from the rules” (Bonifert and others 1998: 30). (For a general critique of the operation of the procurement law, see Dezsériné-Major 1998.)

Non-transparency of Public Contracts and Information Used to Justify Price Adjustments

This section summarizes the present Hungarian practice and legal framework that disfavor access of citizens to public records on service contracts. Following a brief summary of international rules on access to public records we address the issue whether maintaining the secrecy of public contracts has a rational policy basis.

Hungarian Practice

Most of the time, local officials took the position that contracts by public entities with private companies were not public records and, therefore, citizens do not have the right to obtain such documents. In some cases inquiries about whether such records were public made local officials rather uncomfortable and they gave mixed responses. A local official responded that in principle the contracts were public, but that in practice nobody had requested copies of contracts so they were not given out. The same public official also stated that should someone ask, the consent of the contracting company would be required in order to release a copy. In other cases such requests were viewed as unreasonable. As a result, information about what might be in the contracts was limited to information contained in the tender announcement.

Hungarian Law

Contrary to the nearly universal public practice, Hungarian lawyers who were interviewed believed that contracts by public entities are public records. Although Hungarian authorities are more restrictive than western European authorities in regard to access to public contracts and commercial information submitted to public authorities, Hungarian law appears to have stronger public access standards than those of western Europe.

Under the Hungarian Constitution (article 61) "... everyone has the right to ... information of public interest...." Furthermore, under the 1992 Law on the Protection of Personal Data and Accessibility of Data of Public Interest (Hungarian Civil Liberties Union 1997), the authorities are required to grant access to anyone for "data of public interest," unless the data are specifically restricted by law (article 19(3)). The law provides no specific exemption for commercial information. Moreover, "data of public interest" is broadly defined to include "tasks of state and local governments and any other data, utilized by such organ or person who performs public tasks according to legal rules except data defined as personal data" (article 2, section(3)). Another section of the law states that: "Access to data of public interest may not be restricted to protect those data of a person acting within his or her authority within the scope of power of organs mentioned in the first subsection" (article 19 (4)).

One exception to these rules is that: "Unless an Act provides otherwise, data generated for internal use and in connection with the preparation of decisions shall not be public within 30 years following their inception" (section 19(5)). According to the legal experts interviewed, however, the intent of this section is to protect drafts of proposed regulation prepared by a ministry, rather than to protect commercial information. Hungary also has a business secrets law, which protects "any fact, information, solution or data, connected to economic activities, the secrecy of which is in the reasonable interest of the entitled party" (section 4(3)a of the Act on Unfair Market Behavior and Prohibition on Interference with Free Competition).

Hungarian law does not set forth the relation between the accessibility of data and the business secrets laws. In two opinions regarding the relationship between public funds and private business, however, the ombudsman clarified the issue. The ombudsman stated in the

first opinion that: “The transparency and controllability of the privatization processes, as public interest, takes precedence over the private interest of protection of business secrets” (case number 528/A/1996, November 28, 1996). In the second opinion, which involved the refusal of the Ministry of Transport, Telecommunication, and Water Management to provide a copy of a concession contract, the ombudsman stated:

“The right to have information on public data and the right to have business secrets can contradict each other when organs with public activity have business relations with private companies, e.g., when they engage in a public procurement procedure, privatization or concession or through the process of state and municipal property management or in cases when a state or municipal budgetary subsidy or favor is granted to a private company.

State or municipal organs learn business secrets very often when they deal with asset management and when they manage public funds. In these cases the principle of publicity has priority, since the utilization of public finances and the state economy should be transparent. Since free access to information is a constitutional right, the right to have business secrets cannot come before that. Private companies that apply for state or municipal subsidies or enter for a competition for subsidies or companies that have business relations with the state and municipality where public finances are involved, or if they manage public assets, often are exposed to the restriction of the right to have business secrets.

It is obvious from the data protection law and also from the above mentioned regulations of the concession law that when the state, municipality concludes a concession contract, it disposes over public funds. This explains why the content of this contract cannot be considered as business secret, given the present system of information right” (case number 528/A/1996, November 28, 1996).

Access in Other Nations to Public Contracts and Pricing Data

Access to public documents has been an area of increasing concern in recent decades. In 1982 the Council of Europe’s Committee of Ministers adopted a “Declaration on the Freedom of Expression and Information” (70th Session, 29 April 1982). It states that they “... seek to achieve the... following objectives: ... the pursuit of an open information policy in the public sector, including access to information, in order to enhance the individual’s understanding of, and his ability to discuss freely political, social, economic and cultural matters...” (Declaration, section II(c)). Commonly, nations have adopted some type of freedom of information legislation.

National constitutional provisions or legislation governing access to public information usually contain some type of exemption for commercial information that has an undefined scope. Interpretation is largely left to the administrative agencies and the courts. In central and eastern Europe, contracts for public services are generally considered secret. In some western European nations such contracts are considered public records.

French law governing access to administrative documents (*Code Administratif, loi no. 78-753 section 6 du 17 juillet 1978*) provides an exception for commercial and industrial secrets. The Commission d'Acces aux Documents Administratifs (CADA) is responsible for administering the law and making administrative determinations about access to particular documents. A commentary on the French act notes the scope of the exception is not precise and that it has not been defined by the courts (CADA 1998). Each of the sources we contacted, however, indicated that contracts were considered public records.

British law contains a non-statutory Code of Practice on Access to Government Information, which includes an exemption for “commercial confidences, trade secrets or intellectual property whose unwarranted disclosure would harm the competitive position of a third party.” The “Guidance on Interpretation” issued by the Cabinet Office advises decision-makers to ask a three-part question when determining whether to withhold commercial information: Is the information: (a) a trade secret, (b) a commercial confidence, or (c) intellectual property?

- If the answer is “no,” then the exemption does not apply.
- If the answer is “yes,” would its disclosure be likely to harm the competitive position of the subject or source of the information? If so, disclosure is unwarranted unless an overriding public interest in disclosure exists. If not, would its disclosure be likely to prejudice the future supply of information to the government? If so, then disclosure is unwarranted (Cabinet Office 1994).

Presently, the Freedom of Information Unit of the Cabinet Office is drafting freedom of information legislation for consideration by the Parliament which would replace the Code of Practice.

Under Austrian law, public agency contracts are not public record, but a losing bidder in a tender has the right to see the contract made with the winner of the tender (*Federal Law Gazette I, 1997/75, (Reissue), section 56*).

Under Swedish law, “access to official documents may be restricted only if the restriction is necessary having regard to... 5. the public economic interest; 6. the protection of... economic conditions of private subjects” (Freedom of Press Act, chapter 2, “On the Public Nature of Official Documents,” article 2). In article 3 of the same act, the term “document” is broadly defined to include any document in the possession of a public authority.

Under U.S. law, contracts by public entities are public record. The Federal Freedom of Information Act contains an exemption for “trade secrets and commercial or financial information obtained from a person and privileged or confidential...” (U.S. Code Annotated, section 9(b), (4)) (see also American Civil Liberties Union 1992; Kuersteiner and Herbach 1976). State laws, which govern contracts by state and local governments, contain similar provisions. Typically the commercial exemptions are interpreted narrowly. Generally they provide an exemption for commercial information that is used to demonstrate that a company has the financial resources to undertake a project or to protect trade secrets.

The common judicial test of whether a government agency can refuse to disclose business information is whether the release of the information would be damaging to the business or would discourage future competition for public contracts.

(For discussion of the commercial exemptions under the laws of Australia, Canada, France, Great Britain, Ireland, New Zealand, Sweden, and the United States, see Baxter 1997b.)

Does Maintaining the Secrecy of Public Contracts Have a Rational Policy Basis?

Maintaining the secrecy of public contracts seems to be based on a combination of European civil law distinctions between public and private matters, reactions to invasiveness of the communist regimes, and a common view that private companies will be damaged by public disclosure of critical business data. Maintenance of the secrecy of public contracts is common in western Europe, as well as central Europe, although recent decades have seen a strong trend toward allowing increased access.

The concept of secrecy of public contracts based on a theory that disclosure would be damaging to a company does not stand up under scrutiny. The best evidence of the truth of this statement is that the wide scope of access allowed in the United States, including access to public contracts, has not deterred private initiative and commercial activity. On the contrary, such disclosure has increased the credibility of government use of private companies in the provision of public services.

The Drafting of Public Service Contracts and Their Substance

An original purpose of my effort was to provide comments on public contracts with private companies for public services. To a substantial extent, this objective has been frustrated by the practice of keeping these contracts secret. I could obtain information about significant provisions in contracts through interviews, but I could not determine what critical information may have been omitted. Usually I could not determine what rights and economic returns were granted to private investors who provided capital for public works.

Interviewees consistently indicated that they had not had problems under their contracts and that they would not draft their contracts any differently if they were rewritten today. The few contracts I obtained, however, were very brief, leaving the details of payment, the level of service provision, remedies for service breaches, and other matters to the scope of the tender invitation or to oral or unstated possible misunderstandings. Under these circumstances, frustration of objectives and expectations and future misunderstandings and disputes are inevitable.

The contents of public service contracts are governed by a combination of some or all of the following components:

- The Hungarian Civil Code
- A tender announcement, which may be governed by the national procurement law

- The national legislation governing service provision
- A local decree governing the provision of the particular service
- The contents of the contract.

Presently, a substantial portion of municipal contracts for public services do not adequately protect the interests of the contracting municipality. In the course of my research, I found that contracts for public services were typically very brief. Commonly they do not contain adequate descriptions of the scope of services, thus enabling the contractor to perform less work than was envisioned by the municipality when the contract was entered into, or they contain weak penalty provisions, so that the municipality has no real remedy if the contractor fails to provide the required work. Some long-term contracts authorize excessive annual price adjustments. In some cases cities have made critical omissions in their contracts. For example, they have not been aware that in the absence of a clause stating that a contract is an “entrepreneurial” contract, the contractor is entitled to payment whether it performs its obligations or not. Local decrees may address what the service provision must consist of, but they do not address the question of remedies in case of a breach.

The switch in the government’s role from service deliverer to service overseer places the local government in the role of a regulator of the quality of services provided by an entity, which may be guided primarily by the motives of maximizing its profit and preserving its existence. Often these basic transformations are overlooked because of the long-term familiarity between the actors involved. When services are contracted out for a substantial period, provisions for price adjustments must be included in the contract and the local government also becomes a price regulator.

The Process for Drafting Public Contracts

Many of the failings of municipal contracts may be attributed to the process by which contracts are drafted. Typically they are formulated by a city staff person, without review by an attorney, after a contractor has been selected, a price has been agreed to, and any negotiations are over. Under these circumstances, the contract is viewed merely as a formality that puts into effect a relationship that has been agreed upon, rather than as a tool for clarifying the issues and resolving the disputes that may emerge during the life of the contract.

Often the party that is awarded the project drafts the contract for execution by the city staff without amendment. Under section 62 of the Act on Public Procurement, when open procedures are used, a contract must be complete at the time of the written decision, but the invitation for bidding may specify that the contract shall be complete within 60 days of announcement (30 days for construction contracts). Some interviewees recounted circumstances in which any objection to some of the terms in the contract by a city staff person or attorney was viewed as an obstacle rather than as useful input. One interviewee

who now works for a city-owned company indicated that when he drafted major contracts with municipalities on behalf of privately owned companies, the city officials who reviewed the contracts had little understanding of their meaning, and he felt compelled to advise them even though it was not part of his job.

An alternative to the foregoing type of approach would be to develop the contract before the selection of the contractor begins.

- If a tender procedure is used, the contract would be attached to the tender as a part its conditions. This approach is standard in the United States and Great Britain.
- A local decree enacted before the contract is undertaken may describe the scope of services that are involved in the provision of a particular service.
- A draft of the proposed tender conditions could be subject to public review.
- The results of the bidding, along with an explanation of how the winner was selected, should be published in the local press.

When these approaches are used, the contracting process is more open and subject to public review. This openness places pressure on the drafters to prepare a better contract and allows for public input into the drafting process. Attaching a contract to a tender creates certainty as to what the competitors can expect, ensures that contractors are competing for contracts with the same provisions, and prevents possible favoritism through contractual provisions that are formulated after the selection of a contractor. It is suggested that contract drafters do the following:

- Compile a list of the tasks to be provided by the service provider, with a view toward including specifications (inputs and outcomes) for these tasks in the contract. An expert in the provision of the particular service should undertake this task.
- Review the national and local laws applicable to the provision of the service.
- Consider the issues raised by the models in this report.
- Review the proposed contract with experts on the service covered by the contract.
- Review the proposed contract with representatives of the industry to be covered by the contract and civic groups.

Box 15.2 provides a list of what should be covered in a contract or applicable decree.

Cities must use experts on the provision of the particular service in issue and the law. Generally the benefits of such expertise far outweigh their costs. Local governments may save costs by pooling resources to obtain adequate counseling. Although foreign models of contracts and procedures may not be appropriate for local circumstances, they may provide useful lists and discussions of the issues that should be considered in a contract and the overall contracting out process (See, for example, (supra note 1) in ICMA 1992). In the United States and Great Britain, the trade associations of most industries and counterpart government agencies have prepared model contracts. In addition, often trade industry

and scholarly literature contains information about the problems and issues associated with contracting particular types of services. Another approach to improving the quality of contract preparation would be to create separate council committees, which include nonvoting representatives of nongovernmental organizations and experts, just for the purpose of reviewing contracts.

Box 15.2 Issues That Should be Covered by the Contract or the Applicable Decree

1. Introductory summary of the subject matter of the contract

Basic Conditions

2. Reference to applicable decree
3. Definitions
4. Duration of the contract: (a) ongoing or periodically renegotiated; (b) notice period required for termination

Scope of Services

5. Unit of service
6. All the types of facilities served by the contractor
7. Standards for work performed by the employees of the contractor, including treatment of the public
8. Time schedule of activities
9. Hours the service may or must be performed
10. Holidays when the service is not required
11. Location of service
12. Access to service
13. Required equipment
14. What equipment may or may not be used
15. Where equipment may be stored
16. Equipment and facilities supplied by the municipality
17. Maintenance obligations of the contractor
18. Maintenance obligations of the city
19. Standards for maintenance of the equipment and the storage facilities
20. Condition of equipment and facilities at the end of the contract
21. Information pamphlets to be supplied to the public by the municipality or contractor or both
22. Hours and facilities maintained by the contractor to receive complaints and reporting of complaints to the municipality
23. Responsibilities for billing customers and collecting fees
24. Prohibited activities

Fees and Compensation

25. Total fee
26. Breakdown by specific portions
27. When invoices must be submitted
28. When payment must be made (connection to when invoice submitted)
29. Permitted fees to public for services
30. Adjustments of fees
31. Responsibility for tax payments
32. Ownership of improvements at the end of the contract

*Box 15.2 Issues That Should be Covered by the Contract or the Applicable Decree
(Continued)*

Monitoring by the Local Government

- 33. The content, format, and frequency of the reports that must be submitted by the contractor
- 34. Frequency of monitoring

Communication with City; Interpretation and Resolution of Disputes

- 35. Contractor designation of person and place to receive municipal communications
- 36. City designation of an officer to administer the contract
- 37. Interpretation of the contract and governing rules
- 38. Requirement that municipal interpretations of the contract must be in writing
- 39. Procedures for communicating disputes

Remedies

- 40. Warning procedures before termination
- 41. Monetary remedies, in addition to a return of the funds received by the contractor if the contract is terminated without any service being performed
- 42. Reductions in payments tied to specific measures
- 43. Adjustments in compensation to the contractor
- 44. Penalties for late payments by municipality

Modifications

- 45. Terms and conditions for modifying the contract
- 46. Termination—because of an unexpected or uncontrollable event

Other Provisions

- 47. Permits that the contractor must obtain
- 48. Requirement for the contractor to maintain continuous financial ability to perform the services
- 49. Requirement that the contractor comply with all applicable laws relating to the service provision

Long-term Contracts

As previously indicated, long-term contracts are often made to obtain the benefits of private access to financing for necessary capital expenditures. This approach, however, poses substantial risks and has substantial drawbacks. Such contracts may effectively preclude the public from obtaining the economic and service benefits of future innovations that increase efficiency or quality because a company with a long-term contract would not feel compelled to make the improvements or pass through the cost reductions to consumers. In effect, they remove many of the advantages associated with contracting out public services and lead to the loss of future cost control.

In one case a major city has awarded a 25-year contract for refuse collection, with an annual cost price index adjustment, which does not require capital improvements by the private company. The justification for this contract was that the private company would

have the funds to upgrade the rolling stock, but shorter contracts may have accomplished the same result. Other cities have executed similar length contracts in conjunction with private investment in the creation of new waste disposal site. Such contracts may have greater justification, but they carry the same risks.

For example, greater competitiveness in the provision of waste disposal may be obtained by dividing service provision into separate contracts for the creation of a waste disposal site (which requires a long-term investment) and waste collection. One city services manager believed that such an approach would create unworkable conflicts of interest and that it would have to contract out the whole solid waste disposal process when it needed a new disposal site. A private company representative commented that if collection and operation of the disposal site were divided, companies would use other illegal sites that charged lower fees. Other cities, however, are using this approach.

Setting Prices for Public Services

This section describes some of the basic concepts and issues, associated with price setting, but a more important purpose of this section is to address the issues associated with price-setting procedures in Hungary.

Transparency and Secrecy of Financial Information in Price-setting Proceedings

As in the case of public contracts, submissions used for public price settings are not public record. The most significant example of this practice is that submissions to the Ministry of Transport, Telecommunication, and Water Management—used to set water price for the five regional companies, which in turn set rates for 45 percent of the country—are not accessible under current practice. Furthermore, the submissions used to justify local tariff subsidies for hundreds of water districts are not accessible.

Interviews revealed that local assemblies are not given sufficient information to make informed price-setting decisions. Without access to the data submitted to the assemblies and decisions setting forth their reasoning, knowing if they had adequate expertise and if their decisions were reasonable is not possible.

Without public access to cost data, the process cannot possibly viewed as democratic, and developing the independent expertise that is essential to formulating critical independent understanding of price-setting standards will be impossible.

To review requests for price increases, information must be obtained in a manageable form. When specific application forms are not provided to regulated entities, they commonly provide too little information or more information than the price-setting agency can possibly digest.

Price Adjustment Formulas

This section summarizes the characteristics of the two major brands of price adjustment formulas—the rate of return standards and the price indexing.

Types of Formulas

Price setting is necessary whenever a service has to be contracted out for a substantial number of years, or a monopoly supplier cannot be replaced. The institution of price regulations in modern economies has been accompanied by continual debate over what formulas or standards should be used. Setting prices for public services has never been a simple task, and no single best approach is clear. In Great Britain and the United States price-setting formulas and practices have been constantly revised (Beesley and Littlechild 1989; Klein 1996). Price-setting formulas (table 15.3) may be divided into two rough categories: (a) rate of return and (b) price index. Rate of return standards provide that prices shall cover actual operating expenses plus a specified rate of return on capital investment. Price index formulas range from simple formulas that use only one price index to adjust prices to complex formulas that use a weighted price index reflecting the types of expenses incurred by the regulated service.

The cities contacted in this study used both rate of return and overall price index formulas for adjusting prices. Weighted price indexes were used in only a few instances. The city of Eger uses a weighted index for adjusting water prices. The weights in its formula are as follows: materials, 12 percent; wages, 44 percent; amortization, 11 percent; other costs, 17 percent; and energy, 16 percent.

Table 15.3 A Hypothetical Weighted Index Formula

| <i>Factor</i> | <i>Index</i> | <i>Percentage increase over prior year</i> | <i>Weight</i> | <i>Adjustment = (c)·(d) (percent)</i> |
|--------------------------------|---------------------|--|---------------|---|
| <i>(a)</i> | <i>(b)</i> | <i>(c)</i> | <i>(d)</i> | <i>(e)</i> |
| Wages | National wage index | 12 | 0.55 | 6.60 |
| Fuels | Fuel price index | 18 | 0.12 | 2.16 |
| Materials | | 10 | 0.10 | 1.00 |
| Vehicles accessories and parts | | 20 | 0.23 | 4.60 |
| Total adjustment | | | | 14.36 |

Source: Beesley and Littlechild 1989; Klein 1996.

Comment on Rate of Return Standards

The strength of rate of return regulation is that it rewards increased investment and provides security for the investor. The criticism of the approach is that it provides no incentive for efficiency and encourages overcapitalization.

As a practical matter, administering periodic reviews of cost increases to determine if they are reasonable is difficult. Determinations must be made about whether particular expenditures are reasonable, when in reality tradeoffs (or a lack thereof) are constant between quality and price. Determining what types of expenses can be expensed in one year and what types should be amortized (and if so over what time period) is necessary. Use of standards from other codes, such as a tax code, for determining how expenses should be treated may or may not be appropriate. Fair return calculations may become political, with a commission selecting the desired result and then working backward to justify that result. In the United States rate decisions may be appealed to the courts, but the judicial decisions provide little guidance in the form of specific principles that can guide future commission decisions.

Comment on the Use of Price Indexing

Indexes offer certainty, which protects the investor and shields the public agency from having to make repeated unpopular price adjustments. By contrast the index selected may or may not be an indicator of what price adjustments are reasonable. The overall price index may not reflect cost increases for a particular type of public service, which has a far different basket of expenses than the basket of expenses of a typical household, which is used to construct the price index. In light of the complexities and shortcomings of rate of return formulas, price indexes may be most appropriate. By contrast, use of the overall consumer price index may lead to excessive increases, especially if real wages are decreasing.

In Britain a combination of rate of return analysis and price indexing is used to determine water prices. The initial price is set based on a cost review. Then annual adjustments are based on the overall price index. The annual adjustment formula, however, includes an adjustment so that the annual price adjustment is a specified percentage below the full percentage increase in the index. (The adjustment = retail price index – X.) The X factor is based on the theory that the water companies should become more efficient over time. Periodic reviews are then conducted to readjust the base price. The first review was conducted after 10 years, but now the water regulatory authority is planning on reviews every five years. Although this approach may work well in Britain, investors may feel that operating under this type of price control is far more risky in a nation that has a short tradition of private ownership and the application of price regulations to private firms.

Conclusion

Hungary is undergoing a rapid transition. In the area of local service provision, within a relatively short period, it is introducing market economy public procurement systems, privatization of public services, and standards for setting allowable prices for privately owned public services. These tasks are complex, and more economically advanced nations are still trying to master them.

Finding the best method of privatizing public services may even be more difficult and complex in Hungary than in advanced western economies, because Hungarian public agencies, rather than just searching for greater efficiency, are dependent on private firms to bring needed capital into a transition economy

That contracts carefully spell out each of the obligations of the government and the private company providing the service is essential. In the absence of specific contract terms, differing understandings about what is and should be expected from each party are certain to occur. The rapid introduction of long-term contracting out of public services, necessitated by the need to bring in capital for public services, requires rapid growth in national and local government sophistication about public service contracting and pricing. Otherwise, long-term damage can occur, in the form of long-term public service contracts that fail to ensure adequate services, forestall innovation, or permit excessive prices.

Local governments must obtain adequate representation and expertise to undertake the contracting out of programs. To reduce the costs associated with such efforts, local governments should pool resources to obtain adequate counseling and expertise. In any case the costs associated with obtaining such expertise are usually small compared to the costs of operating without it. One Hungarian consultant indicated that some localities saw their high costs for particular services as laws of nature rather than understanding how the pooling facilities with other municipalities would drastically reduce costs. In the course of consulting in the United States, I frequently faced situations in which municipalities incur substantial administrative and legal expenses because they wanted to save on initial legal fees for drafting legislation or because the municipal manager or attorney did not want to acknowledge that he or she needed outside expertise.

The lack of transparency serves little or no purpose at the expense of allowing corruption to be concealed, forestalling the development of independent expertise, and excluding public input on public matters. It leaves decision-making in the control of government without review and accountability. Although interviewees repeatedly explained that the secrecy of contracts and data submitted to justify price adjustments was pursuant to law and was the way that things are done, no one offered a persuasive rationale for such practices.

It may be necessary to maintain the secrecy of some pieces of information associated with private provision of public services, but the broad cloak of secrecy now in effect is a vestige of an old historical concept that places government in a role of master rather than servant of the public. The best results in a market economy occur when information is open so that the most honest competition and the best critical public review can be obtained. In light of the fact that Hungary is starting from a weaker economic position and a lack of contemporary tradition in contracting to private companies, it needs to be even more skillful at contracting out than governments in more advanced economies.

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16

Off-budget Revenues and Expenditures: A Challenge to Subnational Finances

József Hegedüs



The share of a nation's local government expenditures and revenues in total national or public expenditures and revenues is supposed to reflect the role of the local government sector and indicate the extent of fiscal decentralization. Municipal expenditures amounted to 12 percent of gross domestic product and 27 percent of Hungary's general government sector in 2000. I should note, however, first, that some revenues only pass through the local budgets, hence the extent of decentralization is overestimated. For instance, health services and their respective cost normatives are determined by the central government, and local governments reimburse the cost of the provided services and medicines. Second, numerous local revenues and expenditures are off-budget items in the local governments' financial statements. Hence the role of the municipal sector is underestimated. Public services are often provided by various independent legal entities: public or private enterprises, public purpose corporations, nongovernmental organizations, or charity foundations (see chapter 14). Analysts estimate that these entities provide services in the range of 6 percent of gross domestic product in Hungary (see chapter 17).

This chapter analyzes the underlying organizational structure, consequences of, and incentives for off-budget revenues and expenditures (OBRE). Based on case studies in medium-sized Hungarian cities (mainly Berettyóújfalu, Szentes, and Tatabánya), my findings suggest that both inter-temporal and cross-sectoral or regional comparison of municipal service activities should ideally be based on standardized consolidated financial statements. Thus reformers must properly take into account the various organizational and ownership structures and the effects of the off-budget revenues and expenditures. Cross-sectoral and cross-country comparisons in the European Union face similar challenges.

* This chapter is based on Hegedüs 1999.

On- Versus Off-budget Activities and Accounts

The general government sector includes organizations whose primary activity is to assume responsibility for the provision of goods and services to the community or to individual households free of charge or at prices that are not economically significant, and to redistribute income and wealth by means of transfer (EC 1993). This broad definition draws the functional boundaries of the provision of public services; these services, however, are increasingly out-sourced by local governments. As a result, the government finance statistics (GFS) system defines quasi-government operations (QGOs) as the activities of entities performing government functions outside the legal boundary of the general government sector.

The principles of QGOs, however, do not give a straightforward and comprehensive solution to the problems we are facing in analyzing local government activities. Three major cases of QGOs are apparent: (i) Government units may compensate the units concerned directly for some or all of the costs incurred. In this case the amount of the compensation is fully reflected in the GFS system as a subsidy or similar type of transaction. (ii) Government units may provide no compensation or only partial compensation to the units concerned for the costs incurred. In this case part or all of the costs of the QGO will be reflected in the GFS system if the units concerned are partially or wholly owned by units of the general government sector. (iii) Even if the units concerned are not owned by units of the general government sector, part of the costs of the QGO may be indirectly reflected in the GFS system (EC 1993).

Local governments have ownership stakes and interests in thousands of units that provide solely or partially public services such as water supply or cultural and educational services. These units have accounts, budgets, financial reports, revenues, and expenditures separate from the municipal budget. Although the fiscal indicators give a good picture of the local government budget items, the treatment of the OBRE is unresolved. The revenue and expenditure flows corresponding to the public services include central transfers (current and investment grants), local own revenues (transferred from the local government to the service units), nontax revenues (user charges and donations from companies or private persons), and in principle, but not in practice, earmarked tax revenues (see table 16.1).

Table 16.1 Types and Clusters of Local Revenues

| Type of entities | Local revenues | |
|------------------|---|--|
| | Tax revenue | Nontax revenues |
| Budget | Building tax, local business tax, communal tax, land tax | Fees, building fines, school revenues from meals |
| Off-budget | Earmarked tax levied by service entities, for example, special purpose district | Rent, charges, revenues from selling assets |

Source: Hegedüs and others 1999.

With very few exceptions, outsourcing the provision of public services is the trend in Hungary. As a result, more and more municipalities shift service provision to off-budget service units, so off-budget revenues could even surpass on-budget revenues (see table 16.2). This trend highlights the urgent need to enhance the capacity of local governments to exercise tight regulation of price and quality and assure equity in public service provision (see chapter 15).

Table 16.2 Off-budget and On-budget Revenues in Berettyóújfalu, 1998 (Ft thousand)

| <i>Source</i> | <i>Off-budget</i> | <i>On-budget</i> |
|-------------------------------------|-------------------|------------------|
| User charges | 223,334 | 174,226 |
| Revenues from property | 4,576 | 52,389 |
| Donations | 27,490 | — |
| Total | 255,860 | 226,615 |
| As a percentage of the local budget | 12.1 | 10.7* |

Note: * The local government budget without the budget of the local hospital.

Source: Local government of Berettyóújfalu data.

Subnational governments often select special organizational or ownership forms of service provision for taxation, budget, or revenue allocation rather than service efficiency purposes. The organizational setup and the shift from on- to off-budget items, however, have serious impacts on the accountability of providers, the predictability of costs and revenues, the distortion between supply and demand, and the equity and regulation of service provision (see table 16.3).

Table 16.3 The OBRE in Relation to Equity and Efficiency Factors

| <i>Source</i> | <i>Budget</i> | <i>Account-ability</i> | <i>Predict-ability</i> | <i>Distortion</i> | <i>Equity</i> | <i>Regu-lation</i> |
|--|---------------|------------------------|------------------------|-------------------|---------------|--------------------|
| User charges fees, fines, and so forth | On-budget | ++ | ++ | + | ++ | ++ |
| User charges fees, fines, and so forth | Off-budget | + | ++ | + | + | + |
| Revenues from property | On-budget | + | – | – | 0 | -- |
| Revenues from property | Off-budget | -- | -- | -- | 0 | -- |
| Donation | On-budget | ++ | – | ++ | ++ | 0 |
| Donation | Off-budget | +– | – | ++ | ++ | 0 |

Note: + positive effect, – negative effect, 0 neutral effect, -- very negative effect, ++ very positive effect.

Source: Hegedüs and others 1999.

My findings suggest that user charges, when set and regulated appropriately, have generally a positive impact irrespective of the organizational and accounting form of service

provision. On- and off-budget revenues and expenditures are equally suitable from the efficiency and equity viewpoints. When managing and divesting assets, however, OBRE might have a rather negative impact on accountability, predictability, regulation, and supply and demand. Off-budget donations might have a negative impact on both accountability and predictability, but they could play a positive role in supply and demand relation and equity in certain services.

Organizational Structure of Local Service Provision

The share of local own revenues is one of the key indicators of fiscal decentralization, particularly in transition economies, although it depends greatly on the changing organizational structure of service provision. The 1990 Act on Local Government sets an extremely general definition of municipal tasks and conceptually provides local governments with great flexibility in creating new legal or organizational structures for local service provision. The analyses, however, have underscored a strong inertia of the inherited institutional structure, which fueled the initial ambitions of local governments to maintain and operate local institutions and provide basic services directly. Already in the early 1990s, subnational governments moved toward changing the organizational forms of service provision. The changes in the organizational structures were stimulated not only by the well-known legal requirements but also by the following factors: (a) new responsibilities introduced by sectoral laws (for example, fire protection and active unemployment policy services), (b) positive or adverse incentives embedded in financial and taxation policies, and (c) local interests groups.

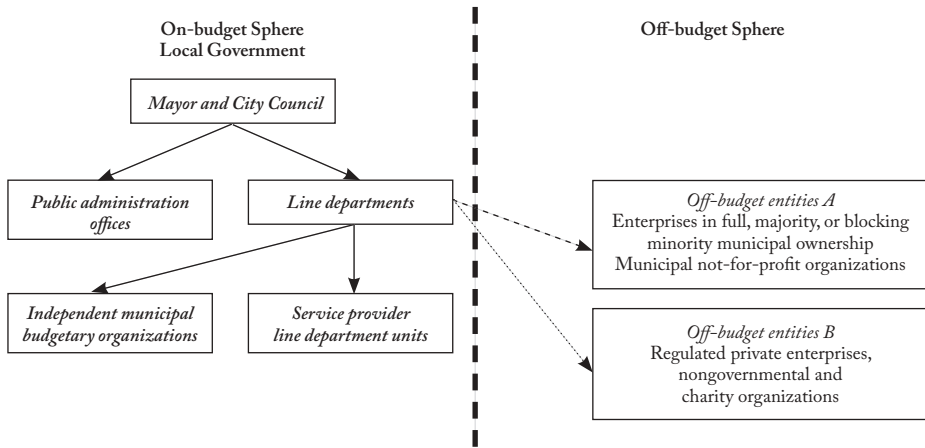
Municipalities provide services through various forms of organizations (see figure 16.1):

- Line departments of the executive office of the local government (for example, building departments, administrative notary offices, or tax offices)
- Municipal budgetary institutions (for example, schools, libraries, or homes for the elderly)
- Not-for-profit municipally owned organizations (for example, public purpose corporations or foundations)
- Business enterprises in full municipal ownership (companies or limited corporations)
- Joint ventures (with majority or blocking minority above 25 percent stake)
- Majority private enterprises with little or no municipal ownership
- Nongovernmental organizations, charity organizations, and private foundations.

The alternative structures of service delivery can be analyzed from two aspects: (a) administrative and management characteristics (such as taxation, bookkeeping, property

rights, control, or legal standing), and (b) financing models (such as cost and revenue mechanisms and impacts on the local budget).

Figure 16.1 Organization Framework for Local Functions and Services



Source: Authors based on Hegedüs and others 1999.

Several questions arose in relation to the transition in terms of local service provision. Most analysts assume that this development is a positive one through which municipalities find more sophisticated solutions in substituting direct public provision with more efficient organizations and broader inclusion of the private sector. These views are one-sided for several reasons.

First, the market and regulatory environment largely influence the efficiency of a new organizational setting. For instance, most transitional economies lack the conditions for market competition, which would guarantee efficiency gains. In Hungary the appropriate legal and regulatory reforms did not precede the contracting out, privatization, or transferring of public service delivery to nongovernmental organizations or foundations (see chapter 15).

Second, a solid regulatory background does not only imply laws on, say, price regulation and procurement; they also imply that public and business entities know and observe the laws. If laws are bypassed or if they contradict each other, they will neither enhance efficiency nor result in lower prices, improved quality, and reliability of public services. Moreover, any reform implemented without the appropriate legislative and regulatory framework would result in adverse effects and behaviors.

Third, the privatization or concession agreements between local governments and private partners should entail clear and operational conditions for regulation; only then the organizational or ownership form of service provision may, in principle, not matter. Local

governments ought to have capacity to control and regulate prices, quality, and performance of private service providers.

As a consequence of these caveats, both inter-temporal and cross-sectoral or regional comparisons of municipal service activities should ideally be based on standardized consolidated financial statements. Thus planners should take the various organizational and ownership structures, the legislative and regulatory framework, and the effects of off-budget revenues/expenditures properly into account. Nevertheless, combining the institutional characteristics with the fiscal indicators, which often cause misinterpretation of the intergovernmental finance system, is technically difficult.

Types of Nontax Own Revenues

Hungarian local governments are not only very innovative in creating various legal and organizational forms for service provision, but they also collect a broad range of nontax own revenues. In this section I summarize the nature and importance of the major nontax revenue categories: (a) user charges, fees, and fines; (b) asset revenues; (c) donations; and (d) revenue collection through not-for-profit foundations.

User Charges, Fees, and Fines

The authority for setting user charges and fees, previously under the purview of central government, was passed on to local governments during the transition. Price setting is a political process everywhere, but is especially contentious in central and eastern European countries. The price-setting process is regulated by sectoral laws and decrees, and the actual procedures are under the control of political forces. In Hungary laws and decrees prescribe how the operators of the various service units can calculate the proposed user charges; this calculation, however, must be approved by the city council, which in most cases has little or no capacity to review the companies' calculations (even if they are in full municipal ownership). Thus the process is influenced by asymmetric information and is often finally decided through political negotiation. In the case of regulated private companies, the city council has two options: either finding the proposed price politically acceptable or rejecting it and paying the difference out of the budget. The latter option is the typical case of public transportation tariffs.

From an analytical point of view, user charges and fines can be considered to be implicit taxes. They also can be characterized according to the degree of discretion of the local government:

- Fixed, prescribed price by law (for example, fees for schools, transfer fees, and payments for meals).
- A pricing procedure set by law, with the price negotiated between the local government and the service company (for example, water, garbage collection, and sewage fees).

- No central regulation, with the price at the full discretion of the local authority (for example, parking fees and charges for use of public space).

Typical user charges (such as water and garbage collection) can be either on- or off-budget revenues depending upon the organizational setting for local service provision. Off-budget user charges are very common now. The sectoral laws and the Price Act define the rules and procedures for setting prices, but sometimes companies levy special—unlawful—fees to cover operational costs. In principle the price-setting procedure could be under the democratic control of the local council, but the elected representatives seldom rely on the support of independent specialists.

Communal services are usually delivered by municipal enterprises. The revenues of the enterprises include user charges paid by the beneficiaries or users of the services as well as municipal grants. In addition, these companies can undertake non-service entrepreneurial activities (see box 16.1). The profit gained from such supplementary activities is often used to cover the losses on core services or the company's deficit. Often, municipalities keep user charges at artificially low levels for political reasons while subsidizing enterprises or supporting them in engaging in business activities that help compensate for missing revenues. The major problem with this practice is that local governments carelessly finance risky business investments without having the capacity to control the supplementary operations of the municipal enterprise and the flow of cross-subsidies.

Box 16.1 Supplementary Business Activities Cover the Revenue Gap

In the city of Püspökladány a municipal enterprise provides garbage collection services. The fee is set by the local government and the municipal council decides on any increase in the fee. The company needs to cover operating and capital expenses from the fee revenues. The municipal council, however, can set the fee below cost for social purposes. The company can use its revenues freely and must report to the council twice a year. The company, together with a municipal committee, decides on the use of the profit. The fees do not cover the expenditures; therefore, the company undertakes supplementary business activities to obtain additional resources. These activities include the operation of an auto repair shop, a timber plant, and a hotel, in addition to renting out the vacant rooms in the company's headquarters. The supplementary revenues are used to cover operating and capital costs of the enterprise's core activities.

Setting User Charges at Szentes Water Works Ltd.

Szentes Water Works Ltd. involves a majority ownership of the city of Szentes (33,000 inhabitants and about Ft 3.5 billion annual budget). It provides services for a microregion setting different prices according to municipalities and users: that is, Szentes, two partner municipalities (Eperjes and Nagytóke), and several satellite village suburbs of Szentes. In each of these settlements water and sewage treatment tariffs are different for households, municipal service institutions, and business organizations. The Water Works management prepares alternative proposals for the upcoming year's tariff in coordination with the supervisory board of the company.

The following cost factors are taken into consideration in compliance with the law on water production:

- Operational costs (for example, electricity and wages)
- Amortization cost
- Other expenses (for example, emergency fund to cover large expenses of major repairs—the most debated element of the water fee, because some representatives do not accept the need for such extra cost)
- Projected amount of water production and sale.

The fee proposals are submitted for the approval of the Financial Committee and the urban development committee of the city council. The Water Works also submits its financial reports to the city council which makes its decision on the water fee with full knowledge of the alternative proposals and the justification of the board and the two committees. The council representatives usually vote for lower household fees and higher institution and business organization fees. This differentiation is also advantageous for the service company because the fees are easier to collect from business organizations and institutions.

Cross-subsidies in Berettyóújfalu (Herpaly Team Ltd.)

The Herpaly Team Ltd. is owned by the city of Berettyóújfalu (17,000 citizens and Ft 2.5 billion annual budget). The company provides various community services, including water supply, sewage, heating, park maintenance, and garbage collection, and undertakes entrepreneurial activities, for example, building construction. On the basis of the company's proposal, the local government sets the water, heating, sewage, and garbage collection fees, primarily aiming at social and political objectives rather than covering the real cost of services. The company has sovereignty in setting fees for swimming pools and rental fees in open markets.

Although the company is an individual legal entity that has separate accounts and financial reporting, it cannot make financial decisions freely. The local government decides which activities should be cross-subsidized from the company's budget and which services ought to generate the required revenues to cover total expenses. Gross revenues and expenditures of the company are not reflected in the municipal budget; only the net balance is recorded as "revenues from asset management," a budget line item. Although the municipality does not give a free hand to the company's management, it nonetheless expects dividends. Even though the local government determines the fee policy, the management of arrears remains the sole responsibility of the company. Although this policy reduces the potential financial burden for the municipality, it distorts the balance of expenses and revenues.

In Berettyóújfalu, Herpaly Team Ltd. is the only municipally owned company that generates off-budget user charge revenues (see table 16.4). The net revenues from construction, one of the supplementary activities of Herpaly Team Ltd., amounted to Ft 6 million in 1998. In parallel to Herpaly Team Ltd., other municipally owned institutions (for example, schools) also rent out rooms or equipment. These revenues, however, seldom appear in the local government budget, and sometimes not even in the budget of the institution. (For example, a foundation of the primary school rents out computer equipment, but the small revenue it receives is not accounted in the school's budget.)

Table 16.4 Service Revenues of Herpaly Team Ltd., 1998

| <i>Service activity</i> | <i>Revenue (Ft million)</i> |
|----------------------------------|-----------------------------|
| Water supply | 60 |
| Sewage | 92 |
| Heating | 100 |
| Swimming pool | 3 |
| Market place rental | 8 |
| Garbage collection | 8 |
| Garbage collection in containers | 2 |
| Landfills | 4 |
| Total | 277 |

Source: Herpaly Team Ltd. data.

Asset Revenues

Local governments own and manage a wide range of assets (residential units, commercial spaces, land, public works, and securities), so asset management is a crucial issue (see chapter 19). The large amount of assets transferred from state to municipal ownership, which initially was assumed to generate a steady revenue flow, apparently put financial stress on local governments because services were provided below costs with huge state subsidies. Several properties conceptually had a negative capital value, because of negative cash flow. The question thus arose: how could this process be reversed? Local governments have gradually adjusted service charges because they had both the right and incentive to cut costs and increase charges, although the capital value of their assets has yet to become positive. Managing swimming pools, district heating, and housing rental still require subsidies. The housing stock still generates a loss, because rents do not cover maintenance costs, mainly because tenants are unable to pay.

Property, however, can provide local governments with profit or sizable proceeds. The large losses on housing services fueled housing privatization. Although housing might have been a give-away divestiture, it resulted in huge revenues. Typically, the urban residential

and commercial land could also result in important revenues and in most cases simply windfall gains.

Municipalities generate sizable revenues from securities and financial assets (such as shares, bonds, and cash). They received securities in the course of privatization of local state enterprises, but they were also active in investing in various securities (for example, treasury bills). In high inflationary environments, cash is a potential source of revenue at least in nominal terms. Local governments have been rather innovative in generating revenues even from the state transfers. Current grants were initially transferred in advance quarterly. Municipalities immediately invested the cash flow temporarily available and resulting from the time lag between the receipt of transfers and effective expenditures. In reaction, the central government introduced in 1998 a net financing system managed by the state treasury, which decreased the revenues of the local government sector by Ft 1.5 billion, more than 1 percent of the sector's total budget (Government Decree 217/1998).

Municipalities are quite active in privatizing core public services to generate one-time revenues, prevent huge investment expenditures, or simply get rid of management tasks and excessive current losses. The fiscal squeeze in the mid-1990s motivated municipalities to privatize core services, thus generating significant own revenues (box 16.2). Nevertheless, they often underestimated the monitoring and regulatory challenges inherent in public-private partnerships. When local governments sell their service companies, the activities involved are no longer treated as municipal operations. The contract between municipality and private service provider, therefore, is crucial in specifying how fees are set and where and how revenues, expenditures, and subsidies flow within the new ownership framework (see chapter 15).

Box 16.2 Privatization of the Garbage Collection Services in Tatabánya

The City Management Co., an 80 percent municipally owned enterprise, provided garbage collection and treatment services in Tatabánya. The company often received various types of subsidies and other *ad hoc* financial support from the local government. In 1993 the local government decided to sell this service company and a concession for service provision to provide sufficient funding for modernizing the facilities and to finance the necessary developments. The possible off-budget revenues and expenditures had an impact on the privatization conditionality, the concession fee, and the investment decisions. The German RWE company took over this service provision by buying the company's assets and paying off the total 20 years of concession fee in advance. These measures provided a one-time revenue from asset management for the city budget. By selling the company, the *ad hoc* municipal supports are no longer expected, though some budget expenditures may occur in the form of investment or social subsidies.

Local governments often invested assets in market services or other business entities (for example, restaurants and industrial parks) with the hope of generating own revenues. The mixed (public-private) ventures often fail to generate significant profits or dividends for municipalities, because the private partners easily wipe out profits as a result of uncontrolled expenditures. Moreover, in several instances local decision-makers, in the

hope of high profits, jeopardized local public assets in business investments where they often lose the assets because they lack the right incentives or because of corruption. The municipal bankruptcy cases have mainly resulted from investments in risky, noncore activities (see chapter 30).

In shifting services from on-budget entities to off-budget organizations, the assets in question often become part of a joint venture; often the returns on these investments are far from being sufficiently controlled by the line divisions or the local government council. The accountability issue should become more important, since local decision-makers, in most cases, consider joint investments to be simply private business. They consider business secrecy more important than public interest and advise “never discuss business decisions in front of a wide audience to prevent losing your advantages in business negotiations.” Local government control is often exercised through the delegation of sometimes inexperienced passive local public servants to the company management or supervisory board. As a result, the public audience and public interest are often ignored soon after the entity had been transferred from on-budget to off-budget legal status.

Donations

Donations and voluntary contributions for public purposes by physical or legal persons are becoming increasingly important sources of local revenues, particularly in the education sector. In principle, no rewards accrue to the donors, though in practice these contributions often yield hidden benefits.

On the one hand, municipalities increasingly encourage their on-budget institutions to collect own revenues to finance the additional costs of quality services by off-budget revenues (for example, to provide more language courses or extracurricular activities). The own revenues of municipal institutions include rental fees, fees paid by students for extracurricular courses, and donations. Donations are usually provided to a foundation established and managed by the donor institution. Municipal transfers to the institution are usually set independently from the supplementary revenues (box 16.3).

On the other hand, donations are given to support activities that donors prefer (for example, sport, leisure, and social care). In addition, donations are tax deductible, which creates special incentives for donors. These incentives often coincide with the institutions' aim to raise soft money through foundations as a substitute for regular fees. Direct substitution of fees with donations was initially very popular, but it is now illegal—although such donations can be made in several indirect ways. For example, taxpayers can assign 1 percent of their annual personal income tax to donate anonymously to any publicly registered foundation. Beyond the direct donations, schools and social service organizations gain sizable resources through personal income tax donations.

Vocational training contribution is another significant revenue source for schools. This voluntary contribution is paid by local entrepreneurs annually to support the operation of vocational schools. The amount of donations depends largely on the informal relationship

between the vocational school and the entrepreneur. Table 16.5 shows that this contribution can represent a significant amount of the school budget (36 percent of the own revenues and 4.4 percent of the total budget in the case I studied). The revenues from user charges, grants from applications, and grants from the decentralized vocational training funds are earmarked subsidies, so they should be used for the intended purposes, but donations can be used to cover all kinds of expenditures of the institution.

Box 16.3 Pay a Donation to Receive a Service!

In Berettyóújfalu parents can sign up for tennis courses and pay the fees as donations to the foundation of the school. The extracurricular language courses are financed in the same way.

In a primary school in Berettyóújfalu two parents volunteered to provide computer system management services. In this way the school can assure competitive prices. The fees do not produce a significant revenue source; however, the school provides an important type of extracurricular education.

Above and beyond the regular municipal transfers, a home center for the elderly collects significant revenues from donations. The relatives of the elderly residents often make contributions to the foundation of the home or offer to transfer the real estate of the elderly residents after the residents have died. As an exchange, the residents expect and receive exclusive services or better rooms. The center has full sovereignty in managing and using these additional resources without including them in its budget and even without reporting these revenues in any form to the local government.

A primary school in Berettyóújfalu developed its computer network with the help of a school foundation. The grants collected by the foundation financed the purchase of modern computers and other equipment. The foundation, however, also leases the computers and generates revenues that are sometimes used to support other school activities.

Table 16.5 The Budget of a Vocational School in Berettyóújfalu in 1998 (Ft thousand)

| <i>Budget item</i> | <i>Amount</i> |
|--|---------------|
| The total budget | 118,132 |
| Transfers (central normative grants plus local government support) | 103,811 |
| Own revenue of the institution | 14,321 |
| User charges | 5,225 |
| Grants received through application | 2,100 |
| Decentralized vocational training fund | 1,850 |
| Vocational training contribution | 5,146 |
| The own revenue in percentage of the school's budget | 12% |
| The vocational training contribution in percentage of the own revenues | 36% |

Source: Local government of Berettyóújfalu data.

Foundation: A Path between the Informal Fee and the Donation

The Clever Love Foundation was established in November 1995 by a kindergarten to support a child day-care center in Berettyóújfalu. The founders included 21 parents of the children in the kindergarten that year. The initial budget of the foundation was Ft 66,000. The board of the foundation decides on the use of the financial support and proceeds on the basis of the foundation's charter. The key objectives of the foundation are as follows:

- To promote the integration of kindergarten education with school education considering the requirements of the different age groups
- To help children develop skills beyond the scope of their regular activities (for example, crafts workshops, drama groups, and special physical training)
- To purchase additional equipment (for example, sports equipment, a small weaving loom, books, videotapes, and musical instruments; for drama groups, purchasing puppets, costumes, and equipment, and financing stage arrangements)
- To provide financial support for part-time teachers in extracurricular activities (for example, crafts artists, painters, drawing teachers, and music teachers).

The donations to the foundation are voluntary, but almost every parent has paid something every month since the beginning. The kindergarten assures the accountability by classes and the use of this resource solely for professional improvement. In 1998 the donations from the parents' contribution amounted to Ft 218,000 and expenses amounted to Ft 188,000 used mainly to buy toys and education-related equipment.

Conclusions

Local governments have been innovative in implementing various legal forms in local public service provision. They shift activities from the on- to off-budget forms partly on the basis of good understanding of the best policy alternatives, and partly as a positive reaction to the challenges that emerged from the fiscal squeeze, from the local business cycle, and from market and regulatory failures. Some evidence indicates that they still tend to follow the routines of the hidden economy inherited from the previous regime (Kenedi 1981).

Moving activities between on- and off-budget forms has become a key local policy instrument. One can find municipalities where virtually all kinds of local services are under the tight control of local government (for example, the Debrecen Public Works Company). Often, however, local governments carelessly outsource the provision of local public services and shift them to off-budget activities. As a result, many municipalities have more off-budget than on-budget revenues and expenditures.

From a policy point of view, key issues are what might be the major effects of the changing service provisions and, in parallel, the growing role of OBRE on fiscal decentralization, on local democracy, on efficiency, and on equity. My findings suggest that analyzing the nature of the different types of OBRE is crucial. I have identified five key criteria for evaluation of OBRE: (a) accountability, (b) predictability, (c) distortions in investment decisions and between supply and demand, (d) equity, and (e) challenges in the regulatory capacity of local governments. My key findings are as follows:

- *Accountability*—Decentralization can be interpreted as a step toward a more efficient system, in which locally elected representatives are more responsible to voters and make decisions on scarce resources giving more weight to local priorities and citizen needs. The role of OBRE should be evaluated against this expectation.
- *Predictability*—A revenue source should be predictable because most of the local government services need longer term planning. OBRE might have an effect on predictability, because windfall gains are easily left out of the democratic decision-making process.
- *Distortions*—OBRE could cause supply–demand distortions in the local economy, since it may give incentives for adverse behavior to both local governments and citizens.
- *Equity*—OBRE may increase rather than decrease the inequity among the citizens. A good example is the informal price on allocation of scarce goods and services.
- *Regulation*—OBRE could decrease the efficiency of the central government in managing the intergovernmental finance system, and local public administration may not have sufficient capacity to regulate the outsourced provision of local public services.

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17

Municipal Enterprises in Hungary

Mihály Kopányi and Zsófia Hertelendy

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In 1991 democratically elected local governments took over nearly Ft 4,000 billion of assets, although the legal transactions were not concluded until the end of 1990s. This initial subnational portfolio represented about one-third of the total public assets and was twice as big as the competitive sector portfolio of the privatization agency. As a result of the immense transfers in and out of the municipal budget sphere, a sizable municipal enterprise sector emerged. The total assets of enterprises in full or partial municipal ownership amounted to Ft 4,300 billion of which the municipal stake was Ft 480 billion; the turnover of these enterprises was about 40 percent of gross domestic product (GDP) in 1998. The municipal sector now represents the largest sectoral stake in the Hungarian economy.

Given the overall weight, role, and importance of municipal enterprises (MEs) the purpose of this study is to identify and assess their scope of activities, describe their multiple relations with municipalities, and analyze their economic performance and behavior. Based on a broad and comprehensive picture of the MEs and their transition over the 1990s, we summarize the key policy challenges related to exercising ownership rights, price and performance regulation, equity and efficiency, funding, financing, and management of the ME sector.

Municipal Wealth and Municipal Enterprises

The principle of fiscal decentralization and the aim to decentralize the former socialist state were the driving forces behind the transfer to municipalities of all local public wealth and assets in support of their broad responsibilities in public service provision. The initial legislative framework and basic property registers, however, were largely incomplete or not

* This chapter is based on Kopányi and Hertelendy 1999.

in harmony with policy objectives. Hence, asset transfer became a long, gradual process, in which legal and accounting transactions often remain unclear in the context of lax political decisions on transfers. As a result, many assets remained without clear legal status for years; moreover, only few retrospective estimates, rather than opening balances, are available to measure the initial size of the state and municipal wealth and the transfers between the two.

The national wealth in 1990 was estimated to be in the range of Ft 15,000 billion (about US\$ 240 billion in 1990 prices) (Pitti and Varga 1995). This comprised a Ft 5,000 billion treasury, Ft 3,000 billion competitive assets in state ownership, and about Ft 4,000 billion in municipal assets (assuming completion of the approved transfers), and the rest were in private ownership. Local governments inherited assets from their predecessor councils, received assets from the state, and had invested subsequent proceeds from own revenues, state grants, and household or private donations. In addition, the book value of municipal assets was subsequently changed through asset reappraisal, privatization, and a change in the legal form of service units from on-budget to off-budget municipal entities (see table 17.1).

Table 17.1 Increase in Municipal Assets between 1990 and 1999

| <i>Asset</i> | <i>Value (Ft billion)</i> |
|---|---------------------------|
| Residential and business real estate transferred from state | 286 |
| Public service companies inherited from predecessor local councils | 333 |
| Compensation in cash and shares from the State Privatization Agency | 199 |
| State transfers (targeted, addressed, and extra-budgetary grants) | 297 |
| Donations and hook-up contribution from residents and enterprises | 72 |
| Revaluation of assets of public utility services companies | 400 |
| Total increase in assets | 1,587 |

Source: State Audit Office Report 2000.

The Emergence of the Municipal Enterprise Sector

The initial book value of municipal assets, however, was and still remains underreported because of uncompleted transfers, missing real estate cadastre, outdated accounting records (for example, land accounted as zero value), and unclear rules in accounting spin-offs from on-budget to off-budget organizations. Moreover, the major part of local assets is recorded only in terms of physical inventory (for example, square meter of parks or roads) with no value-based accounting (see chapters 16 and 19).

The book value of the municipal invested assets increased by Ft 1,300 billion (see table 17.2) between 1991 and 1998. Roughly half of the amount was the result of the asset transfer process (table 17.1) and net fixed investments contributed the balance of some

Ft 700 billion. The proceeds from asset divestitures (Ft 270 billion) were partly reinvested and partly used for current expenditures. The vague accounting system made current expenditures hard to value. A significant sum of assets simply bypassed the municipal budget, because it was transferred from the state at the very time when the legal form of state enterprises was changing to limited or joint-stock corporations, so only the share of a company's registered capital, rather than its total assets, is reflected in the municipal budget. As a result (and taking account of subsequent divestitures), business entities that had full or partial municipal ownership held about Ft 4,300 billion in asset value—of which about Ft 1,100 billion was the municipal stake, owned through the Ft 480 billion municipal shareholdings in the MEs' equity capital in 1998.

Table 17.2 Municipal Assets, Divestiture, and Investments, 199–1998 (Ft billion)

| <i>Stock of assets end of the year</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Invested assets | 313 | 600 | 827 | 1,029 | 1,095 | 1,299 | 1,440 | 1,639 |
| Fixed assets | 304 | 391 | 476 | 566 | 608 | 669 | 800 | 960 |
| Invested financial assets | 9 | 208 | 289 | 380 | 401 | 540 | 529 | 527 |
| Current assets | 83 | 101 | 110 | 125 | 158 | 232 | 348 | 386 |
| Asset total | 396 | 701 | 937 | 1,154 | 1,253 | 1,531 | 1,788 | 2,025 |
| <i>Divestiture and investment per year</i> | | | | | | | | |
| Sale of fixed assets | 9 | 17 | 25 | 38 | 44 | 47 | 46 | 60 |
| Investment in fixed assets | 49 | 79 | 89 | 141 | 109 | 116 | 187 | 236 |
| Net investment | 39 | 62 | 64 | 104 | 65 | 68 | 141 | 176 |

Sources: Assets: State Audit Office Report 2000; divestiture and investment: Ministry of Finance, government finance statistics (GFS), authors' estimates.

Table 17.3 Number of Enterprises That Have Municipal Shareholdings by Legal Form, 2000

| | |
|--------------------------------------|-------|
| Limited partnership | 47 |
| Association | 9 |
| Public purpose nonprofit corporation | 324 |
| Limited | 1,067 |
| Joint-stock company | 99 |

Source: State Audit Office Report 2000.

Municipalities have been innovative in selecting among various legal forms of municipal off-budget entities. They took over, established, or invested in nearly 1,200 limited and joint-stock business entities in fee-base or market services, sometimes in manufacturing or agricultural production (see table 17.3). Nearly 400 off-budget entities, mainly public-purpose not-for-profit corporations, were established to provide non-

fee-based public services (for example, road or park maintenance, social services, and public libraries).

Major Groups of Municipal Enterprises

MEs are primarily providers of public services, but in Hungary a declining, yet still sizable, purely business portfolio remains in municipal hands. MEs often fall beyond the scope of studies on governmental issues, because in terms of statistical classification they are not part of the general government system. Their economic and financial performance is not consolidated in the national accounts. Yet they are closely linked to, and have an effect on, public finances in the following areas: (a) funding of MEs (in- and outflows to the local budget), (b) financing of MEs (guaranteed and non-guaranteed liabilities), (c) MEs' operation (factors affecting financial and operating performance), and (d) contracts and concession arrangements between MEs and local governments (Arthur Andersen 1999).

In a broad sense we refer to MEs as business organizations that have full or partial municipal ownership regardless of legal form or focus of activities. This definition, however, does not reveal the differences and diversity in the universe of MEs. In harmony with the Central Statistics Office classification, and for analytical purposes, we considered four clusters of MEs according to the main focus of their activities:

- Basic public services, such as district heating, water management, sewage and waste treatment, local transportation, local roads and maintenance of parks, and public domains
- Supplementary services, such as supporting and auxiliary transportation activities, telecommunications, real estate rental and trade activities, and other service activities
- Energy sector, including local gas, district heating, and electricity supply
- Non-service enterprises, including companies in which municipalities acquired shareholdings mainly in the course of privatization of manufacturing and market service enterprises (for example, hotels, restaurants, and trading units).

Each sectoral or activity group can be further divided into subgroups in terms of the share of municipal ownership:

- 100 percent municipal ownership
- 50–100 percent municipal ownership (majority MEs)
- 25–50 percent municipal ownership (blocking minority MEs)
- 5–25 percent municipal ownership (minority MEs)
- Less than 5 percent municipal ownership (portfolio investment).

This chapter focuses on enterprises that provide basic and supplementary public services (the first two activities in the list of four above). This focus, however, does not preclude highlighting some features of the other groups of companies.

The Legal Framework of Asset Transfer

Most MEs were established as an independent and flexible means to fulfill municipal obligations in providing compulsory or voluntary public services. Besides, municipalities acquired shareholdings as heirs to the properties of predecessor local councils and as a consequence of the transformation and privatization of state-owned enterprises in the context of the following legislative framework.

Assets were transferred to municipalities: (a) by the force of the 1990 Act on Local Government (ALG), (b) based on the decision of property transfer committees set up by the 1991 Act on State Property (c) by virtue of the 1992 Act on the Transformation of Business Entities, or (d) in connection with the reallocation of public service functions, which entailed ownership change for service providers.

The ALG sets forth that “[state] assets managed by the [socialist] councils or their organs and institutions, shall be transferred to municipal ownership” (paragraph 2, article 107). In addition “property transfer committees should be set up to manage the asset transfer to municipal ownership, and for the distribution of physical and financial assets of public utilities” (paragraph 3, article 107). The Property Act stipulates that committees shall transfer to municipal ownership assets exclusively to the extent that meets the needs of a community, including buildings, networks, and equipment of public utility companies (article 11).

The 1989 Act on the Transformation of Business Entities states that “an ownership stake equivalent to the value of the inner area land stated in the balance-sheet of the state enterprise to be transferred should be conferred on the municipality of the relevant administrative area.” (Article 18). The interpretation of the term “equivalent” was a subject of controversy between municipalities and the State Property Agency. While municipalities claimed ownership stakes equal to the value of the respective inner area lands, the State Property Agency offered shareholdings in the proportion of the land value to the company’s total assets. Because municipalities refused to assume the companies’ liabilities, the State Property Agency deducted the companies’ debts from the land value. The subsequent 1992 amendment of the Act on the Transformation of Business Entities gave precedence to the State Property Agency’s interpretation. Disputes and lawsuits that were underway before the 1992 transfers were in process till the end of the 1990s.

The 1995 Supplementary Act to the ALG regulates the municipal ownership rights in electricity and gas supply companies and stipulates that a 25 percent stake of the local electricity suppliers and 40 percent stake of the local gas suppliers should be transferred to municipalities. The shares were delivered by the State Property and Holding Co., but disputes arose about whether shares should be distributed among municipalities in accordance with their populations or their investment contributions to the network development. About three-quarters of the municipalities had still claims against the property agency (the State Property and Holding Co.) in 1997, and the share transfers were still incomplete in 1999.

The Composition and Weight of the Municipal Enterprise Sector

The composition of the ME portfolio changed significantly during the 1990s. Five major factors have influenced this process: (a) the gradual transfer of state ownership stakes to municipalities, (b) divestitures aimed at cash generation, (c) privatization for outsourcing purposes, (d) portfolio restructuring, and (e) new infrastructure investments primarily supported by state investment grants (for example, potable water, gas supply, and sewage treatment programs). As a result the ME portfolio has become concentrated in basic services, and their weight increased from 59 to 78 percent of municipal shareholdings. Meanwhile municipalities have divested a significant part of their energy sector and non-service sector shareholdings, and their weights decreased from 15 to 8, and from 13 to 4 percent, respectively (see figures 17.1 and 17.2).

Figure 17.1 Municipal Shareholdings by Sectors (1993)

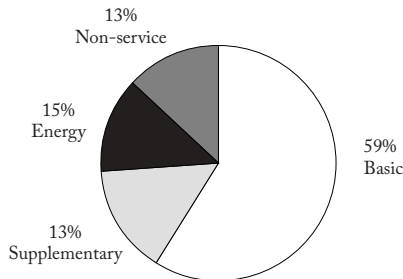
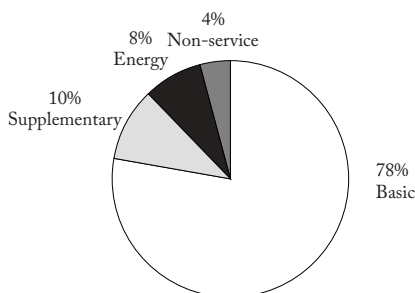


Figure 17.2 Municipal Shareholdings by Sectors (1998)



Soon after taking over, municipalities radically divested their energy sector shareholdings, mostly to generate cash. Full municipal ownership, which was 79 percent of shareholdings in local energy supply (mainly gas) companies in 1993, dropped to zero by 1998 (see table 17.4). Municipalities usually retained only minority—mostly blocking

minority, (25–50 percent)—shareholdings (57 percent of portfolio) in those companies, although often they kept simple minority (less than 25 percent) or negligible (less than 5 percent) holdings. Because of the lack of effective legal protection of minority interests, minority shareholdings serve mainly as reserves for future cash generation rather than as strategic municipal concerns in local service enterprises.

Table 17.4 Change in Municipal Ownership by Sectors (percent)

| <i>Municipal ownership share</i> | <i>Basic services</i> | | <i>Supplementary services</i> | | <i>Local energy supply</i> | | <i>Non-service activities</i> | |
|----------------------------------|-----------------------|-------------|-------------------------------|-------------|----------------------------|-------------|-------------------------------|-------------|
| | <i>1993</i> | <i>1998</i> | <i>1993</i> | <i>1998</i> | <i>1993</i> | <i>1998</i> | <i>1993</i> | <i>1998</i> |
| <5 | 0 | 0 | 4 | 3 | 20 | 19 | 27 | 19 |
| 5–25 | 1 | 0 | 7 | 13 | 1 | 23 | 56 | 52 |
| 25–50 | 1 | 0 | 4 | 5 | 0 | 57 | 6 | 11 |
| 50–100 | 2 | 15 | 12 | 19 | 0 | 0 | 6 | 8 |
| 100 | 96 | 84 | 73 | 60 | 79 | 0 | 5 | 10 |

Source: Central Statistics Office–ECOSTAT data.

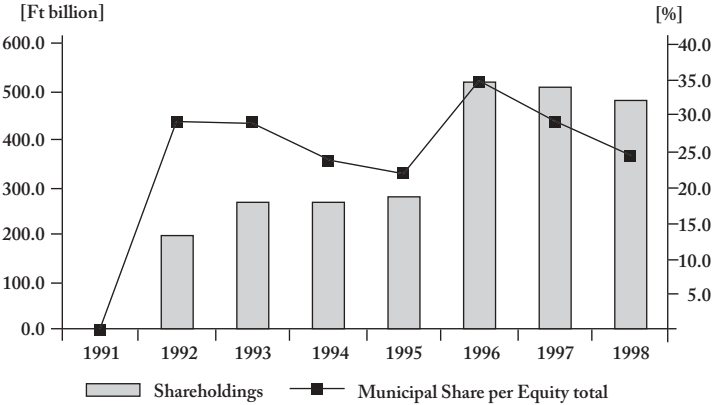
Much outsourcing has been taking place in basic local public services. Full municipal ownership declined from 96 to 84 percent between 1993 and 1998. In parallel, simple majority interest increased from 2 to 15 percent of the portfolio (table 17.4). Minority holdings in basic services have disappeared, however. ME portfolio in supplementary services shows a much more diversified ownership composition with much less, albeit still significant (60 percent), full municipal ownership share.

Municipal ownership stakes in MEs have fluctuated at around 25 percent of total municipal assets since 1992 (see figure 17.3). As a result of the diverse changes described above, municipal portfolio in MEs grew dynamically both in value and in proportion until 1996, when a gradual decrease started and average municipal ownership decreased from the peak of 28 to 26 percent in MEs' equity by 2000.

As shown earlier, a significant municipal portfolio is still associated with low minority ownership in MEs. This portfolio might be a good source for further divestitures, cashing out, or shifting from non-service to core or supplementary service activities. Small minority stakes, however, although accounted at face value in municipal books, are often overvalued, so real market value is lower than book value or is even zero. Majority owners of MEs often seek to take over for free the minority shareholdings, because no third party is willing to buy them (see chapter 19).

As a net result of the immense portfolio restructuring, divestiture, and new investments, the value of municipal assets increased from the initial Ft 4,000 billion to Ft 5,300 billion by the end of 1997. Yet the assets value stated in municipal accounts increased only from Ft 400 billion to Ft 1,800 billion (SAO 1998). As mentioned earlier, just a physical inventory is filed for the other assets, and this estimated asset value is not stated in the balance sheets of the municipalities.

Figure 17.3 Municipal Shareholdings, 1991–1998



Source: Central Statistics Office–ECOSTAT data.

Although municipalities have fully divested their interest in more than 400 MEs over the 1990s, the total number of MEs shows no substantial changes. The number of MEs fluctuated and was as high as 1,821 companies in 1994, but dropped to 1,668 by 1996. Municipalities sold mainly their non-service portfolio investments, and hundreds of new MEs were established in the meantime to provide mandatory and supplementary public services. In particular, the ill-targeted water supply grant system resulted in hundreds of small, inefficient water works that serve substandard quality water, often at high prices and with poor maintenance standards (see chapter 30).

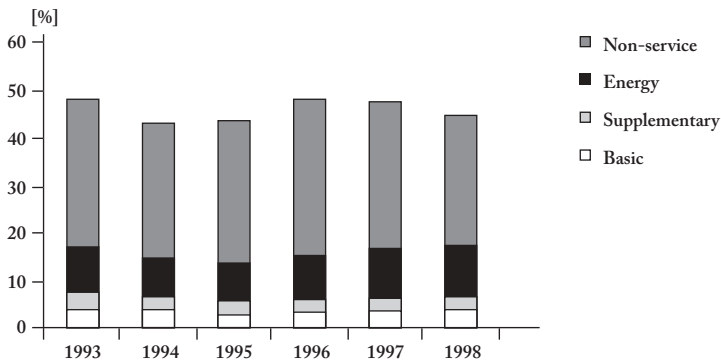
MEs have played a significant role in the economy since the early 1990s in terms of employment, investments, and contribution to GDP (see figure 17.4). The annual turnover of basic and supplementary public service enterprises amounted to 6 percent of GDP—nearly 35 percent of GDP when including the other MEs. Basic and supplementary service MEs together have some 110,000 employees (nearly 2.5 percent of the active work force). An additional 46,000 employees work in the energy sector in which municipalities have retained substantial ownership and influence. Non-service MEs show a declining number of employees, because an increasing number of companies are no longer included in the group of MEs since municipalities have fully sold their shareholdings.

Regarding economic performance, MEs have been contributing between 2.2 and 2.6 percent to GDP. The contribution of the energy sector steadily increased from 1.9 percent to 2.5 percent by the end of 1990s.

The most remarkable performance indicator, however, is the role of MEs in subnational infrastructure and other public service investments. While local governments have spent 2.2–2.5 percent of GDP on infrastructure investments annually, municipal public service

enterprises have carried out investments for an additional 1.5 percent of GDP annually. With respect to their sectoral contribution, MEs' investments in the basic activities accounted for 30 percent of the total sectoral investments (20 percent in the supplementary service sectors). Of the total investments in basic services, about one-third was carried out in energy supply services, and district heating, sewage, and solid waste service investments each represented about 12–13 percent of local public investments between 1993 and 1998. More than half of the investments in supplementary services have taken place in the telecommunication sector, where, however, most of MEs have been subsequently privatized.

*Figure 17.4 Annual Turnover of Municipal Enterprises
as a Percentage of GDP, 1993–1998*



Source: Central Statistics Office–ECOSTAT data.

The Municipal Enterprise Portfolio

This section summarizes the development of the municipal asset portfolio and the performance of municipal enterprises over the 1990s.

Asset Takeover and Register of Municipal Enterprises

The 1990 ALG reflected a broad political consensus that any state properties that are or could be used to provide local public services and functions shall all be transferred to municipal ownership, but carrying out the effective takeover of the assets received by law turned out to be a complicated and slow process for the newly elected local governments. The local governments received no one-time opening balance, register, or appraisal of

municipal assets; nor did they have clear rules for taking over assets, exercising ownership rights, and managing municipal properties. This lack resulted in, among other things, numerous ownership disputes, double accounting, illegitimate takeovers or divestitures, outdated real estate and enterprise registers, and overall poor management of municipal assets. The major shortcomings are described in this section.

Legal regulations did not stipulate rules for allocating state assets among the respective municipalities. The property rights of most public utilities were passed on to municipalities for which the public utilities exclusively provided the services. Debates arose, however, in the cases in which public works were serving the needs of several municipalities. Often political decisions were made on whether the municipalities shall operate and maintain these public works collectively or instead transfer the assets to one municipality with the task to continue providing services for the small region as was previously done. When asset separation happened to be relatively easy, posing no danger to service provision, questions still arose about what portion of assets and liabilities should be allocated to each of municipality. In this regard the most remarkable case relates to the assets of the local gas supply utilities distributed among respective municipalities and privatized soon thereafter under the oversight of the state property agency in 1995. The vague distribution and compensation rules, however, resulted in a legal dispute between municipalities and the central government, a dispute unresolved till 2000.

The contradictions created by divergent legal interpretations of various acts (for example, ALG, the Property Act, the Act on Corporation raise several questions. The vague distinctions between “core” and “non-core” municipal assets, and between “marketable,” “restrictedly marketable,” and “non-marketable” municipal assets (see box 17.1) have resulted in substantially different form, appraisal, and structure of asset takeovers across municipalities. Most local governments considered utilities to be core assets, recorded them as non-marketable properties, and transferred them under a management contract to an operation company usually in municipal hands also. Numerous local governments, however, transferred all the utility’s assets to MEs right after the takeover from the state. Moreover, only the municipal share of the enterprises’ registered capital was recorded in municipal accounts. The utility’s assets, as in-kind investments, were either coupled with an increase in the enterprise’s share capital recorded and controlled by the Registry Court or often only accounted as capital reserves to prevent the recording and control of the Registry Court.

For instance, about Ft 206 billion of water works’ assets were directly transferred to MEs. The State Audit Office ruled only in 1996 that the transfer of property rights of public works to joint-stock companies had been illegitimate and contradicts the principles of the ALG. The legal nature of a joint-stock company requires full marketability of its assets, whereas public works used to fulfill compulsory tasks of the municipality and were, hence, not fully marketable. The spin-off of restrictedly marketable core assets endangers the provision of compulsory services, because the independent enterprises could freely and without any restraint dispose of them; as a result, municipalities may have no longer power to exert influence directly on the management of these properties (SAO 1996).

Box 17.1 Vague or Flexible Classification of Municipal Assets?

- (1) Property of the local government, which serves directly the carrying out of compulsory duties and authority of local government or the enforcement of public rights and powers, may be declared as core assets.
- (2) Property belonging to the range of core assets is either non-marketable or restrictedly marketable:
 - (a) Non-marketable are the local public roads and their structures, squares, and parks, and also any other real and personal property which is designated as such by an Act, or by the local government;
 - (b) Restrictedly marketable are the public utilities, assets of municipal institutions, and public buildings, as well as real property and movables so designated by the local government. Disposition of items of the core assets to be restrictedly marketable may be made in accordance with the conditions defined in an act or in a decree of the local government (article 79, Act on Local Government).

The Act on Addressed and Targeted Grants makes only municipalities eligible for receiving these state investment grants. It initially prohibited the divestiture of utilities built with the support of these grants. The 1994 amendment of the Act on Addressed and Targeted Grants heightened the controversy of public utility ownership because under certain conditions it allows the transfer of property rights from municipalities to MEs.

Local governments had insufficient information about the methods and techniques to appraise, account, and register municipal properties. According to a State Audit Office report, 40 percent of the surveyed local governments interpreted the ALG in such a way that they had no obligations in connection with the asset takeover (SAO 1993). Minority shareholdings in hundreds of non-service local enterprises were, by law, allocated to the respective municipalities in the course of the privatization. The Registry Courts accordingly registered municipal ownership (like any other ownership), but did not notify the municipalities, so these ownership stakes were often not reflected in the municipal accounts. Local governments are very passive owners who do not monitor their minority shareholdings, so these investments are often recorded at face value in municipal accounts even when the respective enterprises are already bankrupt or closed down.

Municipalities have failed to comply with ALG and Property Act provisions that require the preparation of an asset inventory and a comprehensive analytical register for municipal assets. A SAO survey pointed out that almost three-quarters of municipalities had not prepared any asset register by 1998. About the same proportion of municipalities failed to record their core assets separately from their non-core assets (SAO 1998). Because of the outdated real estate records, municipalities have not been capable of identifying the entire set of assets inherited from their predecessor local councils. Assets, the values of which were not recorded, did not appear in the analytical registers either. The other parts of the assets are often registered at an inaccurate book value, far from the appropriate market value. Assets are often appraised only when sold or invested as an in-kind contribution (see chapter 19).

Most local governments have not adopted a local property decree (prescribed in the ALG). When such a decree is adopted, it includes only general statements and does not specify any requirements regarding the rules for managing municipal assets and enforcing municipal ownership rights. Exercising ownership rights is often very weak and limited to a politically driven delegation of members of the local assembly or public servants to the management or supervisory boards of MEs in majority municipal ownership. Municipal representatives often show up in board meetings without a clear mandate and acting power. As a result, a few years after the transfer of municipal assets from on-budget items to independent MEs, many local governments still have neither effective control nor reliable appraisal of their off-budget investments. These shortcomings, among others, also prevent local governments from implementing an active asset-liability management policy; as a result the effective use of municipal assets for backing credit market transactions remains at best suboptimal (see chapters 29 and 30).

Performance of Municipal Enterprises

Municipalities not only inherited shareholdings in business enterprises, but local governments also have sovereign rights to establish for-profit entities to provide public services and market services (for example, hotel catering and trade) and to carry out any other activities (including manufacturing, agriculture, or even banking and brokerage business entities). The efficient operation and management of municipal marketable assets are regulated in the 1992 Act on Public Finance and government decree 137 of 1993. These laws stipulate that municipalities shall undertake entrepreneurial activities only as long as they are profitable. Compliance with such a provision is evidently hard, because local governments always make good arguments for maintaining a loss-maker unit temporarily. Likewise, in investment plans local governments assume that the new enterprise will become profitable over time.

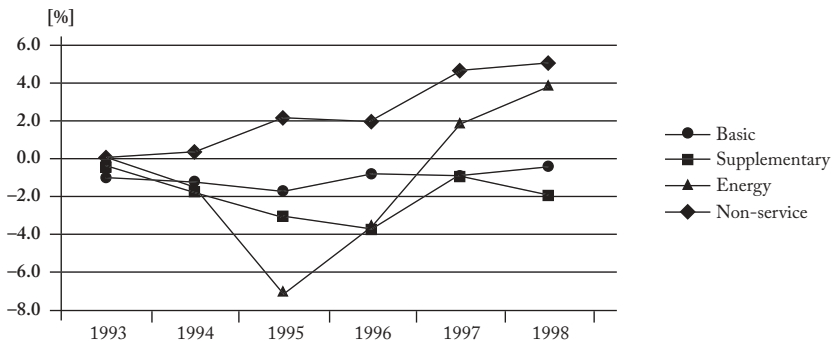
Before they took over state assets, municipalities were not prepared. They could neither develop the proper organization within the local administration responsible nor set up, operate, and control business activities. Municipalities often jeopardize public money when they invest in and run non-service, for-profit MEs without sufficient caution. In a State Audit Office survey, auditors found that municipalities neither prepare analyses to evaluate investment risk nor work out alternatives to ensure the most effective use of asset. The in-kind contributions and money transfers to business entities were often not supported by rational and economic considerations. As a consequence, most MEs where municipalities were the sole stockholders were running deficits (SAO 1994). The nine municipal bankruptcy cases revealed that investments in risky non-service activities with the hope of extraordinary gains were often the key factors behind municipal insolvency (see chapter 30).

Local governments, moreover, can freely and independently decide whether an activity is recorded as basic or entrepreneurial. If a service is provided as basic activity, then the

profitability requirement can be often disregarded. Consequently certain activities (such as operating a marketplace, public bath, or parking facilities) are listed as basic activities in one municipality and as entrepreneurial activities in another. Solid waste collection and water supply are mostly organized as core activities, but a number of municipalities provide these services through for-profit business organizations.

Despite these shortcomings, a profound learning process and a steady improvement in MEs' performance occurred by the end of 1990s. The profitability ratios, that is, return on assets and return on equity, reveal that the non-service MEs, overall, have increasingly fulfilled the profitability objectives (see figures 17.5 and 17.6). Basic service enterprises are steady loss-makers and, in spite of their slight improvement, generated losses throughout the 1993–1998 period primarily because local governments have been reluctant to set cost-recovery charges. The energy sector MEs experienced a sharp downturn in 1995 (the year of their privatization). Because collective irresponsibility was replaced by the individual responsibility of private owners, the performance of energy suppliers improved, and they became profitable. The recovery for energy suppliers clearly reflects the fact that enterprises in minority municipal ownership under strong private management could perform profitably. Analysts are concerned that supplementary service MEs have steadily been even less profitable than the basic service enterprises (although the latter receive various municipal subsidies in covering cost of capital and finance).

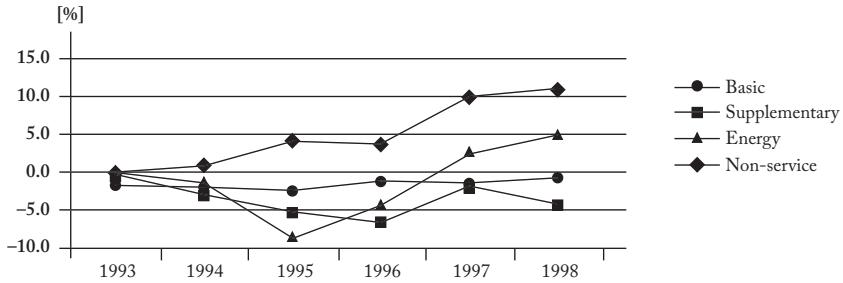
Figure 17.5 Return on Assets, 1993–1998



Source: Central Statistics Office–ECOSTAT data.

The profitability of enterprises was also affected by a reduced demand for public utility services (hot water, district heating, and potable water). In the last few years, residents have changed their consumption behavior and become more economical and cost conscious, mainly as a result of increased user fees and the installation of meters.

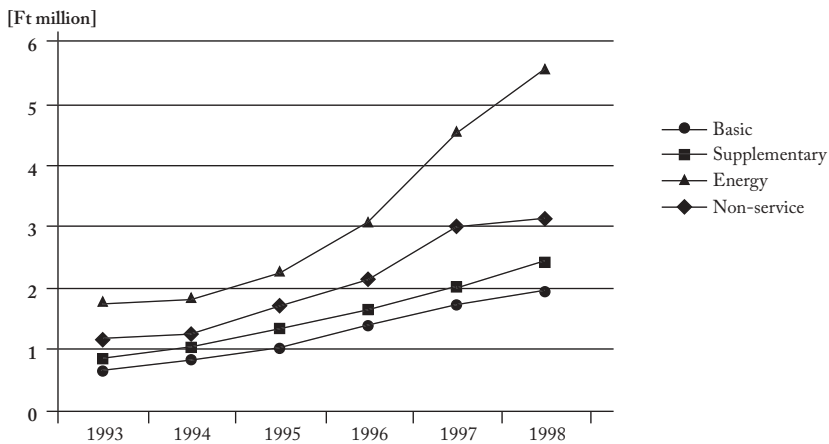
Figure 17.6 Return on Equity, 1993–1998



Source: Central Statistics Office–ECOSTAT data.

Labor productivity ratios show evidence of the cost-effective measures taken by enterprises. MEs in the public service sectors considerably reduced the number of permanent staff. In the basic service sector, the average staff number decreased by nearly 44 percent. In the supplementary service and energy sectors, staffing decreased by 40 and 34 percent, respectively. This important downsizing resulted in a sharp upsurge in labor productivity in all categories of MEs (see figure 17.7). The per capita value added has tripled in each cluster of MEs despite the different asset specificity in the various sectors.

Figure 17.7 Value Added per Employee, 1993–1998

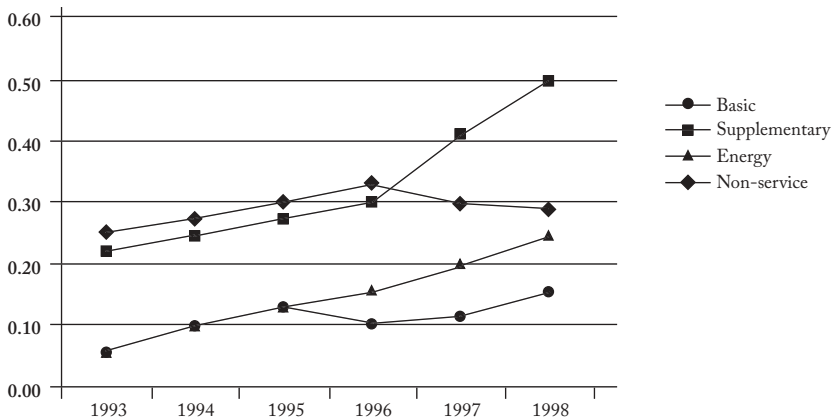


Source: Central Statistics Office–ECOSTAT data.

The ability to meet maturing current liabilities through the conversion of current assets into cash had a slightly negative effect on the current liquidity of basic service and energy MEs in 1993 and 1994, but it stabilized in the second part of the decade. The liquidity ratio, both in supplementary service and nonservice MEs, remained balanced over the whole period according to the ECOSTAT Research Institute of the Central Statistics Office.

The indebtedness of MEs was very low in the early 1990s given the access to various direct municipal funding schemes. Basic activity enterprises still finance their assets primarily with owner's equity, rather than external borrowing. For these enterprises, the debt-to-total-assets ratio hardly exceeds 15 percent (see figure 17.8). The supplementary service MEs started a more active borrowing right after their privatization, although their steadily growing indebtedness is still moderate, the debt-to-total-assets ratio was slightly below 50 percent in 1998. The rise in the indebtedness ratio for the supplementary service enterprises might be somewhat alarming should it continue to grow at the same pace. High indebtedness may result in the escalation of financial expenditures, and greater financial risks may lead, in turn, to an increase in the cost of capital and a reduction in the ability to withstand financial distress. The energy sector MEs show a steadily increasing but rather moderate indebtedness, partly because of their restored profitability.

Figure 17.8 Debt to Total Liabilities Ratio, 1993–1998



Source: Central Statistics Office–ECOSTAT data.

The capital and cost structure of MEs, like the profitability, indebtedness, and liquidity ratios in the period of 1990–2000, ought to be treated with some reservations. First, the asset takeover was a gradual process and involved numerous unclear transactions between

the state and municipalities as well as between municipalities and MEs. Second, the base capital of MEs is often artificial because local governments, who were always short of cash, often established MEs with the legally required minimum registered capital irrespective of the total asset size. For example, the municipality of Vértestarcsa transferred its water works to a limited partnership entity with a capital investment of Ft 20,000, and the similar-sized Gyál es Vidéke water works was established as a limited liability company with Ft 1 million own capital (the minimum by law for a limited corporation). Third, the cost of funding and amortization are mostly not provided in MEs' budgets, because different rules apply for business entities and assets in municipal hands. Currently, different depreciation rules and rates apply for assets owned by private corporate entities and for assets owned by central governments, municipalities, or local government budgetary entities. The first is regulated by the 1991 Act on Accounting and the second, by government decree 54 of 1996. This enables local governments to interpret the accounting rules in a way that hides depreciation costs from MEs' budgets, and postpones them or shields them from the local budget (see chapter 28).

Managing, Controlling, and Regulating Municipal Enterprises

This section summarizes the legal framework and the local governments' capacity and behavior in four key fields: exercising ownership rights, price regulation, managing household arrears, and funding and financing MEs.

Exercise of Municipal Ownership Rights

The Act on Corporation, the ALG, and various local government decrees regulate municipal ownership rights. Line departments of large and medium local governments are entrusted with asset management functions. For this purpose, in most cases asset management departments are set up, but in certain municipalities the financial department and a city management division also takes part in the management of real and financial assets. Special property management offices are established in cities where the number and variety of assets of MEs are high. These departments and offices are responsible for the administration and operational management of municipal asset portfolio within the local government. The asset management offices primarily supervise the legal compliance, but do not control the activities, efficiency, and performance of MEs. They work under the control of the local assembly, the mayor, and sometimes permanent or *ad hoc* committees, which are authorized to make strategy decisions.

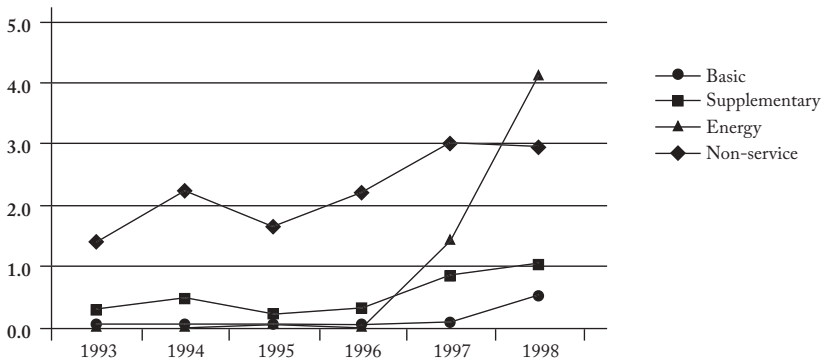
A number of municipalities have set up a so-called "property committee," to professionally assess the financial statements and analyze the performance of the MEs. The objective is to enforce the municipal interests within the enterprise management.

In several cities an additional economic and entrepreneurial committee is established often to tackle problems arising from conflicting goals in ownership, control, and regulation of MEs. These committees are also authorized to request special reports or even hearings from the management of the MEs. The tasks, functions, and responsibilities of these committees, however, often overlap. Although these responsibilities were set forth in the property decrees of most municipalities, in practice these committees have been passive watchdogs rather than effective bodies able to exercise their ownership rights and influence the management of the MEs. Local governments seldom make asset management decisions for operating companies.

Municipalities also delegate representatives to the managing and the supervisory boards of MEs, mostly those with majority municipal ownership. These delegates act in compliance with the Act on Corporation under general fiduciary liabilities. Local governments, however, even when they are in an overwhelming majority position, do not specify special duties or even reporting terms for municipal delegates. These representative positions are often considered to be primarily a means for supplementary personal income or party representation rather than a key function for active asset management or protection of municipal ownership rights.

Shares transferred by law in exchange for the value of inner area lands mostly represent only a tiny portion of the issued capital and hence provide less than a blocking minority position for the municipality. In these cases especially, local governments do not exercise basic influence, control, and supervision and have no permanent representation in these MEs. Municipalities by law can be represented in the annual assembly meetings of MEs, but even if they are, they have no voice in the approval of investment plans, spin-offs, or management composition, so the enforcement of municipal interests is very limited because of the minority position. Under these circumstances, majority private owners are very likely to strip hidden assets and tunnel profits by excessively increasing expenditures.

Most local governments do not assume that they would receive profits from their MEs. They do not make any forecast for the potential yield, dividends, and earned interests either, so these income sources are not reflected in the local budget plan (Bernáth, Jókay, and Szmetana 1999). The yields on municipal investments in MEs were very low in basic and supplementary service MEs (see figure 17.9). The close to zero yield on basic activity enterprises occurs primarily because the price-setting formulas allow for zero or minimal profit. Dividend rates, however, vary between enterprises as well as over time, depending on the investment requirements of the enterprise and its operating performance. The dividend ratio increases in parallel with the rise in profitability. Municipalities gain a moderate but increasing dividend on their investments in energy and non-service MEs. The dividend was already above 4 and nearly 3 percent on non-service equity, in 1998, primarily because of the achievements of private owners and their willingness to pay dividends to themselves and to the other owners as well.

Figure 17.9 Dividend per Equity, 1993–1998 (percent)

Source: Central Statistics Office–ECOSTAT data.

Price Regulation

Because of the changes in ownership structures, the 1990 Act on Price transferred to municipal authority the power to set tariffs and prices of public utility services. The annex of Act on Price specifies by items which products and services fall within the pricing authority of municipalities and which ones fall within the authority of the sectoral ministries. Municipalities are given the power to set the prices of steam, hot water, and potable water and to set the tariffs for district heating and local transportation, when the relevant public utilities belong to the municipality. By law, local governments cannot set, but only monitor and approve, prices for services provided by private service providers or public works owned by counties.

Local governments have not been well prepared for the role of price regulator. Their mixed obligations, such as to act as a price authority, protect the interests of residents (and voters!), and fulfill managerial and ownership duties, are difficult to reconcile. These conflicting interests made setting prices and tariffs more difficult for local governments. The city councils did not formulate rules or concrete requirements for the service supplier with regard to the cost structure or rules and extent of tariff increases, nor did they specify the information needed to set fees and tariffs appropriately.

The price- and tariff-setting behavior of local governments was markedly influenced by the availability of central current grants (price subsidies). Municipalities have delayed the decisions on prices until the central government had set the price limit under which municipalities could apply for current grants. In many instances, municipalities increased tariffs at a higher rate than they had planned after they became aware of the pricing conditions of the central government.

In the early 1990s the central government adopted the principles to reach cost-recovery prices gradually; as suppliers' subsidies were discontinued, utility service tariffs rose by 60 percent on average by 1992. To mitigate excessive price increases, the central government started to grant subsidies to residents instead of municipalities or MEs. The upsurge in tariffs, however, unevenly affected residents in different settlements and resulted in large disparities across municipalities.

When determining prices, municipalities took into account the needs and requirements of residents. In most cities, local governments set prices allowing for limited or no profit margins. The extent of profit rates varied among cities and by types of services. In most cities, tariffs did not cover the cost of funding or depreciation, and that shortfall made raising money for replacement, reconstruction, and new investments difficult.

Today, public utility companies submit for approval by the local government the annual rate proposals based on their own cost calculations. Local governments, however, have no real insight into the feasibility of the MEs' proposals, so decisions on rates are often based on political and other subjective considerations. Municipalities, in most cases, have failed to follow and control the realization of the planned cost figures and seldom make any comparison between the actual and budgeted costs and revenues of service provider MEs. Therefore, neither *ex ante* nor *ex post*, do they exercise effective price control.

The Act on Price allows for a reasonable profit margin for MEs providing services at the officially set prices, assuming that the supplier takes all necessary steps to operate efficiently. Public service suppliers, however, have often increased tariffs without implementing cost-improvement measures. Having been natural monopolies, MEs have not been urged to reduce network losses and increase efficiency. Only the limited consumers' capacity to pay puts a stop to tariff increases in tandem with an escalation of user-charge arrears. Municipalities still receive central grants to compensate consumers for the higher prices (although such subsidies are not always allocated exclusively to the needy and poor), but sometimes the central government makes the grants on a flat basis to all local consumers.

Arrears

Before the political changeover, public utility companies often provided services free of charge or for payments well below the cost of services. As tariffs became gradually closer to cost-recovery prices, payment arrears have mounted, sometimes reaching unsustainable levels. The increasing volume of arrears caused financing problems for MEs, compelling them to incur debt. The increased debt service expenses (interest paid) forced MEs then to raise tariffs, further burdening consumers. The insufficient cash inflow hindered the MEs' ability to carry out new investments even to the level of the depreciation costs charged. The main portion of the arrears was incurred just after the withdrawal of state subsidies for public utilities. Accumulated arrears almost doubled in the basic service sector between 1992 and 1994. This fact, however, is not clearly reflected in the present accounts, because receivables were subsequently sold through factoring transactions.

The accumulation of arrears placed a heavy burden on public service enterprises, which were compelled to find additional financing sources to solve liquidity problems. The respective incremental costs included interest payments and commission fees of borrowing. In addition, because value added tax is due on accrual basis, that is, when the service is provided and not at the time of settling the bills, MEs also had to pre-finance the value added tax. Notably, an interest on the amount of debt-financed value added tax or an even higher tax penalty also had to be paid in the case of overdue value added tax. User charge arrears may result in incremental burden on MEs in the form of forced tariff increase, decrease of consumption, further increase of arrears, increase of the number of users with overdue payments, and extra burden on those paying on time (see chapter 25).

The decrease in consumption may lead to further deterioration in the economies of scale and cost efficiency of MEs. If enterprises cannot tackle their liquidity problems either through debt or equity financing, they first postpone investments, then suspend paying their state and then suppliers' liabilities or file for bankruptcy. Local governments either as owners or as parties responsible for local public services must intervene ultimately, risking bankruptcy themselves (see chapter 30).

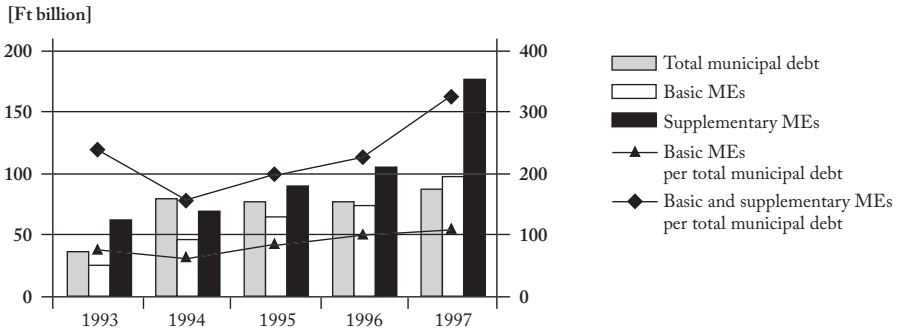
In the course of the 1990s, under a process of learning by doing, municipalities and MEs learned to exert pressure on consumers to pay. Initiatives arose to mitigate the high level of arrears by providing well-targeted support schemes for low-income consumers, choosing the appropriate rate structure, and determining the appropriate future price increases. Moreover, such means include adjustment in collection techniques (such as increasing frequency, checking, and consumer contacts), sanctions, and allowing for installment payments (Péteri and Tausz 1999).

Funding and Financing Municipal Enterprises

Municipalities have been providing various supports for MEs. They provide equity, investment and current grants, lending, in-kind contributions, and often issue guarantees for MEs' debt. In the last few years municipalities offered guarantees for public water associations and investment in telephone and gas networks (SAO 1994). These providers represent specific and identifiable contingent liabilities of the municipalities. MEs, however, have been increasingly relying on debt financing.

Basic service MEs' indebtedness increased progressively during the 1990s. Although it amounted to less than three-quarters of total municipal debt in 1993, it surpassed the total by more than 10 percent in 1997. The combined debt of basic and supplementary service MEs exceeded 300 percent of the municipal debt in 1997 (see figure 17.10). An implicit municipal guarantee always stands behind the debt of these two groups of MEs because of their majority municipal ownership. When an ME cannot meet its operating or performance targets, it may impose unexpected financial burden on the municipality either through unexpected funding requirements (such as increases in subsidies) or through an unexpected financing requirement.

Figure 17.10 Total Municipal Enterprise Liabilities as a Percentage of Municipal Debt, 1993–1997



Source: County Treasury and Information Service Office and Central Statistics Office–ECOSTAT data.

Some MEs seem to be inherently unprofitable because of inefficient public service obligations such as local transportation, sewage treatment, or district heating. Municipalities often provide these services with both investment and operating subsidies. These enterprises receive compensation for operating losses in part because of local governments' desire to keep user charges low, arguing the need to support low-income users.

Subsidies can be classified in the following categories: investment in equipment and land, non-capital subsidies, subsidies from the central budget, and other expenses. Municipalities provide significant cash transfers and financial assistance to entities outside the general government both for mixed and fully private enterprises and residents. The annual municipal grants for both operational and investment purposes amounted to about Ft 50 billion in the second part of 1990s. Out of these municipal grants, the ones devoted to finance public works investments of MEs amounted to Ft 1.2 billion. Other public works investments subsidized costs by Ft 1.9 billion in 1995, 8.4 billion in 1997 (SAO 1998). Although municipalities contributed to these investments, neither the developed public works nor the respective increase in asset value was reflected in municipal accounts. This practice is a matter of concern, particularly in the case of developing core assets (such as public roads or public water utilities).

Conclusions

The weight of MEs and their role in the national economy have considerably increased in the 1990s. They have become key actors in local public service delivery, infrastructure investments, and regional development. According to the different international public finance classifications, MEs do not belong to the general government sector, although

they form a very important part of the public functions. The system of national accounts does not consolidate public enterprises in the national accounts. A clear specification, however, was not made until 1993. Before 1993 the system of national accounts had a definition for “government enterprise” that formed part of the “general government sector.” The government finance statistics system also uses some confusing specifications for “departmental enterprises,” and their presence in the general government sector is dependent upon the volume of services or products sold either to the government or to the nongovernment sector. These definitions have gained greater significance for new European Union member states trying to meet the EU’s strict criteria. This specification, however, is now under review with the aim to extend the sphere of general government to MEs in majority municipal ownership.

MEs in basic and supplementary services: (a) represent a significant proportion of public capital, in both relative and absolute terms; (b) have negligible indebtedness; and (c) are capital intensive, so rate of return considerations are vital. Moreover, the magnitude of MEs’ capital depends on the capability and willingness of the municipality to confer assets upon the MEs. MEs’ profit has been negative throughout 1990s and MEs’ liquidity position has deteriorated significantly by the end of 1990s.

Local governments do not exert effectively municipal ownership rights partly because of their various conflicting and seemingly irreconcilable roles and partly because of their inability to control these natural monopolies. The basic service MEs will probably remain longer in municipal ownership unless the rules of state investment grants are changed. Under present circumstances, several basic public services are unprofitable, so intergovernmental financing sources will further play a significant role at least in financing their investments.

Although MEs are normally required to operate commercially and usually take the same legal form as any private enterprise, standard financial ratios need to be cautiously applied, because MEs often enjoy a monopoly position, while operating in a sensitive socio-economic context. Hence, reformers must formulate specific performance measures, which enable the real assessment of their efficiency and effectiveness. No best practices or guidelines are available in Hungary to define how or in what form MEs’ performance might be reported to: (a) assist in the formulation and implementation of policies; (b) support planning, implementation, and accountability in service provision; (c) monitor service standards and organizational effectiveness; and (d) ensure fair distribution and accessibility of public services.

The challenge that faces Hungary (and other new EU members) is how to get an acceptable balance between commercial concerns and social responsibilities of MEs. The general worldwide trend of improving the financial performance of MEs is to impose limits on the extent to which these organizations can undertake unprofitable social responsibilities. One promising way is to increase tariffs gradually to cost-recovery levels and provide well-targeted subsidies for those who cannot otherwise afford to pay for basic services (see chapter 25). This emphasis on the rate of return principle may lead MEs to give

a lower priority to their social obligations at a time when public awareness of organizations' responsibilities to the environment, clients, and employees is growing.

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18

Strengthening Local Management Capacity: Institutional Development in Transition

Gábor Péteri



Decentralization of the state was interpreted and used in various ways during the past two decades of Hungary's transition. First, the economic and political aspects were emphasized. Later, reformers focused on the creation of a better public sector. As a result, fiscal and administrative issues became more important. Local organizational and management practices, as part of the broad institutional environment, were rarely the focus of reforms, and without sufficient local control decentralization will not visibly improve allocative, fiscal, and economic efficiency; transparency; and accountability in service delivery.

This chapter summarizes the institutional and organizational transition of Hungary's subnational system in public administration, human and physical services, regional development, and fiscal management. This analysis is an institutional one of the emergence, gradual rationalization, and parallel top-down and bottom-up evolution of a multifaceted decentralization. Empirical evidence supports the conclusions that: (a) in the Hungarian circumstances, starting the process by introducing a highly decentralized local government system was justified, and (b) the legal and regulatory steps in the previous restrictive fiscal environment have reached their limits in establishing a modern local government system. The national government should now focus on supporting local governments in increasing their institutional capacity in realizing the full advantages of decentralization.

* This chapter is based on Péteri 1999.

Decentralization and New Institutions at the Local Level

Without sufficient institutional development, the benefits of decentralization will never be achieved, even if all other necessary political and fiscal conditions were fulfilled (Litvack, Ahmad, and Bird 1998). The past period of economic decline and social reconstruction would have not been manageable had decentralization not started with the introduction of a decentralized local government system. Local governments successfully developed responsive local welfare measures in a restrictive economic environment by crossing the traditional political divide between left and right. Local governments not only follow top-down rules and initiatives, but also very often develop new methods and policies, which are later espoused at the national level or built into regulations. Local innovations and incentives push changes in the public sector from below (Clark and Ferguson 1974).

Another example of locally initiated changes is the local governments' intense cooperation with nongovernmental organizations for service delivery. This cooperation later forced the introduction of uniform normative current grant schemes accessible to all kinds of public service delivery organizations. In addition, various local economic development arrangements raised issues related to changing the regulations on planning urban land use. Performance-based budgeting and fiscal information efforts were also implemented first at the local level.

Despite these changes, local institutional development has remained insufficient and lagged behind the overall decentralization process, primarily because fiscal pressure on the economy was so high that austerity measures had to be taken. The fiscal deficit and the weight of general government expenditures on the economy had precedence as the focus of fiscal policy—a priority justified in a period of distress and need for economic restructuring. In the public sector, austerity measures were rather successful: the central budget deficit dropped to a manageable level (3–4 percent of gross domestic product) and general government spending decreased significantly to 40 percent of gross domestic product. Local government expenditures dropped by 21 percent in real terms, and employment in local governments was cut back by 13 percent between 1993 and 1997 (László 1998).

Reformers intentionally postponed local institutional development and used high inflation as the primary technique for managing the austerity program. According to the Ministry of Finance, the driving force of economic transition, major cutbacks had to be implemented through reductions in the real value of wages and services. “Had inflation been small,” comments László (1998 p.173), “it would have been impossible to carry out nominal reduction in public wage.... The significant rearrangement of the structure of the budget was definitely facilitated by inflation. The issue is what the next steps should be now that fiscal austerity programs have fulfilled their goals and economic growth seems to have stabilized.”

To keep the achieved development sustainable and realize the benefits of past efforts, local governments must take one further step: they must develop their institutional environment. Decentralized adjustment has to be supported through various development

activities, otherwise the desired macroeconomic stabilization cannot be achieved (Shah 1998).

The Development of Institutions and Organizations

The present municipal system is based on very liberal principles set forth initially in the Hungarian Constitution and the Act on Local Government. The first declared in 1989 the rights of any local community to establish independent local self-government. The 1990 Act on Local Government provided full sovereignty for local governments in fulfilling virtually all local administrative, legislative, regulatory, and management functions, and made them responsible for providing all kinds of local public services. Hence, conceptually, the national government had no need to impose any further regulation on local governments.

The major steps in the central regulation of local: (a) public administration, (b) human services, (c) public utilities (including communal services), (d) regional development, and (e) intergovernmental fiscal relations (see table 18.1), suggest that the general framework of the local government system was established before any changes were made in the centralized system of public service delivery. As a result, the liberal values of the local government system came into play and soon combined with the demand for sectoral laws based on such arguments as the need to provide equal access to services, to impose hierarchical control, and to support professional standards. Moreover, basic local government institutions were gradually operating in line with sectoral laws, sometimes in contradiction with the original concept of decentralization. These conflicts were even more intense with fiscal issues, because many of the new sectoral obligations had to be financed subsequently by municipalities without respective increases in local revenues.

The first general characteristic, which is rooted in the French–German tradition of public sector management, is that legal regulatory factors now dominate local management. This narrow interpretation of regulatory environment is based on the belief that local governments, being subject to laws and government decrees, are able to follow the rules and intend to do so. Otherwise, central control mechanisms will force compliance. Local governments' capabilities, organizational and management capacity, and staff conditions are not taken into account in this central regulatory approach. Without supporting local government operations in developing the required conditions, the effectiveness of the most sophisticated legal regulations would remain low.

The second general characteristic is the strong influence of sectoral legal regulations. Briefly summarizing the regulatory actions in the five major areas, the most active component seems to be fiscal management. This activity does not mean that other areas are less regulated. In all other sectors, the allocation of functions, competencies, and mechanisms of regulation and control are even more complex—for example, allocation of intergovernmental competencies in public education (Balázs 1998).

Table 18.1 *The Emergence of the Institutional and Organizational Framework of Local Governments*

| <i>Public administration</i> | <i>Human services</i> | <i>Utility services</i> | <i>Regional development</i> | <i>Fiscal management</i> |
|--|--|--|--|--|
| Constitutional changes, functions, and competencies (1991) | New sectoral laws: social policy (1993), public education (1993), vocational training (1993), culture (1997) | Eliminated tariff subsidies, control transferred to local level (1990) | Municipal ownership after privatization of state-owned enterprises | State Audit Office (1989) |
| Regulations on civic and public employees (1992) | Limited own revenue raising, enterprise activities | Concession (1991) | Limiting local participation in enterprise activities. | Government information network (County Treasury and Information Service Office 1991) |
| Public administration offices: legal control and coordination (1991, 1994, 1997) | Centralized cash management practices (optional local treasury 1997) | Utilities in municipal hands (1991–) | Local economic development: employment through investments. | Unified accounting (1991) |
| Minority local governments (1993) | Postponed reconstruction, capital investment | Commercial entities in communal services | Local tax exemptions. | Matching and addressed grants (1992) |
| Urban authority: child protection (1996), building permits (1997) | Education: demographic wave (decline) | Privatization with foreign involvement: solid waste, water, and wastewater companies | Infrastructure deals with investors. | Budgeting procedures (1992, 1995) |
| Forms of municipal cooperation and associations (1990, 1997) | Health care: failed rationalization, selective bailouts | Public procurement (1995) | National regional development network: -county based -corporatist -decentralized grant allocation (1996) | Budgetary institutions (1996) |
| | Welfare policy: decentralized adjustment | Limited compulsory competitive tendering (1995) | Structure plan and regulatory plan (1997) | Property registration: physical indicators (1992) |
| | | Law on Environmental Protection (1995) | | Certified local audit (1994) |
| | | Increasing social consciousness (high arrears) | Elimination of extra-budgetary funds (1999) | Bankruptcy regulations (1996) |
| | | | | Coordination of appropriations, extra-budgetary funds (1997) |
| | | | | Compulsory feasibility studies of capital investments (1998) |
| | | | | Weak interest representation (lobbying) |

Source: Péteri 1999.

Laws, government decrees, and ministerial bylaws now regulate the functions and competencies of local governments (including the council, committees, mayor, chief executive, and municipal employees). The paramount number of regulations reflects that these detailed rules are self-reinforcing toolkits for unnecessary micromanagement by sectoral ministries (table 18.2). Furthermore, the overlapping between the legal rules and the large number of regulations shows that various, and sometimes divergent, concepts and legislative policies affect local governments, motivating them to act as agents of the central organizations rather than to be self-cautious local agents who primarily respond to the local citizens.

Table 18.2 Number of Legal Regulations by Local Functions, 1999

| <i>Sector</i> | <i>Number of regulations</i> |
|---|------------------------------|
| Health care and social services | 58 |
| Administration (interior) | 42 |
| Agriculture | 42 |
| Industry, commerce, tourism, price setting | 35 |
| Administrative (justice) | 34 |
| Transportation, water, and telecommunication management | 33 |
| Finance, fiscal management | 31 |
| Environmental protection, regional development | 30 |
| Labor | 27 |
| Culture and public education | 21 |
| Local government and minority self-government operation | 8 |
| Defense | 3 |
| Total | 364 |

Source: Line ministries' data.

Public Administration

Public administration at the local level requires unified and similar practices. Lawful procedures and professionalism of decisions should be ensured both for general administration matters and discretionary cases. Various attempts were made to improve the professional level of local actions and guarantee a standardized treatment of local public administration employees (for example, on employment, childcare, and building licensing by urban authorities). Administrative expenditures are on average 15 percent of local budgets, but miscellaneous expenditures also are usually accounted under this function. This accounting happens often in small municipalities, where the cost of administration is often the largest expenditure item, representing more than 30 percent of local expenditures.

The public administration offices of the government went through a transformation in this period. Their main function has always been the legal control over local government decisions, but their role slowly moved toward coordination, government information system development, and training. First, a few regional public administration offices were established, but later these offices opened in every county under the control of the Ministry of Interior. After 1997 they became deconcentrated county offices of the central government, and plans are under way to reestablish regional public administration offices.

Human Services

Human services represent the largest municipal expenditures. Public education, health care, social services, culture, and sports together absorb almost two-thirds of local government budgets. These functions have always been local services, but the economic and regulatory environment substantially changed in the early 1990s. Design and approval of the sectoral laws on these activities took two to three years, because lawmakers had to achieve a sensitive balance of central control on service quality and allocation of functions to municipal and county local governments.

At the end of the 1990s evidence is clear that sectoral legislation on human services is not in harmony with the principles laid down in the initial legal local government framework. Allocation of service institutions to certain types of local governments, control of service performance, employment and salary regulations, introduction and regular changes in normative current grants (for example, in education) all have a strong impact on local government structure and behavior. In the period of fiscal austerity, the minimum level of service provision was always a higher priority compared to the decentralization principles in the early legislation.

The fiscal management regulations and the forms of organization and management developed in the traditional budgetary sector of human services supported unified and controlled service provision. Budgetary organizations had limited own-revenue raising capacity, and their business activities were scaled down by law. This attitude was somewhat different from the general one developed in the 1980s. At that time, the entrepreneurial spirit of public service entities was supported. The positive consequences of those changes were that local government units have learned both autonomy in their daily practices and how to counterbalance cutbacks in grants. The negative side of the entrepreneurial character was that sometimes a shift from the main activities of the service organizations toward revenue raising was too radical.

Parallel to these nationally initiated changes, local governments also developed new forms of fiscal management. Consolidated cash management of local budgetary institutions was introduced as municipal treasuries began adopting the design of the national treasury system. Local treasuries proved to be very successful in decreasing idle cash, introducing more precise planning rules, and using appropriations (see chapter 22). In parallel with

the efficiency gains at municipal level, the autonomy of budgetary service institutions is no longer as wide.

Public Utilities

Public utilities and other communal services, including housing, also went through a major reorganization. The first steps were the immediate elimination of the national charge and rental subsidies and the transfer of price- (rent-) setting authority to local governments, with two exceptions, however: a flat-rate subsidy remained for water and sewer charges above a certain level and for the collection of liquid waste from septic tanks.

Local governments became owners of public utility networks and service companies. The water, sewage pipes, and wells became, by law, core assets of local governments and restrictedly marketable properties that could be sold only by a council's decision. The service companies and the operating assets were often privatized. The former state-owned water companies and the county water companies were transferred to local governments, which owned the network, and they have created more than 250 new service organizations and operating companies.

These changes forced local governments to develop new organizational and management forms in the field of public utilities. The concession law was one of the early regulations in this area, but later local governments developed contractual relationships with various service organizations. My survey in 1994 showed different arrangements of various services (Péteri 1996). In-house (budgetary) organizations were used mostly for housing management, and public services were financed by general budget revenues. External service providers or contract-based service management by in-house units were more frequently used in fee-based services (see chapter 17). Now, foreign companies are involved mainly in the municipal solid waste sector, but investment also extended to large cities in water management.

The lack of comprehensive, detailed information on public utilities, communal services, and contracts is a matter of concern (see chapter 21). Even the arms-length companies are not reported in the public finance information system. Model contracts and comparative information on service performance are not available. Ministries do not feel responsibility for these tasks, and professional and local government associations are not capable of collecting and managing this information and do not have the technical assistance that may be required.

The legislature made limited attempts in 1995, when solid and liquid waste collection and disposal and chimney sweeping were declared mandatory local services, and a reporting system was established. At the same time, the national government introduced compulsory competitive tendering. This legislation was misinterpreted by some ministries and also by several local governments. The Ministry of Interior sent out a circular in which only the new (and not the extended) contracts were subjects to tendering. Local governments'

argument was that they have a constitutional right to define how a municipal service is provided, so tendering is unnecessary. The lack of administrative capacity to manage competitive tendering and insider transactions was often behind the reluctant behavior of local governments.

Regional Development

Regional development has always been regarded as a high-priority local government function. Mayors often see it as a more significant local task than providing some traditional local public services. Surveys show that local economic development, as a component of regional development, was especially important in towns (2,000–10,000 inhabitants) and in large cities (more than 50,000 inhabitants).

Local government involvement in business activities is partly inherited from the Soviet-type local government system, in which local authorities had direct responsibilities not only for public services but also for production. This attitude was reinforced in the modern local governments for two reasons: (a) because they became minority owners of former state-owned companies through the privatization process, and (b) fiscal austerity measures forced them to increase their own sources through business-related revenues. Local taxes, especially business taxes and capital revenues from the sale of assets, became increasing and important discretionary local revenues in the late 1990s.

Local government participation in enterprise activities is subject to constraints. They are allowed to take ownership only in commercial entities that have limited liability and financial investments only in state securities. Even those constraints could not prevent losses. During the recent period of stock market decline, some brokerage companies mishandled the municipal portfolios, and local governments did not exercise proper oversight over their contracts.

The goals of local economic development are different in major groups of municipalities. In cities that have more favorable conditions for domestic or international investors, inward investment is the primary aim. In villages that have been hit by unemployment job creation is the primary goal. In Budapest attracting investments into public and market services is a key development factor. The most frequently used methods for supporting inward investment are building public utilities, roads, contacting future partners, and lobbying at the central government level. Industrial parks (for example, in Győr) have proved to be a very successful means of local and regional development.

Parallel to local efforts, the national network of regional development councils was established in 1996. Through this channel, the national government intends to manage regional development in a coordinated way and in partnership with the national funds. A system of subcounty, county, regional (NUTS2), and national regional development councils was created. All the important players in regional development are represented in these councils: local governments, national government, chambers of commerce, and labor offices. The county development councils have a crucial role, because they manage

and reallocate the decentralized appropriations for capital investments. In short, rather than being the driving force for local and regional development, the regional development councils still focus on allocating minor (0.5 percent of gross domestic product) funds primarily for equalization purposes. This focus has proven to be insufficient in building local capacity for absorbing European Union structural funds.

Fiscal Management

Changes in local government finances and fiscal management started in the legislative modernization process in the late 1980s. The goals were to increase own revenues, launch a unified and nondiscretionary capital investment grants scheme, and establish joint fiscal management units for fragmented budgetary organizations. The legislature introduced a significant transformation of intergovernmental transfers, however, just before the political and administrative changes.

Audit

Municipalities and their governing bodies were initially assumed to enjoy a degree of sovereignty, because no organization beyond Parliament had authority to issue binding regulations or exercise any direct control over local decisions. The State Audit Office (SAO), responsible to Parliament, was established in 1989 to monitor the operation of all kinds of government and budgetary organizations, including the flows of state funds (for example, treasury). As part of the overall government system, SAO monitors the operation of municipalities, though only to control legal compliance and the use of national funds, not to review the substance of local decisions. In principle, all other governmental or general overseeing organizations (for example, line ministries or Constitutional Court) exercise monitoring within the boundaries of their functional competency.

SAO carries out comprehensive annual audits of 30–50 municipalities' reports and reviews their use of state funds; it also runs investigations on selected issues across municipalities (approximately 1,000 local governments were included in these investigations). SAO audits were focused on national budget connections (30 percent), comprehensive audits (26 percent), and sectoral audits (19 percent). The rest of SAO's efforts addressed issues such as property management, budgeting, and financial reporting (Kusztosné 1998).

SAO reports and recommendations are presented to Parliament and submitted to the local governments concerned; however, presenting local findings to the local council or the general public of the municipality is not compulsory.

SAO has regional units by county, but their capacity is not sufficient to audit local governments properly. Some reformers attempted to establish a separate local government audit office, but it turned out to be too expensive. Since 1994 larger municipalities that have over Ft 100 million (US\$ 0.5 million) in the budget and that have loans must be audited by an independent external auditor. As a result, 559 local governments contracted with auditors in 1997 (SAO 1997).

External audits focus on the validity of information and analyze the municipal financial position. The minimum requirement is to review municipal budgets, financial reports, and balance sheets. The auditor's report is presented to the local government, and the auditor has the right to call for an extraordinary council meeting if any serious illegal actions are found. If the mayor does not call the meeting, then an appeal process is also stipulated.

The external auditor must be a member of the chamber of auditors and hold a special qualification in public finances. Often the heads of large city finance departments or employees of the County Treasury and Information Service Office are qualified external auditors (for third-party municipalities). The auditor is appointed through a competitive tendering process, and that process sets conditions regarding disclosure of conflict of interests. The local auditors are experts regarding up-to-date analysis of municipal finances and preventive actions to provide support for local governments.

Local governments establish their own internal audit systems. The finance audit committee, to be set up by law, gives its opinion on the budget and the reports and examines the financial process, focusing on own-source revenues, changes in municipal assets, and changes in local borrowing. This audit also covers public service institutions. The committee's reports should be presented to the council, and in case of disagreement, the committee reports would be subject to SAO review.

Cities and major towns have an internal financial auditor who provides management support and prepares the organization for the external audit. Service organizations are also subject to internal audits, even if they are separate budgetary entities of the local government. The methods for internal audits are slowly developing and spreading among practitioners.

The present local government audit system has two major problems: (a) lack of capacity at the SAO for running the external audit efficiently, and (b) undeveloped methods of supportive and preventive audits as a tool of management in all types of audit. In small local governments, joint audit offices should be used. An audit should be developed further into a supportive, professional advisory activity.

The only way to increase the quality of local government audits is to develop the professional capabilities of the internal and external auditors and to establish transparent processes for selecting independent and qualified auditors. This technical assistance might be provided through the chambers of auditors and local government organizations. The Loan Administrative Change Initiative (LACI) of the World Bank should be used as a model in a flexible way, as local auditors' capacity and professional standards are being developed.

Budgeting and Financial Reporting

Preparation of local budgets and development of financial reporting rules are two important elements of fiscal management. All major components of local budgeting and reporting have strictly regulated, unified rules. This unified system is based primarily on the

information needs of the national budget, though local governments typically follow these planning rules and presentation forms even if they do not serve local budgeting purposes.

Several types of fiscal plans are mandatory at the local level. According to the spatial planning regulations, local governments must design a long-term urban development strategy. This strategy might be a basis for the four-year-term economic plan, which must be approved right after the inauguration of a new local government. The Act on General Government Finances also specifies that a rolling plan should be elaborated and approved, together with the annual budget, for an additional two-year-period.

Those medium- and long-term plans are not widely used by local governments. Some analysts have serious doubts about the practical use of the strategies and forecasts in the present local government finance system. First, such a strategy depends heavily on grants; second, recent experiences have shown that intergovernmental transfers and national regulations on local own revenues cannot be forecast. The fiscal austerity programs of the past years did not help design valid and stable medium-term local prognoses.

Annual budgeting procedures, contents, forms of presentation, and reporting are strictly regulated by law and government decrees. Fixed deadlines exist for preparing local budget concepts (November 30), presentation of budget proposals (February 15), approval of budgets (within 30 days after presentation), and semiannual (September 15) and annual reports (within four months). The form of budget classification is also unified: budgets are approved by organizational units and, within each unit, by groups of expenditures (such as salaries, operating expenses, welfare payments, and capital expenditures).

Local government current and capital expenditures and revenues should be presented in two separate balance sheets. This separation serves only presentation purposes, because cross-financing among current and capital budgets is allowed. This separation of current and capital budgets provides useful information for the councilors on general trends in local government finances and use of assets. According to aggregate data on local government capital and current budgets, current revenues are often used for capital expenditures.

Annual financial reports follow general principles of reporting on economic activities. Local government budgetary organizations follow double-entry bookkeeping and cash-based accounting. Gross accounting principle is used for main (public service, budgetary) activities and for enterprise activities. Special rates of depreciation are used in the public sector for tangible assets.

Financial reports include local government balance sheets, cash-based budget reports, reports on cash reserves or savings, statements on profits and losses, and the supplementary annexes. This supplementary annex focuses on performance indicators of municipal functions and services. Local government fiscal information is based on the chart of accounts for budgetary organizations, supplemented by analytical registers. Details of the system of accounts are defined by the local governments within the general legal framework.

Information on local budgets, budgetary organizations, balance sheets, and property registers are collected by the County Treasury and Information Service Offices. These are

deconcentrated units of the Ministry of Finance and Ministry of Interior. Information collection is highly computerized, and limited comparative information is disseminated among local governments.

Analysts cite three basic problems regarding local government budgeting and reporting systems: (a) confused expectations about budgeting, (b) lack of modern planning methods, and (c) limited access to comparative information on municipal finances and service performance. Most of these problems cannot be solved simply through new regulations, but require that innovative techniques and methods be disseminated among and learned by professionals and practitioners.

First, local governments do not define long-term goals and strategies for their major services and functions, and they do not build their plans on a hierarchy of decisions on general mission statements, local values, and general sectoral plans. Lacking this strategic view (and being strongly dependent on transfers), local governments use plans as a simple vehicle to allocate funds among service organizations. In practice, local budgets serve primarily as tools of control over public spending rather than for implementing *ex ante* strategies.

Second, this planning concept is supported by methods for designing expenditure and revenue appropriations. Line-item budgeting is used for planning expenditures by organizational units to calculate inputs of service. This traditional method prevents local governments from having a general view on service areas (such as functions and programs). Inputs are weakly connected to the level of services and performance of the service organization.

These two sets of problems are mutually reinforcing: because no clear strategy for services exists, output criteria (performances) cannot be identified. The lack of performance indicators prevents quantification of measurable service goals and standards. To solve this problem, any move away from the present organization-oriented, input-based planning could improve local budgeting methods (Kassó 1997). One step in the right direction would be to develop and introduce more detailed service performance indicators, which would support output-oriented budgeting under the present system, focusing on organizations. Another step could be to support planning by functions and programs. Experiments to develop zero-based budgeting methods, which help design inputs by functions or programs, are underway.

Third, access to information by the general public and the local governments is a problem. Several hundred expenditure and revenue items are collected by the fiscal information system from each municipality's budget and financial reports. This information is public at the local level, but confidential at the national level after being collected. Only the two ministries that control the County Treasury and Information Service Offices have access to detailed information by municipalities. Some comparative average data by several clusters of municipalities are returned in printouts to local governments, but these data are not sufficient to allow local government associations and think tanks to conduct analyses or evaluate alternative policies.

Capital Budgeting and Investment Process

The present capital budgeting practices and the capital investment management capacity have been strongly influenced by the changes in the financial environment. In the 1990s local government capital expenditures declined from 18 to 13 percent of total local budgets. In this period covering current expenditures was the highest priority for local governments. A restrictive fiscal policy has reduced funds for both regional and sectoral investments and raised local needs for own-capital budgets. Now only urban municipalities might have capital budgets, and no significant capital investment is made in the rest of 2,800 municipalities in the countryside.

The sectoral composition of capital expenditures has changed significantly. In 1991 almost half of local capital investments were in the area of human services (that is, education, health care, and culture). By the end of the 1990s this share has declined to 30 percent, but capital investments in physical infrastructure, housing, and market services account for 50 percent of total capital budgets. This trend was explained by the decrease in education needs and the lack of national budget grants in the health sector.

Parallel to the sectoral changes, the financing schemes of capital investments also changed. The traditional form of grant financing of human services did not work: in the period 1991–1998, only Ft 155 billion were used for matching grants and an additional Ft 128 billion as targeted grants. Among matching grants, public utility services had the largest share, because no grants were allocated for educational purposes after 1996; instead, water, wastewater treatment, and solid waste landfills had a high priority at the national level. The targeted grants (non-matching for large projects above Ft 200 million) were used mostly for reconstruction of large hospitals, homes for the elderly, and theaters. In addition, extrabudgetary funds of line ministries also served local capital investments in water, environmental, and road funds (Jókay, Kálmán, and Kopányi 1998).

The change in the structure of local capital investments has modified the methods and techniques of investment management. The former line department units rarely operated as implementing agencies for local government investments. Their function was to prepare investment plans and control the process of tendering out, contracting, and activating the object. Local government decrees on capital investments also define value limits for the decision competencies of various elected bodies (such as the council, committee, and mayor).

These changes were greatly needed in this period, when the national government financed most of the local capital investments in partnership with the private sector. No information is available on the scale of private involvement in financing local public services, but major projects (such as landfills, sewage plants, and public transportation) always needed financial contributions from the private sector. No estimates are available on private capital investments under urban development deals (such as building roads, water, and sewage networks in exchange, for example, for land or tax exemption).

The second half of the 1990s saw significant changes in the local management of capital investments. The most important one was to set the rules and value limits for public

procurement (that is, the purchase of goods and services). Conditions, types, procedures, timing, and appeal processes were defined by law. Minimum value limits for using the legislation on public procurement are defined by the annual budgets. These limits are rather low (US\$ 140,000 for capital investments in 1999). The new legislation on public procurement followed European Union regulations on competitive tendering. Public procurement rules are often bypassed by issuing the tenders through independent municipal enterprises (see chapter 15).

Another requirement is to prepare a feasibility study on capital projects if they are to be supported by national funds. Changing rules of urban planning will also modify the relationship between the public and private sectors because local governments have more bargaining power as far as construction plans are concerned.

In a market environment, public servants and elected officials must learn new techniques in planning, negotiating, and implementing capital investments. Because more and more local investments are revenue producing by private or privately operated facilities, new financial planning methods are called for. Local governments and their arms-length companies must establish funds for future reconstruction and capital investments. This long-term thinking, however, is not part of the typical operation at local governments so far.

Cash flow project financing will modify the relationship between the local governments, the operating companies, and the financing institutions (generally, banks). National budget grants will still have a strong influence on investments, but because other sources are also needed, local behavior will change. Concession agreements and build-operate-transfer schemes require developed contracting techniques between local governments as clients and the operating companies. Local governments usually want to keep the ownership of the utility network, site for the landfill, and so forth.

The lead bank of a municipality is often the major lender for investments. In this case, the fiscal information is easily available. For many decades, the lead bank for local governments used a very simple rule-of-thumb for evaluating a local government's borrowing capacity: if the ratio of capital expenditures in the total budget was below a specified limit, then it had access to loans. The high level of grants and transfers guaranteed the repayment. Now that Hungary has several domestic and international banks, public information on local governments' borrowing capacity is needed.

Local Debt Management

Municipal fiscal strategies have significantly changed as the economic conditions and financial regulations substantially changed, and local governments learned new methods during the 1990s. My survey showed that the newly elected mayors' first attempts were to cut back expenditures (Péteri 1998). Expectations were high (and so perhaps were reserves) in spending and service management. Later, by the end of their first terms, mayors' preferences had changed. On the expenditure side, local governments made more radical

steps: they canceled programs or transferred functions to county governments. At the same time, more local governments used new revenue, raising options, such as introducing local taxes, borrowing, and selling local assets.

This shift in local fiscal strategies resulted in a more businesslike operation at the local government level. The entrepreneurial approach was always present in local governments, because the lack of public revenues coupled with the transfer of state property provided good conditions for ventures. The rules of the public and private sectors were mixed in the decisions of many councils and local officials. After the new fiscal austerity program was launched in 1996, however, a regulated procedure of municipal debt management and limitations on local borrowing were introduced.

The purpose of these regulations was to separate local governments' financial responsibilities from the national budget. Though the Act on Local Government already declared that insolvency of local governments was subject to court resolution on the request of creditors, the legislature did not define detailed procedures until 1996. New procedures decentralized the management of municipalities in fiscal crisis and defined the conditions for applying for deficit grants only in ultimate situations. The limitation on local borrowing served similar decentralization purposes.

According to the legislation on local government debt management, the mayor has the main responsibility to start the legal process. In principle, after 60 days of overdue invoices, the local government or the creditor can initiate the debt resolution court process. Local governments are responsible for their budgetary institutions, too, but not for independent municipal companies (except when guarantees are involved). In 1998 the hospitals became part of the local bankruptcy procedures, despite the fact that they are financed by the national health care fund.

In practice, the local bankruptcy law was used only in the cases of nine small local governments. These cases were typically locally initiated procedures and closed mostly under an agreed settlement. The main causes for bankruptcy were typically unrealistic plans for capital investments. Although most of these investments were in the public sector (such as schools or sport halls), some also were in the private sector (for example, to promote local tourism). In these cases, lending banks had accepted core (nontransferable) property as collateral, which also caused problems (see chapter 30).

Debt management procedures were introduced together with limitations on local borrowing. The limit on municipal borrowing is 70 percent of net own revenues. The fiscal information system, however, does not present proper data on local government debt service limits. Since the limit is in place, the debt to net own-source revenue ratios were never higher than 15 percent, a level quite low when compared to the allowed limit of 70 percent of total budgets. In this respect, therefore, the aggregate local government borrowing capacity has high reserves.

What to Do?

During the 1990s local government management has been developed mostly through regulatory actions. This brief analysis of the four major service areas and some components of fiscal management showed that administrative measures supported decentralization. This legal framework was necessary for the development of local management. Many failed attempts, however, show that this legal-regulatory approach is not in itself sufficient. Several areas of the decentralization process can be characterized as unfinished business because the legislative steps did not provide the anticipated results in service delivery or the efficient operation of local governments. New institutions require several other conditions, management skills, and knowledge to reach satisfactory outcomes.

Future actions should focus on the following areas:

- Support and advice to local governments to develop new organizational forms and procedures (for example, model contracts, formula-based user charges, and capital investment financing schemes)
- Training and development of sector-specific and general management technical expertise at the local administration and in policymaking both for staff and for the politicians
- Development of locally available information systems with data relevant to municipal operation and management (for example, performance indicators, service standards, public fiscal data, and public information on contracts)
- Support to increase the professional level of local governments by independent policy institutes, think tanks, professional associations, consulting capacity, and information exchange systems among local governments.

The Role of Central Government in Further Decentralization

Most policymakers do not support further decentralization in the local government context. In their views, decentralization is simply equal to a transfer of public functions to lower levels of government. Obviously, several arguments against such an interpretation arise: differentiation of local public services, unmanageable allocation of transfers in a fragmented urban structure, and the present behavior of local governments geared to seeking central grants. The national fiscal policy, however, always relied on local governments' adjustment to economic realities, ability to increase the quality and level of services, revenue-raising capacity, and development of effective forms of service delivery.

The crisis situation—when the basic local government regulatory environment was established and experimented with at both levels of governments—is over in many respects. First, the economic transformation has reached the level at which private ownership has become dominant in the economy. Second, after a long period of economic decline economic growth has picked up in the second half of 1990s. Third, the tight fiscal policy

was successful in significantly reducing the share of general government expenditures. Parallel to these changes, however, local governments are faced with new challenges, including growing needs and membership in the European Union.

Under these new conditions, decentralization efforts should be based more on consensus building than on crisis management. This responsibility is a new one for the national government, which should make local governments capable of realizing all the benefits of decentralization. National policies should support local adjustment not by simple fiscal means only (for example, tightening or reallocation of revenues) but also by other techniques of public administration and public service management. The entire public sector will benefit from a consensus-based decentralization.

Such decentralization requires significant changes in national government's organizations, operation, and management. A broad interpretation of public administration means include: (a) legal and legislative actions, (b) public service management methods, (c) finances and fiscal management, (d) information and monitoring, and (d) support to raise public awareness and publicity. In the main areas of local government functions (see table 18.1), these public administration means should be developed in different ways.

Elements of Public Administration Means

Municipal solid waste management is a good example to highlight the elements of public administration means that are needed in a decentralized system (Péteri 1998). In general, environmental protection is well regulated, although some important components of legal regulations are still missing. This lack causes several problems for local governments: for example, waste is not defined by law, landfills' technical minimums are not detailed, no clear regulations on unauthorized landfills are specified, and legal sanctions on user-charge collection are not built into general regulations on minor offenses.

Public service management can be supported by various national government actions. To develop a decentralized control mechanism, the use of ecomanagement and audit schemes should be advertised, information and professional expertise are needed for environmental planning, and regional planning should be based on market coordination. Tendering and contract practices and information on bids should be provided to local governments and service organizations.

In the field of finances two corrections might indirectly increase the local government's sources allocated to this service: availability of specific grants for major stages of large capital investments and grants for buying equipment and vehicles. Technical assistance is needed for local governments to define general methods for setting user charges and to establish typical forms of cooperation among local governments. Supporting competition among hazardous waste treatment units to decrease management costs and using obligatory cash deposits for contractors are also useful means.

The present information system on communal waste management does not help local governments. A limited set of data is available only at the Ministry of Environment. No comparative information on finances of solid waste services or on tendering and contracting is available. Decentralized decision-making can be supported by increasing public awareness and publicity on waste problems. Regular professional information channels should be developed, and environmental nongovernmental organizations should be encouraged to increase their capacity to participate in local decision-making.

These examples show that in a decentralized environment national governments must develop new techniques. They are all indirect means to increase local governments' autonomy and capacity to respond to local needs.

Legal Framework with Basic Rules and Service Standards

Organizational forms and models meeting local service delivery needs might be developed on a trial-and-error basis, like the “free commune” experiments in the Nordic countries. Sometimes national support is also needed (for example, support of the national tax administration to introduce value-based local property taxation).

Training, knowledge transfer, and guidance to develop local service management capability should be regularly available at an affordable price for local governments. National government projects and coordinated technical assistance programs must be developed for local governments.

Information sharing on service management is greatly needed both for policymaking and for local decisions. More detailed information and easier access to data would support decentralization of services. Standards, performance levels, cost, and efficiency indicators help comparison, which is the basis of decision-making in a decentralized environment.

Finally development of negotiating mechanisms is the basis of consensus building in decentralized political and public service systems. Organizations representing local governments, municipal professionals, or service providers must be involved in the national decision-making process. They could protect the needs of the local government sector against other lobbying groups. By contrast, well-functioning local government associations might help decentralization by keeping the problems within their own circles. Fiscal policy coordination can be supported by intergovernmental committees (Shah 1998).

Summing up, the legal and regulatory steps in the restrictive fiscal environment have reached their limits as far as establishing a modern local government system. A new interpretation of the decentralization of public administration and public service delivery is needed. Indirect support should be provided to local governments to increase their institutional capacity and obtain the full advantages of decentralization. The national government has the main responsibility in creating responsive, efficient, and transparent local governments.

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19

Asset Management in Secondary Cities

Zsuzsa Kassó and Piroska Pergerné-Szabó

Following a quick political decision, municipalities received about a third of total public assets, but the asset transfer was gradual and incomplete until the end of the 1990s. Local governments, however, became sovereign local political and governing bodies whose primary responsibility was to fulfill public service functions. For a long time before that, the fact they were (or not) trustworthy owners, managers, and developers of municipal properties were hardly viewed as an issue. Macroeconomic distress, the fiscal squeeze, and a poor legal, technical, and organizational framework have prevented most local governments from establishing quality property registers and asset management systems. These functions were fragmented and randomly distributed among a host of municipal agencies, committees, and line divisions. Asset management is still a supplement of the main functions rather than a core activity, and that relegation often leads to shortsighted political decisions to respond to the challenges inherent when exercising public functions and bridging the resulting legal, organizational, or professional gaps (for example, *ad hoc* asset sale for urgent cash generation).

This chapter provides examples from three secondary cities—Nyíregyháza (113,000 inhabitants), Pécs (161,000 inhabitants), and Budapest District XI (156,000 inhabitants)—to illustrate the practical application of national and local rules and regulations in managing a significant stock of real and financial assets. These three cities, and the books, files, assets, and organizations reviewed, do not constitute a real statistical sample; by and large, they represent typical challenges, practices, shortcomings, and lessons for the other 220 cities in Hungary. In spite of significant improvements over the 1990s, severe shortcomings remain in recording, classification, accounting, appraisal, and strategic management of municipal assets. These shortcomings result in significant losses, unclear or sometimes fraudulent transactions, poor asset-liability management, and, ultimately,

* This chapter is based on Kassó 1999a and b and Pergerné-Szabó 1999.

suboptimal local development, all of which call for urging further modernization of local asset management.

The confidential assessments and proposals in this chapter were prepared for and submitted to the local governments of the sample cities and have been partially utilized. It seems appropriate to publish here original or slightly modified data and concrete assessments, while referring to the sample cities only as city A, city B, and city C, named in a random order.

Restructuring and Exercising Property Rights

The Act on Local Government (ALG) ordered that state assets, such as real estate, forests, water resources, cash and securities, previously managed by the local councils, would become the property of the newly constituted municipalities on September 30, 1990. The 1991 Property Act ordered that public utility assets become the property of the municipalities to the extent that enabled them to perform mandatory local tasks. By 1995 special committees had finished adjudicating other claims on assets by municipalities under the Property Act. By 1993 all local state residential housing and most local commercial property were transferred to municipalities at historic book value and in bad physical shape. This, in conjunction with the 1993 Law on Housing and Commercial Spaces, led to a massive sale of apartments to occupants at fire-sale prices and also to divestiture of some commercial real estate. To avoid the burden of rent arrears, deferred maintenance, and refurbishment, many municipalities sold all of their residential property and got out of the residential real estate market by 2000.

The ALG grants municipal councils full power to exercise property rights, which often are passed on to committees, line divisions, and local government bureaus, or to the mayor directly. Despite the gradual takeover, the magnitude of the transferred assets overburdened the local government organizations because their capacity to manage assets and exercise property rights lagged far behind the growing asset portfolio. The legislative framework that was emerging in parallel with the growing asset portfolio was a tool for a trial-and-error process rather than a framework for an efficient restructuring of property rights.

Asset Classes

Municipal assets are classified by service functions as either core or regular assets, and as marketable, limited marketable, or non-marketable (see table 19.1). Core assets are key facilities in providing basic municipal services listed in the ALG (see chapter 17), and the rest of the assets are regular properties. This classification is a redundant and perhaps unnecessary rule to assure a minimum level of key public services. First, the ALG makes local governments responsible for providing all local services. Second, local

governments have exclusive rights to assess the need, quality, and quantity of each local service (for example, to maintain a school, to hand it over to a church, or to provide a bus that takes the children to the neighboring city could each satisfy local needs). Third, numerous municipalities lack several core services and assets (for example, sewers or paved roads). These local governments, however, cannot by law be made responsible for these shortcomings. Moreover because they need to respond to local priorities, they may build a non-core utility first (for example, gas pipe) for which the citizens voted. No sanctions punish nonexistent or poor quality core services.

Table 19.1 Asset Classes

| <i>Status</i> | <i>Core assets</i> | <i>Regular assets</i> |
|--------------------|--|--|
| Marketable | None | Base case scenario: they are saleable |
| Limited marketable | Marketable upon local regulation, sometimes with exclusive permits of line ministries (for example, culture, education, environment, transportation) | Buildings with some historical or special artistic value (both municipal and private) require exclusive transfer permit from the line ministry |
| Non-marketable | Base case scenario: they are nonsaleable | None |

Source: Kassó 1999a and 1999b.

Flexible Functional Restrictions

The ALG is flexible in stating that local governments are “responsible for providing” services rather than saying that they “must provide services” themselves. This regulation enables them to provide services through public–private partnerships, subcontractors, budgetary entities, independent legal entities, or even foundations. This flexibility contradicts the asset classification mentioned above. The ALG and the Property Act authorize local governments to classify local assets through exclusive ordinance either as marketable, non-marketable, or limited marketable assets (see table 19.1). Although non-marketable core assets may not be sold, mortgaged, or used beyond providing mandatory public services, the partially marketable asset category enables transfer and more flexible use under certain conditions. As a result, assets in similar functions accounted for in one municipality as non-marketable might be considered to be partially marketable in another municipality.

Sectoral laws provide additional restrictions on marketability and authorize sectoral ministries to review and approve proposals on the sale or restructuring of non-marketable or partially marketable assets. Certain buildings with historical or special artistic value and sensitive environmental areas have limited marketability either in private or municipal hands. The function of these types of properties, however, can be changed (for example, in an urban renewal project), as long as historical preservation guidelines are observed.

Properties classified as core assets by law must be recorded in the land cadastre. Municipalities, however, often do not comply with this registry rule either because of

incomplete internal asset files or because the regional land registry is incomplete. A city council decision can reclassify marketable assets into core assets at any time; the limited marketability status of core assets may also be changed with a modification of the municipality's master plan. Thus the categories of non-marketable and partially marketable assets are flexible. Likewise limited marketability provides ample opportunities for controlled restructuring, transfer, or divestiture of assets. This flexibility allows local governments to apply good judgment and self-governance in the interest of local economic development. The fuzzy boundary between marketable assets and core assets with limited marketability allows a local government to take its operational budget into account when deciding on the future of its real estate assets. Local regulations ought to provide guidance as to when, under what conditions, and for what purpose assets can be reclassified.

Other Types of Restrictions

The state grant programs set additional restrictions on the marketability of municipal assets, such as targeted and addressed grants for wastewater collection and treatment systems. In the latter cases, the full amount of the state grant (for example, 60 percent of capital cost) must be refunded to the state if the asset is sold within 10 years of completion or during construction (see the 1992 Act on Addressed and Targeted Grants). According to accounting and tax regulations, municipal projects, such as wastewater, that become core assets with limited marketability also fall under value added taxation. In other words, municipalities must pay a 25 percent value added tax on their public investment projects ultimately funded by state grants. The value added tax regulations allow municipalities to claim value added tax refunds if the assets are leased out or produce an income stream. If these assets are sold, however, the value added tax refund must be repaid to the state. In other words, privatization or asset sales induce tax liabilities and grant refund obligations, making privatization of physical infrastructure itself rather unattractive.

Assets of core public services were entrusted to municipal enterprises, which subsequently became corporations and independent operators as limited liability or joint-stock companies (see chapter 17). Because core assets were entrusted and not leased permanently, several important court rulings defined the application of the term "entrusted assets" in the event of bankruptcy. The Supreme Court thus decided in 1997 that the core assets were placed at the disposal of a commercial utility company, but in the case of liquidation or any other change in ownership, the municipality owns the assets themselves. As a result, first, the liquidator does not have access to the core assets entrusted to the utility company, and they cannot be used to amortize the debt of the utility company. Second, the ultimate owner is the municipality, which remains liable for the company's overdue debts in case of reorganization or liquidation. Thus the fate of core assets on loan is still unclear in the case of privatization or liquidation, so municipal asset management in many cases meets only tactical concerns and leaves many ambiguities and inefficiencies unresolved in the long run.

Present Conditions for Asset Management

Municipalities have taken over assets originated in a variety of entities; hence, clear titles were few, and inventories and analytic files were far from complete or accurate. The local governments had to identify, catalog, inventory, and appraise assets on takeover. In parallel, setting up municipal organizations capable of maintaining and managing these properties was of crucial importance. Local governments had to accomplish all of these tasks in a short period. These types of background work and property management were entirely new to the just-constituted local governments, and they had little expertise and few experienced staff or managers.

Inadequate Organizational Capacity and Fragmented Responsibility

Even in 2000 few local governments recognized that professional asset management consists of more than selling off residential and commercial real estate and investing the proceeds in securities. Moreover, local governments with significant real and financial assets need to create units that have a comprehensive approach to quality asset management that serves the ultimate public purpose of providing quality services. The municipal units often focused on public administration in dealing with marketable real estate, property rolls, and inventories, but do not treat municipal assets strategically. Furthermore, they do not keep an eye on maintenance and various other obligations that come with ownership.

Local government units that cover business and management functions often have budgetary and accounting biases and perform essentially bookkeeping roles. Given the limitations of the public sector chart of accounts and bookkeeping practices, they have no comprehension of cash flows, asset value, and the value generated or lost by municipal properties. Furthermore, they are unable to detect changes in the real economy that affect the genuine value of municipal properties.

Local governments created commercial entities to fulfill asset management functions. Since then, evidence has mounted to support the assertion that incentives in a commercial, albeit municipally owned, enterprise do not always support the public service goals of the municipality.

Special Situation of the Districts of Budapest

The 1991 Law on Self-Government of the Capital City Districts regulates the legal status of Budapest Municipality, which comprises 23 districts and the Capital City as 24 public service districts each led by elected local governments. There is no hierarchy between the city and the district governments. Budapest has all the rights and responsibilities typical in municipalities and counties. Generalizations that apply to Hungarian municipalities regardless of size do not necessarily apply to Budapest or to its constituent districts. Although the districts are as large as the largest secondary cities, in many ways they are less independent than small villages because of responsibilities and competencies they share

with the city government (see chapters 8 and 20). A multitude of property management functions are cross-district and are handled by the Capital City Council, by its line departments and bureaus, or by the lord mayor.

The Capital City administration of Budapest performs the following tasks for the entire municipality (that is, virtually on behalf of the 23 districts):

- Drinking water supply, drainage water management, sewage treatment, gas supply, district heating issues beyond district boundaries, and management of the main grid of sewers and electric power
- Flood and groundwater control
- Solid waste collection, removal and disposal, including septic hauling and solid waste depot management
- Street cleaning
- Public cemeteries
- Maintenance of main roads traversing a district, routes used by public transportation, bridges, underpasses, and overpasses owned by the Capital City, as well as district-owned roads that are used by public transportation
- Parking lot management
- Provision of public and open-air markets
- Green-space management
- Coordination of urban renewal projects and greenfield investments.

Hungarian municipalities except Budapest districts are responsible for all the tasks listed above. Furthermore, each municipality is allowed by law to hand over local tasks to the respective county, if it lacks local financing or management capacity, but Budapest districts only could ask the Capital City to take over some of their responsibilities. In addition, the Capital City government maintains public health, social welfare, educational, and other facilities that are usually the responsibility of county governments. Given its overarching responsibility for infrastructure, Budapest capital government must maintain the digital public utility and infrastructure maps as well.

Locally Defined Rules for Asset Management

Besides national framework legislation on annual budgets, budgeting, accounting, municipal assets, and other local government activities, local council resolutions and standard operating procedures also provide guidance on property management issues. Soon after they had taken over state assets, city B and city C passed local resolutions that contained separate provisions for: (a) regulating the management, disposition, and potential privatization of residential and nonresidential real estate; (b) controlling public utilities; and

(c) providing general rules, rights, and authorizations to manage and dispose of municipal assets. By 2000, ten years into the new local government system, city A still had only a draft property decree, and it had no conceptual framework for asset management.

Asset management rules in city B and city C, just as in most large cities, have subsequently been incorporated into property decrees that: (a) define and categorize local assets by functions and marketability, (b) regulate exercising property rights, and (c) set up separate procedures for selling marketable and partially marketable assets. These property decrees also provide guidelines for managing municipally owned commercial enterprises and assign the administrative notary (the chief administrative bureau above line departments of the local government) to create and maintain an asset inventory, which should be attached to the annual closing budget report of the municipality.

Organizational Framework for Exercising Property Rights

Conceptually, all local government property rights belong to the local councils, which in compliance with national regulations may change the disposition of properties and regulate their management. These decisions are in some cases delegated to functional committees, the line departments, and their bureaus (see figure 19.1). The professionals working in local administration are thus responsible for preparing and executing decisions of the city council. But property-related decisions are also often made at several levels, in the multitude of municipal institutions and municipal enterprises, without council control or a common set of guidelines.

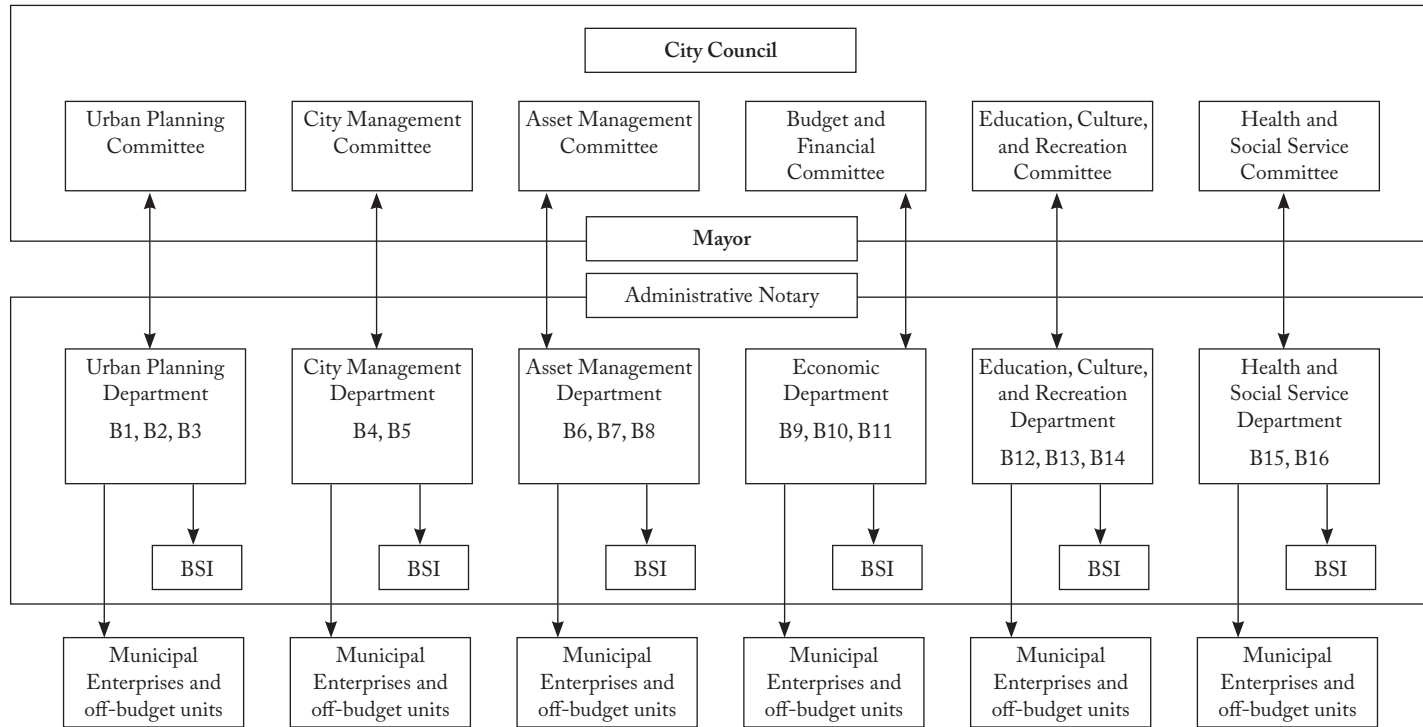
The organizational setup of local asset management varies across municipalities, but the larger ones typically have a similar multilayered framework of responsibilities and organizations in exercising property rights. The allocation of competencies between committees, line departments, bureaus, and independent agencies shows greater variety. Committees and line departments focus on strategy issues and monitoring or control of the subordinate entities in many municipalities, and they do perform numerous operational asset management functions in other municipalities.

Top-layer Organizations for Local Asset Management

Three levels of decision-making govern the local use of assets: the city council, committees, and the mayor.

City Council Decisions. Local governments have issued rules and operating procedures that govern which type of local decisions require a qualified majority (over 50 percent vote of city council) and which require only a simple majority (support of those present at voting). Most asset management issues fall into the second category. Qualified majorities are required in most cases when passing local decrees, establishing or disbanding institutions, joining associations or engaging in joint ventures with other municipalities, establishing a

Figure 19.1 Organizational Setup of the Local Government Bodies in City B



B1 Bureau of Chief Architect

B2 Bureau of Construction Licensing

B3 Bureau of Spatial Planning

B4 Bureau of Maintenance of Parks and roads

B5 Bureau of Public Utility Operation

B6 Bureau for Managing Municipal Residential Real Estates

B7 Bureau for Managing Municipal Enterprises

BSI Budgetary Service Unit

AM1 Park Maintenance Ltd.

AM2 Real Estate Managing Ltd.

AM3 Public Building Maintenance Ltd.

Source: Authors based on Kassó 1999a.

commercial enterprise, modifying the municipal charter, recalling or hiring top management personnel, and investing the municipality's cash or financial assets. Selling assets that have limited marketability often requires a qualified majority of the city council voting by name. Representatives with personal or family vested interests are disqualified from voting.

Committees—Second Rank Organizations in Local Management. In general terms and in most of the 220 cities, councils form a plethora of operational committees that consist not only of council members, but also nonvoting members from the community who hold special expertise or are appointed for political reasons. The committees deal with key issues, such as economic development; economics, budgeting, and finance; property management; city operation; urban planning; culture and education; and health care and social services.

The committees on economics, asset management, and budgeting and finance are particularly important in that they review budget proposals, make suggestions about borrowing and bond issues, and appraise investments and ownership shares in commercial enterprises. They also make suggestions about privatization, and about what assets may be used for commercial or revenue-generating purposes. One committee also manages the transfer of operating assets to utilities and supervises overall asset management.

The city council can delegate certain operational decisions to the committees between the monthly meetings of the council. Such rights include determining short-term investments for cash surplus. The committees, if authorized by the council and the operating procedures, can dispose of assets and set rental fees and sales prices, as well as evaluate competitive tenders below a certain value limit. The committees can place liens on private residential property as well in the case of nonpayment of taxes or refurbishment assessments.

Mayor—Third Rank Asset Manager. The role of mayors (and deputy mayors where applicable) in asset management is included in the standard operating rules for the municipality and the line departments of local government. These rules include conditions and competency limits in negotiating and signing contracts, proposing changes in staff remuneration, making recommendations about which staff of city management or institutions deserve promotion or financial rewards. Deputy mayors are assigned duties that include suggesting policies for dealing with municipally owned commercial enterprises, city operations, budget preparation, social, welfare, and urban development issues.

Line Departments and Bureaus

The scope of competencies and responsibilities of cities' line departments varies. We found no single optimal structure or resolution, and even the best practices differ. In some of our sample cities the departments and their bureaus are involved directly in asset management; in others asset management is delegated to municipal institutions or enterprises via quasi outsourcing; and in still others it is contracted out to independent private entities as paid asset managers. Below we summarize the practices of the sample cities.

City A. The following departments of city A deal with asset and property management issues: (a) Department of the Chief Architect, (b) Technical and Construction Department, (c) Business Department, and (d) Culture and Sports Department. The Department of the Chief Architect includes a city planning bureau, a property management bureau, and inventory bureau. This arrangement is beneficial since the active management of marketable properties takes place in close coordination with city planning and property inventory management. The Technical and Construction Department handles city operations, such as road and park maintenance, and controls service contracts granted to vendors performing city services. The Business Department prepares the budget, does bookkeeping and accounting functions, prepares the annual financial statements, and manages municipal institutions. In addition, the Business Department controls cash and bank payments made on behalf of all line departments. This department also manages the city's long- and short-term investment portfolios. The Culture and Sports Department keeps track of real estate and other properties of these two types of municipal institutions, and also coordinates maintenance, upgrades, and reconstruction projects in the schools and other facilities (see box 19.1).

Box 19.1 Municipal Property Management Supervision in City A

In 1992 the council of City A set up an independent bureau that is not part of line departments to perform several asset management functions in an integrated manner. The bureau is responsible for managing residential and commercial real estate, including leasing, refurbishment, maintenance, and privatization. The bureau prepares proposals for the city council to consider, and actively manages nearly 3,000 residential properties and 1,200 other facilities. It acts as leasing manager and custodian for 140 buildings with 900 leased units and manager for 900 co-op apartments with over 3,300 rental units. The bureau's computer system accounts for billing, arrears, maintenance, and other data on each property it manages. The database allows it to analyze cash flows and rates of return for each property separately (that is, loss-making units are easily identified). Since the bureau is a budgetary agency, the profit it makes can easily be transferred to the municipal budget without any tax implications, and its income statement is included in the city's consolidated financial statements.

City B. The various local organizations emerged randomly, so that asset management tasks and competencies of committees and line departments led increasingly to overlapping, inconsistencies, contradictions, and gaps. Hence, in 1999, city B reorganized its line departments to match the structure of the city council committees and, more significantly, appointed an asset management commissioner to directly oversee the city's assets. Despite this effort to create a professional, transparent, and responsive administrative structure, the new system contains several contradictions. For example, the urban development department oversees real estate bookkeeping and accounting functions, whereas this should be a function of the business department that does the rest of the city's accounting.

Real estate development and residential housing management functions are allocated to one department, although these two services have conflicting goals. The city created a new

support unit for its public administration professionals, and a group that sets economic and municipal development policies. Besides the internal controller's bureau, a set of liaison bureaus maintains ties with nongovernmental organizations, the press, cultural organizations, city marketing, tourism, and other public relations functions. Commercial enterprises owned by the city have to file quarterly operational and financial reports, and there is a monitoring group. So far, this control system is not extended to the city's budgetary agencies and institutions, though it would be of crucial importance to monitor them too.

City C. The standard operating procedures detail functions of departments' bureaus responsible for strategic issues and operational management of the city and most local services. Standard operating procedures do not itemize the various budgetary agencies, commercial enterprises, nonprofit organizations, and associations the city controls. In the course of ISO 9000 certification procedure in 1999, they documented the procedural rules applying to each function of line departments and bureaus. This certification does not extend to the business operations bureau because its numerous *ad hoc* tasks do not fit into the ISO manuals. The city has an economic bureau that prepares and monitors the budget, collects information from city institutions, prepares accounting records, does limited controlling, and also provides for training of financial staff members.

The assets and business bureau maintains the city's real estate records, keeps track of ownership changes, suggests new uses for properties, assists in the disposition of property, and acts as secretariat to the council's economic committee. This bureau maintains the property cadastre. Records are in a paper card format, with changes such as liens and mortgages inscribed by hand. This bureau also manages commercial rental property. In theory, all real estate and property files should reach this bureau, although quite often other departments receive such files by mistake.

The city development bureau prepares urban planning and historical preservation documents, and proposals for the city council to consider. Public procurement tenders, construction projects, project finance, city planning, the city architect, and so forth, are handled in or reside with this bureau. The bureau is responsible for the technical planning and permitting affiliated with city projects and privately sponsored projects as well.

The city operations bureau assists the development bureau in planning and operations-related tasks, provides maintenance and refurbishment support to city institutions, and does technical inspections. The bureau is responsible for street maintenance and cleaning, public lighting, transportation, parking, solid and liquid waste removal, as well as roads. The bureau signs contracts (for example, use of public areas) on behalf of the city. Commercial enterprises working for the city are inspected and monitored by this bureau. District heating, public markets, public baths, beaches, and other water-related functions belong here as well. The bureau serves as custodian of city hall. Despite these important roles, this bureau has no register of the property-management-related functions it is to oversee. Those functions are defined in the various agencies and enterprises the department supervises.

Municipal Institutions and Enterprises

Municipalities often establish institutions to provide non-fee-based public services and fulfill various functions. These tasks are either considered to be part of the municipal divisions and accounted as a part of the municipal budget and balance sheet, or they are legally independent institutions that have their own budgets and accounting systems, but receive municipal subsidies, grants, and contracts that show up as annual expenses in the municipal budget.

Municipal Institutions with Independent Budgets. Schools, social welfare organizations, and health clinics deliver mandatory public services. Although they have separate budgets, these institutions are not fully independent and are sometimes affiliated with a custodial bureau that provides business, accounting, and operational support to several institutions. Within their own budgets that depend to a large extent on transfers from the municipality, independent institutions are responsible for their current expenditures and property maintenance. Renewals and new capital investments are usually carried out by a functional unit of the managing bureau, although often they are covered from the funds of the institution's own budget (for example, computerization financed by a state or private grant application). Construction and renewals, on completion, are transferred to the books of the institution. Changes of service capacity, professional supervision, and many other issues are handled by the respective custodial bureaus.

Municipally Owned Independent Legal Entities. Municipalities have the right to establish commercial and nonprofit enterprises and to transfer assets to them to perform public functions or to generate income. State enterprises (for example, utilities) were commercialized before becoming property of municipalities. Depending on their founding charter, municipalities may or may not be able to control these enterprises through their board representatives; moreover, they may not act as a majority or sole shareholder (see chapter 17). All municipally founded enterprises were also commercialized by the end of 1997, which in principle made their balance sheets, income statements, ownership structures, and property rights transparent (though not necessarily public). This action has again in principle reduced cross-subsidization. Profitable enterprises could no longer subsidize a multitude of loss-making efforts beyond dividends paid to the owners. Ample room remains, however, for capital transfer or for giving more orders to loss-making municipal enterprises.

Most municipalities still do not have a clear idea of the nature of their ownership interests in municipal enterprises. No one municipal bureau keeps track of each enterprise, its business activity, and whether the municipal interests are being best served. Municipal portfolios that contain not only the shares, but also ownership interests in local limited enterprises should be monitored, evaluated, appraised, and actively managed. As opposite to the latter principles, the use of board and supervisory board memberships, with high salaries, is a time-tested tool of local politics. The relationship between the asset manager organ and the key managers of municipally owned or influenced enterprises varies. This determines the extent to which quality services are delivered or dividends are paid to the owner.

The city council, with ultimate responsibility for both finances and the level of local public services, faces conflicting tasks of acting as a profit-maximizing owner and public servant. This duality becomes even more complicated in the case of utilities, where tariffs, which were approved by the city council, affect its own dividend flow, its expenses as a user of the services, and the public's pocketbook simultaneously. Although from an accounting and legal perspective municipally owned or controlled enterprises are profit-maximizing, in reality they often behave in a hybrid way, since their owner and main customer exercises control and, hence, determines their product and ultimate performance.

Asset Records and Local Wealth

An up-to-date National Land and Real Estate Cadastre is the primary precondition for reliable and efficient municipal asset management—for households and business entities alike. The National Cadastre, though varied across geographic reasons, was completed only at the very end of 1990s. The ways and procedural shortcomings of privatization have also led to delays, legal disputes, and severe shortcomings in setting up local property registers. Being familiar with the logjams, local governments have repeatedly postponed the development of quality asset registers. This issue has become one of the major development challenges, particularly in the largest 100–200 settlements.

Real Estate Cadastre

The Property Act set up the following categories to be distinguished in property registers and on titles to the properties: residential and nonresidential property; historical properties; buildings for servicing handicapped people; buildings housing utilities or institutions if those services are defined in laws or decrees as serving public purposes; nature preserves; agricultural land; property belonging to utilities; water, public drinking water systems, and utilities; and other properties. Decrees define the format and content of municipal property registers, although local governments are free to add supplementary data.

Municipalities label their properties using the official plot numbers issued by the County Land Bureau, and the legal descriptions also match the official terms. The property registers and inventories often are updated with a big time lag. Therefore, liens, mortgages, and values are recorded only if a bank or other vendor insists on it. Property registers do not contain values, and property inventories do not fully match the content and descriptions of the respective registers. In all three of the sample cities, matching the land bureau and municipal land registers with the value-containing asset inventories is a never-ending task. Mismatches and problems are often discovered when executing sales contracts or when financial institutions want to register a lien on municipal property. Given difficulties in both the physical content of the registers and the lag in entering values, if any, municipal balance sheets rarely reflect a realistic value of municipal real estate inventories.

City B developed a digitized base map and, by 1997, added land and real estate cadastre modules to its asset management system containing details on ownership, liens, contested ownership, and various other rights associated with land and building ownership and use. This real estate register, however, does not contain information about utilities, because these assets (for example, water, sewage, and district heating pipes and equipment) were passed on to the various commercial operating enterprises under various lease contracts.

City B's real property cadastre goes beyond the statutory requirements, capturing relevant supplementary information. The register contains technical data that allow the city to group pieces of land according to their expected income-generating capacity. Land and buildings are also classified by potential functions and, if available, by latest market value, making it possible to identify income-producing and loss-making properties. These categories allow the city to identify loss-making properties that need to be retained because they are used to perform mandatory public services.

Thus properties can be classified as core properties with no marketability or limited marketability. All other properties can be thus classified as being marketable and available for income-generating purposes through privatization, leasing, or concession agreements. The municipal cadastre includes only properties owned directly by the municipality. Land and buildings that are owned by municipal enterprises fall into a separate legal category and are recorded only in the enterprises' balance sheets and analytic files. Line departments and bureaus are not able to track changes in real estate values, because real property ought to be cleared out from the municipal inventory if it is used as in-kind investment by the municipality. The value of investments should be traced instead, which would require municipal enterprises to report changes in their balance sheets.

Asset Inventory

The ALG requires that municipalities attach a full inventory of their real and financial assets to their annual closing budgets, which are due within six months after closing a budgetary year (coincides with the calendar year in Hungary). Many local governments fail to attach the full inventory because they do not have the data or they lack a comprehensive management system to fully capture the various types of property scattered across municipal institutions and bureaus. Beyond the assets actually used by municipal budget organizations, the asset inventory would have to detail real estate that has been leased or granted to a concessionaire for temporary use. Given that accounting standards do not enable local governments to list realistic values for all of their properties, only a reliable asset inventory could hint at the scale of a municipality's property in descriptive terms. Changes in ownership would also need to be shown line by line if necessary. Several field investigations have shown that substantial outside assistance would be needed to assemble a comprehensive and updated inventory at the municipal level.

City A created a detailed property inventory that it has never matched with the respective land bureau records, which, although also substandard, are the only records with legal authority. The property inventory, when possible, gives estimated values. Because accounting rules keep track of property by book value, matching properties in the inventory with properties listed by book value on the balance sheet is very difficult.

Shortcomings in the Sample Cities' Asset Records

Our three surveys identified anomalies in the accounting, recordkeeping, and inventory methods of each city. These anomalies were partly due to regulatory contradictions and partly clear-cut local shortcomings that could be resolved through a concerted reform effort. The three secondary cities showed balance sheets of around Ft 20 billion (US\$ 70 million) each in 1998. In each case, securities, cash, and real estate accounted for most of the assets, even though significant portions of real estate assets were recorded at historical book value or at zero value.

Challenges in City A

The assets of city A in 1998 amounted to Ft 16 billion (US\$ 57 million). Invested assets amounted to Ft 4.5 billion, of which 60 percent or Ft 2.7 billion were long-term claims on the new owners of recently privatized municipal apartments. Although the quality of these claims over the long run is doubtful, no provision for risk is made against these assets nor are they classified as doubtful in the municipal balance sheet. Real estate holdings (with numerous appraisal problems) still amount to nearly two-thirds of the city's assets.

The fixed asset increase accounts for 88 to 89 percent of the total capital expenses in city A (see table 19.2). The difference is further highlighted if we consider that assets are recorded in the books at net value. That is, gross value is reduced by depreciation, discards, or rejects, and is increased by the amount of investments incurred in the current year. The lack of tight relationship of fixed asset increase and capital expenses is also well demonstrated in figure 19.2.

Table 19.2 Types of Capital Expenses in City A, 1996–1998 (Ft million)

| <i>Year</i> | <i>Capital expenses</i> | <i>Expenses on non-marketable core assets and on assets with zero book value</i> | <i>Public utility investments</i> | <i>Other capital expenses resulting in no asset increase</i> | <i>Capital expenses not resulting in asset increase as a percentage of total capital expenses</i> |
|-------------|-------------------------|--|-----------------------------------|--|---|
| 1996 | 1,250 | 59 | 22 | 65 | 12 |
| 1997 | 1,219 | 64 | 34 | 49 | 12 |
| 1998 | 1,629 | 43 | 100 | 36 | 11 |

Source: Szabó 1999.

Challenges in City B

Assets are extensively recorded at par value, and unrealized change in gains or losses on invested assets is not tracked. Over 56 percent of the city's assets were in the form of financial investments, marketable shares, and ownership interests in commercial enterprises. These shares and ownership interests are recorded at par or original issue price, completely neglecting to incorporate changes in market values. In-kind and property contributions to municipally owned enterprises are also recorded at book value. Government decrees require that assets that are leased or otherwise signed over temporarily to other legal entities, such as concessionaires, must be recorded separately from securities and capital contributions. Almost all the latter assets of city B are non-marketable core assets used temporarily by utilities.

City B's balance sheet does not accurately reflect its true wealth in that significant real properties are recorded at zero value. The city's auditor has suggested that all assets listed with zero value ought to be appraised and a fair market value entered into the city's books. Unless these steps are taken, the entire balance sheet would not reflect the true scale of the city's assets and their potential for income or as collateral.

Accounts receivable represent a big challenge for city B (see table 19.3). Another weak point of city B's asset structure is the receivables stemming from the sale of municipally owned apartments under 30-year installment payment contracts. These are essentially long-term loans by the city to the new owners with a very long and unpredictable payback structure. The unpaid rental fees and other uncollected debts boost receivables to 5 percent of total municipal assets. City B's fully owned municipal utility enterprises have also amassed uncollected, and perhaps non-collectable, receivables, which ultimately need to be written off by the enterprise and eventually may induce municipal budget expenditures. For example, 80 percent of families who rent apartments from the city are in arrears to the district heating company.

Table 19.3 Accounts Receivable in City B

| <i>Accounts receivable</i> | <i>Forint million</i> | <i>Percent of total assets</i> |
|--|-----------------------|--------------------------------|
| Loan exposure due to the sale of municipal flats and nonresidential premises installment payments period expire mostly by the year of 2028 | 988 | 3.6 |
| Stock of overdue receivables taken over from municipal enterprises in 1994, so these should have been written off | 89 | 0.3 |
| Arrears in rent and other fees (overdue) | 76 | 0.3 |
| Receivables recorded at the business bureau of the local government | 262 | 1.0 |
| Total | 1,415 | 5.2 |

Source: Kassó 1999.

A critical point is that the large scale of receivables affects negatively the liquidity of the local government and may have a significant impact on property management.

The structure of receivables deserves attention as well. Actions should be taken against nonpaying tenants—128 notices came into force, but they cannot be executed because there is no place to move the tenants.

In addition, a matter of concern is the growing amount of irrevocable debt that has emerged in municipal institutions and enterprises. For example, rental contracts mostly inherited from the previous regime, which cannot be amended, include water bills as a part of the rent, so that public utility debt is due in addition to the rent.

It can be established that: (a) the invested assets are gradually decreasing, (b) the proportion of receivables is increasing, (c) the coverage of the assets with own resources is continuously deteriorating, and (d) the deteriorating trend in indebtedness and liquidity indicators may have a negative effect on the city's future development (see table 19.4).

Table 19.4 Changes in the Financial and Property Position of City B (percent)

| <i>Unit</i> | <i>1994</i> | <i>1995</i> | <i>1998</i> |
|-------------------------------|-------------|-------------|-------------|
| <i>Assets</i> | 100.0 | 100.0 | 100.0 |
| Proportion of invested assets | 95.8 | 94.5 | 87.2 |
| Proportion of receivables | 0.5 | 1.6 | 5.8 |
| <i>Resources</i> | | | |
| Own resources | 95.9 | 94.8 | 90.7 |
| Extent of indebtedness | 3.4 | 4.4 | 5.2 |
| Liquidity indicator | 3.8 | 2.1 | 2.2 |

Source: Kassó 1999.

Challenges in City C

In 1998 the city's balance sheet accounted nearly Ft 17 billion (US\$ 60 million) in assets. Nearly half of these (Ft 7.6 billion) were real assets (mostly real estate and other physical assets) and Ft 6.3 billion were financial assets. In 1998, as in the previous case, City C was faced, with Ft 1.2 billion in outstanding claims on the owners of the privatized (formerly) municipal apartments with nearly 30 years' maturity. City C keeps separate records of properties that are permanently transferred to utility operating companies, because these assets are accounted for in the municipal balance sheet. Capital revenues amounted to Ft 850 million in 1998, which represented only 6.4 percent of total revenues. Over the period under review, capital revenues were continuously decreasing, while capital expenditures were increasing significantly relative to total expenditures (see table 19.4). This picture, however, is misleading, because sizable revenues generated from the sale of nonresidential real estate—about Ft 97 and Ft 107 million in 1997 and 1998, respectively—were mistakenly recorded as current operational revenues instead of capital revenues.

City C has about 50 institutions with separate budgets and balance sheets under its control, and each institution performs public service functions (for example, education,

health, social welfare). In reality, the system has 150 legal entities, most of which do not have separate accounting systems, but are serviced by one of the 50 independent institutions that handle management, payroll, accounting, purchasing, and other services.

More important, city C is majority or controlling owner of 22 commercial and nonprofit enterprises and foundations and has ownership stakes in 33 other enterprises. This group of 55 entities held a municipal portfolio valued at Ft 6.4 billion (US\$ 23 million) accounted in the municipal closing balance sheet of FY1998. These entities either provide public services (such as zoo, district heating, cemetery, water, public markets, community television, and city services) or supplement public services (such as health foundation, education foundation, scholarships, public aid, and so forth) or serve in economic development (such as real estate development, industrial park, innovation center, small business incubator, and cable TV), or even are intended to generate income (such as highway construction and portfolio management). Even this extensive list omitted several significant enterprises owned or controlled by the city, and in many cases gave an incorrect (low) valuation for the shares. If the annual filings of these commercial enterprises, together with dividend data, were shown in more detail, then a more realistic valuation could be used instead of the par value or the original investment made in these firms. Neither the Property and Business Bureau nor the City Management Bureau had reliable data on the extent of municipal investment in these enterprises or the form of the investment (that is, cash, real estate, or another form of in-kind contribution).

Table 19.5 Capital Revenues per Expenditures in City C (percent)

| <i>Year</i> | <i>Capital revenues in total revenues</i> | <i>Capital expenditures in total expenditures</i> |
|-------------|---|---|
| 1995 | 9.3 | 9.4 |
| 1996 | 8.6 | 8.8 |
| 1997 | 7.9 | 13.0 |
| 1998 | 6.4 | 12.2 |

Source: Kassó 1999.

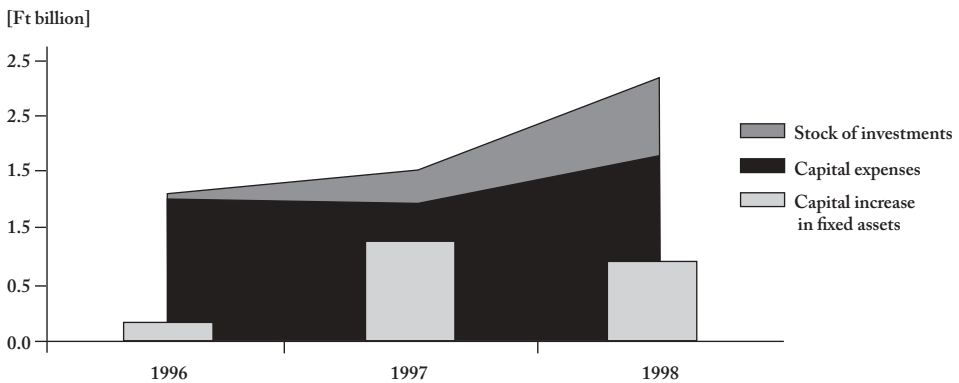
This municipality still holds significant real estate assets that have zero book value. When maintenance and other capital improvements were carried out, the municipal balance sheet did not reflect any changes in the value of these assets, because the funds expended by the municipality were accounted as current expenditures. The local government interpreted this accounting practice in such a manner that the zero book value reflects the assets' special functions; hence, capital improvements do not have to be accounted as asset increases in the municipal balance sheet.

The Finance Ministry, referring to European Union standards, has recently indicated in an opinion that core assets must have positive values on the balance sheet, even those that are currently recorded as zero value because they are non-marketable core assets.

Replacement cost, or depreciated cost based on technical parameters, could serve as a basis of appraising the value of these assets.

As a result, our study included, among other things, a proposal for city A to reconsider its present accounting policy, because about 12 percent of upgrade and capital improvement expenses were omitted from the line of invested assets of the city's balance sheet between 1996 and 1998. This omission resulted in an artificially accounted capital loss when no such loss took place at all.

Figure 19.2 Relationship between Capital Expenses and the Change of Fixed Asset Value, 1996–1998



Source: Kassó 1999a.

Relationship between Capital Expenses and the Value of Fixed Assets in City A

Capital expenses, in principle, increase the value of fixed assets. In practice, however, certain types of capital expenses are not reflected in the financial reports of most Hungarian municipalities, so they do not result in an increase of fixed assets. In the case of city A, these assets included capital expenses on improvement and replacement of non-marketable core assets and on assets with zero book value. According to the interpretation of accounting standards by the municipality, improvements to assets with zero book value are not taken into account as an increment to the asset value. Public utility investments also are not reflected in the balance sheet of the municipality. These assets, after the completion of investments, are transferred to the operating public utility companies. As a result, these assets are not present in the municipal balance sheet. Other capital expenses that do not result in the growth of municipal fixed assets are expenses of life-annuity contracts, evacuation of buildings to be reorganized, or expenses of the cancellation of forced residential rental.

Recommendations

The central government must take urgent steps to enhance accounting standards and bookkeeping rules applied to budgetary agencies and their operating environment, preferably in a manner to get them closer to the rules and practices of commercial entities. Capital and current budgets should be clearly distinguished and their interrelations regulated. Detailed national rules need to be introduced for preparing consolidated municipal balance sheets that reflect the requirements applied to commercial holding companies.

Municipal property registers and inventories should be scrutinized and standardized to reflect the true value of holdings. Market value, replacement cost, or some type of depreciated value should be used to supplement historical book value. Assets listed with zero value should be immediately revalued. A clear set of data entry rules should guarantee that entries are made at each appropriate level and agency. Inventories maintained at various levels in different entities should have a transparent and transferable structure. Local governments should set up a consolidated register to record all assets (including buildings, plots, and equipment) whether in the hand of the municipality or its institutions. This register also should include the assets owned by the municipality but operated by other, usually off-budget, entities. The assets are recorded by local government functions and services based on the classification recommended by the International Monetary Fund for the public sector (see table 19.6). In this case, the classification only indicates functions that are relevant at the local level.

Table 19.6 Classification of Assets According to the UN-IMF Classification of Functions of Government (COFOG)

| <i>Identification code</i> | <i>Relevant public services at the local level</i> |
|----------------------------|--|
| 01. | General public services |
| 01.1.1 | Legislative and executive bodies, foreign affairs |
| 01.1.2 | Budgetary and financial affairs |
| 02. | Defense |
| 02.1.2 | Civil defense |
| 03. | Public order and safety |
| 03.1.1 | Police |
| 03.1.2 | Fire safety |
| 04. | Education |
| 04.1 | Preprimary, primary education |
| 04.2.1 | Secondary education—general |
| 04.2.2 | Secondary education—vocational |
| 04.3 | Higher education |
| 04.4 | Other education |
| 04.5 | Other supplementary services |

| <i>Identification code</i> | <i>Relevant public services at the local level</i> |
|----------------------------|--|
| 05. | Health |
| 05.1.1 | Hospitals—general |
| 05.1.2 | Hospitals—specialized |
| 05.1.3 | Maternity hospitals and homes |
| 05.1.4 | Sanatorium, convalescent home |
| 05.2.1 | Adult and child family doctor services |
| 05.2.2 | Specialist clinics |
| 05.2.3 | General and special dental services |
| 06. | Social security and welfare |
| 06.5 | Family and child protection services |
| 06.7.1 | Services for habitation |
| 06.7.2 | Other social supports |
| 07. | Recreation, cultural and religious services |
| 07.1 | Recreation and sport activities |
| 07.2 | Cultural services |
| 07.3.1 | Communication |
| 07.3.2 | Publishing activities |
| 08. | Housing, urban, and community services |
| 08.1.1 | Housing |
| 08.1.2 | Village/urban development |
| 08.2 | Water service provision |
| 08.3 | Public lighting |
| 08.5 | Other village/urban development services |
| 09. | Environmental services |
| 09.1 | Solid waste collection, management |
| 09.2 | Sewage treatment |
| 09.3 | Environmental protection |
| 09.4 | Protection of nature |
| 11. | Economic affairs and services |
| 11.1 | Fuel and energy |
| 11.2 | Agriculture, forestry, fishing, and hunting |
| 11.4.1 | Road transport and public transportation |
| 11.4.2 | Air transport and transportation |
| 11.6.2 | Hotels, restaurants, and tourism |
| 11.6.3 | Multipurpose projects |
| 12. | Others |
| 12.1 | Transactions to finance budget deficits |
| 12.3 | Other |

Source: Kassó 1999a.

For each function, the register (box 19.2) keeps records of the assets, their book value, types, whether they are core assets or non-core assets, and whether they are marketable, non-marketable, or restrictedly marketable. It also indicates other legal regulations beyond the ALG that may restrict the use and management of the asset. The register gives details on the form of operation and the legal entity responsible for managing and keeping records of the asset. It also indicates the self-financing sources (if any) that are raised through managing the asset (for example, entry fees or rents). The methods and legal regulations that apply at the valuation of the asset are also presented in the register.

Box 19.2 Items of the Register

- Name of local public service
- Description of public service
- Book value of the asset
- Typical assets within this public service group
- Type of assets according to the ALG (marketable, partially marketable core, non-core)
- Entity which records asset value (mayor's office, institutions, and so forth)
- Form of operating the asset
- Self-financing
- Valuation of asset
- Compulsory statistics, reports on asset
- Legal regulation/requirements on the management of the asset

Source: Kassó 1999a.

Local governments should introduce clear rules and mandates for various managing units. A municipality's chart of accounts should reflect where each asset is located and which agency, department, or outside entity is responsible for reporting on and maintaining and maximizing the usefulness of the asset.

The annual municipal financial statements should be supplemented with, among other things, an annex that lists major changes in asset value and composition in the reported fiscal year.

A complete revaluation of all municipal assets should be carried out using replacement cost, depreciated value, or perhaps market value as terms of comparison. This way, annual depreciation, though not financed, could show up as a notional expense item, and the balance sheet shows capital loss if the proper maintenance and upgrades are not a part of the operational budgets.

Residential and nonresidential real estate, including rental properties, should be classified along the lines of social needs and commercial viability. The expenses and revenues accruing to rental properties, if otherwise consolidated in the municipal budget, should be shown separately, to allow for a clear understanding of where interventions (such as subsidies, privatization, and investment) are needed.

Conclusions

Experiences of the sample cities summarized in this chapter highlight the key characteristics of the legislative and regulatory framework and the mainstream practices of municipal asset management. Asset management is still primarily treated as a bookkeeping and tactical task rather than a core and strategic function of local governments. The local shortcomings are caused by: (a) the national accounting, financial, and budgetary rules and regulations; (b) lack of local coordination in and capacity for strategic and operational management of municipal assets; (c) incomplete and outdated asset registers and inventories; and (d) conflicting interpretation of legal rules.

The value, scope, and extent of real estate and other assets owned by municipalities and their affiliates are not reflected fully and accurately in the variety of statutory and voluntary registers and balance sheets. Municipalities that own the biggest asset portfolio in a vast majority of settlements do not have a full grasp of what properties they own, because asset files are maintained at several levels by many organizations, and inventories and cadastre reflect neither market value nor replacement cost.

Municipalities acting as owners of commercial enterprises do not fully capture the operational results and increases in firm value on their own balance sheets nor can they fully monitor the extent to which public purposes are being met.

Non-collectable receivables are gradually accumulating at various levels within a municipal structure. These contingent write-offs do not appear on a consolidated municipal balance sheet unless the charge-taking unit passes the loss up as a request for a subsidy. Ownership stakes are not reevaluated to reflect accumulated gains and losses on municipal investments.

A comprehensive reform of the municipal accounting system to shift from cash- to accrual-basis bookkeeping and record maintenance requirements is indispensable. Accurate and publicly discussed financial statements would be a key first step toward rationalizing governing bodies and institutions of local governments and in making their interaction with the capital market more attractive.

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20

Emergence of Strategic Planning in the 1990s: The Case of Budapest

Katalin Pallai



In the early 1990s cities around the world started to elaborate strategic plans for urban development by integrating different sectoral and functional policies. Such a strategy depends on broader political and legal circumstances. The newly established local governments in the transition countries were also faced with the challenges of strategic planning, although in the context of very different planning traditions and unstable economic circumstances. On the one hand, they had to shift their focus from the communist supply-side system toward a demand-side strategic approach based on new perceptions about the public sector's role and public policies. On the other hand, the establishment of local self-governments introduced a new and relatively independent layer of policy formulation in the context of the monolithic and top-down decision-making traditions. These traditions required clarification and reallocation of competencies and functions and the introduction of new coordination methods.

This chapter summarizes the evolution of the general urban policies, development concepts, and strategies in Budapest during the 1990s. Although development concepts have long been prepared, this chapter shows that the local government had to go through a reform process before real and viable strategies could be elaborated and complex strategic plans developed. General planning and management capacities in Budapest became conducive to strategic planning by the end of 1990s, a time during which the merits of the new strategies became apparent. The distinction of the so-called supply-and-demand approach, widely used for studying infrastructure policies, proved to be a useful tool for analyzing the evolution of the urban development planning in Budapest.

* This chapter is based on Pallai 2000a.

The Developmental Context

A well-designed strategy for Budapest ought to correspond to its present and historic position. The underlying factors are the city's weight and importance in the present economy, but also its pretransition heritage and the "supply driven" development before 1990.

Budapest at First Glance

Budapest is an internationally recognized metropolis with huge development potential. Its strength is due to its geopolitical position in Europe as well as to its economic and political weight within the country. It lays at one of the major intersections in the network of existing and planned trans-European transportation corridors. The city has 1.8 million inhabitants, with an agglomeration of about 2.5 million inhabitants, and provides a consumer market of at least 5 million persons. More than 90 percent of the insurance, banking, and telecommunication sectors and 60 percent of research and development capacities of Hungary are located in Budapest (see table 20.1). The city produces more than one-third of the gross domestic product (GDP).

The concentration of strategic functions and the high quality of human resources explain how in the last few years, Budapest has acquired 60 percent of the foreign direct investment channeled to the country and become the most favored target of such investment in central Europe.

Table 20.1 Major Indicators of Budapest

| <i>Indicator</i> | <i>Hungary</i> | <i>Budapest</i> | <i>Budapest as a percentage of Hungary</i> |
|---|----------------|-----------------|--|
| Size (square kilometer) | 93,000 | 525 | 0.5 |
| Population (million) | 10 | 1.9 | 19.0 |
| GDP in 1997, Ft billion (US\$ billion) | 8,541 (46) | 2,950 (16) | 35.0 |
| GDP per capita in 1997, Ft thousand (US\$) | 841 (4,504) | 1,552 (8,315) | 185.0 |
| Average wage 1998 Ft, (US\$) | 70,450 (328.5) | 89,402 (416.9) | 127.0 |
| Investments by businesses in 1996 (Ft billion) | 1057 | 333 | 31.5 |
| Foreign direct investment (US\$ billion, cumulative 2000) | 23 | 13.5 | 60.0 |

Source: National and Budapest Statistical Yearbooks 1999.

Supply-side Versus Demand-driven Development Strategies

Socialist planning focused on supply-driven investments, technically fixed solutions, and quantitative results. This "predict and provide" method spilled over from production to

infrastructure and urban development. The dominance of central plans and distorted demand information caused by symbolic prices created not only uncoordinated sectoral policies, inefficient structures, severe shortage in service delivery, but also high effective costs covered eventually by taxpayers. The lack of local autonomy degraded local planning to an administrative task with a profound hidden function of lobbying for central subsidies and, consequently, turned plans into a wish list of interventions. The contemporary urban planners who took the lead locally were mostly architects and engineers who focused on projects rather than processes.

During the 1990s the policy environment moved progressively in a positive direction. The transition to a market economy, strengthening of the private sector, cost-based user charges, liberalization, and privatization necessitated new types of control mechanisms and a new political culture based less on decision-making power and more on interest reconciliation. The focus of policies has shifted from regulation and intervention toward the mediation of impacts and interests based on the understanding of the micro-dynamics (see Table 20.2).

In parallel, the perception of the role of the public sector changed from sole provider of services to facilitator in creating a supportive environment. The establishment and empowerment of local governments created the opportunity to exploit the advantages of local information and initiatives and to package and translate these initiatives into comprehensive local policies. This new framework is more supportive of local management and elaboration or adjustment of plans according to local needs.

One of the biggest challenges within the new public policy environment has been the shift from state intervention techniques to more liberal, better coordinated, and cooperative strategic planning in public entities. The unrealistic dreams of old urban planners had to be replaced by an active strategic urban management approach. Instead of listing possible interventions, plans now must concentrate the limited public resources on actions that generate further development and private investment and transform the development of the city into a public-private partnership program.

Table 20.2 Characteristics of Supply and Demand-side Policies in Urban Management

| <i>Supply-side approach to urban development FIS</i> | <i>Demand-side management of urban development DSM</i> |
|--|---|
| Dominance of central planning Local planning for lobbying for central subsidies | Local planning, local-level aggregation of policies based on local information, initiatives, and accountability |
| Focused on supply-side investment and network extension | Focused on mediation in responding to local needs and for increased system efficiency |
| General macro-approach | Micromanagement based on understanding of micro-dynamics and flexibility of procedures |
| Impact based on public investment and regulative logic | Pricing and incentives as influence on users |
| Top-down approach and enforcement | Coordination of interest and mobilization |

Source: Adapted from Guy and Marvin 1996.

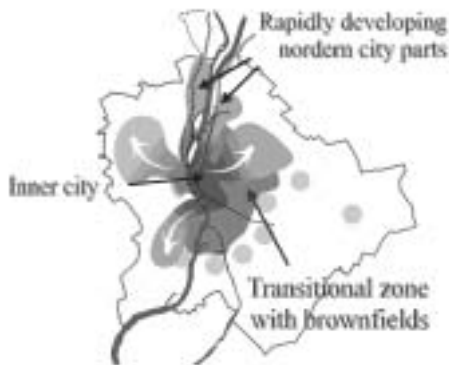
The Pre-transition Heritage of Budapest

Buda and Pest have been famous cities on the map of Europe since the Middle Ages. Although their fame faded during the Turkish occupation, a process of slow revival followed. During the 19th century, especially after a historical compromise with the Habsburg Monarchy in 1867 and the unification of Buda and Pest with the neighboring settlements in 1873, an incredibly dynamic growth period started. During the course of a few decades, Budapest developed into a huge industrial metropolis with prospering trades and pulsing international traffic. In this period a beautiful eclectic-style city emerged, and a sizable peripheral belt developed for industries and service functions. Furthermore, outer agglomeration settlements clustered around Budapest and started to grow quickly in the backyard of the big city. Now, these all have been consolidated into one big city comprising five historic inner city districts and a belt of 18 residential and mixed residential-service-industrial districts.

At the very end of the 19th century and during the following decades, the construction of the Danube bridges enhanced the development of Buda, the western part of the city. Elegant villas were built on the hills of Buda, while industries and larger apartment houses settled in south Buda. On the Pest side, the garden city of Zugló grew eastward first.

During the last decades of the socialist regime, the construction of large streets, commuter trains, and a metro line to the north launched fast urban growth along these transportation corridors. As a result, the former industrial belt rapidly shrank in the north of the city, but a gray transitional zone survived in the southeast of Budapest. By 1990 Budapest included, as a result of its natural position and its development potential, three challenging sections: the inner city, including the historic eclectic-style core; the northern development zone; and the transitional zone, with industries and brownfields, and the potential to merge functionally into the inner city (figure 20.1).

Figure 20.1 Historical Development of Budapest



Source: Budapest Municipality.

Concepts and Strategies during the 1990s

Right after the first local elections, the new leadership started to elaborate an urban policy concept (UPC91). The goal was to review and reconsider the needs and possible development interventions in the city under the new conditions. Half a year of intensive work resulted in a summary of issues that could initiate public and professional dialogue on the major urban policy issues at the start of the transition.

The Initial Challenges and Responses

UPC91 identified three troublesome development elements of the socialist heritage: (a) an over-centralized road system with low capacity and high ratio of through traffic, (b) serious decay of the historic core city, and (c) insufficient public services in big outer city areas.

Under the socialist regime, the severe shortage in privately owned vehicles was coupled with a fairly good coverage by public transport. Even in the 1980s, the vast majority of residents used public transport. As a result, an underdeveloped and strongly centralized road network could temporarily satisfy traffic needs. The traffic has since become burdensome for the city because of noise, pollution, and time wasted in transit.

The challenge of the historic core city was that this zone, with the country's best tourist and business potential, desperately needed rehabilitation. On the one hand, the core city suffered because of the lack of public funds for maintenance and refurbishment of apartment houses, most of which were cheap public rentals. The legal impediments and the lack of a real estate market, on the other hand, prevented mobilization of private funds into this territory.

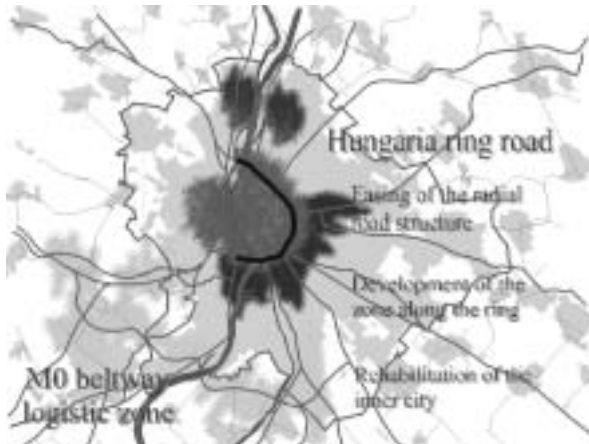
The challenge of the outer area was rooted in uncoordinated and asymmetric development in the previous decades. Housing development previously was focused on the outer areas of the city without the parallel development of public services onsite; hence, these outer cities were not self-standing zones but functioned as satellite towns.

As a simple answer to these conditions and urban conflicts, three priorities for urban development could easily be defined in 1991: (a) ease the increasing traffic problem, (b) start a building and street rehabilitation program in the inner city, and (c) develop public services and improve connections for outer districts.

UPC91 and the ensuing dialogue provided a framework for defining the most urgent large-scale development tasks. These efforts led to the first mega-project of Budapest—development of the Hungaria ring road in conjunction with a new Danube bridge. The Hungaria ring road supplements the two historic rings of the core city. It is currently the longest and outermost continuous ring street on the Pest side. It serves several functions: (a) it is a bypass for an immense volume of through traffic, which thus protects the inner city; (b) it provides better connections between the inner city and the outer districts; and (c) it provides for excellent connection and improves the development potential for a large part of the gray transition zone.

While the city government invested in construction of the Hungaria ring road, the central government started to construct a beltway around the city called the M0 highway (figure 20.2). The construction of a beltway was also well justified. First, when fully constructed, it provided a fast and easy way for both the heavy and the passenger through traffic between the seven major highways approaching Budapest from nearly all cardinal points. Second, the M0 could effectively and entirely keep all through traffic out of the expanding inner city. Third, the M0 not only supplements but also reinforces the Hungaria ring road development, since the latter, no longer burdened with through traffic, could serve to readjust city traffic. The M0 highway is not only a primary tool for bypass traffic, but it has inspired the dynamic development of a gigantic new logistic zone at the southern edge of the city. For instance, a dozen shopping malls, several truck terminals, and tens of logistic bases have grown as greenfield investments. This logistic zone has gradually become the fourth strategic zone of Budapest (figure 20.2).

Figure 20.2 Challenges and Development in the 1990s



Source: Budapest Municipality.

Parallel to the formation of the logistic zone, the construction of the Hungaria ring road has created development zones and partly counterbalanced the M0's unfavorable city deconcentration effect by pulling back some investments closer to the inner city (table 20.3). Private investments have fairly reinforced the Hungaria ring road development program (table 20.4). By 2000, for instance, as real estate became a strategic market segment in Budapest, half a dozen of shopping centers opened, and dozens of modern office buildings and new hotels were built at the Hungaria ring road and along the radial avenues that connect the inner city and the ring road.

Table 20.3 Capital Investments in Budapest as a Percentage of the Municipal Budget, 1990–2000

| <i>Investment</i> | <i>1990–1999</i> | <i>2000</i> |
|----------------------|-----------------------|-----------------------|
| Transportation | 30–40 | 41.5 |
| Other infrastructure | 15–20 | 27.8 |
| Rehabilitation fund | Ft 2 billion per year | Ft 3 billion per year |

Source: Budapest Municipality data.

Table 20.4 Private Sector Investments, Budapest, 1990–1999

| <i>Investment</i> | <i>1990–1999</i> | <i>Under construction</i> |
|----------------------------------|------------------|---------------------------|
| Offices (square meters) | 277,500 | 280,000 |
| New retail space (square meters) | 340,000 | 378,000 |
| New hotels (rooms) | 1,200 | 2,000 |

Source: Statistical Yearbook 1999.

The Hungaria ring road has proven to be a well-selected development intervention, because its construction alone could increase the potential of the surrounding area so that dynamic development could start there. Because the Hungaria ring road is beyond the border of the inner city, it stretches significantly farther beyond the limits of the densely used inner area. This ring alone, however, has not yet been able to create an impetus large enough to restructure the southeastern industrial brownfield toward the outer area.

The inner city rehabilitation was much less successful in the early 1990s. To rehabilitate and upgrade the inner city, parking regulations had to be instituted and bypass routes started to improve the quality of the physical environment. The first building rehabilitation programs were only partially successful because of serious legal and ownership impediments and the economic depression in the middle of the decade. The extensive and fast divestiture of the rental apartment buildings (around 300,000 units were sold by 1995) and legislative changes have laid the basis for rehabilitation of the inner city driven by the private sector. The private investors adjusted fast and well, so the inner city of Budapest has absorbed the largest private hotel and office building development among the central and east European capitals.

The outer city development program turned out to be the third element of the overall development strategy both in terms of timing and emphasis. It was crucial to improve accessibility by creating better connections among the radial avenues through the gradual construction of new sections of the Hungaria ring road. This third strategic element of the city development has proceeded at a much more moderate pace, and the first results occurred only by the end of 1990s. The improvement in public services was driven by the local governments of the respective districts, which started their own development programs in coordination with the municipal council of Budapest.

Halfway to a Realistic Plan: The Mid-1990s

Although the municipal government of Budapest was overburdened with important operational, financial, and management issues, two strategic concepts were elaborated by 1994. The first laid down a strategy concept for the administrative restructuring and management reform of service delivery (UPC94), and the second was an urban development concept (UDC94). UPC94 was realistic in attempting to foresee the maneuvering in the fiscal, financial, and political arena and delineating the next reform steps. Based on three years of experience and the transition process, the future of the local government system was far more predictable in 1993–94 than in 1991. It was possible to adjust administrative structures to tasks and capabilities, and the strategic concept document attempted to define the scale of present and proposed activities in accord with forecast revenues. The 1994 local elections reconfirmed the previous leadership, and this program became the basis of the coalition agreement between the two largest parties in the new local assembly and also served as the work plan of the local government for the next period.

UDC94, however, was almost entirely neglected for two reasons. First, the program of the new local government was understandably focused on administrative and management reform, which was further reinforced by the fiscal squeeze. Second, the urban development concept presented the vision of an idealized future state of the city, but not ideas as to how to achieve this vision. The wishes for an end-state concept implied huge development interventions, but failed to set clear priorities. This method was still a supply-side approach, useless in a system where the local government policy had to optimize locally available resources.

Modern Strategic Planning on Track

In 1996, after a short financial crisis caused by huge delays in receiving transfers from the central government, a new financial strategy was approved. This strategy started with a drastic reorganization of the municipality's financial management and a thorough reform of service delivery. As a consequence, the budget began to improve in parallel with the increasing predictability and creditworthiness of local finances, a change that made possible the operation of public services and the financing of public investments on a sustainable basis. These provided good ground for sound strategic-planning practice.

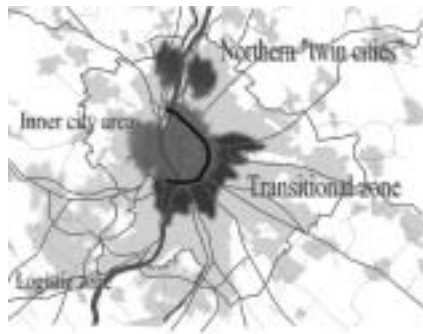
Urban Development Concept, 1998

The elaboration of a new urban development concept started in 1997. By that time Budapest had experience with ongoing city development under market conditions. The effects of the reorganization of traffic patterns, privatization of housing and infrastructure services, the

strengthening real estate market, and the effectiveness of interventions could be analyzed. As a result, the identification of problems and possible solutions became more focused.

A new urban development concept was developed in 1997–98 (UDC98). The expert team analyzed the different urban areas based on their prevailing problems and developmental stages, and distinguished four strategic zones: (a) the inner city, (b) the transition zone, (c) the northern twin cities, and (d) the southern logistic zone (see figure 20.3). UDC98 listed the most important local government actions for upgrading each zone. At the same time, a financial prognosis was prepared. The first comparison of the rough cost estimate of the necessary actions and projected financial resources clearly showed that more focus and priorities needed to be established under UDC98. As a consequence, the concept could be viewed only as a first iterative phase of strategic planning. Still, when the concept was published, professional and public review did not criticize the lack of focus. On the contrary, its generality and all-embracing nature was highly appreciated and ultimately led to widespread public acceptance.

Figure 20.3 Strategic Zones in 1998



Source: Budapest Municipality.

From Concept to Strategic Plan, 1999–2000

The second phase of the new urban development concept started in 1999 (UDC99) and focused on the delineation of a viable strategy in line with needs and capabilities. The new strategy aimed at developing a competitive and sustainable urban structure involving: (a) construction of a fourth ring road and two Danube bridges to merge most of the transitional zone into the inner city and use huge land reserves, (b) continuation of the rehabilitation of public spaces and buildings, and (c) improvement of the outer areas.

The concept identified the low-density transitional zone, especially its southeastern part, as the biggest obstacle in the development of an efficient urban structure for Budapest.

The key argument was that this economically depressed area, which is badly decaying and underused, increases the length of routes and travel needs and separates the inner and outer parts of the city. Hence, the construction of one more outer ring road, the *Körvasúti Körút*, with two new bridges in the north and south became a key long-term public investment project.

In addition, this concept aimed at upgrading the transitional zone into a “Park City” ring area (figure 20.4). Planners assumed that completion of the fourth ring road would result in better access to a huge territorial reserve and, they hoped, would attract sizable investments. The development strategy envisages the creation of new centers, public spaces, and intermodal nodes in the zone, as well as a few major flagship projects. Underlying the concept is the idea that this concentrated development in the transitional zone beyond the exploitation of local land reserves, can take over some functions from the inner city, facilitating improvement of the quality of both the inner city and the outer districts.

A development strategy that focuses on the transitional zone as a long-term objective considers the development process to be a huge public–private partnership undertaking. The public sphere must take a leading role in upgrading the area by construction of the ring road and some centers as focal points and give access to a huge territorial reserve in a strategically good position. The dark areas on the map show the territories that can be redeveloped for housing, green, and mixed functions (see figure 20.4). Most of this land reserve is in private hands, so the infrastructure plan is targeted to encourage private investment in the process. If the infrastructure improvements and regulation bring the zone into the position of a good investment target, the redevelopment of these areas can clearly be accomplished by the market or in public–private partnerships.

Figure 20.4 Strategies in 1999–2000



Source: Budapest Municipality.

Besides the new Park City project, continuity in earlier strategies for upgrading and rehabilitating the inner city remained a key part of the long-term urban development. Rehabilitation and the consequent improvement of the quality of life in the inner city is the primary precondition for Budapest to obtain and strengthen the role it hopes to fulfill as a regional business, financial, communication, and cultural center in central Europe. Likewise, a refurbished inner city could keep or attract the middle- and upper-class population to live in this zone. Targeting the physical, functional, and environmental improvement of the inner city is based on three elements:

- Constructing a new metro line (in my view, this construction is the optimal vehicle to facilitate the increase of urban density without increasing noise and pollution)
- Undertaking comprehensive street and public transportation rehabilitation and an integrated traffic system to filter the in-city traffic through the development of adequate parking places in tandem with proper parking fee policies within and outside of the inner city
- Launching a further development and rehabilitation process by focusing local government interventions on public spaces.

On the outskirts of Budapest, the goals are to:

- Establish new infrastructure connections
- Initiate large-scale public-private partnership actions for developing several mixed residential-business sections in this zone
- Revitalize or establish new local urban centers.

Local centers are the key developmental factors, not only to improve the local supply of public services and quality of life but also to decrease travel needs to the inner city of Budapest and simultaneously ease the inner city traffic by creating so-called “local inner cities.”

Budapest’s Strategic Plan for the New Millennium

At the end of 2000 Budapest did not have an urban development strategic plan, although the city came very close to it. The urban development strategy elaborated in 1999–2000 focuses on the transitional zone of the capital for long-term development to ensure that reserve land can be exploited. This effort is a mega-project that aims to be the engine of the whole urban development process. This urban development concept considered to be a draft development plan was adopted in 2001. After the official acceptance of the concept, the challenge for the local government will be to adjust policy tools, resources, and management instruments to facilitate the targeted processes. To achieve this goal, it will be critically important to amend pricing policies, introduce value-based property taxation,

and reconsider regulations and incentives. The draft plan comprises three groups of strategic development targets and actions (see table 20.5).

A complete and full-fledged strategic urban planning process is not yet achieved. This learning-by-doing strategic planning process is gradually proceeding, however, and comprises more and more complex and outreaching ideas, absorbs new elements based on previous results, and is adjusted to changing conditions. The draft strategic development plan gives the hope that in the coming years the necessary implementation tools will also be elaborated and the strategic plan will be completed in a timely manner.

Table 20.5 Budapest Urban Development Strategy for the New Millennium

| <i>Goals</i> | <i>Targets and actions</i> |
|--------------------------------|---|
| Access to territorial reserves | Körvasúti Körút: construct the fourth ring road, including two Danube bridges Access isolated territories Develop intermodal hubs Extend development zones along the Danube Relieve inner areas |
| Inner city development | Filter traffic, develop parking, and set regulations Rehabilitate buildings and public spaces Construct of a new metro line |
| Improvement of outer areas | Construct an external ring road to complete the M0 beltway Develop transversal connections from the Buda hills Develop public-private partnership programs in the southern outer districts of Pest |

Source: Budapest Municipality data.

Lessons Learned

Looking through Budapest's urban development concepts of the 1990s, one can clearly see that the policies and development concepts aimed at creating new strategies and contained key strategic elements. The urban policy elaborated in UPC91 was a necessary and courageous first attempt to stabilize the city.

The 1994 management reform concept sought to organize and harmonize systematically the financial and management aspects of sectoral policies. The 1994 urban development concept, however, could only give a vision of how the city would look in the future. An ideal end-state was sketched, but no policy goals or programs were articulated, so these concepts cannot be considered to be a strategy by any standards of policymaking.

The first real development strategy was the financial and management reform that could be fully elaborated and implemented only under the pressure of an approaching crisis in 1996. This historic momentum made reaching a consensus in bearing the political costs of serious restrictive measures politically possible. This new financial strategy and its implementation resulted in a comprehensive reform of the internal functioning of the local government by the end of the 1990s.

The 1998 urban development concept UDC98 was conceptually different from its predecessors. It focused on the sections of the city that had the most development problems, listed possible programs, and specified needed development interventions in the four strategic zones. This concept was still full of problem statements and supply-side actions, and these naturally reactive policies did not cover key issues of financing and decision-making capabilities of the city government.

It happened only in 1999 that the previous approach of “what should be done in the different areas?” shifted toward the more strategic question of “how can the development and investment process be best influenced or strategically guided with the limited resources available?” Clearly under the conditions of market economy, the primary goal should be to influence demand patterns, which could be achieved only by coordinated active strategic policies.

The crucial and symbolic point in this process was the shift of focus to the transitional belt. Discussions on the relative importance of each strategic action pushed the objective of construction of a new ring road to the top of the priority list. The conceptual change was that the evaluation was no longer the mere supply-side argument (for example, need for new traffic connections). The importance of the project in the new reasoning was twofold. On the one hand, the plan upgraded the low-density area in the transitional zone by giving access to badly underused areas and attracting investment. On the other hand, the plan had an objective to improve development possibilities of the whole city through the indirect effect of a more efficient urban density structure. This approach qualifies as demand-side management, because the role of the local government was to modify urban demand patterns by bringing areas of the city into the position of an investment target.

The 1998 technique weighed and prioritized possible interventions by the importance and urgency of the problem to be solved. In 1999–2000 a strategy was used in which interventions were prioritized by the strength and range of their effect. The first approach remains in the domain of passive, supply-side thinking, lists “the reactions to problems,” and “achieves as much as possible.” The second approach is a more active, demand-side one, in which effectiveness is targeted by interventions at optimal points to reorganize demand patterns and initiate a further development process. The fact that importance was given to the Park City program symbolizes the shift from concept to strategy.

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21 Regulation of Urban Land Development

Gábor Locsmánci and Kenneth K Baar



To understand the operation and impact of land use regulations, realizing the context in which they are implemented is critical. For example, in one country, discretion in land regulation may be primarily a tool for screening out inadequate development proposals, whereas in another, the overriding policy may be to approve all projects regardless of rules. Realizing that land use regulation may stimulate as well as deter development is also essential. Without the order that land use regulations and subdivision requirements may bring, development may take undesirable forms that discourage other development in adjacent and neighboring areas. Absence of regulation or great fluidity in regulations may subject development proposals to unacceptable risks concerning potential neighboring uses.

Factors that may be used to evaluate the effectiveness of land use regulations in promoting development include: (a) the existence of an overall planning scheme designed to foster beneficial development; (b) the likelihood that permits may be obtained for reasonable plans; (c) the time required to obtain permits; (d) the cost of obtaining permits, including impact and subdivision fees and dedication requirements; (e) protection from physical and regulatory takings; and (f) an adequate and secure process for transfers of property ownership.

The purpose of this chapter is to describe Hungarian land use regulations and to comment on their impact on development. In addition, the chapter contains a limited discussion about land management and sales by municipalities, and the impacts of land registration (titling procedures) on development. The enforcement of regulations is hampered by the lack of an overall development strategy and coherent planning schemes. So far, urban planning has been largely a technical process, without due consideration of its economic side, as a result of which current land use practices have unduly favored developers.

* This chapter is based on Baar and Locsmánci 1999.

Land Use Regulation before Transition

The forms of land use regulation that developed during the pre-socialist and socialist eras are central to the current schemes of regulation. From the end of the 19th century, land use was regulated by detailed official street and zoning maps. In addition, land subdivisions were regulated. The creation of a “City Beautiful” was an objective of the early measures.

Expropriation of land for public purposes (eminent domain powers) has been authorized since 1881, provided that full compensation is paid, but compensation costs were seen as high because public authorities had to pay fully for a portion of a parcel taken, even if the resulting public improvements would increase the value of the parcel’s remaining portion still privately owned.

The 1937 Act on Land Regulation

A major change on land regulation was adopted in 1937, when the government authorized the expropriation of up to one-third of a parcel for roads without compensation. The underlying rationale was that increases in value associated with the improvements on the land that was taken would offset losses in value resulting from partial expropriation.

Also, the regrouping of land was authorized. This step was important because much of the land was divided into narrow strips that were unsuitable for residential development. When regrouping occurred, affected landowners were obliged to compensate each other according to the gains and losses in their land values.

In the 1937 act, the government adopted a two-tier framework for urban planning consisting of: (a) a comprehensive “general” plan (ART) drafted by municipalities, but which required the approval of the Ministries of Interior and Industry, and (b) “detailed” plans (RRT), which were also adopted by municipalities, but were not under ministerial control. The detailed plans were publicly created subdivision plans. Based on the German practice, urban land was divided into building and nonbuilding sections. Subdivision into plots of less than 2,900 square meters was prohibited in the nonbuilding sections of cities.

Land Regulation in the Socialist Era

Although the legal framework of land use regulation remained nearly the same during the socialist era, the realities of planning were radically altered. The state became the major developer. Although adoption of plans was the responsibility of municipal councils, the drafting of plans was strongly controlled by the Ministry of Planning and Construction, and financing of local developments came from central sources in accord with national priorities and the objectives of the various ministries (primarily industrial development and construction of multifamily housing).

Most of the planning and building law was governed by national statutes, including the 1964 National Planning and Building Act and the National Building Code. The code set forth zoning classifications that could be adopted only with the national rules for those classifications as to density, height, setback, and so forth. For example, a medium-density residential zone could be defined in only a single way. The list of possible classifications, however, provided a great deal of variety.

The building code contained virtually no rules governing the details of uses within nonresidential zones (for example, density, lot coverage, height, or setbacks). This approach was consistent with the fact that until 1989, nonresidential construction was almost solely a state activity, which the state had no interest in regulating. Moreover, central areas of cities, where the housing stock had been nationalized, were not subject to detailed regulations.

The national law included guidelines governing the percentages of land that had to be devoted to particular uses. The National Planning Board formulated specific requirements for residential buildings covering parking, open spaces, spaces for shops and other services, preschools, and so forth. Another set of national standards formulated by the Ministry of Urban Planning and Building contained guidelines to be followed by local planners, which were stricter than the National Planning Board requirements.

Development took place typically on urban fringes or in central areas that had low-rise development. In the case of urban fringe development, authorities could avoid costly rehousing requirements that would have been necessary for central city demolition and redevelopment. Although local councils had the legal authority to adopt or reject zoning plans, sometimes their discretion was limited by party pressure. At times, localities were forced to accept plans that were unpopular. In the 1980s the planning process became more sensitive to public opinion, and the party played less of a role, while public debate over development issues increased (sometimes including televised statements by project opponents).

Although most development was directed and financed by the state, by the 1970s private development became a major source of housing. In rural-urban fringes, growing demand for individual houses led to the subdivision of agricultural lands.

Because state developers focused on multifamily housing, they had very little concern about the regulation of single-family housing. Land subdivision requirements were reduced to a minimal level in single-family areas, covering only basic infrastructure, setback, and lot size. In areas of private development, no master plans were adopted, and subdivisions commonly lacked any type of amenities or open spaces. Responsibilities for infrastructure costs were not clearly set forth; over time increasing portions were paid by residents.

In the central city and areas of multifamily development, the detailed plan concept (RRT) played a key role. Detailed plans differed from zoning plans of the type adopted in the United States and Britain. They were virtually architectural (building envelope) plans in the sense that they set forth the physical outline of allowable structures, including their size, location on a plot, and height. The RRT approach posed many problems. Detailed RRTs for some areas were not coordinated with overall zoning plans. Often RRTs that were developed in response to particular development proposals remained in place even if the proposal was not implemented. Sometimes RRTs that required substantial alterations

of existing patterns strangled intermediate development, pending the institution of broader redevelopment. In other cases, the RRTs were not taken seriously by state developers because they could easily be modified in response to changes in their proposals.

During this era the state paid no compensation for bans on construction even if they were permanent, and the concept of “regulatory” taking did not exist. One aspect of public power, however, was seriously limited by the repeal of the public power to reallocate plots without the unanimous consent of the effected landholders. This change affected matters such as street development.

Although the expropriation laws remained substantially unchanged, significant modifications took place in expropriation practices. In the early socialist era compensation was nominal. Later in this era citizens who could afford legal representation obtained substantial compensation. Throughout this period the right of the state to take property in a particular case could not be contested, and lower court decisions overruling administrative bodies regarding the amount of compensation could not be appealed. By contrast, the state avoided undertaking projects that would incur the opposition of wealthier groups, especially in single-family areas.

Land Use Policy after 1990

In the late 1980s, especially after the transition, analysts understood that the system of planning regulation had to be modified. Work on a new act was started in 1990. The main problem was that the preexisting RRTs were still in effect, although their concept of a detailed physical plan for each plot within a specified area no longer made sense within a framework of privately generated development. The result was that most development proposals required official modifications of the RRT for the project area, as well as approval of the actual project.

In the event a proposed project did not conform with the applicable zoning provisions of the ART, an RRT had to be created and then amended to conform with the new RRT. From the goal-oriented perspective of a city, the RRT and ART stood on an equal plane.

RRT: Serving or Guiding Individual Plans?

In formulating proposals for a market-oriented planning system, planners debated whether planning regulations should continue to require: (a) the traditional type of RRT plans, (b) broad zoning classifications leaving substantial discretion to developers as long as they complied with the regulations, or (c) a permit review, as well as zoning classifications, so that the details of a proposed development could be reviewed. Consistent with the overall thrust toward decentralization, planners debated how much planning control should be delegated to local authorities.

Pursuant to the 1997 Act on the Formation and Protection of the Built Environment, cities must be divided into building areas, where over 10 percent lot coverage is permitted, and nonbuilding areas, where lot coverage is limited to 5 percent. Under the act, all areas of a city must be covered by a general plan (structural plan) and a zoning ordinance.

Detailed plans (regulatory plans), which are comparable to the old RRTs, must cover areas subject to urban renewal or extension of the built-up area. Changes from the previous systems are that some development rights must be permitted in all areas, and that regulatory plans must take into account overall zoning.

In practice, cities, which suffered from serious cash shortages and were anxious to get development, worked out *ad hoc* responses within the existing legal framework. Generally, they adopted whatever changes in the general plan and RRT were necessary to legalize approval of proposed developments, with little or no consideration of the relationship between a particular proposal and an overall planning scheme.

Typically, localities contracted with or employed planners specifically to draft plan amendments so that developers' needs could be met without the resistance of a chief architect interested in preserving preexisting concepts or following the directions of political authorities.

Commonly, the developer has been required to pay for plan modification in response to a proposal. Some cities made a concentrated effort to review their RRTs and repeal those that did not make sense. Other cities adopted a unified city zoning ordinance and coordinated scheme of RRTs. Many cities consolidated reviews of a number of land use plan modifications to speed up such processes.

Negotiations with developers to obtain planning advantage became very common, especially when public lands were sold. Under the direction of planning commissions and city councils, dedication conditions have become common. Some jurisdictions have introduced variance procedures, even though the Ministry of Agriculture, which now has jurisdiction over planning matters, believes that such variance procedures violate the Act on the Formation and Protection of the Built Environment.

In the view of the ministry the standard local practice of planning amendment through negotiation in response to individual applications was undermining the concepts of urban planning. In its view cities were modifying their land use regulations to approve permit applications regardless of whether they fit within an overall land use concept. When applications did not fit within the existing plan, the plan, rather than the proposal, was judged to be at fault.

One of the objectives of the authors of the national legislation was to make amending zoning plans pursuant to developer requests more difficult. The number of required special purpose reviews for regulatory plans and approvals for permit applications was increased to 27. Local planners responded, however, by requesting letters of interest from effected agencies at the outset of a proposal. Typically, many do not respond, and the process is not much more burdensome than before. Key informants commented that local plans suffer from the lack of an overall development strategy.

Takings and Compensation Standards

Under national legislation adopted in 1990, officially recorded and notified bans on construction were limited to three years (Decision of the Constitutional Court 1991). After that, yearly compensation equal to 5 percent of the value of the property was required. The concept of using bans was limited to situations involving hazards or instances where a ban was required to implement a plan.

Bans that were not recorded and officially notified were not subject to compensation requirements. Out of fear that limitations on development rights would trigger compensation requirements, many cities reduced the areas covered by such limitations. This period was also marked by the commencement of discussions of even more substantial expansion of regulatory taking concepts. Moreover, citizens obtained the right to challenge taking actions as well as the amounts of compensation.

Regional Planning Considerations

In 1995 the government mandated that regional economic and infrastructure planning issues must be considered in local plans. The scope of this regional control has not yet been defined, although clearly, it governs infrastructure, road networks, and natural conservation areas.

From a fiscal point of view, control over national development subsidies has been shifting from the national government to county and regional development agencies, and the special agencies for the Budapest metropolitan area and the Lake Balaton region (see chapters 4 and 7). Whether these councils will consider physical as well as economic plan issues is not known.

The Current Organization of Planning Control and Building Permits

The basic structure of the planning and permit system has not changed substantially from the pretransition system. The components of the planning framework are: (a) the structural plan (preparatory land use plan), (b) local planning and building regulations (zoning and building code), and (c) the regulatory plan.

The local planning and building regulations must cover the whole city with zoning districts. The regulatory plan (continuation of the RRT concept) is not required for the whole city and can be limited to single blocks. What interactions will occur between the new zoning plans and the old RRTs is uncertain, as is how development will be affected by the new requirement for adoption of citywide zoning plans. The administrative bodies of the planning process are: (a) the local council and its committees, (b) the building authority, and (c) public agencies (national, regional, and local).

The local council has control over the structural plan, regulatory plan (former ART and RRT), and the local building code. The building authority has control over individual permit applications. Other public agencies are involved in the planning and permit processes. The local council and its committees have a great deal of discretion, but the role of building authorities is largely administrative.

The local authorities must submit their structural and regulatory plans for review and comment by the Ministry of Agriculture, which operates in planning matters through its agents, the Regional Chief Architects and their consultative boards or juries, and 27 public agencies (see box 21.1). The local authorities do not have to abide by the agencies' comments concerning plans and regulations; however, they must provide a justification for not complying. If a city does not adopt the recommendations of the public agencies, those authorities can still block approval of an individual project, which must comply with all of its prerequisites.

Box 21.1 Agencies That Review Permit Applications

- Aviation Directorate
- Chief Inspectorate of Technical Security
- Chief Inspectorate of Traffic
- Civil Defense Headquarters
- County Agriculture Office (agrarian land consolidation)
- County Labor Center
- County Land Offices and Inspectorates of Environmental Protection (protection of agrarian land)
- County Office of Plant and Soil Protection
- County Regional Development Councils
- Defense Ministry
- Department of Frontier Guards
- Directorate of Nature Conservation and National Parks
- Fire Department
- Hungarian Geological Service
- Hungarian Office of Mining
- Inspectorate of Environmental Protection
- Inspectorate of Forests
- Ministry of Agriculture and Rural Development, Regional Development and Building Office or Regional Chief Architect
- Ministry of Interior
- Museum Authorities
- National Chief Directorate of Water Management
- National Office of Nuclear Energy
- National Office of Protection of Monuments
- National Police
- National Public Health Agency
- Telecommunications Inspector
- The Air Force

If an applicant's building plan conforms to the regulatory plan and local regulations, the applicant will apply directly to the building authority; however, an application will be made to the council if a modification of the regulatory plan is required. The building authority determines whether a development application conforms to the regulatory plan and local and national building codes. A modification of the regulatory plan usually is required because the old ARTs and RRTs are still in force and, typically, are inappropriate for the new applications (furthermore, their adoption did not involve the required review by the special purpose authorities).

In addition, individual permit applications must be reviewed by the 27 public agencies that govern matters such as utility services, historical preservation, parks, mining, defense, health services, and so forth. In the past, applicants could address each of the authorities directly and obtain their consent. Currently each of these authorities must be contacted by the building authority; however, the review by many agencies (for example, those representing the military, police, civil defense, nuclear, aviation, museum, mining, monuments, and telecommunications) is only perfunctory because the application does not raise significant issues within the scope of their jurisdictions. In addition to the agencies, neighboring land owners must be notified (see table 21.1).

Table 21.1 Steps in the Formulation of a New or Modified Regulatory Plan for a Designated Area

| <i>Actions/events</i> | <i>Time to accomplish</i> |
|---|---------------------------|
| 1. Preliminary discussions and negotiations with the developer | 0.5 to 1.5 months |
| 2. Preparation and provision of notice to effected parties (city, building authorities, special purpose authorities) which must indicate if they are interested in the plan. Replies must be provided within two weeks. | 1 month |
| 3. Selection and contracting with consultant planner and determination of how cost will be allocated (unless an in-house planner is used) | 1 to 1.5 months |
| 4. Preparation of consultant's report or an in-house planner's report. Length of preparation depends on complexity, whether in-house planner used, and whether council planning committee objects to draft plan. (City support may speed up the process.) | 3 to 9 months |
| 5. Official review of the plan by the interested authorities (time limit is mandatory) | 1.5 months |
| 6. Resolution of disagreements among interested authorities (if needed) (time limit is mandatory) | 1 month |
| 7. Publication of plan (time limit is mandatory) | 1 month |
| 8. Presentation of plan to chief architects or county or ministerial jury (for major project) | 1 month |
| 9. Review and adoption or rejection Rejection is rare at the final stage. | 1 month |
| Total | 12 to 15 months |
| Additional time for building permit (agencies have 30 days respond) | 60-day ceiling |

Source: Locsmándi 1999.

Denial of a building permit application may be appealed to the County Administrative Office, but its scope of review is limited to consideration of legal errors. Appeals of decisions by the office are subject to review by the Constitutional Court.

Based on our experiences in consulting with localities on development issues and the opinions of key interviewees, we believe that planning regulations do not act as a significant deterrent to development.

Land Registration and the Development Process

Hungary has been upgrading its land registration process during the past few decades. From 1973 through 1981 a new real estate registration (cadastre) was finished. Property sheets for each parcel contain physical information, owner-related data, and data on property rights (mortgages, servitudes, and so forth.).

The land registration and titling system for all of Hungary is administered by the Department of Lands and Mapping in the Ministry of Agriculture. The department oversees 19 county land offices and 116 district land offices that together have a staff of about 4,300 persons.

Since the transition, land registration and titling requirements have been substantial as result of the privatization of apartments, distribution of properties pursuant to compensation, and distribution of cooperatively owned land. With major assistance from the European Union, the land registration process is being computerized.

The reports we received indicated that the lag between a transfer of ownership and the time when the title is registered is generally 18 months to two years. Local offices may give priority to transfers involving real estate mortgages. Presently, notations of the existence of new transactions are made on existing land records, so that all related transactions can be traced. Prospective purchasers, with the aid of attorneys, rely on their own title searches to ensure the adequacy of title. Title insurance is not available. Interviewees indicated that the land transfer process was not being delayed by the length of time required to register a new title.

Public Ownership of Urban Land

In 1990 a substantial portion of state-owned property, which included commercial property, vacant land, and residential land, was turned over to municipalities. The bulk of the property consisted of residential flats. In 1992 the government adopted legislation requiring that localities develop an inventory of all public assets, including land, by 1994.

From the outset, municipalities, most of which have been in a desperate financial condition, have developed strategies to obtain revenues from their properties. These strategies have included various combinations of sales and rentals. Social considerations

have governed the strategies for residential rental properties, so rents and sale prices to residents have been maintained at nominal levels. Typically, cities have found that residential sales even at nominal prices are beneficial because they relieve them of maintenance costs, which exceed the rental income generated by the properties. Municipal strategies in regard to nonresidential properties have varied greatly in sophistication. In some cases, desperate conditions have led cities to sell or rent on unfavorable terms (see chapter 19).

No data are available on the quantity of municipally owned land before 1994. Data compiled pursuant to the inventory legislation provide information on the number of publicly owned parcels of different types and the proportion of parcels that are non-marketable or semi-marketable (for example, streets, parks, water reservoirs, public utilities, public buildings, park areas, historic buildings) (see table 21.2).

The 3,200 municipalities owned approximately 818,000 pieces of real estate (parcels) as of 1997, of which 271,000 were residential flats, and 41 percent were “unmarketable” or “semi-marketable.” The data did not indicate the values of the parcels, however. Therefore, the significance of the publicly owned land cannot be evaluated, but we should note that the amount of publicly owned land increased between 1994 and 1997 (CSO 1998). This increase is a result of various factors, such as the progress of the gradual takeover of municipal properties in accordance with the Property Act, improvement in property registers both regionally and locally, and the gradual review and cross-checking of municipal asset inventories and property registers (see chapters 17 and 19). The number of state-owned flats declined from 365,315 in 1994 to 270,898 in 1997 (see table 21.2).

A recent analysis of publicly owned land (Péteri 1998) noted that in 1991 local governments were direct owners of material assets, the majority of which were real estate. By 1995 one-third of municipal ownership had been converted into shareholdings because of the privatization of state companies and transfers of municipal assets into indirect ownership in the form of municipally owned share companies.

Of the marketable properties that can be used for development, one-third of the total estimated value is owned by Budapest and one-fourth by the smaller cities (table 21.3). Cities with county status (which contain 20 percent of the population) own only about 8 percent of the marketable properties.

In these county cities, the average share of marketable property in the estimated total value of their property assets is only 14 percent. These cities have been more active in disposing of their properties (see table 21.4).

We requested specific information on developable land ownership, purchases, and sales from six municipalities. Data from the four cities that responded indicated that three of them owned less than 1 percent of the developable land and the other city owned 3 percent.

According to key information, the general strategy of cities is to sell their developable land, and the cities consider whether alternate uses of their land capital would be more productive. Four of the cities provided information on land values. The increases, in absolute terms, were less than the offsetting inflation, which was approximately 80 percent.

Table 21.2 Real Estate Properties of Hungarian Local Governments, Selected Years

| <i>Properties</i> | <i>1994</i> | <i>1997</i> | <i>Change 1994–1997</i> |
|--|-------------|-------------|-----------------------------|
| Number of units total | 734,800 | 818,465 | 11.4% |
| Number of units not assessed (zero value) | 603,476 | 632,929 | 4.9% |
| Share of marketable properties (percent) | 45.5 | 47.4 | — |
| <i>Number of buildings</i> | <i>1994</i> | <i>1997</i> | <i>Change 1994–1997</i> |
| Dwellings | 365,315 | 270,898 | –25.8% |
| Rooms in buildings of other uses, for example, shops | 69,137 | 72,681 | 5.1% |
| Industrial premises | 12,176 | 12,663 | 4.0% |
| Retail, service, administrative | 9,494 | 10,758 | 13.3% |
| Social services, public health | 7,495 | 8,030 | 7.1% |
| Education | 12,837 | 13,964 | 8.8% |
| <i>Number of other properties</i> | <i>1995</i> | <i>1997</i> | <i>Change 1995–1997</i> |
| Cultural, sport units | 5,582 | 5,743 | 2.9% |
| Swimming pool, bath | 310 | 308 | –0.6% |
| Cemetery | 6,389 | 6,537 | 2.3% |
| <i>Publicly owned land (hectares)</i> | <i>1995</i> | <i>1997</i> | <i>Change 1995–1997</i> |
| Unbuilt land | 175,481 | 190,860 | 8.8% |
| Open spaces (parks) | 15,787 | 20,199 | 27.9% |
| <i>Characteristics of properties</i> | <i>1995</i> | <i>1997</i> | <i>Change 1995–1997</i> |
| Total number of real estate properties | 806,210 | 818,465 | 1.5% |
| Non-marketable (percent) | 40.5 | 41.2 | — |
| Limited marketable (percent) | 11.5 | 11.4 | — |
| Marketable (percent) | 48.0 | 47.4 | — |
| Number of assessed (gross value indicated) | 140,754 | 133,636 | –5.1% |
| Non-marketable (percent) | 20.9 | 23.4 | — |
| Limited marketable (percent) | 24.2 | 25.5 | — |
| Marketable (percent) | 54.8 | 51.5 | — |
| Number of not assessed (zero value) | 626,978 | 632,929 | 0.9% |
| Non-marketable (percent) | 45.8 | 48.0 | — |
| Limited marketable (percent) | 8.8 | 8.5 | — |
| Marketable (percent) | 44.5 | 43.5 | — |

Source: Central Statistics Office 1997 data.

Table 21.3 Publicly Owned Real Estate by Type of Jurisdiction, 1997 (percentages)

| <i>Population in jurisdiction</i> | <i>Share of total population</i> | <i>Assets as a percentage of country total</i> | <i>Marketable as a percentage of country</i> | <i>Unbuilt land as a percentage of country</i> | <i>Marketable land as a percentage of municipality total</i> |
|-----------------------------------|----------------------------------|--|--|--|--|
| Under 499 | 3.1 | 2.6 | 1.8 | 2.3 | 17.3 |
| 500–999 | 5.9 | 6.7 | 17.4 | 17.1 | 66.1 |
| 1,000–1,999 | 11.3 | 15.8 | 2.1 | 4.8 | 3.5 |
| 2,000–4,999 | 18.2 | 21.7 | 4.5 | 25.0 | 5.5 |
| 5,000–9,999 | 11.3 | 4.7 | 12.0 | 11.0 | 66.5 |
| 10,000–19,999 | 12.5 | 7.4 | 8.0 | 7.5 | 28.2 |
| 20,000–49,999 | 13.4 | 7.7 | 8.1 | 7.2 | 27.3 |
| 50,000–199,999 | 4.0 | 16.4 | 9.1 | 5.5 | 14.6 |
| More than 200,000 | 2.1 | 0.2 | 0.3 | 0.1 | 43.4 |
| Budapest, county ^a | 18.2 | 29.9 | 36.6 | 19.5 | 57.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 26.1 |
| Budapest | 18.2 | 13.4 | 34.2 | 19.3 | 66.9 |
| Counties | — | 3.3 | 2.4 | 0.1 | 19.4 |
| Cities with county rank | 20.2 | 15.8 | 8.4 | 4.8 | 13.9 |
| Other cities | 24.2 | 17.5 | 24.7 | 19.9 | 37.0 |
| Villages | 37.3 | 50.0 | 30.2 | 55.8 | 15.8 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 26.1 |

Note: a. Population data of Budapest, the rest of the line Budapest and Pest county data.

Source: Péteri 1998.

Table 21.4 Publicly Owned Developable Land and Amount Sold for Development in Five Cities, 1992 and 1997

| City | Administrative area 1992 (hectares) | Official built-up area 1992 (hectares) | Public land in 1992 (hectares) | Public land sold 1992–1997 (hectares) | Land bought by the city 1992–1997 (hectares) | Land remained public 1992–1997 (percentage of 1992) |
|--------------|-------------------------------------|--|--------------------------------|---------------------------------------|--|---|
| Eger | 10,473 | 1,473 | 170 | 16 | 1 | — |
| Kecskemét | 32,136 | 3,200 | 155 ^b | 31 | 4 | 81 |
| Püspökladány | 18,695 | 928 | 8.5 | 7.8 | 0 | 8 |
| Szentes | 32,323 | 1,684 | 32 | 18 ^c | 18 ^c | 100 ^c |
| Szombathely | 9,752 | 2,932 | 345 ^a | n.a. | n.a. | n.a. |

Notes: a. In 1997 no data are available for land sold, or information about many private transactions.
 b. Rough data because development land is not registered separately.
 c. Between 1992 and 1996.

Source: Locsmándi 1999.

Conclusion

Current land use practices are highly favorable to developers. The following are our key observations and conclusions:

- When cities desire a project, they are committed to amending the applicable land use regulations so that the project can be approved.
- The actual permit process does not involve substantial costs.
- The time needed to obtain a permit is not excessive by modern standards.
- Although a large number of agency approvals is required (27), in practice the process has not led to major costs or delays.

Moreover, the common lack of a comprehensive, coherent planning scheme could hamper overall development in the long run. In reaction to these concerns, national support is growing to make modifying plans in response to individual applications more difficult and to introduce tighter subdivision controls on the urban fringes. Cities without overall development plans may be less economical to operate, less attractive to long-run development, and less attractive to live in. Up to this time, urban planning has been largely a technical process, without due consideration of economic matters.

The national government is taking substantial steps to provide security from regulatory expropriation. Compensation is now required for unlimited moratoriums. In fact, the requirement that compensation be paid for any reduction in value caused by changes in the law goes far beyond the requirements of any industrialized country and, if seriously enforced, could have a negative effect on planning.

As indicated, the weaknesses in the land registration process have not had a significant impact on land transfers.

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Municipal Treasury

Izabella Barati and Gábor Péteri

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

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

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

* This chapter is based on Barati and Péteri 1998.

The Conceptual Framework of Cash Management

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

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

International Models of Treasury

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

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

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

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

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

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

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

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

Why Cash Management Became Important

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

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

The HST

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

Box 22.1 Historic Roots

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

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

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

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

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

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

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

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

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

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

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

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

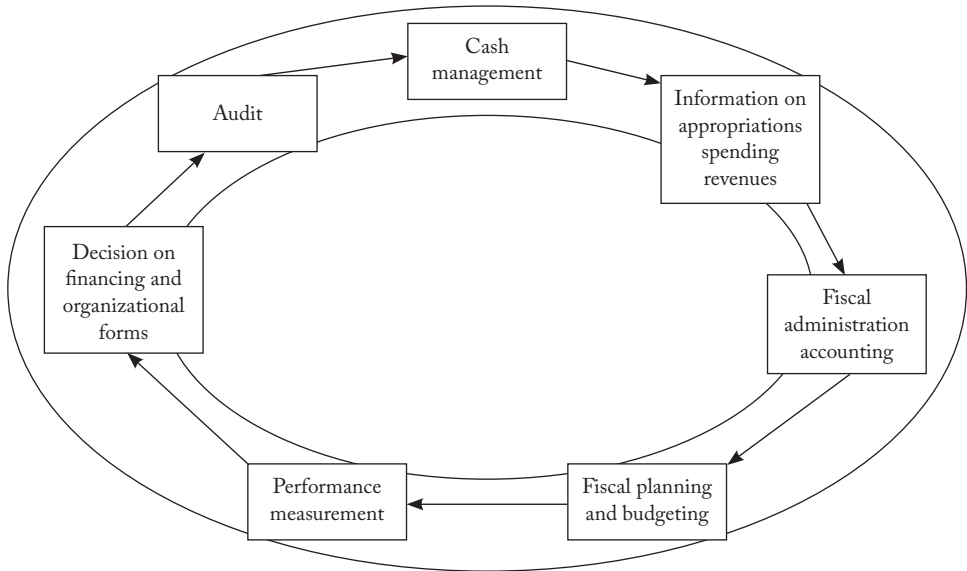
The immeasurable benefit of the partial integration of local governments into the HST is that the Treasury has now direct information on local finances. Financial transactions between the subsystems of the general government budget became more transparent for both the national and the local governments.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

The Concept of Municipal Treasuries

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

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

Figure 22.1 The Stages in Development of Local Financial Management



Source: Authors.

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

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

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

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

Municipal Treasury Solutions and Models

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

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

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

In-house Treasury

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

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

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

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

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

Independent Treasury

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

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

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

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

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

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

Operational Issues of the Two Treasury Models

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

Size and Type of the Municipality

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

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

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

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

Financial Advantages and Disadvantages

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

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

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

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

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

Ensuring Institutional Independence

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

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

Incentives

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

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

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

Financing Schedule

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

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

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

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

Relationship with Fiscal Planning

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

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

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

Case Studies of Local Treasuries

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

The Independent Municipal Treasury in Tokaj

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

Economic and Financial Crisis in 1994

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

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

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

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

National and Local Crisis in 1995

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

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

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

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

Actions for Recovery

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

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

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

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

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

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

Preventing Bankruptcy

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

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

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

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

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

Consolidation of the Institutions and Setting Up the Municipal Treasury

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

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

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

Lessons and Achievements

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

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

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

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

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

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

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

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

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

Introduction of a Treasury-type Financial Management in Szeged

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

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

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

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

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

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

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

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

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

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

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Financial Management Reform in Budapest

Katalin Pallai

The Act on Local Government in 1990 created a clear legal basis for democratic and fully autonomous local management. At the same time it became a local task to fulfill assigned responsibilities by exploiting local opportunities. Municipalities faced a key challenge of transforming the financial and administrative systems inherited from the socialist local councils into an efficient, prudent, and accountable management system adapted to an autonomous local government.

Budapest, as the biggest city, the strongest economic region (see chapter 20), and the most professional local government, plays a unique role in Hungary's municipal development. The positive experiences of the Budapest financial management reform have been used by secondary cities and could become a model for the largest cities in neighboring transition economies.

This chapter discusses the financial management reform of Budapest accomplished during the 1990s. This reform has been a gradual process. Reform steps had to be introduced and matched with inherited and new obligations to maintain the balance in fast-changing circumstances. After the overview of the tools and procedures of the reform process, I also summarize the cornerstones of the city's current financial strategy.

Financial Management in Transition

The first elected government of Budapest clearly knew that political independence, fiscal stability, and sound municipal finances reinforce each other and provide the basis for real sovereignty. It also was understood early that financial autonomy required increased own revenues; stability and sustainable financing required clearly defined tasks, competencies, and responsibilities; and planning, decision-making, and management processes had to be restructured to fit the responsibilities and exploit the opportunities of the autonomy.

* This chapter is based on Pallai 2000b.

Objectives and Tasks of the Financial Management Reform

The financial reforms had two strategic objectives: (a) to obtain a sustainable balanced budget to secure city operations and service delivery, and (b) to enhance creditworthiness to enable optimal and equitable financing of city development. To achieve these objectives, municipal functions and services had to be rationalized and user charges adjusted. Also, a task financing scheme and a multiyear planning and forecasting system had to be introduced, and borrowing and privatization had to be integrated into the management and financing strategy. These were carried out in parallel with the fiscal squeeze and steadily reduced intergovernmental transfers between 1990 and 2000. Budapest has a two-tier system of management, finance, and delivery of services. These tasks are divided between local governments of the 23 districts and the municipal government (see chapter 8). I focus on the issues at the municipal level.

For sustainability of the operation, the key transition challenges were to reconsider municipal functions and to rationalize and reorganize service delivery. With limited resources available, the city had to concentrate on what functions could be reinforced and what eliminated from the inherited group of tasks. Decisions on tasks had to be made in conformity with the conceptually desirable role of local government and predictable financial constraints. This rationalization consisted of change in the scale of services and functions, and privatization or concession arrangements for service delivery.

The long-term security of service delivery also necessitated: (a) an increase in own revenues to strengthen financial independence, and (b) establishment of a sustainable balanced budget through financial forecasting and multiyear planning. “Balanced budget” in this sense means one that prevents deficit and generates an operational surplus for renovations and new investments (for future security). A 20 percent surplus of operating revenues over operating expenditures was targeted to have a secure capital budget for capital expenses even after privatization revenues dried up.

The forecasting and planning system was crucial in creating a sound financial management and improving transparency and accountability. The sustainable task structure, the sustainable balanced budget, and the reorganization of financial management enhanced creditworthiness and allowed a shift to an active borrowing policy to facilitate future project financing.

The Process of the Financial Reform

We begin by summarizing how the reform was achieved in Budapest. A clear and consistent strategy and readiness for implementation were the driving forces of the changes in Budapest. At the same time, success required adequate timing and coalition building (see table 23.1). The vision and adaptability together could enable the municipality to achieve gradual reform in changing and often unfriendly circumstances.

Table 23.1 The Reform of Financial Management in Budapest, 1990–1998 and Beyond

| <i>1990–1994</i> | <i>1994–1998</i> | <i>1998 and beyond</i> |
|--|---|---|
| <i>Situation</i> | | |
| <ul style="list-style-type: none"> ▪ Fiscal pressure ▪ Fiscal uncertainty ▪ Biased relationship with central government | <ul style="list-style-type: none"> ▪ Macroeconomic problems ▪ Improving fiscal certainty ▪ Improving relationship with central government | <ul style="list-style-type: none"> ▪ Starting economic growth ▪ Public finance reform ▪ “Fend for yourself” |
| <i>Policy goals</i> | | |
| <ul style="list-style-type: none"> ▪ Maintenance of financial balance and operational capacity | <ul style="list-style-type: none"> ▪ Strategy for balanced budget and liquidity management | <ul style="list-style-type: none"> ▪ Sustainable financial management and balance |
| <i>Reform goals</i> | | |
| <ul style="list-style-type: none"> ▪ Renewal of decision processes and procedures | <ul style="list-style-type: none"> ▪ Strengthening fiscal independence ▪ Implementing of medium-term planning | <ul style="list-style-type: none"> ▪ Strategic development plan ▪ Reform the institutional structure and operation |
| <i>New tools</i> | | |
| <ul style="list-style-type: none"> ▪ New decision procedure for new projects ▪ A formula-based model for shared funds elaborated | <ul style="list-style-type: none"> ▪ Increase of own revenues (tax, user charge, and privatization) ▪ Forecasting model ▪ Four-year planning of capital budget ▪ Reform of operation elaborated and started | <ul style="list-style-type: none"> ▪ Rationalization of operation ▪ Task financing of operation ▪ Seven-year forecasting and planning ▪ Active borrowing policy |
| <i>Results</i> | | |
| <ul style="list-style-type: none"> ▪ Coexistence of old and new elements of financial management: ▪ Fight for regaining central revenues ▪ A formula-based model for shared funds ▪ A “base financing” of institutions ▪ New decision procedure | <ul style="list-style-type: none"> ▪ Operation surplus increase ▪ Better fiscal balance until the end of term ▪ Enhancing creditworthiness ▪ Bond issuance | <ul style="list-style-type: none"> ▪ System of sustainable financial balance ▪ Flexible optimal project financing ▪ Sound base for strategic planning |

Source: Pallai 2000.

Increased service revenues and lower expenditures were necessary to achieve a sustainable fiscal balance. In addition, various policies had to be integrated into a broader framework of urban management to increase competitiveness, improve quality of life, and secure long-term revenue flows for local public services (see chapters 10, 14, 20, and 22).

The chronology focuses on the strategically important steps and features listed by election periods (see table 23.1). The reform process can be best followed by the changing goals. In the three periods discussed, the municipality had three different targets. The first election term (1990–1994) targeted the first simple steps in reforming and consolidating local functions. The second election term (1994–1998) focused on the elaboration and initiation of major financial management reforms. By the end of the second election term and in the first years of the third one, a sustainable balance was achieved and a robust

economic growth started. The third government period and future development will be guided by an increasingly complex strategic development plans (see chapter 20).

Progress in the 1990–1994 Period

The start of the new local government system was very promising in 1990. First, municipalities received 100 percent of the personal income tax, some other central transfers, and virtually all local public assets to fulfill the wide range of tasks assigned to them.

One major weakness of the Hungarian system, however, could be seen in the early years. The intergovernmental finance rules and budget envelope were (and are) determined by the annual national budget; hence, central transfers could be significantly modified from one year to the other, but own-revenue capacity could be built up only slowly by the local governments. This weakness caused growing fiscal uncertainty. A profound tendency of the 1990s was that the central government passed on more and more service responsibilities while cutting transfers to local governments to decrease overall public expenditures and ease the pressure on the central budget. These processes together caused considerable fiscal pressure on localities.

During the first election term (1990–1994), the fiscal pressure was so high that the leadership of Budapest made great efforts to maintain its financial balance and operating capacity, and struggled to regain at least part of the resources withdrawn by the central government (see box 23.1). At the same time, elaboration of a strategy to reform fiscal and operational management started. As a result, new elements were introduced into the system, which for the time-being coexisted with the surviving old elements and practices.

Financing operating tasks remained within the framework of the traditional base-line financing system, because a new task financing system was premature. Capital budgets were accepted only for a given year and projects could be approved at any time of the year, as in the old system. From 1993 on, as a first step toward stricter budget constraints, the consequences of new projects on the capital budget for following years were also calculated and adjusted to total financing projections. The decision rules were also made a bit more transparent and accountable. These first improvements of financial planning were effective on the capital side of the budget, but could not adequately handle the operational consequences.

Box 23.1 Electoral Cycles Matter

In Budapest the situation was further aggravated by the fact that, in the first and third electoral periods, the city leadership belonged to the opposition parties of the Parliament. This split caused various tensions between the city and the central government. Beyond general fiscal restrictions in intergovernmental transfers, Budapest was not preferred in central investment grants in two electoral periods. As a result central government transfers in the Budapest budget dropped from 71 percent of the total revenues in 1990 to 57 percent in 1994 and to 27 percent in 2000. Because own revenues could not increase enough to counterbalance the missing transfers, the real value of total revenues decreased, while local tasks increased.

Progress in the 1994–1998 Period

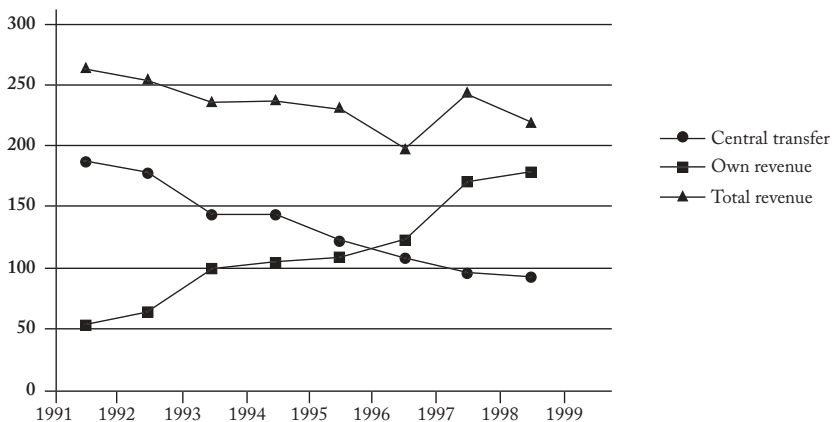
During the second election period (1994–1998), there was good and bad news for Budapest. The country faced serious macroeconomic stress, but intergovernmental relations improved and became more predictable, which significantly helped the enactment of reforms in Budapest. The strategy changed from survival to development. Important reform steps became effective, and the goals to obtain a balanced budget and introduce liquidity management became achievable.

Analysts knew from the beginning that the central government had serious fiscal problems and that Budapest had a structural deficit as well (Ebel and Simon 1995). In this situation the key element of the city's strategy was to increase own revenues and target real fiscal autonomy by increasing local taxes, charges, and capital revenues instead of a fruitless fight for regaining the earlier central transfers.

Firm reform steps became plausible and unavoidable in 1995 when a large amount (Ft 8.5 billion) of central grant funding was pending for months. This short instability helped the city's financial leadership gain broad political acceptance for the first privatization, dynamic revenue raising, and introduction of a seriously restrictive expenditure policy foreseen in the new financial strategy.

Local taxes increased from Ft 9.9 billion to Ft 29.4 billion from 1995 to 1998, and other own revenues increased dynamically (see figure 23.1). The privatization breakthrough was the sale of shareholding in three major public utility companies that in itself provided for US\$ 300 million municipal revenues. Further increase of own revenues was a crucial element of the institutional and fiscal restructuring strategy adopted in 1996.

Figure 23.1 Municipal Revenues, 1991–1998 (Ft billion in 1998 prices)



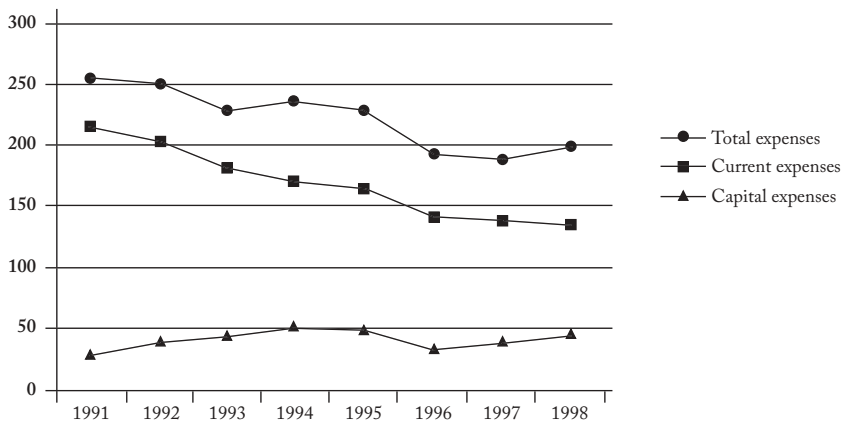
Source: Budapest Municipality data.

The cornerstones of the new financial strategy had to be defined by an analysis of tasks and resources. A seven-year financing projection model was developed for Budapest

with the assistance of the French Credit Local International Council, which allowed a multiyear plan to be established. In 1997 the municipality introduced a seven-year revenue forecasting and a four-year planning scheme (in 1999 a seven-year planning of capital budgets was implemented).

The Credit Local model, besides helping establish multiyear planning, highlighted the need for structural changes. Projections of any set of plausible hypotheses in the model proved that, without important changes in service delivery, the structural deficit could not be eliminated except by an increase of own revenues and a decrease of operating expenditures (see figure 23.2).

Figure 23.2 Municipal expenditures, 1991–1998 (Ft billion in 1998 prices)



Source: Budapest Municipality data.

The financial projection model seemed to be a simple tool, but it became a decisive element in the political process. It helped many politicians who previously opposed financial reforms to capture the notion of the structural deficit. Hence, the model encouraged the emergence of common support for reform and willingness to accept its political costs.

The local government had to face the fact that the increase in current revenues and revenues from asset divestiture had serious limits. Under such circumstances, maintaining the operating expenses in real terms would result in a shortage of investment resources, and eventually even financing these operations would become impossible.

The strategy to decrease operating expenditures had three pillars: (a) developing concepts for each service sector to define core functions while setting up a strategy to get rid of superfluous functions whose expenses could not be covered in the long term, (b) reducing unit operating costs by introducing a task financing system, and (c) rationalizing the service institutions financed from asset revenues through a rationalization fund.

Because of this decrease the municipality could change the expenditure side of its budget considerably. In 1998 operating expenditures decreased from 85 percent to 47 percent and capital expenditures increased from 13 percent to 24 percent. The rest of the budget (that is, the remaining 29 percent in 1998) was earmarked for debt service, financial investments, and reserves.

Targets and Progress in 1998 and Beyond

It was clear at the beginning of the financial reform that these major changes would require several years. The capital budgeting reform was easy and complete, but only the first introductory steps were taken toward the operating budget reform. In the third election term, the shift to task financing of operations was targeted. In 1999 and 2000, besides the traditional operating budget, so-called shadow budgets based on the new task financing scheme were also prepared, to be ready for exclusive use after necessary refinements. The extended budget reform aimed to establish a predictable and transparent fiscal planning system, to build creditworthiness, to create incentives for efficiency, and to discourage institutional slacking.

Enhanced creditworthiness was a precondition to the shift to an active borrowing policy, to enter the capital market as a fully autonomous entity, and to be able to build a loan portfolio in which financing risk is dispersed. To adopt an active borrowing policy, the municipality had to increase its financial reserves to be equivalent to at least one year's debt service obligations. After positive experiences with European Bank for Reconstruction and Development and International Bank for Reconstruction and Development transport loans, the municipality issued debt for German Mark 150 million on the international bond market.

Financing infrastructure investments partly from borrowing ensured that the amount of annual investment outlays remained roughly equal. Had this practice not been pursued by the city, investments would have been implemented with delays, on the one hand, and great fluctuations would have characterized development activities, on the other.

The strategy of prudent financial management became a key objective of this period. Every autumn, when the concept for the next year's budget is prepared, a seven-year forecasting model is updated. Based on the financial forecast and analysis, the targeted annual proportions of the operating and capital budgets are set. The operating surplus is a crucial element of budgeting. Each year planners make an effort to obtain or approach a 20 percent surplus, even if current expenditures ought to be decreased for the sake of long-term sustainability. The most heated debates among the members of the local government are often around this issue from November, when the concept for the budget is accepted, until March, when the budget of the actual year is approved.

In the yearly budget debate, the financial management fights for the operating surplus (that is, to peg operating expenditures to operating revenues). This approach resists the short-term political temptation to avoid cutting expenses and increasing own revenues

to enable continuing capital investments and strategic development. For the advocates of the operational needs concept, the operational surplus is a big target, because a 20 percent surplus seems to be an arbitrary number for the arguments to improve services instead. Until 2000 the financial leadership proved to be strong enough to accept the short-term political costs of restrictions, and after serious conflicts in the leading coalition, the proposed financial strategy was kept. Thus, the operating and capital expenditure items defined on the basis of the pre-set proportions of the budget, the multiyear planning of capital budgets, and financial reserves for active borrowing policy are maintained.

The key reform achievement is that even after two years of serious decrease in intergovernmental transfers, the budget figures of the municipality demonstrate financial health and balance in 2000 (see table 23.2). Debt service is fairly low and the proportions of expenditures are good: 47 percent operating expenses and 42 percent capital expenditures.

Table 23.2 Major Budget Figures, 2000

| <i>Revenues</i> | <i>Ft billion</i> | <i>%</i> | <i>Expenditures</i> | <i>Ft billion</i> | <i>%</i> |
|---|-----------------------|--------------|--------------------------------|-----------------------|--------------|
| Central transfers | 75.2 | 27.3 | Operating expenses | 125.4 | 45.5 |
| For operations | 69.2 | 25.1 | Investments, transfer of funds | 61.8 | 22.4 |
| Capital | 6.0 | 2.2 | Cost of refurbishment | 9.0 | 3.3 |
| Own revenues in the reporting year | 112.9 | 40.9 | Debt service | 2.4 | 0.9 |
| Current revenues | 88.4 | 32.0 | Government securities bought | 36.0 | 13.1 |
| Accumulation and capital-type revenues | 24.5 | 8.8 | Maturity within one year | 18.5 | 6.7 |
| Residual funds | 0.1 | 0.1 | Maturing over one year | 17.5 | 6.3 |
| Redemption of government securities purchased in preceding years | 68.5 | 24.8 | Specified reserves | 39.0 | 14.2 |
| Maturity within one year | 43.4 | 15.7 | For operations | 2.4 | 0.8 |
| Maturing over one year (municipality) | 25.1 | 9.1 | For accumulations | 36.2 | 13.1 |
| Loans | 18.8 | 6.8 | For refurbishment | 0.5 | 0.2 |
| | | | For local minority governments | 0.0 | 0.0 |
| | | | General reserve | 1.7 | 0.6 |
| Grand total of revenues and loans | 275.5 | 100.0 | Total expenses | 275.5 | 100.0 |

Note: Differences in totals one caused by rounding.

Source: Budapest Municipality data.

Tools and Procedures in Financial Reform

This section summarizes the key instruments and procedures applied in the 10-year reform program in Budapest, namely, the Rationalization Fund, the task financing procedure, the major privatization actions, the new borrowing policy, and the change in user charges.

Rationalization Fund

The Rationalization Fund was set up in the 1997 municipal budget to facilitate the institutional restructuring process by providing resources for one-time investments aimed at cost saving and increased efficiency in local budgetary institutions. The underlying considerations were that: (a) an institution often did not have resources for a large one-time investment or for compensation needed to realize continuous cost savings later, and (b) because of information asymmetry the management of the institutions had to be motivated to explore and disclose possibilities for reducing operating expenditures and cooperating with the financial department in the cost-saving process.

All local budgetary institutions can bid for resources from the Rationalization Fund by submitting calculations on cost savings achievable by a rationalization investment. The calculations are not revised, but the annual cost savings presented are automatically deducted from the operational budget envelope of the institution. This rule encourages accountable decisions. The financial department sets the financial conditions, the rules, and the amount of resources to fill up the fund each year. The sectoral departments of the local government make the actual decisions on the bids, keeping the given financial framework and using their professional standards.

This fund, on the one hand, avoids long debates on small refurbishing and rationalizing interventions with relatively small amounts. On the other hand, it has broken the old routine of lobbying for capital investments without considerations of operational cost consequences. The directors of institutions now must take responsibility for cost savings. The fund secures positive steps toward more efficient institutions and optimally allocates decision-making roles. The needs assessment is made by the institution, the financial conditions are defined by the financial leadership, and professional priorities are set and decisions are made by sector departments and professional committees. The merit of the fund has gained wide acceptance and resulted in increasing resources.

Task Financing

The base-line financing method in budgetary institutions was a heritage in Hungary and in Budapest alike. This method means, first, that the institution rather than the delivered task is financed. Second, the actual expenditures of the base year are the basis of the budget plan of the following year, and line items are increased or decreased in accordance with various benchmarks, such as inflation or overall change in resources, or are changed without any normative arguments. This old and simple method can result in serious disparities across institutions because it gives no information about the financing level of each activity, efficiency, and possible cost reductions or obstacles to reducing costs without risking service delivery.

To reduce municipal operating expenditures as targeted in the financial strategy, reformers had to introduce a more effective and transparent system of financing service

delivery. Resources had to be scaled to tasks rather than financial positions gained over years. Hence, the most complicated systemic change was the shift to zero-based task financing in the whole financial management reform.

The task-financing program started in 1997, when a comprehensive assessment of budgetary institutions and task performance was prepared. The primary items of every account were recorded at least throughout one year to measure the attainment of material expenditures. On the basis of these data, the legal framework of a normative task financing was prepared and normatives were set. Soon after, the preparation of a zero-based budget proposal started, linked to benchmarks and task normatives. In the first phase new labor and material expenditure plans were calculated for each institution.

Planners realized at the beginning that an all-embracing change to zero-based budgeting required at least three to four years. In the first, experimental years (1998–2000), so-called shadow budgets were prepared beside the traditional type budgets, which remained in use. On the basis of an assessment of the results of the two budgeting schemes, the benchmarks and the normatives of the zero-based budget would be refined before shifting the system to the exclusive use of the task-financing scheme.

After the system's introduction, the municipality annually updates the normatives and benchmarks if necessary and sets financing (current transfer) conditions accordingly. The receiving institution, however, then has freedom in the actual use of resources received (that is, reallocation of funds between tasks performed).

Privatization

The basic principles of privatization are service security and the involvement of professional investors with adequate financial strength and operating experiences. The privatization concept considered a very large circle of companies, set guidelines and procedures, but left room for exclusive decisions (Municipality of Budapest 1994). By 1996 all of the service enterprises were transformed into commercial companies to prepare them for privatization. Of the 15 public utility companies, eight essentially were natural monopolies, and seven worked in a competitive market prior to the privatization. Four companies retained their natural monopoly after privatization. The privatization decisions and other regulations will determine the market position of the other companies.

Privatization of the Three Big Utility Companies

The most important transactions in Budapest have been the privatization of the Gas Supply Company, the Waterworks, and Wastewater Works. The privatization of the three major utility companies has three common features. First, each of them was tendered in a two-round open international competitive bidding process. Second, the municipality retained its majority ownership stake in each company. Third, privatization involved the companies' core assets (physical network and structures) to maintain the unity of the assets and operation.

An exception will be the new sewage treatment facilities, which will remain in 100 percent municipal ownership because they were financed from earmarked state grants (see chapters 4 and 7). The privatized company, on the basis of a lease or an operation agreement, will also operate these new components of the municipal infrastructure (see table 23.3).

Table 23.3 Privatization of Utilities

| <i>Parameter</i> | <i>Gasworks</i> | <i>Waterworks</i> | <i>Wastewater works</i> |
|----------------------------|--|---|---|
| Conditions to be fulfilled | Operation and maintenance | Operation and maintenance, plus reconstruction | Operation, maintenance, reconstruction, and development |
| Market position | Monopoly | Monopoly | Monopoly |
| User charge set by | Central government | Municipality | Municipality |
| User charge formula | None | Cash-flow basis | Cash-flow basis |
| Subsidy | None | None | Development subsidies |
| Privatization method | 50% in preference shares plus dominant management rights | 27% of voting shares, dominant management rights, and responsibility of operation | 25% of priority shares, dominant management rights, and responsibility of operation |
| Privatization revenue | Ft 13.5 billion (1995) Ft 4.3 billion (1997) Combined US\$ 142 million | Ft 16.5 billion (1997) US\$ 88 million | Ft 16.9 billion (1997) US\$ 90 million |
| Period of contract | Indefinite | 25 years | 25 years |
| Investors' benefit | Dividend | Management fee | Dividend priority |
| Local government benefit | Dividend | Cost savings | Dividend earnings |

Source: Budapest Municipality data.

Besides similarities, the differences between the utility companies justified the application of different privatization models. The Gas Company was essentially in good condition at the time of privatization, so investors were called to submit two bids each, one for majority and one for minority ownership. The decision by which a minority shareholding was sold with majority management rights was essentially political. A professional investor (VeW Ruhrgas consortium) was awarded the contract, which assured the enhancement of the company's efficiency. Privatization, nonetheless, should be regarded as a financial investment, but the market price of the shares sold depends on the gas price. Because the gas price is regulated by the central government, the Budapest local government could not offer a rate-of-return guarantee to the investor. The investor receives dividends only if this company is profitable under these conditions.

Although divestiture to a minority municipal ownership is still not on the agenda, it is in principle an alternative. For this reason, the local government changed the statute of the company prior to privatization and created a so-called "golden share." The latter will be retained even if virtually all the shares are sold, because the golden share assures

key ownership rights (for example, vote against closure, spin-off, merger, change in the company's core activities or capital).

The waterworks had a current and a forecasted future deficit at the time of its privatization. Therefore, the investor was not interested in acquiring a majority ownership stake, but sought another way of earning its profit. The investor (Suez Lyonnaise des Eaux and RWE-Acqua GmbH consortium) acquired 27 percent of voting shares and a 25-year concession to be the operator of the company under a management fee agreement. The investor was able to obtain its profit from 75 percent of the cost saved. Cost savings are calculated on the basis of the 1996 costs according to a formula set in the contract.

Privatization of the wastewater works likewise did not ensure adequate return on the shares acquired. This company was profitable enough to enable reinvestment for needed development. Therefore, the profit on investor's return on equity was projected to remain very low for years. As a result, the investor (CGE/Berliner Wasserbetriebe) received a priority dividend right. This means that all profits up to 18 percent of the face value of the shares purchased must be paid exclusively to the investor, and additional dividends, if any, can be made only above this amount in proportion to the share ownership.

The Privatization Benefits for the Municipality

In the privatization contracts of the utility companies, the municipality remained responsible for control, monitoring, and regulation of service delivery in accordance with the Act on Local Government. The city also retained its ownership rights. Ownership rights are exercised through delegated members on the board of directors, on the supervisory boards, and at the companies' general assembly.

Between 1995 and 1997 privatization revenues amounted to nearly US\$ 320 million, which represented on average 7 to 20 percent of municipal annual revenues. Since 1990 the municipality has used amortization and capital revenues strictly for capital expenditures. Although privatization revenues constitute one-time resources, their availability was a cardinal element of infrastructure development. They played a crucial role in Budapest, because central transfers were seriously decreasing in a period when the fast reconstruction of the degraded and underdeveloped infrastructure was a major strategic task of the city.

Because the municipality is not only the owner and user but also the price authority, a trade-off occurred between the one-time revenue from the share price and the water and wastewater charge efficiency. The long-term price policy received higher priority than the revenue goal in Budapest. Besides these considerations, the distinction between the share ownership and the management rights sought to enhance efficiency. The strategic investors received proportionately higher management rights than their share ownership, because a rational private-like management was assumed to increase operational efficiency.

In both cases, a complicated cash-flow-type price formula was introduced to secure incentives for short- and long-term investments alike. Looking at the past three to four years of the Budapest privatization, we can see that although the gas and wastewater

privatization have been rather successful, calculation and contractual problems are causing continuing conflicts between the ownership partners of the waterworks.

In Budapest the joint sale of assets and management rights to strategic investors was not only a revenue source for the local government, but also meant a strong commitment for the restructuring of the entities and creation of market conforming efficient companies. In transition, especially, the symbolic content of these changes has also particular importance.

Borrowing Policy

Because the infrastructure investments could not be exclusively financed from capital revenues and operating surplus, external resources have also been used since the early 1990s. For timely financing of long-term development projects, the local government aimed at establishing a loan portfolio in which financing risk could be spread.

The local government borrowing strategy has been based on conservative assessment of resources, selection of quality partners, the use of negative pledge, and creation of a continuously optimized and versatile loan portfolio. The one-time capital revenues were used to upgrade assets and enhance operations, leading to improved budget figures and creditworthiness, and gradually to improvement in the borrowing position. This transition first enabled a shift from domestic to international markets, and then from money to bond and equity markets.

Until 1996 the municipality borrowed from two sources: domestic bank loans and local currency denominated loans from the international financing institutions. In 1996–1997 the city was able to enter the international money market because it had a small debt portfolio and a relatively large investment portfolio, at a time when investments required sound financing, privatization progress was good, and foreign confidence in the country was increasing.

The decision for the first bond issue was in the Eurobond market, targeting personal investors. Because the city could not get a higher rating than the country, and the Eurobond issuance of the Hungarian National Bank had only a slightly lower interest rate than the city was projected to obtain, a decision was made to issue a bond without rating (see box 23.2).

In 1996 the municipality conducted a two-round tender to select the lead manager of a bond issuance, which was postponed because of the change of taxation rules. Following the amendment of the tax rules in 1998, the decision was made to launch the bond issue. Meanwhile, the rating of Hungary had improved from the speculative to the investment category (Moody's Baa2), and the city's financial status had also strengthened. In the absence of a rating, the local government compiled an Information Memorandum, and the issuance took place in Frankfurt with the Deutsche Genossenschaftsbank as lead manager in July 1998.

Box 23.2 Terms of the Budapest Municipal General Obligation Bond 1998

| | |
|------------------|----------------------------|
| Issuer: | Municipality of Budapest |
| Amount: | German Mark 150 million |
| Type: | Fixed rate |
| Maturity: | Five years |
| Amortization: | None, bullet payment |
| Interest rate: | 4.75 percent |
| Issue price: | 101.55 percent |
| Status: | Direct, unconditional |
| Security: | Unsecured |
| Rating: | None |
| Negative pledge: | Yes |
| Purpose: | General funding |
| Use of proceeds: | Infrastructure development |
| Performance: | Punctual |

Source: Budapest Municipality data.

The trading price of the bond was 99.35 percent and its offer price 101.55 percent. The interest rate of the bond was 4.75 percent fixed rate, which represented a 57 basis point risk premium over the yield of the reference German government bond. On LIBOR, a 35 basis point premium was obtained. A bond issuance of the Hungarian National Bank obtained a 33 basis point risk premium over LIBOR in February 1998, so the market assessed the risk of the municipal bond very similar to the country risk. Institutional investors subscribed 80 percent and personal investors 20 percent of the bond, mainly on the German and Austrian money market.

User Charges

During the socialist period, a clear supply-side planning approach, with its all-consequent weaknesses in developing utilities, resulted in inefficient networks, huge subsidies, and financial losses. Utility charges remained still symbolic in the early 1990s. The gradual increase of charges modified consumption patterns, enabled nearly full cost recovery, and furnished the conditions for improving service delivery. This change made separating the service delivery and social assistance functions of the municipality possible.

For instance, the inherited symbolic charge for waste containers was replaced by a volumetric charge for household waste in Budapest in 1996. The inflexibility of this charge scheme was strongly criticized in the few months following its introduction. Later, as the users got familiar with the new system, some 20 percent of containers were returned, and both the collected volume and charges reached a balanced level in the course of one year. The major fear before the introduction was that illegal dumping would increase, but similarly to other countries' experiences, no evidence to this effect was found. Since 1997, because of the charging policy, only the development expenses of waste management were debited from the budget of the municipality.

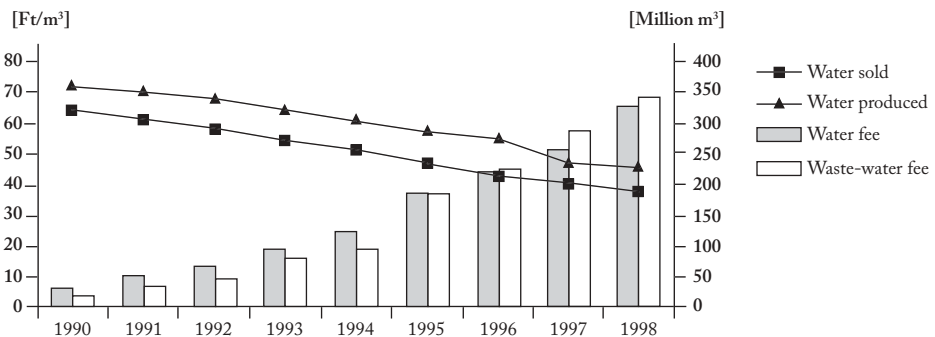
In the field of water services, the socialist heritage was a relatively well-developed, but with a poorly maintained network of both water supply (with 97.5 percent coverage) and sewage collection network (with 90.2 percent coverage). The rate of wastewater treatment, however, was very low (25 percent in 1999). At the same time, as a result of symbolic prices, water consumption well surpassed western European standards.

The gradual increase of user charges decreased consumption to 140 liters per day per household, about the European Union average, and allowed nearly full cost recovery. Charges became a tool to improve efficiency and conformity with the market and made privatization possible. In the wastewater system, some investment subsidy is still needed. The wastewater figures, however, cannot be used as comparative data, because they contain only the costs of the existing 28 percent capacity in full treatment.

The pricing system has further changed with the privatization. Water charges now consist of two parts: a connection fee and a use charge that covers an access fee and a water price, both calculated on a volumetric basis. The volumetric charge is based on average accounted costs determined by a cash-flow-based formula that is set in the privatization contract. Before the privatization, the charge was decided yearly by the municipal assembly on the basis of direct accounting cost estimates prepared by the companies.

Though the pricing is based on an average cost rather than marginal cost type charge, it still affected users' behavior (figure 23.3.) The present system provides for adequate information about the demand, which helps in introducing further rationalization steps in service delivery. The city plan for wastewater treatment capacity development was 1.5 million cubic meters in 1993; it was cut back to 600,000 cubic meters per year in 1999, and the process of adjustment of plans to demand continues. This adjustment provides huge savings on development costs for wastewater services and operating costs both on water and wastewater services.

Figure 23.3 Changes in Charges and Amount of Water and Wastewater, 1990–1998



Source: Budapest Municipality data.

Conclusions

The case of Budapest clearly demonstrates that a successful reform requires not only a clear and consistent vision, but also adequate external and internal conditions for implementation. The strong strategy and adequate timing of the introduction of the reform elements are equally important. A decisive issue is to recognize when the system is mature enough for the implementation of more sophisticated tools, and to see whether the political arena is suitable for building a supportive coalition for the reforms.

The stability and transparency of the financial management made the local government a reliable partner for banks, investors, and other private partners. The financial management reform of Budapest has been used as a model in other Hungarian municipalities. It is widely cited and used as a best-practice case in training of municipal staff in transition countries.

The recent recentralizing fiscal strategy of the central government that endangers the emerging prudent local financial management also influences the development agenda in Budapest. One of the most important achievements of the Hungarian transition, the existence of a multilayer public sector with strong and independent local governments, is jeopardized for the sake of a power concentration that historically has been proven ineffective.

For the time-being, the financial system of Budapest could keep its balance with further reduction of operational expenses. Most local governments, however, must seriously restrict their development programs to prevent financial difficulties. Still, the situation calls for the reconsideration of the entire system of intergovernmental transfers (see chapters 2, 6, and 9). The overall amount of transfers to the municipal sector that was subject of annual changes over the 1990s ought to be pegged to macroeconomic indicators (for example, gross domestic product or the national budget) to maintain present achievements and support further local improvements. “To date the Hungarian transition has been not only gradual and systematic, but also bold and creative. There is no doubt that this will continue” (Ebel, Várfalvi, and Varga 1998: 444).

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Municipal Budget Reform in Szentes

Ritu Nayar-Stone and Andrea Tönkö

The typical municipal budget inherited from the central planning era was a list of line-item revenues and expenditures prepared for accounting rather than for real decision-making purposes, and it was traditionally not shared with the local citizens. The local government of Szentes—a mid-sized city with a population of 33,000—introduced a new slogan in 1997: “Anyone who needs information about the city can obtain it from the budget.” The residents and council members of Szentes can look at the budget and know much more about how the city works today than they could in 1996. The process of achieving this objective was difficult. The local government finance officers and department heads had to enhance their skills to improve budgeting and financial management. The increased workload and the need to keep staff motivated were more than they had anticipated, but the results—faster and more informed decision-making and a smoother budget approval process—are extremely rewarding.

This chapter analyzes the successes and difficulties experienced by Szentes officials as they reformed the budget. The process and the lessons learned could be valuable for other cities motivated to bring about budget reform.

Departure from the Traditional Budgeting

Before 1997 the Szentes budget was traditional and included no information beyond what was required by central regulations. The main document consisted of a proposal for the next year’s budget, as well as a municipal decree on adopting and implementing the budget proposal.

* This chapter is based on Stone and Tönkö 1999.

The narrative part of the decree set forth the rules of the central budget law that regulated local governments, instituted the impact of central regulations on municipal financial management, and set up local measures accordingly. For example, the 1996 document stated that funds from the central budget had decreased, which necessitated raising more local funds and implementing some austerity measures. The primary objective was to generate sufficient funds to cover operating expenditures without borrowing. The 1996 budget also outlined the measures to be taken during the year to achieve that objective.

The traditional document was essentially a line-item budget, which had no details on service accomplishments and program results and did not facilitate objective decision-making in the city council. Nor did it explain to residents the local government's policies or use of revenues.

Need for Changes

The city had been struggling with very high expenditures for years, and neither the departments nor the institutions of the local government knew the exact amount of expenditures or savings on specific services. A decrease in financial revenues had led to an increasing need for a more transparent budget document.

Leaders of the financial department felt that a completely restructured budget document was required to make informed decisions about discontinuing or decreasing municipal activities without affecting service levels. The new document would need to provide information on any duplicate services and related expenditures, so that decisions could be made based on data rather than subjective policies.

Initiating Program Budgeting

The U.S. Agency for International Development program provided technical assistance, including training and resource materials in program budgeting and financial management (see box 24.1). The Szentes municipality committed the staff time necessary to undertake the reforms and identified the priority area in which to initiate program budgeting. For the 1997 budget, city officials targeted communal services as a relatively small but suitable sector for experimental program budgeting. Two subprograms were identified: (a) park and green area maintenance, and (b) public area sanitation. The heads of the finance department and of communal services attended the training seminars. The latter stated that after attending the first day of the two-day seminar, he did not want to continue. As a person whose job was technical, he did not see the need to understand financial matters. The training, however, revealed that even though the budget was a financial document, its preparation involved technical elements and his participation and training were crucial to reform. Moreover, he began to see that a program budget could be a powerful tool to acquaint the committee members and the public with his sector and help them recognize its value.

Box 24.1 Program Budget Training Series

In July 1996 Szentes began to participate in a three-year program initiated by the U.S. Agency for International Development in Hungary (1996–1999) titled “Modernizing Financial Management for Hungarian Local Governments.” The program is comprised of six one- or two-day training seminars following the local governments annual budget cycle (January–December), with training in developing a program budget along with other financial management skills, such as forecasting techniques, fiscal indicators, revenue alternatives, performance measurement, and capital budgeting. The training material also covers other categories, such as citizen participation in governance, the budget process and calendar, implementing and monitoring the budget, and budgeting and accounting.

Program Budgeting

A program budget focuses on the expected results of services performed by the government rather than on what a municipality buys (for example, human services or commodities). Goals and objectives are stated for each service category and subcategory in specific quantifiable terms. The program budget identifies what activity is proposed, what effect it will have on the public, and the estimated costs of the resources needed to accomplish the objectives for each program.

A program budget cannot be initiated without sufficient political support and guidance from the mayor, the finance director, and budget committee of the local government. In Szentes, the champions of program budgeting were the mayor and the head of the finance department. They initiated the reform process as follows:

- Council members were first informed about the proposed budget reform in the required semiannual report in June 1996. They requested a work plan prior to adopting program budgeting.
- The needed reform in the park maintenance and green area program was outlined, and a work plan was developed. The 1996 work plan for the 1997 budget was quite preliminary and remained a theoretical rather than practical tool. In retrospect, it served more as a draft for the 1997 work plan, which was strictly followed.
- Internal meetings were held among council members and the budget and line department staffs to inform everyone about the reform and concepts of program budgeting.
- The local council decided to adopt program budgeting in the communal sector in the August 1996 session.

By the time the budget concept was discussed in February 1997, each council member understood the changes that had been made in the structure and content of the budget, and practically all of them supported those changes.

After adopting the 1997 budget, the city decided to expand the program budget to include the entire social sector (see box 24.2). The finance department submitted a detailed work plan to the city council in May 1997, and it was unanimously supported and approved. The work plan specified the following actions:

- A complete review of the social sector by the August session of the council, so decisions regarding restructuring (if necessary) and changing the sector could be implemented in time for the 1998 budget
- A description of the phases of budget reform, including the various steps, deadlines, and names of persons responsible for specific tasks.

Box 24.2 Development of the Program Budget in Szentes

| | |
|------|--|
| 1997 | Program budget for communal sector (two subprograms) |
| 1998 | Program budget for the entire communal sector (three subprograms) Program budget for the entire social sector (three subprograms) |
| 1999 | Program budget for all sectors, all programs <ul style="list-style-type: none"> ▪ Communal sector ▪ Social sector ▪ Education sector ▪ Other sectors (culture, library, sport, tourism) Separate operating and capital budgets |

The concept approved in November 1997 listed all the social sector subprograms to be included in the 1998 program budget. The city also decided to add bridge and road maintenance as another subprogram of communal services to the 1998 program budget.

The social sector includes 23 mandatory activities specified by central regulation. Szentes grouped them into three subprograms of social activities: (a) subsidized by the central government, (b) subsidized directly to the service provider, and (c) providing personal care directly to the citizens.

In addition to the main budget, a separate budget and volume of indicators document was also developed for all city institutions. This document consisted of two sections: (a) tables with fiscal and performance indicators from 1995 through 1998, and (b) tables with all line items of revenues and expenditures from 1996 through 1998. Input, output, and efficiency performance indicators were included, but no outcome indicators were calculated.

For 1999 the city developed a program budget for all its sectors: communal, social, education, and other activities. The education sector includes five kindergartens, six primary schools, six secondary schools, one dormitory for the primary school, and one dormitory

for the secondary school. The “other” sector comprises administration and management, fire protection, public culture, sport, tourism, and civil defense. In addition, a separate capital and operating budget was prepared.

Budget Reform in Szentes

The process of budget reform takes several years. Szentes started program budgeting in one sector in 1997 and has slowly expanded to additional sectors. The actual process of budget reform involves: (a) evaluation of community needs, (b) organization of the budget process, and (c) decision-making. These require an in-depth analysis of each sector in a joint and sustained effort by the financial department and all the institutions involved.

Evaluation of Community Needs

The communal and social sectors that have completed a program budget first undertook a detailed SWOT (strengths, weaknesses, opportunities, and threats) analysis. The SWOT analysis, which was specified under phase two of the Szentes work plan, led to the development of program alternatives, detailed knowledge of current service levels, identification of future needs, and options on how to achieve them.

The budget is a reflection of how citizens’ money is being spent; therefore, it should involve greater public participation. This participation promotes citizen understanding of local government and vice versa, builds relationships and trust, and ultimately leads to better and longer lasting decisions. The head of the Szentes finance department said that the weakest point in the budgeting process is the lack of the public’s direct involvement in articulating its needs and demands to the government. The city is aware of this shortcoming and has tried to increase direct contact with the citizens. In 1999 the city conducted its first citywide multiservice household survey and prepared a questionnaire to investigate the need and opinion of parents regarding kindergartens.

Currently, information about community demands and needs is obtained indirectly from city council members, who learn about the needs or complaints of the citizens at a public forum or when they receive citizens in their offices. The city council member then informs the appropriate government agency and tries to help solve the problem in a fairly informal way or formally states the citizens’ concerns at a city council meeting. The staff of the municipal unit concerned must then respond to the complaint and state if the problem can be solved or financed from the current budget. Since 1994, the mayor has had “open day” once a month to hear the grievances and complaints of residents. The head of the finance department also has monthly meetings with institution heads who give progress reports on their current work and future plans.

Public complaints and demands are identified in two ways: (a) at public forums and city council forums and during office hours, or (b) from letters addressed to and processed

by the finance department. The department estimates a cost associated with addressing each of the problems and includes them in the budget policy document under the title “Public Demands.” If people want to influence budget decisions on important issues (usually major investments), they can participate at the local government’s discussion of the budget.

Organization of the Budget Process

To organize the budget process and make the budget document more friendly for citizens, the head of the finance department prepared a form for the 1997 budget that had to be completed by each institution. The form requested information about revenues and expenditures, number of staff, and salary scales. Detailed work plans were also prepared by the sector developing a program budget.

The additional data requirements for a program budget necessitate greater cooperation between the financial department and the sectors. According to the head of the finance department, stressing to all department heads that a program budget will allow better articulation of their needs and make clear the consequences of their inadequate funding to the city council and citizens is important.

The budget process can be made smoother by: (a) preparing a budget calendar and a work plan, (b) improving cooperation among departments, and (c) adhering strictly to realistic deadlines.

The social sector is relatively large and has more staff than others. Cooperation between the social policy group and the finance department has been more difficult because the former is overburdened. For example, the head of the finance department had to develop independently a list of demographic and other indicators for the social sector to measure efficiency and effectiveness. The head of the social policy group later created a short list of the indicators. During the process of preparing the budget, both of them realized their interdependence and need for cooperation. Their work together was successful not only because they eventually achieved the program budget, but also because their attitudes and way of thinking changed. The strategic goals for the 1997 work plan were formulated jointly by the finance department and the head of the social policy group.

The heads of different social institutions were involved in developing the subprograms. Institution heads also played a major role in collecting such data as the number of clients of various services, mapping the current situation, evaluating collected information, and prioritizing the different services.

Dialogue between the heads of the communal and social sectors was limited. They both stated that their sectors were so different that discussions on program budgeting techniques were unnecessary. Because the communal sector was the pilot group for program budgeting, however, lessons learned could have made program budgeting in the social sector easier (for example, obtaining additional information from the staff and motivating them; developing indicators, charts, and graphs).

Decision-making

As a result of the budgetary reform, the decision-making process has undergone changes in considering alternatives to achieve a particular goal. Being a small sector, communal services did not offer many opportunities. In the 1997 budget, two alternatives were proposed to achieve each subprogram's goal. For park maintenance and green area management, the alternatives were to increase the grass area under city maintenance by 10 or 20 percent. For the public sanitation subprogram, the alternatives proposed to increase the surface area of the roads to be cleaned by two different percentages.

The sector analysis and detailed information generated in the budget reform process also benefited decision-making in the subprograms. Planners decided to expand the area of park maintenance and to create a five-year plan for park maintenance, beginning with 1997 (this was eventually approved by the city council). The same was done for public sanitation, and a detailed list of regularly cleaned streets was prepared and reported in the budget for the first time. Thus, citizens interested in the functioning of government became better informed, and now they complain if streets are not cleaned on time.

Because bridge and road maintenance was also included as a program budget in the 1998 city budget, planners prepared a detailed list of work to be done in square meters (for example, maintenance and repair of potholes, curbs, unpaved streets, pavements, and bridges). They also specified the amount of money to be allocated to each of these areas. According to the head of the communal sector, other cities, such as Eger and Gödöllő, maintain similar detailed information for this sector. In 1997, however, the other cities were not aware that this information is used and can be crucial in program budgeting.

The welfare sector includes several highly diverse services. Central regulations are numerous, so the municipality's flexibility is limited. Despite these constraints, three alternatives for improving the welfare provision system were suggested after sector analysis was completed in August 1997.

All the committee members interviewed for this report stated that decision-making in both communal and welfare services were based on a clearer understanding of the program. The impact of restructuring the sector and any changes in resource allocation on service delivery was clearer after 1997.

The Budget Document

The transfer of more central government functions and responsibilities has challenged local governments to maximize resources and improve managerial productivity and accountability. Information on local government policies, operations, programs, and expenditures is demanded by policymakers and citizens—and by the investment and business communities. In this environment, a community's budget document can serve as a policy statement, financial plan, operations guide, and communications tool.

The Budget as a Policy Statement

The budget can be considered to be a single policy document that articulates the government's fiscal and program policies and explains their rationale. Because budget decisions and estimates are based on certain assumptions, these assumptions should also be disclosed in the budget. The budget should guide the activities of people who are budgeting. All local governments face practically the same constraint of financial resources that are insufficient to satisfy competing needs of the community. Managers must, therefore, identify the current and future community environment; define needs; establish goals, priorities, and strategies to meet the needs; and wisely allocate limited resources.

The policy overview of the budget usually includes the following items:

- A transmittal letter—Although not essential, the transmittal letter may summarize key budget decisions, serve as an extensive budget message with goals and priorities, and provide a description of fiscal and program strategies to address pressing issues and help the local government fulfill its mission.
- A time perspective—Long-term goals and short-term objectives are stated and clarified by past trends, current events, emerging issues, and future directions.
- Organization along major themes—Successful policy overviews are constructed around major themes that are action-oriented statements and guide budget development for the upcoming year (for example, “Make the City a Great Place to Live and Do Business”).
- Illustration with graphs and graphics.

Szentes' 1997 budget included several new elements, but substantial progress began only with the 1998 budget. Box 24.3 shows elements of the 1997 and 1998 budgets satisfying these criteria.

Box 24.3 The Szentes Budget as a Policy Statement

1997

- SWOT analysis for each subsector (two subprograms). This analysis identified each sector's current status and future direction.
- Use of graphs and figures to explain the working of some institutions.

1998

- Letter from the mayor stating the budget reform rationale and city's priorities.
- SWOT analysis for each sector (entire communal and social sectors) that identified their current status and future directions.
- Summary of working of the government—past and future—with graphs and tables.
- Increased use of figures and graphs throughout the document.

The city's major policy objective is to maintain its level of services (despite decreasing central government transfers and subsidies) and to develop the city as a venue for sport and

tourism. Even though these action-oriented statements guided the development of the city budget, these policies were not formally stated in the budget document. One must keep in mind, however, that the budget reflects government policies not only for the benefit of the citizens of the community, but also for other cities and possible investors. Thus, the city's major missions should be stated up front in the budget.

The Budget as a Financial Plan

The financial section of the budget should present summaries of revenues, expenditures, debt, and capital spending. In addition, it should have a consolidated summary of all the financing sources and uses, including revenues, transfers, debt proceeds, expenditures, as well as opening and closing balances.

Local budgets have traditionally served as financial documents, with a summary and detailed tables (see box 24.4). The 1997 and 1998 Szentes program budgets had the following additional financial information:

- Consolidated financial summaries of revenues and expenditures, as well as a summary of expenditures by institutions
- Description of major revenue sources and discussion of significant revenue trends and underlying assumptions for revenue estimates
- Expenditure data and analysis by activities, which together give a better picture of the current working of the government because they show the amount of money received and spent in each sector
- List of major capital projects and their costs for the budget year, plus the estimated impact of capital projects on current and future operating budgets, all of which highlight financing needs and help prioritize activities
- Financial statements that have three or more years of information for trend analysis, which facilitates more accurate projections for future budgets
- Balance statement of expenditures and revenues
- Outstanding debts.

Box 24.4 The Budget as a Financial Plan

The budget should provide a comprehensive perspective of the government's financial condition over a set period. To develop a rough framework of financial constraints that will be faced in the budget year, the following issues should be examined and analyzed:

- Current revenue performance and preliminary estimates of revenues for the budget year
- Current expenses versus the budget and the prospects for surplus carryover into the budget year
- Trends in inflation and local economic conditions
- Prospects for new taxes and fees or changes in current tax and rates
- Major cost items that will fall due in the budget year.

The Budget as an Operations Guide

The budget should guide department managers, measure the departments' productivity, and outline operational and spending plans for agencies and programs. Each program should have detailed information on the agency's mission, staffing level, performance objectives and indicators, expenditure level, and financing sources, if possible. The budget operating detail (usually the longest part of the budget document) includes department or program goal statements, performance objectives and measurements, financial data, and staffing and organizational structure.

With the start of program budgeting in 1997, program goals were identified for both subprograms in the communal sector. The local government also prepared detailed revenue and expenditure tables for all municipal institutions, which provided brief a description of each institution's professional activities via major indicators and set goals for these institutions. Using a program budget for the social sector in 1998, the city developed goals for each social institution. The three institutions provided 23 services, which were grouped into three subprograms. No program objectives were stated in the budget.

Regarding staffing and organizational structure, the 1997 and 1998 budgets included flow charts showing the structure of the city council, institutions, and mayor's office. Both budgets also contained staffing summaries by institutions.

The Budget as a Communication Tool

The budget can be a powerful communications tool that brings valuable information to citizens, businesspersons, potential investors, central government officials, and others. In addition to providing information to the local community, the budget should highlight the following elements:

- Major factors that influence the budget from one budget period to another
- The community profile, including statistics and the organization of the local government
- Organizational and financial structure of different municipal departments and agencies
- The fund structure and budget classification used to categorize resources and spending.

Because the budget is a vehicle for communicating budget decisions in an accurate and clear manner, the document should be formatted and printed in a way that will enhance its merit and that the lay reader understands. The budget should include reader guides (for example, "How to Read the Budget"), budgets in brief, and graphs or other visuals that will effectively communicate policies and priorities.

A new element in the Szentes 1997 budget document was a table of contents followed by an introduction to the city, which briefly described its demography, economic situation, infrastructure, major economic units, and investment opportunities. Other new elements

were charts presenting the structure of the city council, the list of municipal service institutions, the structure of the local government office, and a list of major municipal responsibilities. The document also provided an overall analysis of the communal sector: strengths and weaknesses, legal background, local information, description of the 1996 conditions, identification of tasks for 1997, and crucial issues that needed to be addressed to improve municipal services.

The local press and radio publicized the budget reform several times. The local government wants to maintain a day-to-day contact with the media, because it is an effective way to keep the public informed. In 1997 the newsletter of the Ministry of Interior and the national magazine *Autonomia* covered the topic of program budgeting and budget reform in general, and Szentes was cited as a best-practice example. Since then, the local media (newspaper and radio) in Szentes have increased their coverage and directed questions regarding budget reform to the head of the finance department.

In the 1998 budget, in addition to including all these elements, the city expanded the section on general information about the community and also discussed internal and external factors affecting the budget. Improvements in the budget layout, however, could make the budget even more effective. For example, all information pertaining to a sector could be consolidated and presented in one section, with a separate section for each sector.

Impediments to Change

Despite its tremendous achievements in budget reform, Szentes faced several constraints to the reform process, such as time, resistance, lack of human capital, and technical shortcomings.

Time is the main constraint mentioned by the staff involved in the budgeting process. The reform process entails an enormous amount of extra work, often done after regular working hours. Because the process requires the cooperation of several units and agencies, all staff members must work overtime.

Resistance to change is another key impediment. According to the head of the finance department, the budgeting reform process slowed down for two major reasons. First, some institution heads tended not to understand immediately the purpose and benefits of reform (the institutions' financial managers were better partners). Second, some persons responsible for a given sector within the office of the local government did not do what was expected of them. The institution heads were unable to manage the budgetary reform because they lacked an overview of the process. This blindspot often made them reject the idea of reform. The mayor and the head of the finance department spent a lot of time persuading the staff that the budget reform was useful and worth the increased workload.

Lack of adequate staff can be a problem even when they have the necessary skills and knowledge. They need training to improve their expertise in putting together a program budget, which again requires time. According to the mayor, developing the right attitude

in the staff was important to keep them motivated despite the time shortage. In some departments, increasing the number of staff to cope with the increased workload was also necessary.

Technical shortcomings were also serious. Another impediment to the reform was the inadequate technical equipment and financial constraints on purchasing (for example, insufficient computers, color printers, software, and filing equipment).

Overcoming technical difficulties would allow the staff to focus on the necessary analytical and policy changes. Certain inefficiencies, such as duplication of efforts because of inevitable parallel compliance with laws (old budget standards) and with the requirements of a reformed budget, could be addressed more easily by removing technical obstacles. Once all city government offices are computerized, the staff could easily prepare the two budgets.

Conclusions

Because local government responsibilities are defined and categorized by sectors (as are institutions and departments of the local government), the best way to introduce program budgeting is to take a sectoral approach. The city of Szentes has created a structure of programs and subprograms centered usually on mandatory responsibilities by sectors. This method is a useful one, especially in the first years of creating a program budget when obtaining a clear picture of how these sectors function is crucial. The city, however, should later strive to create budgets that concentrate on solving problems, that is, program objectives should not merely meet responsibilities but also solve major problems. To find out what these major problems are, each city must go through the various stages of refining its budget.

How does the budget process in Szentes differ from the traditional budgeting process? After three years of budget reform in Szentes, the following improvements have been made in its budgeting process:

- The finance department is more careful about timing and starts to look at priority areas as early as April instead of November.
- A work plan is developed and strictly followed.
- Key individuals responsible for the various activities are identified early and held accountable if they do not deliver results in time.
- The city collects actual data for measuring its performance.
- Informing those involved in the budget reform has become an ongoing process.

Szentes shows a long-term commitment to budget reform. Each year, the city has added more sectors to the program budget, and in 1999 it had a program budget for all sectors. After that, the city focuses on refining its budget.

The committee members recognize the tremendous work and effort by the finance department and appreciate the new budget. All the interviewed members stated their willingness to support the budget reform and create a conducive and cooperative environment for future work. Several obstacles to change have arisen, but the local government states that it is motivated and committed enough to continue with the reform process.

Reference

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25

Managing Household Arrears in Utility Services: Social Policy Challenges and Responses

Katalin Tausz



The system transition made the introduction of cost-recovery prices for local public services both possible and necessary. Serious price increases have taken place in many countries in eastern Europe. Although some effects were positive, these changes contributed to the deterioration of the household budgets of most low-income families. Either as a natural or an adverse reaction, this deterioration has resulted in hundred of thousands of unpaid utility bills, producing a growing amount of overdue receivables and losses in service companies.

Household arrears have reached alarming magnitudes in Hungary. The problems have greatly affected local governments, which have fallen into a situation of having been owners, customers, and regulators of most local service providers, and also the politically responsible protectors of the citizens' interests. Following the principles of cost price and restrained supplier subsidization, many municipalities started to analyze the underlying factors, categories, and possible treatments of household arrears in the mid-1990s. They also turned toward targeted preventive measures and means testing for welfare subsidies to support primarily families that would otherwise be unable to pay service charges.

This chapter addresses three issues: (a) the reasons that have led to household arrears, (b) the major actors in resolution and preventing arrears, and (c) the role of social policy in managing household arrears. This chapter summarizes the findings of surveys carried out in Budapest in 1998 by the Central Statistics Office, and social policy lessons learned during a successful experimental program supported by the British Know How Fund in Nyíregyháza. The program aimed at finding resolutions and treatments for household arrears in this large secondary city in northeast Hungary.

* This chapter is based on Tausz 2000.

Household Arrears and Underlying Factors in Hungary

Analysts recognize three main categories of household arrears: overdue charge and fee obligations to utility service providers, overdue rental fees, and arrears in housing loan installments. Household arrears are, nationwide, the highest in district heating, and housing loan installment arrears are the second highest. Arrears in electricity and natural gas services are much less significant because utilities can legally and simply switch off services in case of overdue payment obligation.

The Ministry of Finance estimated the amount of household arrears to utility companies at about Ft 4.8 billion in 1998, and the Ministry of Welfare estimated them at Ft 10 billion for the same year. According to these ministries, some form of utility arrears occurred in 800,000–900,000 households, and 40–50 percent of them had been accumulating for more than six months (Kristóf 1999). Installment payments on 652,000 housing loans were in arrears; with a combined amount of Ft 21 billion in 1998 (utility and installment arrears together were equivalent to US\$ 150 million). During that year, the Hungarian Savings Bank, the major provider of housing loans, started legal actions to collect arrears in 38,000 cases (Nagy and Tausz 1999). By international comparison, household arrears to utilities are proportionately not high, but are more worrisome in the light of the average family income in Hungary.

Causes and Underlying Factors of Household Arrears

During the shift to a market economy, Hungary faced several difficulties that negatively affected households. From the perspective of household arrears to utility companies, the following problems are the most significant:

- Change in the price-setting system and elimination of subsidies
- Privatization of utility companies
- Increase in the preferential interest rate of outstanding housing loans from 3 to 12 percent in 1990
- Privatization of the housing stock and fall in the number of social housing
- Decrease of real income, increase in unemployment, and increase of poverty and income inequalities.

Unjustified Growth

The quality of the housing stock significantly improved in the last decades. In 1960, 74.6 percent of dwellings were supplied with electricity, 22.7 percent with piped water, and 13.7 percent with piped gas. By 1997, 100 percent of dwellings had electricity, 84.4 percent had piped water, and 41.2 percent had piped gas.

At the same time, households began to use durable goods and electronic devices extensively, which significantly increased use of electricity. In 1970 average per capita electric energy consumption was 53.9 kilowatt hours, and monthly gas consumption was 78.4 cubic meters. By 1997 electricity consumption increased to 179 kilowatt hours and monthly gas consumption to 125 cubic meters. These positive developments were financed, however, from growing external and internal indebtedness of the central budget, while the country ran into an economic crisis and a steep inflation spiral.

Households in Expenditure Trap and Poverty

As a result of the price adjustment, the economic crisis, and the subsequent stability measures, household revenues did not grow in step with the multiplying expenditure needs, and the rise of household expenditures exceeded the high inflation rate (see table 25.1). The gap widened between housing costs and household incomes, so that the housing costs grew significantly as a share of household expenditures. These reasons undoubtedly underlie the growing household arrears. Differences in arrears by income groups, by financing possibilities, by household means, and by motivations to cover these expenses are substantial.

Table 25.1 Consumer Price Indices in Percentage of the Preceding Years, 1993–1998 (percent)

| <i>Name</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>Total 1998 per 1992</i> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------------------------|
| Electric energy | 111.0 | 109.0 | 160.9 | 132.2 | 133.0 | 121.9 | 417.2 |
| Piped gas | 109.8 | 103.4 | 150.7 | 135.2 | 133.1 | 119.8 | 368.8 |
| District heating | 121.3 | 112.4 | 129.7 | 123.6 | 129.2 | 116.5 | 329.0 |
| Coal | 105.1 | 108.4 | 121.9 | 128.9 | 115.9 | 113.6 | 235.7 |
| Firewood | 120.3 | 118.0 | 124.7 | 120.0 | 109.8 | 104.6 | 244.0 |
| Heating oil | 115.8 | 122.5 | 236.0 | 187.2 | 120.2 | 109.9 | 827.9 |
| Bottled gas | 111.0 | 121.0 | 139.6 | 137.9 | 136.3 | 118.1 | 416.2 |
| Household energy, total | 112.4 | 111.7 | 150.0 | 132.5 | 129.9 | 117.9 | 382.2 |
| Consumer price index | 122.5 | 118.8 | 128.2 | 123.6 | 118.3 | 114.3 | 311.8 |

Source: Central Statistics Office data.

Today food and energy represent the most significant items in the household budget (see table 25.2). The Central Statistics Office found that the cost of food increased from 32 to 40 percent, and housing costs from 10 to 18 percent of average household expenses from 1989 to 1997 (CSO 1998a: 103). As a result of income disparities, housing costs represent 16 percent of the expenditures of rich families, 20 percent for lower income families, and more than 40 percent for the poorest people who receive some social assistance.

In 1998 the Central Statistics Office conducted a survey to determine the living conditions of families who receive some form of social assistance. These data prove that

the housing conditions of families who have household arrears are worse than for other families. More of these families live in flats with district heating or in damp, dark, and unhealthy dwellings and neighborhoods. Only one-third of those in arrears are active earners and one-third live on unemployment benefits or social assistance. Many of these people receive a disability pension (CSO 1998b: 112).

Of the households represented in this survey, 17 percent had been unable to pay one or more bills, 47 percent had one type of debt due, and 53 percent had two or more types of debt due. The 66 percent of households with debt due were in cities, 28 percent in rural settlements, and 6 percent in Budapest. Almost one-fifth of the families with children receiving social assistance cited some form of debts to the utility companies.

One-quarter of families with household arrears who live on social assistance have been sanctioned. Electricity was switched off in 45 percent of the cases and gas in 17 percent, at least temporarily. Movable properties were foreclosed for 17 percent of the cases, and 12 percent of these the dwellings were put up for auction,

Social disparities by regions are also very sizable. The poorer eastern parts of the country and the urban areas with large living quarters of housing estates are hardest hit by social problems. In the eastern part of Hungary, the accumulated arrears are four times as much as the country average (Alliance of Social Professionals 1998).

Table 25.2 Consumer Price Index by Main Expenditure Categories, 1991–1998

| <i>Year</i> | <i>Food</i> | <i>Household energy</i> | <i>Total^a</i> |
|-------------|-------------|-------------------------|--------------------------|
| 1991 | 121.9 | 181.0 | 135.0 |
| 1992 | 145.6 | 277.4 | 166.1 |
| 1993 | 188.1 | 311.8 | 203.4 |
| 1994 | 232.1 | 348.3 | 241.6 |
| 1995 | 304.3 | 522.5 | 309.7 |
| 1996 | 356.9 | 692.3 | 382.8 |
| 1997 | 419.4 | 899.3 | 452.9 |
| 1998 | 479.8 | 1,060.3 | 517.7 |

Notes: a. The total is a combined index of consumer price index of food, alcoholic beverages, tobacco products, clothing, consumer durable goods, household energy, heating, other articles, fuel, and services. 1990 = 100.0 percent.

Source: Central Statistics Office data.

Arrears in Nyíregyháza

Nyíregyháza is among the cities that have suffered the most from the so-called transformation recession. High unemployment and poverty levels resulted in serious household arrears despite regular central and local subsidies. In 1998 a working group was formed, including experts of the local government, utility companies, and consultants hired by the

Know How Fund, to find a sustainable resolution for the overdue receivables, the vast majority of them accumulated (over 180 days) household arrears (see table 25.3).

One-fifth of households in Nyíregyháza had some kind of overdue obligations to public service providers. Arrears were especially high (73 percent) for families who live in public dwellings. This situation occurred in 1997 despite the fact that 42 percent of citizens eligible for social assistance received a special benefit to cover the deficit in housing expenses and despite the city spending on average 5 percent of its budget on welfare subsidies.

The increase of arrears threatens more and more the housing security of families, the profitable functioning of the utility companies, and the social peace of communities. Thus, from the aspect of social policy, overdue obligations to utility companies now appear as the problem of over-indebted people, and consequently as the problem of social assistance, poverty, and impoverishment (Győri 1995).

Table 25.3 Household Arrears in Nyíregyháza, 1997

| <i>Service companies</i> | <i>Arrears (Ft million)</i> | <i>Overdue receivables, percentage of total sales</i> | <i>Arrears over 180 days, percentage of total arrears</i> | <i>Household arrears, percentage of total arrears</i> |
|---------------------------|---------------------------------|---|---|---|
| District heating | 237.3 | 13 | 72 | 90 |
| Water | 56.0 | 4 | 40 | 88 |
| Social housing management | 81.3 | 16 | 77 | 92 |
| Solid waste management | 21.0 | 4 | 36 | 53 |

Source: Local government of Nyíregyháza data.

The Actors in the Arena of Household Arrears

Four major groups of actors could and ought to influence the change of household arrears: the central government, local governments, service providers, and households. While developing the means of handling the problem, reformers must get acquainted with and assess the diverse interests of these actors. Only by understanding these groups will reformers find ways to make compromises and devise long-term solutions.

The central government is interested, on the one hand, in reducing political tensions due to the sharp social contractions and, on the other hand, in satisfying the sense of justice of deserving taxpayers. The central government is also responsible for the defense of central resources; thus, it is interested in transferring the problem to the local level.

The interests of the local governments are complex. Since 1990, in the new political and economic regime, the system of governance has been based on the principles of decentralization and subsidiarity. Thus, local governments have direct responsibility for municipal utility services (water, district heating, and solid waste management) and for public housing. Because municipalities provide various welfare services to citizens, they are indirectly responsible for managing a wide range of social problems.

As a consequence of the transformation of the command economy to a market system, utility service companies were privatized and price subsidies were withdrawn. In several cases, municipalities became totally or partly the owners of the local service providers. This process resulted in a schizophrenic situation: the local government as owner has a role in setting cost-based prices, and it is also responsible for providing basic utility services and for the well-being of the inhabitants. The local government as owner is interested in profit maximization, which in several cases affects the household budgets and forces the same local government to provide social transfers to poor families.

Moreover, local governments are politically divided: they must keep the political and social equilibrium between the interests of the beneficiaries of social transfers and the general taxpayers of the municipality.

The service companies and the banks are, first of all, interested in avoiding the accumulation of existing arrears and in their reduction, but not at any price. Their motivations depend on the cost of collecting overdue receivables. The utility service companies have different options to force households to pay and to sanction them—the electricity service can be switched off or the water supply can be reduced to a minimal daily service allowed by law—but in most places utilities have no way to suspend the district heating service. Moreover, the companies work in a given political and social framework, so their collection actions influence the image of the whole company.

The basic interest of households is to use the services and to save their housing security. Different types of households, naturally, have diverse interest structures. Some of them, when calculating costs and benefits, are ready to give up some elements of their consumption to pay utility bills, but others do not make sacrifices to avoid arrears.

Addressing Household Arrears in the 1990s

The actions to resolve the problems of accumulated household arrears have been based on the principle that all the players involved must make some financial contribution to the resolution.

Nationwide Measures

The central government launched several programs to handle the problem of household arrears. In 1992 the Ministry of Welfare set up a Crisis Management Office to assist cities facing extreme difficulties. In 1993 the newly enacted Act on Social Administration and Assistance introduced a housing benefit, a new form of social assistance, as a proactive instrument to protect the living conditions of poor families. In 1997, to counterbalance the increase in energy prices, the central government proposed to set up an Energy Foundation based on joint financial resources of the utility service companies and the government.

A government resolution passed in 1998 aimed to provide a more effective way to reduce the burdens of over-indebted families. The national grant schemes developed to reduce household arrears required supplementary local government decrees to facilitate the management of arrears and provide a significant local financial matching contribution. The legislation supported a decentralized solution of the problem. To receive central and local government financial support, families had to contribute 30 percent toward the resolution of their arrears.

The local governments had to formulate their own resolutions on the eligibility criteria for the housing benefit. Although the law initiated a proactive measure and did not prescribe exclusion, several local governments excluded households with arrears from the group of beneficiaries. In Nyíregyháza, for example, one-fifth of the city's annual welfare payments are used for the housing benefit. The only persons eligible for the benefit are those that have no debt due to utility companies or have made an agreement on the installments to repay their arrears.

Nonprofit organizations were set up in several places. The Héra Foundation was organized in 1991 on the recommendation of specialists participating in a special committee working on the energy concept of the government. This nationwide foundation, financed by donations from energy suppliers and other companies, local governments, and private persons, assists families with cash and in-kind benefits (for example, energy-saving bulbs) and provides consultation services. Several local governments have also created foundations to provide grants to the service areas, which are local functions that have the highest arrears: water, district heating, and public housing.

Actions in Nyíregyháza

Utility companies made several attempts to increase their efficiency. In Nyíregyháza the water company implemented layoffs and energy rationing programs, but the sewage treatment plant works at one-third of its capacity because of the drop in water consumption. The district heating company could solve its problems only with a major reconstruction. It operates at 30 percent below capacity because large institutional customers changed their heating systems to individual ones. The solid waste company uses cross-financing techniques, because it operates some profitable activities as well. Rents have not changed since 1994, which partly explains the financing problems of the public housing management company.

In Nyíregyháza the service organizations also made efforts to increase customers' control over their level of consumption. Most of the utility services (water, gas, and electricity) can be measured now. The district heating consumption is the only one that cannot be measured and is regulated individually by users. The technology in housing estates does not allow individual measurement, which leads to significant losses and causes arrears. The district heating company, together with the local government, launched a

program to install meters in apartments in the framework of a national environmental program. The company, however, was able to install the meters for only 10 percent of its customers by the end of 1999.

The local government has the legal authority to set user charges. This conclusion is based on the information collected from the service organizations. No predetermined formulas are available for calculating service prices. The service organizations are responsible for the collection process. Different practices were developed for reading the meters, for billing, for routine collection, and for collection of accumulated arrears.

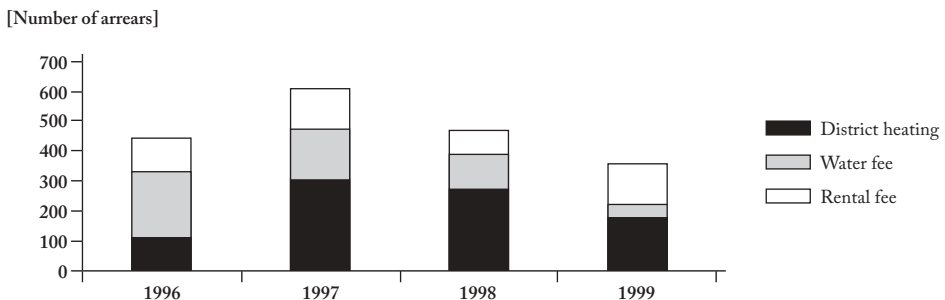
The four service organizations have different practices and do not have a joint database on nonpayers. Recent changes in incentive payments proved that when fee collection was contracted out, the collection ratio became much higher. In other cases the companies prefer collection by their own employees, because they can offer new schemes or simply check the service.

Through a public foundation of Nyíregyháza (RES Foundation), the two major service companies and their customers can cooperate with the city. Using this financial channel, funds of the private service companies can be transferred to public purposes. The customers (represented by the association of large families) are also involved in the allocation of the housing grant.

Among the eligibility criteria for the grants, the key component is that the applicant household should pay, within two years and in one sum, two-thirds of the accumulated arrears. The companies also contribute, and they benefit from this system because the grant is directly paid to them. The amount they had transferred to the foundation determines the grant they might receive, so cross-financing among the service providers does not occur. The service organizations monitor the eligibility of the applicant households and prepare the resolution contracts with the customers. The companies follow their own procedures in means testing and evaluating households' financial status.

Out of the 10,000 households in arrears, nearly 2,000 cases were successfully resolved with the technical and financial assistance of the RES Foundation from its establishment in 1996 through 1999 (see figure 25.1).

Figure 25.1 Number of Arrears Worked Out by the RES Foundation in Nyíregyháza, 1996–1999



Source: RES Foundation data.

The foundation as an organizational form has several advantages. First, it provides a proper framework for cooperation among the interested parties: the local government, the service companies, and the customers. As an outcome of the coordination, plans to increase tariffs are directly evaluated in tandem with the social policy consequences of the decision, so the foundation also works as a consulting forum for combining local financial and welfare policy objectives. The foundation also supports implementation by coordinating various channels of social assistance.

Categories of Households by Positions and Strategies

Over-indebted households and those facing financial difficulties apply different survival strategies. On the basis of these strategies and their situation, the households that have debts due can be grouped into different categories. When creating preventive and active measures in resolving and reducing household arrears, reformers should take some characteristics into consideration: the length of the period of nonpayment, the debt due, the type of nonpaid services regarding the penalty for nonpayment, and the role of lack of solvency in willingness to pay.

Duration of Nonpayment

Nonpayers are of two types: occasional and recurrent. Recurrent nonpayers are also of two types: those who have moderate accumulated arrears and those who have large accumulated arrears. These three groups each require different treatment. The first two categories are good candidates to improve their payment discipline through a sophisticated fee collection and punishment system. The third category, recurrent nonpayers who have large accumulated arrears, requires more complex treatment and joint action by the central and local governments and suppliers, including targeted welfare subsidies.

- Occasional nonpayers have small arrears for a short period because of fluctuating income or for some unforeseen reasons.
- Households that have recurrent moderate debts due cannot be considered chronic nonpayers, although they are unable to pay three or four times a year or are put off from regular paying.
- Households that have large accumulated debt due have not been paying for a longer period of time (10 or more collection periods) and have accumulated significant arrears.

Generally families facing financial difficulties rank their obligations. They reduce consumption and are willing to pay first for those services that can be switched off easily (for example, electricity and piped gas). Electricity consumption declined in Nyíregyháza when customers realized that exclusion was technically simple. Water services can be reduced, but

no exclusion is allowed because of public health regulations. Water consumption decreased very significantly, however, in response to price increases and punishments. Terminating the district heating service is almost impossible, because the present in-house networks do not allow individual closure.

Since 1993 the nonpayment of rental fees might lead to eviction. Likewise, the arrears in installments on loans may result in the foreclosure sale of the dwelling. The risk is enormous, living itself is at stake, and because debt collection practices are different and changing, assessing the consequences is difficult.

The results of a research project carried out in the second half of the 1980s proved that income poverty is only one of the key reasons for falling into arrears. The lack of a well-functioning household and the lack of stability of the household economy also contribute to the process.

Households in Poverty

Some households and persons face serious, often inherited, long-term poverty because of factors that reinforce each other and may lead to multigenerational poverty. These factors are related to family composition, education, and lifestyle or living conditions. Family composition might be one of the following:

- One-person “households” of people who live without a family, such as those who grew up in state homes for children and have no skills to run a household; single people from households disintegrated as a consequence of divorce
- Constant, long-term poor families that have lived in deep poverty for generations, and who have little educational background and uncertain labor market participation; families who have disabled members or members with long-term illness
- Sliding, unstable intermediate families whose income depends on moderately paid, often temporary or seasonal jobs or who are temporarily unemployed; families with sickness or family crisis
- Rootless people who may live without a household, with uncertain housing and family conditions, and without a permanent source of income, frequently suffering from some form of addiction
- Unskilled workers who receive a small fixed salary, who are living on wage labor or pension, and who are generally good at managing, but whose real income has decreased and they are no longer able to survive on it
- Entrepreneurial workers who once lived on wage labor, but who were forced to become small entrepreneurs with fluctuating incomes and without savings
- Welfare workers who got or bought subsidized dwellings but who became unable to cover the rent and utility fees because, for example, they lost their jobs or prices increased (Györi and Gábor 1990a and 1990b).

The differentiation of these groups is of key importance, because the problems of each are managed differently. Sporadic experiences and researchers' findings show that the group that would be able to pay, but simply does not want to pay, utility charges is relatively small compared to the poverty groups listed above.

Alternatives and Dilemmas in Managing Household Arrears

The actors in managing household arrears have different, sometimes contradictory, interests. The local government as the key actor can avoid participation in solving the problems or fortify contradictory interests. It also may motivate the actors, however, to cooperate and smooth conflict. In the latter case, the local government may try to find a balance between conflicting interests. For instance, the service companies are mainly interested in getting the fees, but not by all means from the consumers. The local government or a foundation may assume part of the arrears. Sharing the burden of overdue debts between the consumers, the utility companies, and the local government is always a better solution than letting the families lose their housing and then providing them with very expensive social housing services.

Preventive or Corrective Measures

As a consequence of these roles, a decision must be made about whether: (a) to use compelling measures to collect arrears, or (b) to support the families. Pressure and punishment may, in the short run, result in paying, but they will not solve the problems of those families who have no resources to mobilize.

In addition, the local government must choose between preventive and corrective measures. If the local government chooses prevention, it must concentrate its efforts to help, first, households that have short-term arrears to one or two service companies, and second, households that are able, with extreme difficulty, to pay for the time-being, but that would be pushed into the group of nonpayers by further price increases. If, in the short run, the local government would like to decrease outstanding arrears, it must deal with the largest, long-term arrears.

The target group of the preventive measures is endangered lower-middle-class families. Corrective means, by contrast, would support the poorest part of the population. The lessons from large cities indicate that slow accumulation of arrears might lead to an unmanageable crisis situation, so social policy actions should also focus on households that have short-term debt due to one service company.

How to Cover the Expenses of the Interventions

Expenses can be covered in several different ways. Nyíregyháza organized a foundation that shares the costs among the local government (from taxpayers' money), the service companies (from the fees paid by good consumers), and the households in arrears.

The amount of support to be provided to nonpaying consumers must be carefully calculated. The supported consumers must contribute financially to the resolution, often with a predetermined amount. The 1998 central government resolution stipulates a one-third consumer contribution, but a reasonable alternative would be to consider the actual potential of the household. This method would slow down the rhythm of debt repayment, but would broaden the base or number of households realistically involved in the collection of arrears.

Households must receive a detailed description of the preconditions and eligibility criteria for support. The support must be used to decrease overdue debt. Therefore, the money is transferred not to the consumer, but directly to the service provider or is credited to the consumer's account.

Several local governments use various eligibility criteria, such as the so-called recognized size of dwelling, the minimum or maximum amount of arrears, and the cost of housing.

As a precondition of support, the consumer may be required enter into a contract with the service provider to pay the arrears in installments. A useful precondition to motivate the long-term overdue debtors would be for them to use debt management counseling services.

Setting excluding preconditions is a risky and nonequitable solution, because exclusions generally affect the poorest households (for example, excluding from the debt resolution those who have no permanent job).

Present and Future Challenges

This section summarizes the challenges in the arena of household arrears, namely how to set service prices; how to assess needs and eligibility; how to define appropriate support; how to set up a program for resolution of household arrears; how to join their efforts; and what are the key factors beyond social policy.

Price Setting

Price setting is a crucial component in developing a preventive social policy at the local level, and local governments can have a strong influence on the procedure. The assessment and review of company finances, and the evaluation of the efficiency of operation and management practices in a monopoly situation require expertise in municipal administration. Such expertise is not always available, even in large cities, so new forms of cooperation should be established between local governments and the service companies.

To increase the influence of local social policy, price negotiations and price-setting procedures should be improved. The criteria of welfare policy should be enforced from the very beginning of the process. The factors included in planning the price increase should be agreed on and preferably fixed by a formula. In this way the framework of the negotiations is given, and coming to an agreement on the actual scale of changes of various factors incorporated in the formula will be easier.

Need Assessment and Eligibility

A conscious welfare-service strategy must be based on need assessment, which should be made by collecting: (a) data on the families in arrears and on the basic characteristics of their overdue debt, and (b) opinions from citizens and from some public and civic organizations (for example, social service providers, nongovernmental organizations, labor market centers, and minority self-governments). A key impediment to need assessment and means testing is that the law on protecting private information prohibits merging different databases. Hence, information about the real estate, indebtedness, arrears, and personal financial condition of a family cannot be compared. This shortcoming is bypassed in Nyíregyháza with an information sheet that households applying for debt resolution must fill out. This solution is not perfect, but it is a relatively workable one.

Monitoring and regularly evaluating the effectiveness and efficiency of the system of managing overdue debt is necessary (for example, whether it prevents the rise of new arrears and reaches the target group). Evaluation methods should be developed in the planning phase.

A communication system is a key part of the resolution program. Citizens must be provided with information on public services, consumers' rights, and eligibility criteria for resolution of the arrears. The flow of information between the institutions and sectors also must be organized. Cooperative planning processes can prevent or solve many tensions and conflicts.

Appropriate Support

Support of the different types of overdue debtors necessitates special measures. The standard of living rather than the way of life of a family could be the basis for assessing the real household situation. In the case of consumers who have one or two overdue bills, a notice can be enough to pay. It is a good time to correct administrative mistakes. For people who have temporary financing problems because of an unexpected crisis situation, one-off and urgent support payments might be given to prevent the accumulation of arrears.

Paying installments or delayed repayment may be effective if some family members have the opportunity to get back to the labor market (because they have the necessary training and skills), making it likely that their incomes will increase in the near future. Here, active social policy measures can be effective.

Labor market and debt management counseling services may give additional help to families that are unable to increase household income on their own. These families have to be provided with income support for the long run and may be motivated to move into a low-cost dwelling.

In the case of long-term nonpayers who have given up hope, social workers can play an important role.

Inevitably the last two groups will have hardly any chance to solve the problem by their own efforts. Either the service providers need to write off their arrears or some of the actors (local government, service provider, or a foundation) must assume part of it.

Those consumers who are able to pay but simply do not want to pay may face compelling measures. This problem resides primarily with the service providers.

Program for Resolution of Household Arrears

The reasons for getting into arrears, the behavior of different types of households in arrears, and the interests of the actors raise very complex issues. Hence, we advise constructing a system and an implementation program for resolution of household arrears with very different measures. This system would be an action strategy that is: (a) planned for the long run, (b) systematized, and (c) based on the combined resources of all actors. This system requires data and information collection, resource calculation, and decisions on the political as well as the professional dilemmas.

Adaptation of a model consisting of connected modules of preventive and corrective components proved to be effective in Budapest. In this model, households are eligible for compensating support to prevent the development of arrears on a normative basis, the decision on discharging debt is discretionary, and selection is based on a complex assessment of a household's standard of living and income.

The most important advantage of normative solutions for households in need is that the conditions are measurable and guarantee legal security. Decision-makers may also benefit from the relatively simple administrative procedure and reduction of expenses that would be incurred by means testing.

Selection based on the discretionary principle cannot be measured by the consumer because doing so results in consumers who are in need being unable to protect themselves. These procedures are generally based on long, expensive assessment processes at the end of which the real situation of the client may not be revealed.

In a programmatic structure, the most important elements of the model must be built into one system (for example, the type of benefit, the benefit to discharge overdue debt, and the housing benefit).

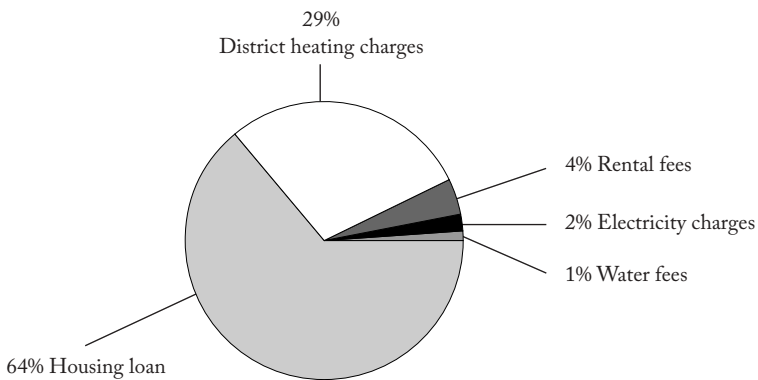
Joint Efforts

To work out a complex support system and action strategy, the representatives of the actors (local government, service companies, banks, and consumers) must, first of all, be invited to a conference table. Joint efforts will lead to better solutions both in welfare policy and in methods of managing arrears at the service organizations. Joint effort requires an established forum of permanent cooperation to balance the equity and efficiency aspects of the overdue debt problem. All the interested parties, in equal position, should be involved in this process. This cooperation is the only way to establish a long-term, stable solution for managing social and service company efficiency problems at the same time. A joint decision-making procedure is more complicated in cases in which a number of local governments own one service company.

Coordination of the actors' interests is absolutely essential to construct a complex, adaptive, and stable supportive, regulatory, and organizational system. All the actors must realize that people running into arrears is not an exception. Any method of managing arrears must take into account that a market economy will always have households that run into arrears in the long run. Over-indebtedness endangers their basic living conditions, and they will not be able to solve the problem using only their own efforts. A stable local and nationwide social policy system, adjusted to the circumstances of a market economy, must be in place to promote troubled families.

In Nyíregyháza, in addition to the RES Foundation, a Household Debt Management Counseling Service Association was set up in 2000 within a nongovernmental organization using financial support from the local self-government and some service companies. The counseling service treats more complicated cases than the RES Foundation. The nongovernmental organization has been able to arrange some form of solution for nearly 500 households (debts were rescheduled, arrears are repaid in installments, and so forth), and resolved about Ft 40 million overdue debts by end of 2000 (see figure 25.2).

Figure 25.2 Adjusted Arrears by Services in Nyíregyháza, December 1999–2000



Source: Household Debt Management Counseling Service Civic Organization data.

Beyond Social Policy

Solving the problem of arrears, however, is impossible with only social policy measures. Economic processes directly influencing the living conditions of the households (the gap between the increase of incomes and the energy prices, and so forth) need other economic-type interventions.

The social assistance system in itself cannot solve the problem either. Between 1993 and 1997 the number of people provided with a housing benefit in cash grew from 35,000

to 206,000, while the number that received the benefit in kind increased from 19,000 to 95,000 (CSO 1998c: 104). At the same time, the number of households in arrears grew.

The only way to achieve fundamental changes would be extension of education, improvement of labor market participation, and increase in incomes. Because the fact that one has to pay for services is a basic social norm, nonpayment can be labeled as deviant behavior. Thus overdue debt may legitimate social exclusion.

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26 Financing and Regulating District Heating

Kenneth K. Baar



In Hungary 16 percent of the residences are served by district heating. Provision and use of this type of heating present special problems because its cost is substantial relative to household incomes and because fixed charges, which constitute about half of total charges, are set on a collective rather than an individual basis. Therefore, residents who have district heating cannot control the cost the way that residents with other types of heating do.

The emphasis of this chapter is on the institutional, financing, investment, and regulatory strategies related to the provision of district heating. These strategies can be addressed through legal and institutional reforms and by moderate financial expenditures. Significant issues include: (a) the shift to charges for district heating based on building consumption, which is required by the 1998 Act on District Heating; (b) the introduction of cost allocators and charges based on individual unit consumption, which has been done voluntarily in thousands of flats; (c) the role of the national government in supporting district heating provision, cogeneration, and pricing of electricity from cogeneration sources; (d) municipal concession agreements for district heating company operation; and (e) information needs and availability.

District Heating in Central and Eastern Europe

The basic technical and economic problems of district heating in central and eastern Europe have been widely discussed and are well known and understood (EGI 1995; Martinot 1997; WB 1999). A summary of how district heating has operated over the last 30 years follows. Central plants provide energy for heat and hot water for buildings through pipes. Commonly losses are great, because utilities produce an excess capacity, especially when

* This chapter is based on Baar 2000.

energy is required only for hot water supply. In residential buildings the district heating systems serve radiators (typically three per flat), which do not have valves. The piping is arranged vertically, rather than in a single link for each flat, so measuring the consumption of a flat with a meter is impossible. Traditionally, heat charges have been based on the number of cubic meters in each flat, and hot water charges have been based on the average consumption per cubic meter in the city. To bring each flat up to the required temperature, many are overheated, and in buildings that do not have bypass pipes between flats, the only way to reduce the heat is to open a window.

District heating systems were constructed for new multifamily housing in urban centers during an era when energy was very cheap, substantial state subsidies were provided, and consumption was viewed as social rather than individual. District heating was often a byproduct of the huge energy center of the state enterprises, without clear rules for cost allocation. The emphasis was on production of as many housing units (and heating systems) as possible as cheaply as possible. As a result, heat consumption of district-heated households is far higher in central and eastern Europe than in western Europe. For example, per capita heat consumption is 45 percent higher in Hungary than in Finland or Sweden (EGI 1995).

Since the transition, the ensuing shift to market pricing of heat, and the increasing withdrawal of state subsidies, the costs and energy wastes associated with district heating have become a major issue. Commonly, district heating costs now consume a large share of household income. As a result, district heating has been the target of numerous pilot projects designed to increase efficiency and reduce costs. The concept has been to demonstrate the benefits of efficiency measures in terms of rates of return that would be attractive even without subsidies and that would thus induce others to follow their lead. The World Bank, the European Bank for Reconstruction and Development, and various bilateral assistance programs have funded such projects. Numerous private investors also have entered the energy efficiency market in this area.

On the supply side, utilities have taken various measures to make plants and heat distribution systems more efficient. Many analysts believe that cogeneration has major potential to bring about significant cost reduction, so cogeneration efforts are widespread, but they still constitute only a small portion of total production. To varying degrees, cities have identified the portions of their supply systems where improvements would be most beneficial and are economically feasible. On the demand side, one standard project has been to install valves and cost allocators that measure the consumption of individual radiators and to introduce fees based on the consumption levels of each flat. Some consumers have also taken simple energy-saving measures, such as weather stripping around doors and windows.

The implementation of improvements and cost reduction measures in district heating faces various economic, structural, and institutional problems. The costs of capital are so high that even relatively high rates of return by market standards are inadequate relative to

amortized costs. And district heating companies have a virtual monopoly because the cost of installing alternative heat sources is prohibitive.

Although analysts have seen district heating as a major problem in central and eastern Europe, in western Europe major efforts in recent years have expanded the scope of district heating in conjunction with cogeneration. Cogeneration can produce cost-efficient heat, but the benefits may not be passed through to heat suppliers. It also reduces pollution levels associated with energy production. In line with this approach, the European Union has taken a position in support of a combined heat and power program and favors dismantling barriers to its development (EU COM 1997). Cogeneration suppliers, however, have commonly faced discriminatory conditions for access to electricity grids.

District Heating in Hungary

The provision of district heating in Hungary is undergoing significant transitions. With the withdrawal of national subsidies and the introduction of cost pricing, pressure is great to increase the efficiency of district heating on both the production (primary) and consumption (secondary) sides. The 1998 Act on District Heating required extensive measures including separate charges for each building (but not each flat) based on consumption after 2003. Furthermore, the measurement and allocation of charges for individual flats based on consumption is spreading.

In Hungary, 103 municipalities have district heating systems. The breakdown is as follows:

- District heating serves 647,000 dwelling units (16 percent of the total stock) throughout Hungary.
- Seventy-one percent of the units served are concentrated in 10 cities.
- Budapest has 241,000 flats that are served by district heating.
- The nine secondary cities have a combined total of 15,000 to 32,000 units that are served by district heating.
- Approximately half of all units in cities with a population over 100,000 (other than Budapest) are served by district heating.
- Less than 2,000 dwelling units in each of 61 cities (40 of whom serve less than 1,000 units) are served by district heating (a combined total of 48,901 flats).

Nearly all of the district-heated flats are in multifamily dwellings, most of which are in housing estates constructed during the socialist era. During the 1990s the change in the number of flats served by district heating or in their overall consumption has not been significant. Meanwhile, the district heating consumption by industrial users has dropped (see table 26.1).

Table 26.1 National Heat Consumption by Users 1990 and 1997 (tetra-joule per year)

| <i>Users</i> | <i>1990</i> | <i>1997</i> |
|-------------------------------------|-------------|-------------|
| Industrial | 42,761 | 25,490 |
| Residential | 21,981 | 25,996 |
| Residential hot water | 12,777 | 8,986 |
| Institutional heating and hot water | 4,248 | 4,874 |
| National total | 81,767 | 65,346 |

Source: District Heating Providers' Yearbook 1998.

Before the transition district heating companies were owned by the state, and a central authority set the prices in accordance with the 1990 Price Act. Charges for households were based on their size in square meters rather than on consumption levels. In the early 1990s municipalities became the owners of their district heating distribution systems, but the power sources were privatized. The right to set heating prices was transferred to the cities.

The district heating charges of the major cities are based on a combination of fixed rates per cubic meter and either: (a) district-wide consumption charges that are prorated by the per square meter, (b) individual building charges based on their consumption (see table 26.2), or (c) both. Comparisons are limited by the different criteria that are used to set fees. Interviewees frequently indicated that district heating fees vary substantially among cities and noted that the fees in Szigetvár are double those in Győr. As table 26.2 indicates, however, the dispersion of fees among most cities is much smaller.

A significant percentage of interviewees indicated that the price-setting process is largely political and that city councils feel pressure to keep rates low. Some thought a return to the system of national price setting in accordance with the Price Act would enable district heating companies to charge rates that would cover their operating costs and provide capital for needed improvements. Others felt that their city assembly already set prices in a reasonable manner, enabling the company to recover cost increases. Some saw little justice in setting different prices for each municipality, because local district heating costs were the result of past national development decisions rather than the will of the residents. Interviewees repeatedly noted that cities were in the difficult position of having to represent the competing interests of consumers and district heating companies at the same time.

Operating Costs of District Heating Companies

The costs of district heating provision are mainly for energy. Interviewees indicated that energy costs were approximately 60–70 percent of total revenues (see table 26.3). In most cities, the prices are adequate to cover operating costs and some amortization, but are not adequate to finance substantial improvements. A notable exception is Miskolc, which has

Table 26.2 Residential District Heating Charges, March 19, 1999 (Ft per air-cubic-meter per year)

| Settlement | Number of district heated flats | Heat/consumption fee | | | Base fee | | |
|------------------|---------------------------------|--|---------------------------------------|---------------|----------------------------------|---|--------------------------------|
| | | Pre-calculated average charge Ft/am ³ /year | Consumer hot water Ft/am ³ | Metered Ft/GJ | Heating Ft/am ³ /year | Consumer hot water Ft/am ³ /year | Total Ft/am ³ /year |
| Szigetvár | 832 | n.a. | 180.00 | 1,338 | 232.00 | 67.00 | 299.00 |
| Kaposvár | 6,868 | n.a. | n.a. | 1,026 | 223.68 | 47.28 | 270.96 |
| Nagykőrös | 534 | 228.40 | 214.50 | 1,042 | 213.36 | 57.60 | 270.96 |
| Keszthely | 1,128 | 222.80 | 249.70 | 1,021 | 219.00 | 49.20 | 268.20 |
| Cegléd | 1,605 | 232.14 | 191.20 | 910 | 181.44 | 81.00 | 262.44 |
| Kiskunfélegyháza | 1,494 | 205.32 | 170.40 | 947 | 175.20 | 83.00 | 258.20 |
| Esztergom | 1,346 | n.a. | n.a. | 716 | 209.40 | 45.00 | 254.40 |
| Székesfehérvár | 19,694 | 186.30 | 247.10 | 963 | 200.52 | 51.60 | 252.12 |
| Dorog | 2,100 | 177.48 | 139.90 | 676 | 208.20 | 41.16 | 249.36 |
| Nyíregyháza | 15,564 | 176.54 | 228.95 | 780 | 219.27 | 29.17 | 248.44 |
| Miskolc | 32,765 | 249.86 | 244.87 | 882 | 218.51 | 27.80 | 246.31 |
| Szekszárd | 5,595 | n.a. | n.a. | 979 | 172.00 | 69.00 | 241.00 |
| Gödöllő | 1,982 | n.a. | n.a. | 1,020 | n.a. | n.a. | 238.00 |
| Mosonmagyaróvár | 3,554 | 209.00 | 172.00 | 823 | 192.00 | 45.00 | 237.00 |
| Ajka | 7,005 | 156.60 | 160.00 | 576 | 201.60 | 32.40 | 234.00 |
| Érd | 1,044 | 259.00 | 183.12 | 1,039 | 183.00 | 48.80 | 231.80 |
| Sárvár | 1,457 | n.a. | n.a. | 1,106 | 177.96 | 53.76 | 231.72 |
| Százhalombatta | 4,037 | 208.80 | 211.00 | 765 | 176.40 | 51.60 | 228.00 |
| Sátoraljaújhely | 1,073 | n.a. | 262.00 | 990 | 214.88 | 10.12 | 225.00 |
| Szolnok | 8,681 | 192.72 | 149.70 | 966 | 191.04 | 32.16 | 223.20 |
| Salgótarján | 3,843 | n.a. | 250.00 | 960 | 222.00 | n.a. | 222.00 |

Table 26.2 Residential District Heating Charges, March 19, 1999 (Ft per air-cubic-meter per year)
(continued)

| Settlement | Number of district heated flats | Heat/consumption fee | | | Base fee | | |
|-------------------|---------------------------------|--|---------------------------------------|---------------|----------------------------------|---|--------------------------------|
| | | Pre-calculated average charge Ft/am ³ /year | Consumer hot water Ft/am ³ | Metered Ft/GJ | Heating Ft/am ³ /year | Consumer hot water Ft/am ³ /year | Total Ft/am ³ /year |
| Debrecen | 30,977 | 201.60 | 207.30 | 924 | 188.04 | 32.40 | 220.44 |
| Hajdúnánás | 652 | 213.12 | 208.50 | 877 | 199.54 | 20.90 | 220.44 |
| Szigetszentmiklós | 1,020 | n.a. | n.a. | 895 | 154.20 | 65.40 | 219.60 |
| Tiszaújváros | 5,552 | n.a. | n.a. | 767 | n.a. | n.a. | 219.60 |
| Budaörs | 2,357 | 198.00 | 178.80 | 959 | 179.52 | 39.72 | 219.40 |
| Dunaújváros | 1,455 | 189.00 | 154.20 | 847 | 122.41 | 96.05 | 218.46 |
| Dunakeszi | 2,560 | 226.00 | 217.00 | 937 | 150.00 | 66.00 | 216.00 |
| Komló | 4,915 | 216.00 | 210.00 | 890 | 216.00 | n.a. | 216.00 |
| Budapest | 241,022 | 479.76 | 225.60 | 1,036 | 190.68 | 24.72 | 215.40 |
| Kecskemét | 11,072 | 219.96 | 208.00 | 947 | 174.48 | 38.76 | 213.24 |
| Veszprém | 8,425 | 220.78 | 234.80 | 1,043 | 159.54 | 53.61 | 213.15 |
| Tata | 1,820 | 319.29 | 308.97 | 1,278 | 197.23 | 15.65 | 212.88 |
| Dombóvár | 1,898 | 218.40 | 300.00 | 910 | 208.65 | n.a. | 208.65 |
| Cellödömök | 459 | n.a. | 212.68 | 1,016 | 162.00 | 45.57 | 207.57 |
| Ózd | 5,550 | 221.60 | 243.80 | 820 | 162.00 | 40.00 | 202.00 |
| Sopron | 6,077 | n.a. | n.a. | 825 | 183.48 | 18.48 | 201.96 |
| Mátészalka | 1,705 | 199.80 | 231.00 | 1,080 | 172.20 | 29.10 | 201.30 |
| Szentendre | 1,516 | 244.00 | 223.00 | 916 | 148.00 | 51.00 | 199.00 |
| Tatabánya | 21,380 | 160.20 | 144.00 | 694 | 152.52 | 45.36 | 197.88 |
| Vác | 2,739 | 284.00 | 172.00 | 902 | 143.00 | 52.00 | 197.00 |

| <i>Settlement</i> | <i>Number of district heated flats</i> | <i>Heat/consumption fee</i> | | | <i>Base fee</i> | | |
|-------------------|--|---|---|----------------------|---------------------------------------|--|-------------------------------------|
| | | <i>Pre-calculated average charge Ft/am³/year</i> | <i>Consumer hot water Ft/am³</i> | <i>Metered Ft/GJ</i> | <i>Heating Ft/am³/year</i> | <i>Consumer hot water Ft/am³/year</i> | <i>Total Ft/am³/year</i> |
| Siófok | 1,133 | n.a. | 214.00 | 1,074 | n.a. | n.a. | 195.50 |
| Eger | 4,744 | n.a. | n.a. | 988 | 148.32 | 46.80 | 195.12 |
| Kisvárdá | 1,248 | 197.00 | 158.00 | 1,353 | 143.00 | 36.00 | 179.00 |
| Nagyatád | 240 | 292.52 | 99.11 | NA. | 178.98 | NA. | 178.98 |
| Nyergesújfalu | 866 | 276.00 | 305.00 | 1,153 | 132.00 | 36.00 | 168.00 |
| Mohács | 2,015 | n.a. | 207.90 | 792 | n.a. | n.a. | 166.80 |
| Szombathely | 11,300 | n.a. | n.a. | 842 | 127.08 | 34.56 | 161.64 |
| Győr | 21,865 | n.a. | 148.40 | 742 | 121.00 | 29.00 | 150.00 |
| Oroszlány | 4,216 | n.a. | n.a. | 1,301 | 43.20 | 12.00 | 55.20 |
| Hódmezővásárhely | 2,717 | 344.00 | 370.00 | 1,676 | n.a. | n.a. | n.a. |
| Pécs | 30,393 | 423.00 | 427.80 | 1,000 | n.a. | n.a. | n.a. |
| Szeged | 27,355 | 382.00 | 328.00 | 1,654 | n.a. | n.a. | n.a. |

Note: am³ size of apartment measured in air cubic meter. GJ Giga joules.

Source: Hungarian Professional Association of District Heating Providers data.

been operating with substantial negative cash flows since 1992, even with a municipal subsidy equaling 10 percent of revenues.

*Table 26.3 District Heating Companies' Operating Cost Ratios, Selected Cities
(percent)*

| <i>Cost</i> | <i>Budapest</i> | <i>Salgótarján</i> | <i>Tiszaújváros</i> | <i>Debrecen</i> | <i>Miskolc</i> | <i>Szombathely</i> |
|-----------------|-----------------|--------------------|---------------------|-----------------|----------------|--------------------|
| Energy | 68 | 50 | 77 | 74 | 58 | 70 |
| Other materials | 7 | 8 | 3 | 1 | 7 | 5 |
| Personnel | 10 | 15 | 12 | 13 | 11 | 12 |
| Depreciation | 9 | 11 | 5 | 4 | 5 | 10 |
| Other costs | 6 | 15 | 3 | 8 | 20 | 3 |

Note: Variations in ratios are partly attributable to differing classifications of expenses.

Source: Interviews with district heating company representatives, 1999.

District Heating Costs Compared with Household Incomes, National Expenditures, and Revenues

At the end of the socialist era, district heating costs were low for households, because energy was still relatively cheap and the national government subsidized the cost. In 1990 the national subsidy was Ft 9.2 billion, which covered over half of the cost of district heating. This amount constituted 0.4 percent of gross domestic product and 0.8 percent of government expenditures in that year. In the early 1990s these subsidies were withdrawn and fuel costs started to increase.

Currently, the national expenditure on district heating by households is in the range of Ft 50 billion (US\$ 210 million) per year. Overall turnover in the district heating sector was about US\$ 330 million in 1997 (Euroheat 1998). A subsidy covering half of current household costs for district heating would roughly equal about 0.25 percent of gross domestic product and 0.5 percent of government expenditures.

Although the cost of district heating is low relative to gross domestic product, it is high relative to the incomes of the households served. In 1998 typical annual estimated household costs for district heating and hot water averaged Ft 70,000, an amount exceeding 10 percent of median household income and over 20 percent of the income of households on pension. (In winter months, the costs may exceed 40 percent of household income for low-income households.) Furthermore, because these are only averages, for a significant proportion of lower income households, the burdens are unbearable.

Available data indicate that the average incomes of households with district heating are not lower than the national averages (table 26.4). This situation may change, however, because the distribution of housing is becoming increasingly market based and higher income households are starting to leave the housing estates.

*Table 26.4 Average Annual Heat and Hot Water Costs for District-heated Flats, 1998
(Ft per year)*

| <i>City</i> | <i>Metered charges</i> | <i>City</i> | <i>Metered charges</i> |
|------------------|------------------------|-------------------|------------------------|
| Szigetvár | 92,775 | Eger | 64,965 |
| Tata | 78,580 | Szigetszentmiklós | 64,762 |
| Nagykőrös | 77,509 | Mosonmagyaróvár | 64,392 |
| Kaposvár | 76,893 | Nyíregyháza | 64,315 |
| Kisvárd | 76,793 | Hajdúnánás | 64,185 |
| Keszthely | 76,320 | Komló | 64,073 |
| Sárvár | 74,558 | Dombóvár | 63,829 |
| Kiskunfélegyháza | 72,091 | Budaörs | 63,199 |
| Érd | 71,990 | Miskolc | 62,807 |
| Székesfehérvár | 71,868 | Dunaújváros | 62,757 |
| Gödöllő | 71,604 | Szentendre | 62,728 |
| Cegléd | 71,251 | Esztergom | 62,673 |
| Szekszárd | 70,949 | Vác | 61,913 |
| Budapest | 69,611 | Százhalombatta | 60,917 |
| Veszprém | 69,570 | Dorog | 60,438 |
| Mátészalka | 69,359 | Tiszaújváros | 59,834 |
| Sátoraljaújhely | 69,165 | Sopron | 59,509 |
| Siófok | 68,328 | Ózd | 59,446 |
| Szolnok | 67,993 | Oroszlány | 57,706 |
| Cellödömök | 67,761 | Szombathely | 54,723 |
| Salgótarján | 67,596 | Ajka | 54,468 |
| Nyergesújfalu | 67,575 | Tatabánya | 54,026 |
| Debrecen | 65,995 | Mohács | 53,510 |
| Kecskemét | 65,887 | Győr | 49,267 |
| Dunakeszi | 65,883 | | |

Note: Heating costs are estimated to constitute 75 percent of the total (1998).

Source: Hungarian Professional Association of District Heating Providers data.

National Subsidies

District heating industry representatives and citizens continually comment on the lack of national subsidies for these programs. Household expenditures for district heating exceed those for water and sewer, but subsidies are far greater for water and sewer. This difference may result from the extensive European Union standards for water and sewer provision, compared to absence of standards for heat provision.

Table 26.5 Average Annual Household Expenditures, 1997 (Forint)

| <i>Expense</i> | <i>Household expenditures</i> |
|------------------|-------------------------------|
| Water | 3,551 |
| Sewer | 1,272 |
| Electricity | 10,965 |
| Piped gas | 9,309 |
| District heating | 5,063 |
| Firewood | 2,818 |
| Coal | 2,023 |
| Bottled gas | 1,951 |

Note: Expenditures include all households whether they use the service or not.

Source: CSO 1997: 37.

Subsidies for developing district heating systems in the range of a few billion forints per year are available. Under one program, the government uses Ft 2 billion to cover one-half of the interest cost of commercial loans, but it does not guarantee the loan. The loans are administered by one bank selected on a competitive basis by the interest rates it offers. The maximum loan per demand-side project is Ft 30 million and per supply-side project is Ft 150 million. One interviewee noted that this subsidy provided funds that were adequate only for a feasibility study. To put these amounts in perspective, typically several billion forints are required to renovate one district heating plant.

Some interviewees suggested that a national fund should be created to guarantee loans to district heating companies and private companies for district heating projects. A second program, introduced in 1999 (government resolution 1025 of 1999), authorized Ft 150 million in grants and an Ft 50 million subsidy that covers 50 percent of the interest payments up to Ft 1 billion in loans to companies that provide energy savings systems within district-heated flats. In some interviews, district heating companies seemed to be pinning their hopes on national assistance, although they indicated that they were not optimistic about it.

Household Arrears as Internal Subsidies

Under the current system the district heating company and the users who pay regularly cover arrears. Because of the arrangement of the piping in district heating systems, switching off an individual household for nonpayment is not feasible. Instead, a district heating company must resort to the courts to place a lien on the flat of the nonpaying households. (This remedy is not useful in the case of municipally owned flats.)

As a practical matter, district heating companies have been compelled to provide heat to households that have not paid. In this sense, they have been compelled to perform a social function in providing a basic utility.

Household arrears are commonly seen as a substantial cost for district heating companies. A major portion of arrears was incurred just after the withdrawal of state subsidies. In most cities the rate of arrears has been low, and accumulated arrears are high, although they have been decreasing in some cities in recent years. Accumulated arrears were typically about 10 percent, but have reached as high as 40 percent of annual utilities' revenue (see table 26.6).

Table 26.6 Arrears in District Heating Payments, Selected Cities, 1998

| <i>City</i> | <i>Annual arrears (percentage of firms' revenue)</i> | <i>Accumulated arrears (percentage of annual gross income)</i> |
|----------------|--|--|
| Budapest | 7–10 | n.a. |
| Dunakeszi | 3 | 10 |
| Eger | n.a. | 25 |
| Kaposvár | 3 | 10 |
| Miskolc | 0.5 | 10 |
| Nyíregyháza | n.a. | 40 |
| Szeged | n.a. | 16 |
| Székesfehérvár | n.a. | 10 |
| Szombathely | 1 | 10 |
| Tiszaújváros | 2 | 8 |

Source: Interviews with district heating company representatives.

A survey prepared for one city found that the rate of arrears was not a function of income. Instead, in the opinion of the district heating company representative, it was a function of households' confidence that they would not suffer adverse consequences as a result of failing to pay their bills. Miskolc and other cities reported that the rate of arrears was particularly high in municipally owned flats. (Usually, only a small percentage of flats are municipally owned.)

The Shift to Consumption-based Pricing

This section summarizes the various demand-side measures towards consumption-based pricing: metering consumption by buildings; insulation and installing cost allocators in flats; and pilot energy-saving projects.

Charges Based on Consumption for Each Building

The 1998 Act on District Heating required billing of each building according to its consumption after 2003. Most district-heated buildings have their own heat-exchange centers, and for them the cost of complying with the metering requirement is not substantial. For cases in which several buildings are served by one heat exchange, the cost of creating separate exchanges for each building is in the range of Ft 500,000 per flat. The installation of the necessary equipment cost Ft 6–7 billion in Budapest and Ft 1 billion in Miskolc, according to interviewees in those cities.

At this point, cities are permitting individual buildings to decide whether their charges will be based on consumption. Buildings that elect to have their billing based on consumption are no longer part of the set that is used to compute the average consumption level for the per cubic meter charges in the balance of the district-heated flats. Typically, the most efficient buildings elect to have their charges based on consumption. Consequently, the costs for the remaining buildings increase.

Billing each building according to its actual consumption level may conform to some notions of economic justice. Consumption levels can also be viewed as “non-elective,” in the sense that citizens did not choose their residences. Instead, they had to take whatever was allocated to them.

Heating costs can vary by over 100 percent among buildings depending on the quality of their construction. Systematic data on heat consumption by building types in Székesfehérvár revealed that 49 percent of all flats had consumption levels (as measured by building consumption) within 10 percent of the median. About 80 percent of all flats had consumption levels within 20 percent of the median, but differences in consumption levels among building types amounted to 50 percent or more (see figure 26.1).

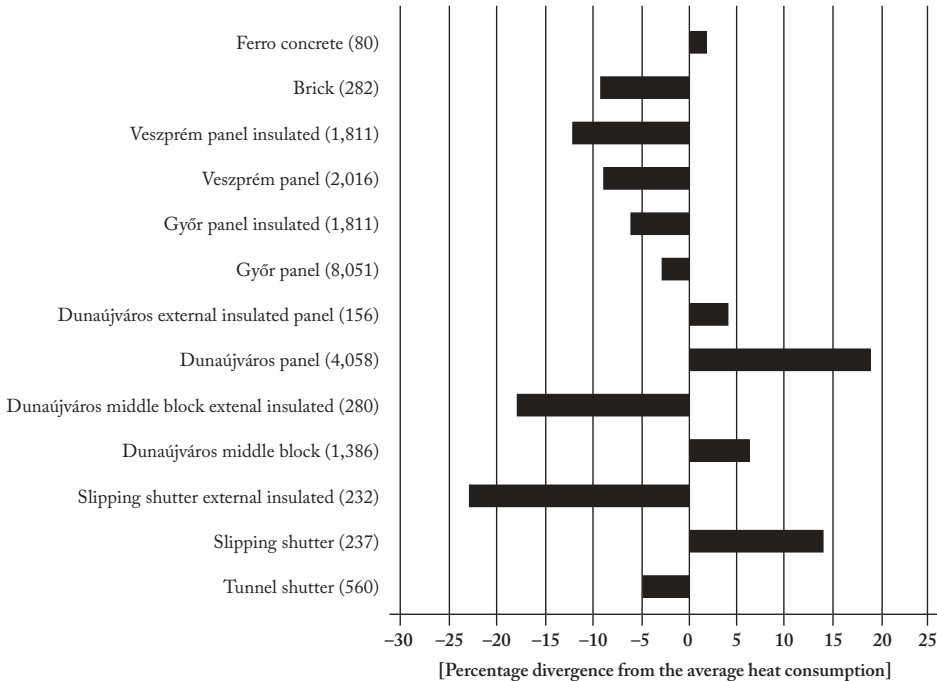
Differences in actual district heating charges for buildings also depend on what portion of the district heating charge is fixed and what portion is based on actual consumption. Generally, about half of district heating company revenues derived from fixed charges and the other half from consumption charges.

Generally, interviewees indicated that condominium organizations were not taking collective measures to reduce heating costs in response to the introduction of charges based on consumption. In Szombathely, where buildings have been metered since 1993, buildings have elected widely differing heat settings, ranging from 17 to 25 degrees Celsius, but usually they were not undertaking other steps, such as installing simple insulation measures. Several interviewees indicated that each reduction of one degree in temperature reduces heating costs by 6 percent (above certain temperatures, each degree increase in temperatures increases the required energy substantially).

In Szeged, where all heat charges have been based on consumption since the mid-1990s, without any fixed charges, buildings that have approximately 6,000 units have elected to have cost allocators installed without the aid of subsidies. (Over 85 percent of all buildings have been metered since 1997.) The complete reliance on actual consumption

in setting fees was seen as central to the widespread unsubsidized installation of cost allocators. Other interviewees commented that basing the entire district heating fee on consumption levels would be unreasonable, because fixed costs inevitably amount to a substantial portion of costs.

Figure 26.1 Divergence from the Average 206.06 Mega-joule per Air-cubic-meter Heat Consumption by Types of District-heated Buildings in Székesfehérvár, 1998–1999 Heating Seasons (percentage)



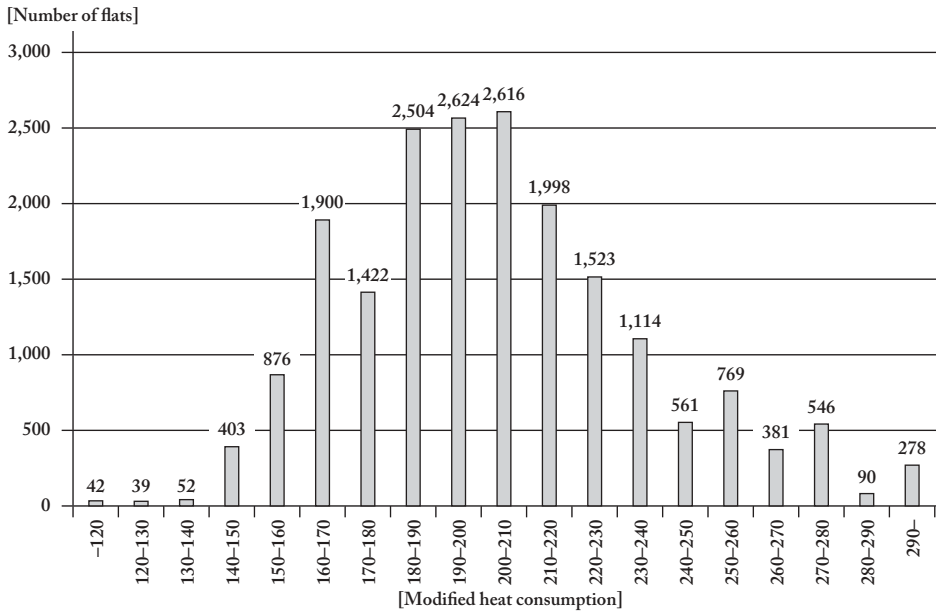
Source: Székesfehérvár district heating supplier data.

One interviewee believed that the implementation of metering by building for all buildings would create a political scandal. Others viewed the legislative requirement for charges by buildings as a useless half-step because individual efforts to conserve would occur only when charges are based on individual flat consumption.

Although the provision of equipment allowing buildings to regulate heat consumption was generally considered part of the policy, some interviewees indicated that this step was not a legal requirement. One district heating company indicated that even though heat consumption could be measured for each building, it still could not be controlled by buildings (see figure 26.2).

Although the weight of empirical information on communal actions has limits, building systematic databases of the impacts of the type of construction, temperature adjustments, and simple insulation on heat costs would be useful.

Figure 26.2 Distribution of Heat Consumption Level among District-heated Building, 1999 (mega-joule per air-cubic-meter)



Source: Székesfehérvár district heating supplier data.

Cost Allocators and Basic Insulation Measures

Cost allocators enable analysts to determine the proportion of consumption by radiator relative to total consumption in a building. Metering by building, individual valves, and cost allocation according to consumption have been seen as prerequisites to economic operation of district heating. Without them, individual households have neither the incentive nor the opportunity to conserve costs and energy. For example, the 1999 national energy policy states that a basic condition for the competitive operation of the district heating market is that consumers should be able to regulate and meter their heat consumption. To support this purpose the state should play an important role (NEP 1999).

Unlike water, gas, or electricity consumption, however, heat consumption is not totally individualized because the flats are also heated externally by the heat from the neighboring

flats. Individual heat consumption, hence, is largely dependent on the position of a unit in a building (interior, outside corner wall, and the heat level selected by the neighboring flat). Some flats can meet most or all of their heating needs from the neighboring units. In East Germany, to combat tenants getting a free ride off the heat of other units, valves cannot be set below a certain level.

One partial remedy for unreasonable divisions of heating charges is a combination of fixed charges and consumption charges. A common, but far from universal, practice has been to use correction factors in computing the consumption for each flat within a building. The leading installers of cost allocators suggested correction tables. Some interviewees believed that it made no sense to bill according to the consumption for each unit if correction factors had to be used.

A common view is that the cost allocators can be manipulated, but representatives of district heating companies usually disagreed with this view. One of them indicated that only one case of manipulation had occurred over several years.

Others questioned whether cost allocators led to decreases in costs or whether the cost reductions that appeared in pilot studies were the outcome of associated insulation measures. In Slovakia legislation requiring the introduction of cost allocators was repealed on the grounds that they were not cost effective (ECB Interview 1999).

In Hungary interviewees consistently suggested that the installation of cost allocators and simple insulation measures usually reduced consumption by about 15–30 percent. The cost of such measures has been in the range of Ft 40,000 per flat, and the annual savings typically are about Ft 10,000 per flat. Interviewees in cities where cost allocators were introduced without accompanying insulation measures gave similar estimates of resulting consumption reductions. Unfortunately, these impressions about the impacts of allocators were not supported by systematic research. The research that exists consists of data for one year comparing the heat costs in buildings with and without cost allocators, rather before and after the installation of cost allocators. Differences between buildings with and without cost allocators may partially reflect the fact that more efficient buildings elect cost allocators rather than reductions in consumption following their installation.

Commonly, projects for the installation of valves and cost allocators have been funded by a combination of central government grants, municipal grants, interest-free loans, and loans with conventional terms. Another source for funding such projects has been an increase in the fixed charges (a temporary surcharge) for all flats within a jurisdiction. In a significant proportion of the cities with such subsidies, less than half of the available subsidies have been used.

In Nyíregyháza, where 16,000 units are served by district heating, subsidies have been provided for cost allocators and basic insulation measures in 3,900 flats. Project funding consists of a combination of a grant, a zero-interest five-year loan from the national environmental fund, and 4 percent of the fees for all households served by the district heating system. The average savings has been Ft 10,000 per year out of an average annual heating cost of Ft 73,000 per flat.

In Eger, where substantial subsidies are provided for installation, 40 percent of households have installed cost allocators. A substantial portion of the available subsidies has not been used, however.

In Dunaújváros a public campaign was undertaken to install cost allocators. By the end of 1999, 70 buildings with 3,500 flats elected to participate in the program out of 19,391 district-heated flats in the city. Each participating flat must pay a one-time fee of Ft 800 per radiator. The balance of the cost of the program is financed from an increase in monthly charges of Ft 100 per radiator.

In Szeged buildings have been metered for the past few years, and the fees are based solely on consumption. Approximately 6,000 out of 27,000 district-heated households have installed allocators without public subsidies. District heating staff has not published data that compare the district heating costs for the buildings with and without cost allocators. Based on its review of bills, however, staff indicated that consumption levels in buildings with cost allocators were 15–20 percent lower than for other buildings and for prior years. Thorough examination of the expense information for Szeged would be particularly valuable for measuring the impacts of cost allocators, independent of insulation measures.

Table 26.7 Portion of Units with Cost Allocators, Selected Cities

| <i>City</i> | <i>District-heated flats (number)</i> | <i>Flats with cost allocator (percent)</i> |
|---|---|--|
| Cities with over 10,000 district-heated flats | | |
| Budapest | 240,837 | Minimal |
| Debrecen | 30,909 | 8 |
| Dunaújváros | 22,180 | 18 |
| Kecskemét | 11,078 | 15 |
| Miskolc | 32,125 | 3 |
| Nyíregyháza | 15,948 | 25 |
| Szeged | 27,534 | 22 |
| Székesfehérvár | 19,654 | 4 |
| Szombathely | 11,022 | 23 |
| Other cities | | |
| Eger | 4,752 | 35 |
| Kaposvár | 6,874 | 30 |

Source: Interviews with district heating company representatives.

In lieu of encouraging cost allocators, Kaposvár has subsidized central regulatory systems for each building, which allow residents to regulate the temperature of water flow into each building. The city pays a portion of the cost of these systems, about Ft 500,000 per building. Residents pay for the accompanying installation of valves, which costs about Ft 50,000 per flat. District heating company interviewees indicated that these systems, which

are now in about 60 buildings, are as effective as cost allocators in reducing consumption. In considering the Kaposvár experiences, one must note that, typically, about 15 flats are served by the regulatory systems, which may make communal action more feasible than in the large panel buildings that are typical in other cities.

Decision-making by Buildings

In the case of building cooperatives, a majority is needed to make decisions and investments. Otherwise, the introduction of cost allocators requires the unanimous consent of the residents of a building. As a practical matter, usually introducing a cost allocation system is impossible without physically entering each flat, which requires the consent of the occupant.

Pilot Projects—Other Energy-saving Strategies in Buildings

Pilot projects, which involve extensive insulation measures (for example, insulation of external walls) as well as regular measures in conjunction with the installation of valves and cost allocators, have been common and have achieved healthy rates of return. Usually, these programs have been funded by international donors, national, or municipal subsidies. The costs for such projects have typically ranged from Ft 400,000 to Ft 800,000 per flat. The problem with these projects is that they cannot be replicated without subsidies.

Supply-side Measures

This section addresses the combined heat and power generation, the most powerful technical measure at the supply side, but other technical solutions are beyond the scope of this chapter.

Cogeneration—Combined Heat and Power

Cogeneration is widely seen as a strategy for significantly reducing district heating costs. Currently, the share of cogeneration in district heating is 24.9 percent (Euroheat 1998). Cogeneration potential of each city depends on the particular characteristics of the local situation in regard to energy costs, availability and price of alternate sources, the particular type of power plant, and facilities of the district heating company.

Interviewees repeatedly indicated, however, that national energy policy lacks a unified approach between district heating and other energy issues. In particular, Hungarian regulations regarding electricity pricing are unfavorable to cogeneration. Electricity purchasers are not required to pay a capacity fee to cogeneration sources. In contrast, some other nations have more favorable prices for electricity provided through cogeneration.

Current statements of energy policy require more favorable treatment for cogenerated electricity on the basis that such policies are in the national interest, but they have not been implemented with specific regulations.

Miscellaneous Supply-side Measures

Description and analysis of the various types of measures designed to make heating supply more efficient are beyond the scope of this chapter. They vary among cities depending on the characteristics of their particular district heating system.

Several interviewees indicated that cities were seriously hampered by a lack of energy expertise and suggested that they each be required to hire an energy expert. The lack of expertise was especially serious in smaller cities.

Privatization of District Heating Provision

Because of a lack of available national and municipal financing for district heating companies, the introduction of private capital is taking on increasing importance.

Concession Agreements

At least 10 cities have entered into concession agreements for the operation of their district heating company, including Dunaújváros, Kiskunfélegyháza, Nagykőrös, Sárbogárd, Szeged, and Szolnok. Such agreements may be politically attractive to local governments, because they may shift political responsibility for a service that cannot be provided in a manner that will make the users content.

These agreements typically have terms in the range of 20 years and require that the private company install designated improvements (Illés 1999). Because the contracts are kept secret, we had difficulty obtaining specific information about them. According to information from interviews, price adjustments in the contracts are based on a weighted-cost index. (One report notes that the cost index used in one contract tied increases to actual wage costs and over-weighted the wage factor, thus subjecting the price-setting mechanism to manipulation. Typically, when price indexes are used, the coefficients are tied to external measures rather than actual company costs.)

Investments for cost allocators are covered by increases in fees. Interviewees repeatedly stated that the contracts require only minimal investments by the concessionaire company and, therefore, did not accomplish any objectives that could not be performed by the existing district heating company. Several interviewees noted that concession contracts violate the Act on District Heating, because they set prices without complying with the requirement that the local government shall request the opinion of consumer protection

agencies and consumer representation groups prior to determining prices (Act on District Heating 1998).

Concession agreements may or may not bring about benefits to district-heated households. Contractors may be selected on a competitive basis. Once the contractor is selected, however, competition is terminated for the length of the contract, which may lock consumers into a particular pricing structure regardless of what supply-side innovations and cost-saving potential may emerge.

Difficulties with concessions are compounded by the inexpert and secretive processes associated with such arrangements. As a matter of practice, neither the expert reports nor the concession contracts are available to the public. (For further discussion on public access to public contracts see chapter 15.)

National Oversight over Concession Contracts and Prices of District Heating

In Poland, under the National Energy Law, the Energy Regulatory Authority (*Urząd Regulacji Energetyki*) awards local concessions for district heating services and sets their tariffs. Under the national law, the tariffs should ensure: “Coverage of justified costs of energy enterprises’ operation in the field of production, transformation, storage, transmission, distribution or trade of fuels and energy and costs of development and environmental protection; and protection of interest of consumers from unjustified price increases.”

The law also directs that pricing include incentives for cogeneration, and “Tariffs for... heat... may include costs of co-financing by energy enterprises of projects and services which purpose is to reduce energy and fuel consumption by customers and which provide an economically justified alternative for avoidance of development of new sources of energy or grid” (Energy Law, 10 April 1997, section 45).

Lease Agreements

Lease agreements are an alternative to concession contracts. Leases generally have a term of seven and a half years for a fixed monthly fee, under which private companies agree to install specified improvements. At the end of the term, the improvements become the property of the residents and the district heating company. As in the case of concession contracts, cities keep lease agreements secret. For a lease agreement entered into by one city, a substantial investment was required and the price level was fixed throughout the life of the contract. Of course, without knowledge of the actual price, evaluating the adequacy of such contracts is impossible.

Conclusions and Recommendations

Overall resolution of the fundamental inefficiencies and costs associated with the provision of district heating may not be economically feasible, but institutional issues, some of which may be addressed without substantial funds, should be reviewed. These include the following:

- Data on the impacts of individual charges for buildings, the use of cost allocators, simple insulation measures, and related issues should be systematically collected and analyzed by independent third parties and made available to the public. Because information on district heating charges is computerized, the cost of such research should not be high.
- The potential economic and environmental benefits of central government subsidies for district heating should be compared with returns obtained through other types of infrastructure subsidies, such as water and sewer.
- Public review of the basic documents related to concession contracts and adequate expert representation should be a precondition to any transfer of the operation of District heating programs through long-term agreements. Possibly, a national agency should be given the role of reviewing and commenting on proposed concession contracts that exceed a minimum time period.
- Review of the impact of energy rules and electricity pricing policies on district heating should be undertaken.
- Pilot projects and deep subsidies should be evaluated and the focus should shift to projects that are more effective and financially feasible to replicate.
- A review should be undertaken of the legal policy of requiring unanimous or near unanimous consent for the installation of cost allocation devices in buildings. Although the introduction of cost allocators may reduce average costs, at the same time they increase the costs for some units. Requiring unanimous consent serves the interest of the minority at the expense of the majority. In western democracies, universal compliance with and participation in energy-saving measures is generally required without unanimous consent.
- Often, reports by public agencies are considered secret and are provided to individuals on the condition that they not be circulated or quoted. Information availability should be increased. Independent public expertise is a valuable tool in bringing about effective and useful reforms.
- The present focus in central government subsidies and local efforts on the installation of cost allocators should be carefully evaluated and compared with the potential benefits from basic insulation measures, supply-side improvements, and technical assistance for local governments in supervising and pricing district heating.

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PART 2.
**ISSUES OF SUBNATIONAL
DEVELOPMENT**

Section 3.
**Developing a Competitive
Subnational Finance System**



Credit Markets and the Role of Specialized Intermediaries in Local Infrastructure Finance

Samir El Daher



In developing and transition economies, the combined effect of decentralization and urbanization has increased demand on local governments to provide and finance public services. Against this background, tight fiscal policies have constrained budgetary transfers from central to local governments. Competing claims for scarce budgetary resources have caused large funding gaps for local infrastructure investments. Local governments will need private capital if they are to bring services to minimum standards that support growing urban demand.

Local capability to shoulder the expanded responsibilities and, in particular, mobilize the required resources, is contingent on the existence of an adequate regulatory and fiscal framework for decentralization, which requires three key conditions:

- Responsibilities for service delivery should be clearly assigned among government tiers.
- Capacity for own-source revenue generation (local taxes and user charges) should be enhanced.
- Net flows (tax sharing and transfers) from central to local governments should be and made rational and predictable.

The ability to access credit markets is a function of creditworthiness, which is assessed by prospective creditors on the following bases: (a) overall quality and efficiency of local asset management; (b) institutional vehicles and operational mechanisms for local service delivery, which might involve entities distinct from existing political divisions; (c) selection criteria for local public investments, especially the benefits these investments would yield at the local level; (d) pricing policies that contribute to the sustainability of service provision; and (e) laws and regulations regarding such credit-related issues as local asset pledge, bankruptcy, and default remedies.

* This chapter is based on El Daher 2000.

This chapter addresses issues of development of sound municipal credit market and the possible role of specialized financial intermediaries in financing local infrastructure investment, a particular need in Hungary and in central and eastern Europe.

Conditions for the Development of Sound Municipal Credit Markets in Transition Economies

Local governments in developing countries face challenges when they attempt to access to private savings. Their local financial and institutional capacity is often constrained, and local infrastructure investments are sometimes associated with inefficient implementation, unattractive returns, and high credit risk—hardly an inducement for investors seeking competitive risk-adjusted returns and lenders wary of poor credit. The development of domestic municipal bond markets should thus go hand in hand with improvements in the municipal revenue base and in the institutional framework within which municipal services are delivered. The development of effective mechanisms to diversify and transfer risks is also important, but first the broad macroeconomic framework should foster domestic savings and the efficient allocation of credit.

Macroeconomic Issues

Municipal credit markets develop as a subset of domestic capital markets, which beyond the confines of municipal governments, require rational macroeconomic, fiscal, and monetary policies. Like other fixed income instruments, municipal issues will remain attractive to bondholders only when inflation is kept in check. Moreover, as a result of political constraints, local government borrowings in developing countries may actually become part of the overall public debt. This involvement makes it crucial for countries seeking to expand local borrowing operations to ensure that the consolidated public debt remains consistent with macroeconomic policy objectives and fiscal targets (see chapters 6 and 7). Departure from these principles might have destabilizing effects at the macro level. Genuine municipal bond markets imply that municipal issues should entail no sovereign support or guarantee that might create contingent liabilities at the sovereign level. As a result, they would be priced at market-determined rates usually at a spread above central government securities.

Institutional and Regulatory Issues

The development of municipal credit markets also requires that local governments have sound institutions, predictable fiscal relations with the central government, and an efficient organizational setting for service delivery. This set of requirements implies transparent

city budgets, credible accounting systems, independent audits, a sound competitive environment with rational pricing policies, and performance criteria that can be monitored for monopoly services. Private provision of infrastructure services and concession arrangements, many of them already proven, must be encouraged and developed (see chapter 15). Public utility companies should be autonomous and have a secure recurrent income through reliable services to consumers. To play their role effectively, capital markets must rely on well-functioning banking institutions with reliable payment systems and custodial services.

Municipal credit markets also require adequate legal and regulatory frameworks covering supervision and disclosure as well as debt issuance, settlement, and repayment. Regulations allowing municipal bankruptcy would be needed in the event of default (see chapter 30). Strains on municipal finances, which might be evident in periods of economic downturn, are likely to be combined with declining central government transfers and mounting taxpayer resistance to higher levies. Creditors' rights and the seniority of their claims on municipal assets should thus be well specified because these claims (even on dedicated revenues and taxes) would likely be weighted against the effects of disrupting the provision of critical public services and actually subordinating such other municipal liabilities as employees pension claims.

Credit Issues

Credit risk accounts for a critical component of investment risk, because returns and initial capital could be lost as a result of issuer's default. Credit quality thus becomes a determinant parameter as far as market acceptance and pricing of debt are concerned. Countries with developed financial markets rely fairly strongly on credit ratings, which provide independent opinions to investors as to the creditworthiness of debt issuers (World Bank 1999). Moreover, developing countries can use financial and legal structures that enhance the credit quality of municipal debt—guarantees, insurance, securitization, and derivative products—and improve investors' acceptance of debt issues. In countries that have sound banking systems, issuing municipal debt might be possible if the debt is backed, for instance, by bank letters of credit, so that all or part of investors' exposure is transferred away from issuing municipalities to more creditworthy commercial banks.

Pricing Local Government Debt

In countries that have market-determined interest rates, the central government securities, which are deemed to be free from credit risk because they carry the full faith and credit of sovereign governments when they issue debt in their national currency, provide the reference yield curve, or benchmark, for pricing other debt obligations including corporate and municipal issues across the maturity spectrum.

Some developing countries conform to a different pattern in which administered interest rate structures make the ready identification of a benchmark difficult. In China, for instance, where the bond market is under partial government control, non-sovereign debt issues must comply with the state credit plan. Coupon rates on corporate bonds and rates on commercial bank deposits may not be higher than those on government securities of comparable maturities. Efficient credit markets require that the level and structure of rates reflect economic conditions in which: (a) short-end, base rates (for example, the U.S. federal funds rate) are set by monetary authorities in the context of monetary policy objectives, and (b) long-term rates reflect inflation expectations as expressed by the market (that is, investors in the primary or secondary markets).

Debt by non-sovereign, including municipal, borrowers can then be priced at a spread above the reference risk-free yield curve. Spreads reflect issuers' parameters in terms of creditworthiness, liquidity, and size. When the government market cannot provide a benchmark because of the absence of market-determined interest rate structures or because of the absence of securities in specific maturity ranges (such as India where no government debt issues were beyond a 10-year maturity) efforts have to be made to develop synthetic benchmarks, or proxy yield curves.

Country Experiences with Specialized Local Government Financial Intermediaries

Mobilizing foreign equity to fund infrastructure investments in developing countries has become common, although it is selective in terms of countries and sectors and is often flowing in enclave investments. A strong challenge for local governments is to raise debt finance in the domestic as well as the Eurobond markets. Some countries, especially the larger ones, have relatively developed credit markets where local governments can mobilize debt. Other countries have established specialized intermediaries for local government finance.

Many developing countries have established municipal development banks as a channel for municipal credit. Some have received pools of loans from government sources. Others have sought to serve as a bridge to private credit markets in borrowing on domestic or foreign markets (although mostly with central government guarantees) and on-lending to local governments, directly or through domestic banks.

Industrialized countries have also established specialized financial institutions to foster local economic development. Examples include local government financial intermediaries in Belgium, Finland, France, Spain, and Sweden; municipal finance corporations in Canada (mostly provincial agencies operating at the provincial level); and municipal bond banks in the United States (state-owned intermediaries operating at the state level). A state revolving fund is an example of bond bank that has an element of public support and in which lending is mostly accomplished in leveraging central and state capital grants through bond issuance.

Among European intermediaries specialized in municipal finance, no clearly defined pattern of ownership emerges. Some are privately owned (France and Spain) and others are publicly owned (Belgium and Netherlands). The public sector can be present at the central or local government levels or both. Thus, Finland's Municipal Finance Plc. is owned by the association of local governments. It is involved in debt pooling for specific and identifiable projects, as is the case for U.S. bond banks. The Swedish local government funding agency Kommuninvest is owned by the association of local governments but is privately managed.

The central and local governments jointly own Holland's Bank Nederlandse Gemeenten; its loans are subject to the joint and several liability of the cooperative of local government borrowers and shareholders. Spain's Banco de Credito Local is privately owned by Argentaria and Dexia, a world leader in financial intermediation to local governments, with equity participation in a number of European funds. Dexia is the holding structure for Credit Communal de Belgique and Credit Local de France. Credit Communal de Belgique is a local government-owned cooperative; Credit Local de France, originally government-owned, has been privatized. Credit Local de France's resources are raised through bond issues, whereas deposits represent the main resources of Credit Communal de Belgique, which is a major depository institution, unlike most specialized financial intermediaries for local governments.

In several countries the World Bank has supported local governments through municipal development funds (MDFs). A comprehensive assessment of World Bank experience in MDF operations has yet to be conducted, but a number of reviews address specific aspects of MDF operations (Davey 1988; Peterson 1997). The reviews suggest that the investment components have been largely successful, met physical targets, added to the capacity of municipal infrastructure, and helped local governments build a credit record. The institutional development components, focused on local administration and technical capacity building, seem to have had limited success.

In terms of resource mobilization beyond official multilateral or bilateral sources, achievements have, with few exceptions, generally fallen short of goals. The reviews suggest that, despite some successes, MDFs have been to some extent alternative vehicles for central transfers to local governments, often associated with government subsidies or guarantees, directed or inefficient allocation of credit, and sometimes political patronage.

Future MDF operations should aim at encouraging transition to market-based municipal credit systems, including self-sustaining financial intermediaries for local government investments. To this end, reformers must define the requisite policy conditions for local government borrowing and the steps by which existing MDFs could be transformed into market-based operations. These issues are debated in a number of developing countries.

Evolving Role of Specialized Local Government Financial Intermediaries

The role, operating strategy, and financial structure of specialized financial intermediaries for local governments can evolve through different stages by focusing successively on:

(a) funding streams of local government investments, (b) assisting in local institutional development and helping build a local credit culture and record, and (c) mobilizing private long-term resources for local infrastructure projects.

First Stage

MDFs would act as a conduit of budgetary and other resources to local governments along specific criteria applicable to loans or grants. The comparison of the two scenarios, with and without MDF, shows that, in rationalizing the *ad hoc*, arbitrary, and sometimes politically guided process of resource transfers from central to local governments, the criteria-based MDF funding, which relies on strong technical capabilities, can strengthen local capacity, improve the selection of investment priorities, and markedly enhance the quality of local project finance.

Second Stage

Specialized financial intermediaries would further develop their capacity in local project finance. Local governments that draw on the intermediary's resources must service their loans out of the economic benefits directly or indirectly generated by the investments funded by such loans. This procedure would help rationalize borrowing practices at the local level and improve the quality of local investment programs. At this stage, the specialized financial intermediary's resources could consist of budgetary as well as bi- and multilateral official funding. The intermediary's institutional objectives would be, among other things, to help local governments strengthen creditworthiness by enforcing improved budgeting, auditing, and disclosure standards. This improved status would provide prospective lenders with credible and transparent information and establish a reliable credit track for future borrowings.

Third Stage

Within a maturing financial sector, specialized financial intermediaries would provide the pooling mechanism through which local governments could mobilize additional private financial resources for their investment programs. Market-based financial intermediaries for local government entities would operate along commercial principles and issue long-term debt that has no government guarantee for on-lending mainly to viable, revenue-generating infrastructure investments. Part of the lending may also be directed to investments in public goods (such as street paving, lighting, and security) if lenders can establish, and shoulder, the risk that local borrowing entities generate. The range of borrowers would be expanded beyond local governments to cover utility corporations serving local constituencies. These corporate entities would be eligible borrowers whether they are public, private, or operating under concession arrangements.

Objectives and Features of Market-based Local Government Financial Intermediaries

Market-based financial intermediaries for local governments are institutions able to raise long-term resources on private credit markets and operate in a financially sustainable manner. They support local government operations through a range of financial instruments and products adapted to local needs. Market-based local government financial intermediaries (MLGFIs) may operate in primary or secondary credit markets. They involve pool-financing arrangements for local infrastructure investments and provide smaller local government borrowers the possibility to access long-term debt markets. Lending would be accomplished mostly in leveraging the intermediary's equity funds through bond issuance. Nonlending products, including fee-based financial advisory services, may also be offered to local governments, mainly the larger ones. The intermediary's portfolio, diversified among a large number of local government borrowers, would provide a good security and strengthen the credit quality of its debt issues.

In an open and competitive financial system, the comparative advantage of MLGFIs among other financial institutions would rest mainly in their knowledge of the local government sector. The specific focus on local government business allows specialized intermediaries to build a competitive edge over other lending institutions that have a broader client base and act as a preferred lender for local governments. To achieve financial viability, MLGFIs need a regulatory environment conducive to enhancing local government creditworthiness. They must engage in efficient financial transactions within a business framework that is well defined in terms of: (a) strategic and institutional objectives; (b) eligibility criteria and operational features, including specific guidelines for portfolio diversification among sectors and borrowers; (c) a range of lending and nonlending products (such as loans, equity participation, guarantees, underwriting, and advisory services); (d) financial policies related to funding, lending, and capital adequacy; (e) product pricing for balance as well as off-balance sheet transactions; and (f) market, credit, and currency risk management policies. When relevant, the steps needed to transform existing intermediaries into sustainable market-based operations would have to be considered.

Market-based Local Government Financial Intermediaries and Municipal Bond Markets

MLGFIs and municipal bond markets are not mutually exclusive approaches to local government access to credit. They play complementary roles and serve different, albeit overlapping, market segments in meeting local government demand for long-term credit. This dual source provides local governments with different options to fund capital investments. Therefore, the establishment of MLGFIs is no alternative to building efficient municipal bond markets able to meet part of the credit demand of the larger local governments, which in aggregate might be significant. The availability of such alternative

sources of funding may somewhat reduce the claims by the larger local governments on scarce budgetary resources. These reductions might in turn release additional fiscal space for smaller local governments that are not able to access private credit. Moreover, domestic bond markets would be a source of long-term funding for MLGFIs and thus, indirectly, local governments.

Local governments differ markedly in terms of resource base and economic size. These differences bear on funding strategies and choices of financial instruments for capital investments. Thus, although larger, better endowed local governments that have good financial records may be able to tap the domestic municipal bond markets—and the international markets, in the case of a selected few local governments—smaller local governments often need to rely on the pooling capabilities of financial institutions to mobilize long-term credit. (Some small local governments may not be able to access credit in any form.) Moreover, in deciding whether to borrow from a specialized financial institution or to issue debt obligations on the bond market, local governments need to assess and compare the cash-flow implications of both alternatives. Indeed, whereas credit lines from financial institutions allow a draw-down of funds in accordance with borrower expenditure requirements, bond issues would result in relatively large, lump-sum cash in-flows. For local governments usually unacquainted with good liquidity management practices, loans from financial institutions allow for more manageable cash profiles and a better control of the cost-of-carry.

Role of Market-based Financial Intermediaries in Local Government Access to Credit

MLGFIs mobilize long-term institutional savings for local infrastructure finance by pooling the credit demand of local government borrowers. By acting as a bridge between local government demand for and capital market supply of debt securities, the intermediaries fill a void where little potential for direct local government access to credit exists. Indeed, when institutional investors are in no position to assess individual local government risk, they may be willing to assume a diversified local government exposure through the financial intermediary. As such, the capital markets remain, indirectly through the financial intermediary, the ultimate funding source for local infrastructure investments.

In leveraging their equity funds through debt issuance, the intermediaries can deepen and expand the market-based funding pool for local governments and contribute to the upstream development of domestic long-term credit markets. Regardless of intermediation-specific issues, the development of domestic credit markets requires regulations and guidelines on, among other things, disclosure, credit rating, and benchmarks for pricing local government debt securities.

MLGFIs must develop appropriate policies and mechanisms for lending to viable, revenue-generating investments (project finance), as well as to priority public good investments (public finance) that enhance the fiscal revenues of local government borrowers and generate the tax resources needed for debt service. As their expertise grows, financial intermediaries, who are the repository of knowledge, data, and indicators on local government operations and finance, could expand the range of their activities by offering additional products to local governments. Lending products could include, for instance, short-term credit to improve cash-flow profiles as well as seasonal expenditure and revenue mismatches. Nonlending, fee-based services could include advisory and technical assistance to local governments, as well as underwriting of local government securities, especially in the case of private placements requiring no retail infrastructure.

Market-based Local Government Financial Intermediaries and Management of Risks

Like all financial institutions seeking to maintain financial viability (and achieve growth and profitability), MLGFIs must effectively manage the main risks inherent in their lending business. Foremost among these are the market, credit, and foreign exchange risks. Specific issues (strengths as well as weaknesses) associated with the financing of local governments need to be duly factored in the intermediary's risk management policies. On the one hand, local governments, unlike corporate borrowers, are subject to constraints and regulations likely to hinder their debt service capacity, including inflexible staffing structure and costs, obligation to maintain minimum levels and standards of services even during economic downturns, and special jurisdiction that may shield them from creditor claims. On the other hand, local government borrowers that have taxing authority may increase revenues to meet debt service obligations in calling, within limits, on additional sales, business or property taxes.

Interest Rate and Off-balance Sheet Risks

MLGFIs, which are in the business of funding long-dated assets through long-term loans, need matching long-term resources that they raise on capital markets. Because they are not depository institutions, MLGFIs are unlikely to engage in maturity transformation in any significant way. Nonetheless, maturity mismatches may arise between the financial intermediary's resources and applications. Any resulting interest rate or duration risk would need to be adequately managed. Moreover, MLGFIs need to develop the capability of managing their contingent liabilities (such as off-balance sheet exposure, including guarantees and other capital-sensitive nonlending products). In particular, the pricing of such transactions should reflect the cost of capital tied up in them.

Credit Risk

The ability of a MLGFI to mobilize long-term debt on private markets is conditional on its creditworthiness. In turn, creditworthiness is a function of the credit quality of assets (that is, the portfolio of local government loans). For MLGFIs, the built-in portfolio diversification resulting from the variety of subsectors and borrowers translates into improved portfolio quality. Such a diversified asset base: (a) provides good security to creditors because it strengthens the credit quality of debt issued by the intermediary, and (b) allows the use of credit enhancement structures that require a diversified, expanded pool of debt. Thus, a MLGFI can use guarantees and derivatives that effectively increase market acceptance or lower the cost of debt issues. Securitization of the intermediary's loan portfolio can further strengthen the credit quality of its debt obligations.

Foreign Exchange Risk

MLGFIs may have difficulty hedging any foreign currency exposure that is not passed on to borrowers. Yet, local governments that generate no foreign currency resources (tax and fee income mostly accrue in local currency) may not be able, in the absence of efficient currency swap markets, to bear such foreign exchange risk. Hence fostering the development of domestic markets as a source of long-term, local currency finance is of crucial importance. Should the national authorities decide, when foreign currency is involved, to assume the foreign exchange risk on the grounds that they control monetary policies and foreign exchange reserves and would therefore be prepared better to hedge and manage the risk, the intermediary or the ultimate beneficiaries would have to levy a duly priced fee to cover government's exposure.

Ownership of Local Government Financial Intermediaries and Elements of Public Support

Ownership structure is an issue often raised in connection with MLGFIs. Although private ownership would be the preferred option, public or joint private–public ownership can also be considered as long as the MLGFI has no monopoly in local government finance and operates under the same rules and regulations as other private financial institutions involved in the local government sector. In the case of public ownership (where public equity funds are leveraged in private credit markets), any guarantee that either the central or local government may provide to back the intermediary's debt issues should be duly priced and structured to reduce the likelihood of its being called on, and thus alleviate the incidence on the guarantor. Budgetary transfers and grants, if any, from central to local governments may be handled by the intermediary for a fee on a managed, off-balance sheet basis. For example, the government may channel through the MLGFI clearly targeted and transparent grants for projects involving more exacting national environment standards and for which externalities are demonstrated.

Specialized Financial Intermediaries for Local Governments: A Useful Tool

Specialized financial intermediaries for local governments can serve a useful purpose in allowing local government access to long-term credit markets through an evolving process. In the initial stages, the institutional and operational focus of the intermediary would be mainly on the asset side (that is, portfolio quality and the economic sustainability of local projects):

- The ultimate objective would be to move toward establishing market-based approaches involving commercially viable, well-capitalized financial intermediaries that could independently mobilize long-term debt on private markets for on-lending to priority local investments.
- The evolving role of the intermediary would require a parallel development at the financial and infrastructure sector levels, including structural and regulatory changes to remove barriers to private sector entry into local infrastructure provision and to private financial institutions' participation in local project finance.
- Although private ownership of MLGFIs is preferable, public or joint private–public ownership can be considered as long as no restrictions or penalties are placed on other private financial institutions involved in the local government sector.
- MLGFIs and municipal bond markets play complementary roles in meeting local demand for term credit. They offer alternative options by financing local governments, the needs and capabilities of which vary in line with their economic size and resource base. Municipal bond markets may be more suited for the larger, better endowed borrowers. Yet, when local governments lack the scale for direct market access, MLGFIs can fill the void by pooling credit demand and mobilizing long-term resources on local government's behalf.

Credit Rating

Local governments planning to tap the credit markets may want to obtain a credit rating by a recognized rating agency. A rating entails a credit agency review that would measure a local government's ability to service debt in light of available taxes and other resources, and assess its record in honoring financial commitments, especially under adverse circumstances. Relevant areas of focus would be the economic and social characteristics of the constituency, and the structure of the government debt and financial operations (including sources of revenues, spending requirements, and unencumbered cash available). Improving the credit standing of municipal issuers requires that municipal tax bases be expanded and tax rates rationalized, and that local investments, including infrastructure, be screened to select those that have large payoffs in helping cities develop services, expand business, and increase employment.

As a general rule, no issuer will receive a rating higher than the sovereign rating of the jurisdiction in which the issuer is located—the so-called “sovereign risk ceiling.” This rating reflects the risk that depreciation in the value of the local currency or imposition of foreign exchange controls might restrict the ability of subsovereign issuers to honor their debt service obligations. Under certain circumstances, securitization through offshore receivables, for instance, may provide the basis for a credit rating that may be above that of the sovereign.

By providing independent opinions to investors as to the credit quality of debt issuers, credit ratings have become important parameters in market acceptance and pricing of debt. Ratings are now viewed as easy-to-use tools for differentiating credit quality by individual investors and by institutional investors often required to hold instruments of given credit categories in their portfolio.

Definitions and Features

Credit ratings are public opinions about the creditworthiness of an obligor (that is, a debt issuer) with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program, such as commercial paper. Ratings are based on the likelihood of default and the capacity and willingness of the obligors with respect to timely payment of interest and principal in accordance with the terms of their obligations. A rating is not a general-purpose evaluation of an issuer; it may also be predicated on the credit enhancement provided by a third party, such as a guarantor, insurer, or lessee.

Credit ratings are analyses based on current information obtained from the obligors and other sources that rating agencies consider reliable. The agencies are unambiguous in their disclaimer that a rating is not a recommendation to buy, sell or hold a debt security as it performs the isolated function of credit risk evaluation, which is only one element of the entire investment decision-making process. Moreover, despite the thorough rating process, rating agencies do not conduct an audit of the information supplied by the issuer, which forms the basis on which ratings are assigned. Rating agencies have no fiduciary responsibility in relation to investors. Therefore, although ratings are important elements of disclosure, they should not be outright substitutes for credible reporting by issuers as far as investors are concerned.

Change in Rating of Outstanding Debt

The financial condition of a rated entity may change, sometimes rapidly, because of intrinsic reasons that alter the price structure of a product line or erode the competitiveness of a business concern. A lapse in the risk management and control systems of an obligor may cause a rapid change. For example, California’s Orange County, which despite its high-

quality rating had to file for bankruptcy protection in 1994 after sustaining large losses in its liquidity portfolio. A macroeconomic downturn or financial shocks (for example, financial crises in east Asia) that deflate asset prices, reduce demand for companies' output, or contract the revenue base of public entities may also cause a rapid change in credit rating.

Credit ratings on outstanding debt obligations may be subject to downgrade or upgrade, so a rating agency should consider that material changes in the financial condition of an issuing entity do warrant a rating review. The issuer's rating may be put under credit watch with positive or negative outlook until such time as a revised rating is assigned. The timeliness of rating reviews is critical to investors, who view ratings as leading indicators of credit quality. In this regard, the speed in which rating agencies recognize, and reflect through credit downgrade, the onset of a financial crisis, for instance, might be viewed by investors as a performance indicator of the agencies' role as an early warning system for the financial markets. Rating agencies walk a fine line and argue that a precipitous action of downgrade, in restricting or increasing the cost of access to credit markets in time of crises, can further compound borrowers' ills.

Ratings as Relative Measures of Creditworthiness

A credit rating provides a relative ranking of issuers' creditworthiness under similar stress conditions. As such, ratings offer a vehicle for the relative pricing of debt securities when yield spreads among debt issues that have different credit ratings reflect the credit risk premium required when investing in the riskier issues. The benchmark reference for the pricing of corporate and subsovereign debt would normally be set by the debt securities of even maturity issued by the sovereign government in the currency of the debt. The interest spread would compensate for the credit and liquidity risk of the debt issue relative to the so-called "risk-free" sovereign debt obligation. (For instance the U.S. Treasury securities set the benchmark off which all U.S. dollar denominated debt issues would be priced.)

Sovereign Ceilings for Foreign Currency Ratings

Country risk considerations form an integral part of the credit analysis of debt issuers, because credit ratings take into account the currency in which a debt obligation is denominated. To this end, rating agencies assign sovereign ratings for countries. These ratings generally set a ceiling for the foreign currency denominated debt of domestic entities, including subsovereign governments. The rationale for the sovereign rating ceiling is that domestic entities might eventually have to rely on central governments and central banks to secure the foreign exchange required for external debt service, but a domestic entity could qualify for a foreign currency debt rating higher than the sovereign's, for instance, when debt securitization is backed by export trade receivables or using other forms of credit enhancement such as insurance.

Project-specific Ratings

Rating agencies provide credit assessment of project finance deals. Project finance deals would normally be capped by, and not necessarily qualify for, the sovereign rating of the country in which the project is located. Regardless of country ceiling however, some projects, typically exports with structured financing, may claim a subsovereign rating higher than the sovereign's. Moreover, a project-specific rating based on secured or structured debt for instance, might be different from, and superior to, the rating of the company issuing the project debt.

Short-term Ratings

Credit ratings reflect the issuers' ability to meet their debt obligations as they come due over the contractual term of the borrowings. In this regard, debt with long-term maturity would be assigned a "long-term" rating. Rating agencies assign "short-term" ratings to debt obligations that have original maturities of one year or less, such as commercial paper. A short-term rating may also be used to indicate the credit standing of an issuer with respect to a put feature on a long-term debt obligation (where the put gives investors the right to sell back the debt obligation to the issuer at an agreed price within a specified period). In this case, a dual rating may be published with the short-term rating relative to the put feature and the long-term rating relative to the underlying long-term security.

Credit Quality and Default Rates

Although a credit rating is just a solid assessment of the credit quality and as such just one element of a complex investment decision-making process, evidences suggest that there are strong correlation between the credit quality and the subsequent defaults. This section summarizes results of enquiries on coincidences between: default and economic environment; default and credit quality; volatility of defaults by credit categories; and the risk of unforeseen event.

Default Rates and Economic Environment

Statistical analyses correlate credit quality and default rate on an historical basis. For instance, analyses can quantify the occurrences of default x_{aaa} %, x_{aa} %, and x_a % over a specified holding period for entities that had been rated respectively AAA, AA, and A at period-start. Analyses confirm that x_{aaa} is lower than x_{aa} , which is in turn lower than x_a . Yet, absolute default probabilities may not be inferred from the credit rating categories, because default occurrences x_{aaa} %, x_{aa} %, and x_a % are period dependent (with higher concentration of defaults in periods of economic depression). For instance, analyses of corporate debt defaults during the U.S. Great Depression show that, of all corporate issuers rated by Moody's as of July 1932, almost one in ten defaulted within one year. Of the U.S. municipal

debt issues that were rated in 1929 and went into default in 1932, 78 percent had been rated AA or better, and 48 percent had been rated AAA. Reflecting the severity of the depression, such default occurrences of highly rated municipal entities over relatively short holding periods are unlikely to be matched in other times.

Default Occurrence and Credit Quality

Among the studies correlating default rates and credit-rating categories are Moody's analyses of historical default rates (Moody's 1987). The recent 1997 update of the research covers the 77-year period 1920–1996, over which Moody's had rated the debt of some 14,000 corporate and sovereign issuers. Recent studies of municipal default rates might be less representative than for corporate defaults, because the majority of U.S. subsovereign issuers are in the middle-to-high end of the investment grade spectrum, with most recent debt issues covered by bond insurance. Claims against municipal bond insurances show insignificant levels of default. In Moody's studies, default is defined as any missed or delayed disbursement of interest and/or principal. Default also includes distressed exchanges where bondholders are offered packages of securities with diminished financial obligation such as preferred stock.

The studies show the inverse relationship between default rates and rating categories, with a clear pattern of higher risk of default for the speculative grade-rating categories. For instance, over the 27-year segment 1970–1996, average one-year default rates were 0.01 percent for A-rated issuers, 0.12 percent for Baa-rated issuers, 1.36 percent for Ba-rated issuers, and 7.27 percent for B-rated issuers. Over the entire period 1920–1996, one-year default rates were 0.08 percent for A-rated issuers, 0.30 percent for Baa-rated issuers, 1.48 percent for Ba-rated issuers, and 4.47 percent for B-rated issuers.

For defaults over holding periods exceeding one year, the studies also show a significant jump in default frequency for progressively lower ratings. Indeed, during the 1920–1996 period, (cumulative) default rates over a 10-year holding period averaged 8 percent for issuers rated Baa, against 18 percent for Ba and 31 percent for B-rated credits. A similar pattern of increasing average default rates for lower rated issues also prevails over 5-, 15-, and 20-year holding periods.

Volatility of Default Occurrences and Credit Category

The studies also show that the volatility of default rates increases with lower credit rating (for instance, default rates within one-year for B-rated issues reached 22 percent in 1970, with no such default in 1971). Volatility of one-year default rates expressed by the standard deviation over the study period 1920–1996 range from 0.1 percent for Aa credits to 0.3 percent for A credits, 0.4 percent for Baa, 1.7 percent for Ba and 4.5 percent for B. The lower predictability of default rates also explains the significantly higher risk premium required by investors in lower rated issues. (Moody's 1997)

Event Risk

Regardless of credit quality and rating category, defaults may be brought about by special events, which Moody's defines as follows: Changes in a borrower's "prospects of financial position that result in a sudden shift in credit quality although its precise timing and nature could not have been predicted by the fundamental tools of credit analysis" (Moody's 1997: 87). Examples would be mergers or takeovers, divestitures, and filing for bankruptcy protection as a defense against litigation (for example, the litigation-related bankruptcy filing of the Aaa-rated Texaco). Although credit evaluation is supposed to factor special events into ratings of individual issuers, the full implications in terms of default experience of individual companies cannot be predicted in advance. Special events are likely to have their greatest impact on default rates of higher rated issuers because these, by definition, are more resilient to default than lower rated issuers would be under similar exogenous economic conditions.

Subsovereign Credit Ratings

Local governments in emerging and developing economies are increasingly seeking ways to raise debt on private credit markets to finance local investments. As a result, subsovereign credit assessment has become an important topic for investors and policymakers. In the United States most municipal debt issuers are rated. In emerging and developing economies, subsovereign credit evaluation, which is in its early stages, would need to respond specifically to the concerns of potential domestic and foreign lenders and investors as they evaluate credit demand and investment proposals by local governments. To this end, the information systems upon which ratings are predicated must be built and improved (see also chapter 19).

Credit-rating systems in which creditors rely on the subsovereign borrower's capacity to repay, not on an explicit or implicit sovereign guarantee, analyze the assignment of responsibilities among various levels of government, the structure of local government expenditures and revenues (including own source), and the regulatory and institutional setting within which local services are delivered. Creditworthiness, as assessed by market players, including rating agencies, should reflect the local resource endowment, soundness of the local government finance framework, and its capacity to withstand stress and issue debt in a way consistent with macroeconomic stability. Thus, credit analyses of subsovereign issuers and the assessment of an issuer's ability to service debt seek to address the following:

- *Economic and social characteristics of the jurisdiction.* These characteristics include local resource endowment, the existing stock of productive assets, level and distribution of income, level of education, and quality of services.
- *Sources and composition of revenues and expenditures.* These criteria cover the predictability of fiscal relations with, and transfers from, the central government and the local revenue

base. The latter includes composition of taxes (property, business, development, and sales), adequacy of tax rates and tax administration, and existence, diversification, and sustainability of other revenues upon which local governments would call to meet debt service. This evaluation would be matched and assessed against the level, structure, and profile of local expenditures.

- *Structure of local government financial operations.* These operations include outstanding debt and other financial commitments, structure of assets and liabilities, liquidity, and unencumbered cash available. Also relevant would be the quality of financial controls and the transparency and credibility of budgeting, accounting, and auditing systems. The issuer's record in honoring financial commitments, especially under adverse circumstances, would also be assessed.
- *Regulatory and institutional setting for local service delivery.* This setting includes the capacity and efficiency of local government institutions, the quality of local asset management, the degree of autonomy of utilities companies, the reliability of services to consumers and recurrent income, the competition and pricing policies in the provision of local services, the criteria for monitoring performance of monopoly services, and the processes for planning and selecting local investments (including infrastructure) that help local government expand businesses and increase employment.
- *Legal and regulatory environment for local government credit.* This environment includes the framework for debt issuance, settlement, repayment and custody; regulations on local government bankruptcy; creditors' rights; and claims on local assets against other liabilities.
- *Credit enhancement mechanisms.* These mechanisms include the assessment of features that strengthen the credit of local government debt issues in providing security collateral through dedicated streams of income and third-party support, such as guarantee, insurance and bank letter of credit, and derivative structures.

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Appendix
Credit Rating Rules

| <i>Standard & Poor's Long-term Ratings Scale and Definitions</i> | <i>Moody's Long-term Ratings Scale and Definitions</i> |
|--|--|
| <p>AAA Debt rated AAA has the highest rating assigned by Standard & Poor's. Capacity to pay interest and repay principal is extremely strong.</p> <p>AA Debt rated AA has a very strong capacity to pay interest and repay principal and differs from the highest rated issues only in small degree.</p> <p>A Debt rated A has a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.</p> <p>BBB Debt rated BBB is regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher rated categories.</p> <p>BB, B, CCC, CC Debt rated BB, B, CCC, or CC is regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. BB indicates the lowest degree of speculation and CC the highest degree of speculation. While such debt is likely to have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.</p> | <p>Aaa Bonds which are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt edge." Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.</p> <p>Aa Bonds which are rated Aa are judged to be of high quality by all standards. Together with the Aaa group they comprise what are generally known as high-grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long-term risks appear somewhat larger than in Aaa securities.</p> <p>A Bonds which are rated A possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment somewhat in the future.</p> |

| <i>Standard & Poor's Long-term Ratings Scale and Definitions</i> | <i>Moody's Long-term Ratings Scale and Definitions</i> |
|---|---|
| <p>C The C rating is used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued.</p> | <p>Baa Bonds which are rated Baa are considered as medium-grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and, in fact, have speculative characteristics as well.</p> |
| <p>D Debt rated D is in default, and payment of interest and/or of principal is in arrears.</p> | <p>Ba Bonds which are rated Ba are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interests and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.</p> |
| <p>Plus (+) or Minus (-) S&P's ratings from AA to B may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.</p> | <p>B Bonds which are rated B generally lack characteristics of the desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.</p> |
| | <p>Caa Bonds which are rated Caa are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.</p> |
| | <p>Ca Bonds which are rated Ca represent obligations which are speculative in a high degree. Such issues are often in default or have other marked shortcomings.</p> |
| | <p>C Bonds which are rated C are the lowest rated class of bonds and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.</p> |
| | <p>Ratings from Aa to B may be further disaggregated in numerical sub-categories (1, 2, 3).</p> |

Source: World Bank 1999: 6–5.

28 Municipal Infrastructure Financing Cases

Charles Jókay, Judit Kálmán, and Mihály Kopányi



Since 1990 local governments in Hungary have made significant investments in water and wastewater treatment systems using mostly state funds, mainly targeted and addressed grants. Drinking water systems were completed in five years, and now serve all localities and 99 percent of Hungary's population. Regardless of the success in terms of quantity, the financial efficiency and economies of scale of these developments came under increased scrutiny. Many of the fixed networks for natural gas supply, electric power, and telephones were privatized and operated on a regional basis. The next challenges are in wastewater collection and treatment, solid waste handling, and road construction. All three functions are important for European Union membership.

Local governments have proven very innovative in financing infrastructure; at the same time, they are far from using financing techniques common in more developed economies. Within Hungary's mixed regulatory system and almost entirely privatized banking and financial system, local governments with a broad range of business and economic activities provide many examples of creative infrastructure finance that are rational in the environment in which they operate. These creative solutions on a project-by-project basis, however, are often suboptimal at the national level, and reveal the distortions caused by uncertainty and the adverse incentives of the investment grant system.

This chapter addresses municipal infrastructure finance issues based on extensive field research and a comprehensive review of several recently completed sewage-treatment and collection projects. In addition to identifying the actors, their roles, and prototype models, this chapter describes four cases which demonstrate that: (a) the primary criterion for local government decisions is to maximize grant funding rather than optimize investments, (b) the grant distribution system causes liquidity problems for municipalities during construction projects, and (c) expensive and semi-legal bridging tools are used to overcome these liquidity gaps.

* This chapter is based on Jókay, Kálmán, and Kopányi 1998.

Actors Involved in Municipal Infrastructure Projects

Several actors develop and provide utility services, each with different, sometimes conflicting, objectives, legislative and economic conditions, and motivations. These actors are the local government, the utility operator company, the large users, the prime contractors, the financial institutions, and the small customers of utilities.

The Local Government

The key actor in initiating, planning, funding, constructing, and operating a sewage treatment plant and collection system is the municipality or a group of municipalities in a loose association managed by a lead municipality. In most cases the municipality directly owns the treatment plant and the network because these facilities are by law core assets (see chapters 17 and 19); the municipality often also owns the utility operating company. The municipality and its institutions, such as schools and hospitals, are often major consumers of utility services, and the local government is also a regulator and oversight body representing the interests of commercial, private, and industrial consumers.

As project manager, the local government supervises technical planning, engineering, and construction and obtains funding sources in the form of grants, loans, and equity. Setting utility rates is a conflicting and difficult municipal function. On the one hand, the local government should support cost-based pricing with a modest profit; on the other hand, as a political entity, it often fails to support an economically rational price or an adequate price adjustment. As the price regulator, the local government has the right to examine in detail the utilities' operation and cost structure, even if it is not the owner. This arrangement raises the classic principal-agent dilemma in the sense that the public authority may not have technical skills to review and encourage efficient utility operation.

The Utility Operator

The operator could be a department of the local government, an independent municipal enterprise, a private enterprise, or a state-owned firm. At the onset of the new local government system, core and noncore assets were separated. Assets such as machinery, vehicles, and buildings were spun off into an operator company, and core assets, such as land, sewer pipes, and treatment plants were transferred from the state to the books of municipalities. Commonly, a pre-arranged lease arrangement was created between the municipality and the operator, who pays a negotiated leasing fee, which conceptually should be sufficient to cover the real depreciation and financing cost of the core assets.

Political considerations, however, limit the extent to which the leasing fee covers these expenses. Under this arrangement, the value and depreciation of municipal assets are indirectly related to user fees (see chapter 15). Very often, the user fee is set on a

political basis, and the leasing fee is calculated to enable the operator to cover its capital and operational expenses and provide a moderate profit. As a result, the leasing fee is often nominal.

Looking at the whole universe of the integrated utility service system, most assets are owned by the municipality, and the undercapitalized operator owns only a relatively small portion. One major consequence is that the operator does not have enough physical collateral to obtain financing for new investments, necessitating various local government guarantees involving real estate and other assets with no relationship to the capital project being funded.

Large Users

Large industrial and commercial users of water and sewage services have a vested interest in plants that have the capacity to treat their effluent adequately. These interests are often at odds with those of the population, which does not feel the effect of environmental degradation directly. Heavy users must comply with discharge standards to obtain or renew operational licenses and to avoid fines and penalties or a disruption of operations. In project planning, when several large users account for a significant portion of the effluent and pollutants, local government's best interest is served by involving the large users at all stages from planning to capacity engineering, especially to project finance preparations.

Prime Contractors

Because of the size and complexity of a utility development, a prime contractor should serve as the sole counterpart of the investor and be responsible for completion of the project. The contractor should also select subcontractors, coordinate their work, and ensure their cooperation. The prime contractor should be sufficiently capitalized because its capital should provide liquidity and guarantee against unforeseen risks. The prime contractor often volunteers to cover significant expenses, although some of them occur prior to selection. The 1995 Act on Public Procurement, however, requires a public competitive tender for projects above a certain size; all but 10 percent of water, wastewater, and sanitation projects fall into this category.

The prime contractor could be a municipal enterprise, but very often it is a private company. The latter often volunteers to provide three types of bridge financing to the investor municipality:

- *A loan identified as such in a contract or note.* Mortgaged real estate unrelated to the project could also be involved.
- *A loan against a fictional sale contract.* To hide contingent liability, the contractor purchases a piece of real estate or other property at a low price with a put option and sells it back at a more favorable price when the municipality's liquidity is restored.

- *Accepting delayed payments for services rendered.* The due amount is paid when the municipality obtains funds from another source.

A closer look at these arrangements shows that the effective real interest rate and the total cost of funds in most of these schemes far exceeds those of purely market-based loans and other forms of credit, because of the lack of local government creditworthiness, as well as lack of expertise in project finance and in the analysis of real or effective price of such offers.

Financial Institutions

In the late 1980s, before the transition from socialism, local councils issued 10–15 year notes with fixed 8–10 percent interest rates. In the early 1990s inflation 30 percent and above destroyed the real value of these instruments. Afterward long-term fixed rate financing (such as 20–30 year bonds) was not available; banks tended to lend for three to five years at variable interest rates indexed to short-term government bonds. The present prudential regulation requires banks to set up reserves of 100 percent against municipal loans.

The prevalent grant and soft money system creates adverse incentives for project-based cash flow financing. In addition, the general level of uncertainty and perceptions of creditworthiness prevent the issuance of classic general obligation debt. Legal regulations—such as the debt service limit provision of the 1990 Act on Local Government—prevent excessive debt. The municipal accounting system is cash-based, however, and does not accrue or apportion an impending balloon payment as “debt service,” which may cause sudden, unpredictable violations of the debt service limit in the year of the balloon payment.

Customers

The population is, first, a consumer of infrastructure services and, second, but no less important, the taxpayer, voter, and enforcer of popular sovereignty over the local government that is the owner, price-setter, and perhaps operator of the same infrastructure. In addition, the population pays a gamut of central government taxes, a portion of which comes back in the form of capital grants to municipal projects. In a slightly schizophrenic situation, the local citizen encourages grant seeking, which is not necessarily in the citizen’s favor as a payer of national taxes. Various segments of the population could have multiple roles as local business leaders, consumer advocates, and environmentalists.

Customers also play a critical role as financiers through user fees, connection charges, and local taxes. User fees are often in the crossfire of local political debates, which could result in economically dubious compromises. The willingness to pay “unfair” rates is thus critical if the population is not educated about the true costs and benefits of the

infrastructure. In addition to hook-up fees and contributions to utility capital costs, the population often forms wastewater associations, signing petitions enabling the associations to borrow funds from banks where 70 percent of the interest cost is paid by the state directly. These associations essentially signal a form of highly subsidized phantom municipal borrowing in which the state bears an additional burden. This dubious involvement of the citizens in project financing supports the arguments for keeping user charges below full cost recovery.

The State

The state, through various grant and soft loan programs, is essentially the chief financing source for local infrastructure projects that reflect some national priority. These funds come in the form of targeted and addressed grants, from special funds (from the Water and Environmental Ministries), and regional development sources. Using the principle of matching grants, this system means roughly a 50 percent direct state share that in some cases, given the lack of coordination and enforcement, could be tuned up to 100 percent or more of project costs.

The state provides payments only against invoices that have been paid. This reimbursement scheme causes a major liquidity problem even for projects that are overwhelmingly grant funded. Preparation costs are not reimbursed by the state, and, in essence, local governments have to pre-finance the eventual state grants. Vendors and prime contractors, as well as financial institutions, provide up-front money. The state as rule-maker and creator of the enforcement mechanism motivates grant-seeking and grant-maximizing behavior removed from economic and environmental rationality.

Four Basic Investment Models

The four sewage development cases summarized below do not represent a statistical sample, yet they show four common ways of financing local utilities in the 1990s. Our findings support the conclusion that beyond the intrinsic economic circumstances, the views, perceptions, policy priorities, and political connections of local governments determine the technical and financing character of these investment projects. The system of state investment grants, beyond its primary role in supporting national priorities, often distorts the size, financing forms, and efficiency of local utility investments (see box 28.1).

Box 28.1 Four General Financing Models

The scale and dimensions of various sources of funding distinguish the four general models of infrastructure finance, ranging from using almost entirely state funds to using largely own-source funds and private capital that is to be repaid from operational revenues. The following descriptions show the different role of own sources in capital costs.

100 percent or overwhelmingly state-funded projects. No local government project is done without some degree of state funds. One extreme would be a complex mix of state funds (for example, targeted grants, addressed grants, funds from ministries of environment, water, transportation, and regional development) adding up to 100 percent or perhaps more of a project's cost. Central government funding sources are not synchronized, coordinated, or cross-referenced. Starting in 1999, donors are required to coordinate among themselves. Targeted and some other infrastructure grants also play an economic equalization role and are distributed on an entitlement basis.

Entirely own sources. At the opposite end of the spectrum, a local government could fund a project entirely from its own sources such as loans, operational savings, capital contributions, and hook-up charges. A popular practice is to characterize as an "own source" all funds that are obtained from sources other than the one being applied for at the time. In other words, a grant from the Ministry of Environment is considered to be own source when matched against the targeted grant or other state grants. Genuine own sources can include asset sales, capital income, operating profits from user-fee-based services, as well as loans based on future cash flow from these sources. Borrowing is seen as a last-resort mechanism, in contrast to the pay-as-you-go system of intergeneration equity in practice in more advanced Organization for Economic Cooperation and Development countries. Bond financing, whether general obligation or revenue, is still controversial, yet a hopeful future option.

Public-private partnership. This model involves several variations. In one case a large commercial or industrial user offers a soft loan to the project company or to the municipality, in return for quicker construction or the use of a technology that is more appropriate to the donor's needs. The large user offers cash that can be used to complete the project faster than otherwise possible given the 3-year draw-down under the traditional targeted grant system. The large user avoids environmental penalties and operational disruptions, and the municipality enjoys a steady stream of predictable user fees during operations and liquidity during construction. Another variation is to involve a concessionaire in a so-called build-operate-transfer arrangement, where the concessionaire finances, builds, owns, then later transfers ownership to the municipality in return for a guaranteed rate of return. In a unique central European twist, an inverse build-operate-transfer became typical. In this arrangement, a piece of infrastructure is built with public funds then sold to a concessionaire or leased to an operating company. Privatization of Hungary's gas and electric utilities represent an inverse build-operate-transfer.

Vendors finance. Vendors could be asked not only to provide liquidity loans, but essentially to finance the own-source portion of a municipal project by delaying payments over long periods and by actually loaning cash or buying services at disproportionate prices from the operating company or project company. The project's own sources are provided by the vendor who then recoups the investment through its usual profit margin. The vendor essentially extends a loan that would be repaid from the proceeds of a potential concession fee offered to the municipality in return for the right to operate the facility. The infrastructure, built with state funds and from explicit and hidden loans from the prime contractor and major services and equipment vendors, is financed from anticipated profits from user fees and from high markups on services rendered.

Project Supported Entirely by State Funds

The first typical case is a small village of 1,700 citizens in one of Hungary's most disadvantaged regions that has a high unemployment rate above the national average. This

village decided to initiate a sewage project with a total three-year cost about 10 times its annual budget. Given the village's small size, any infrastructure project of significance is likely to be a multiple of its annual budget. This village was motivated by the availability of free money and soft money, and by rivalry with neighboring communities of similar size. The community began planning when it was already pre-treating its wastewater without an expensive sewer system.

The village had four options: (a) improve the existing wetland and connect the new sewage collection network there, (b) build only a network and connect it to a nearby large city, (c) connect its new network to a nearby medium-sized city's treatment plant under construction, (d) construct a network and a small treatment plant with a neighboring small village.

Expanding and improving the existing wetland and building a collection system was the first and the most economical option in terms of capital and operating expenses. The regulatory authorities did not favor natural or alternative treatment systems, and imposed discharge standards that made using the existing system difficult. In contrast, European Union discharge standards do not apply to settlements with populations of fewer than 2,000. Zealous environmental regulations prevented the most cost-effective form of treatment in this case.

The second option was to build collection systems and mains, and connect the village to a nearby large city's underused modern treatment plant, which had low capital but higher operational expenses. This option was rejected because of the cost of moving sewage a large distance and doubts about the citizens' willingness to pay high sewer charges. The grant system requires an estimate of operational expenses, not coverage of all costs, including replacement and capital costs. Hence, municipalities focus on minimizing operational costs and do not select the most economical option.

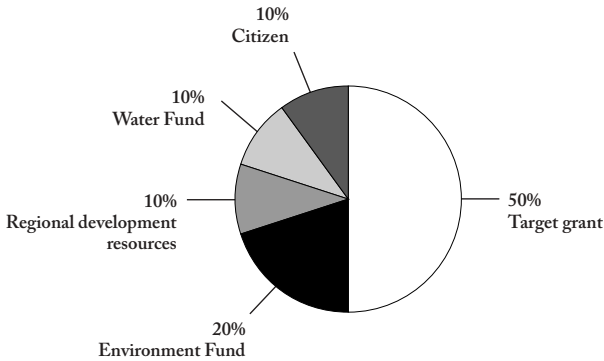
The third option was to build the collection system and connect it to the treatment plant under construction in a neighboring town of 5,000. Because the village was not part of the other town's original grant application, however, it could not join later because of grant regulations. In this case, the grant regulations prevented joint provision of a service because, illogically, a grant-supported project underway could not be modified.

The fourth option was to construct a new treatment plant jointly with a neighboring village. This joint effort brought the user population to more than 4,000, and the other village contributed the presence of an industrial user interested in a plant expansion.

The village selected this last alternative, financed a technical plan, and applied for state grants in 1998 (figure 28.1). Of the Ft one billion total investment cost, the village needed to assemble Ft 471 million (Ft 31 million toward the treatment plant and Ft 440 million toward the collection system), of which 90 percent was expected to come directly from state sources and about 10 percent from hook-up fees from the population. Discussions with the local government led us to the conclusion that this preferred alternative was selected based on the lowest possible user fees, but we realized that the village had not taken certain expenses, such as depreciation, into account and that estimated user fees for

approximately 500 households were likely to be much higher than indicated by the village's own projections.

Figure 28.1 Financing Sewage Investment in NT



Source: Municipality of NT data.

The investment alternatives were further distorted by an informal rule of cost calculation still common in the country. The village reasonably expected to make this development without any significant cash contribution of the municipality even when it was likely to generate a sizable positive cash flow. Investment costs were based on “national average unit costs” announced initially by the Transport, Water, and Telecommunications Ministry as cost ceilings for reviewing the grant applications, but soon became used as national average unit costs (see box 28.2). Because this village had favorable soil conditions, its construction costs were significantly lower than calculated in the project proposal.

In the end, this project was dropped because of political changes, but it serves to demonstrate the major role of political relations between the local and central governments and of state funds in selecting project alternatives. A significant feature of this situation is the huge difference between the sponsoring village's annual budget and the total or annual capital cost of the sewage system being built. In other words, a village with a Ft 80 million annual budget was encouraged to be responsible for a Ft 470 million project. We cannot be certain that sufficient technical and financial competence existed to manage the project. Moreover, even if the project eventually provided a positive cash flow, the small local budget would have been insufficient to overcome the liquidity management problems over the project cycle.

Box 28.2 The Centrally Set Unit-cost Ceilings

The Ministry of Water, Transportation, and Telecommunications published in the *Official Gazette* the centrally set unit-costs ceilings for sewage developments in 1996. These costs have been introduced with the foresight of providing a basis for comparability and cost effectiveness. The unit costs are given along technical measures in the following format: for pipelines according to size of pipe, for machinery for transfer of sewage according to performance measured in cubic meter per day, and in similar ways for other equipment to be built into treatment facilities. Some examples are as follows:

| <i>Pipe size (millimeter)</i> | <i>Unit cost (Ft per meter)</i> | <i>Performance (cubic meters per day)</i> | <i>Unit cost (Ft per cubic meter)</i> |
|-----------------------------------|-------------------------------------|---|---|
| 40 | 3,500 | 0–100 | 120,000 |
| 110 | 8,000 | 101–300 | 80,000 |
| 250 | 20,500 | 301–600 | 65,000 |

Source: Ministry of Water, Transport, and Telecommunication.

According to several expert and local government officials, however, these unit costs are not diversified enough to mirror differences in geographic, water-base, and other characteristics. Moreover, although originally intended as maximum allowable unit costs, these unit costs are used by local governments as benchmark numbers orienting budget calculations in grant applications, and are also accepted by grantor agencies as such.

Thus central budget pays large amounts of subsidies for developments in areas in which, because of soil quality or other features, such investments can be constructed with unit costs lower than those centrally set. Local governments as investors can save significant amounts and use them for other purposes, which in practice, because the lack of proper monitoring, might stay unnoticed. In a recent report the State Audit Office dealt with this problem and found that real unit costs of certain technical solutions (e.g., sewage network construction) are lower than those published (prime contractors chosen by public procurement could make offers of 15–30 percent less costs) whereas in other cases (e.g., the transferring machinery) the Ministry's unit costs are underestimating real costs (SAO 1997).

In our opinion this system needs improvement, because it provides no incentives to find cost-efficient technical solutions and thus results in overspending of public money.

Investment Predominantly from Own Sources

The next case describes a fortunate county capital of 36,000 residents with a well-managed, strategically oriented local government that had a prudent financial record. This city had a budget of nearly Ft 5 billion and a local economy with low unemployment and a vibrant business sector. Annual budgets were based on a long-term strategic plan, and the city had significant savings. The specific project was to refurbish an existing wastewater treatment plant and expand its capacity. Upgrades have been planned since 1996, when the existing plant proved unable to meet more rigorous standards. The initial project did not include expansion of the sewage network system.

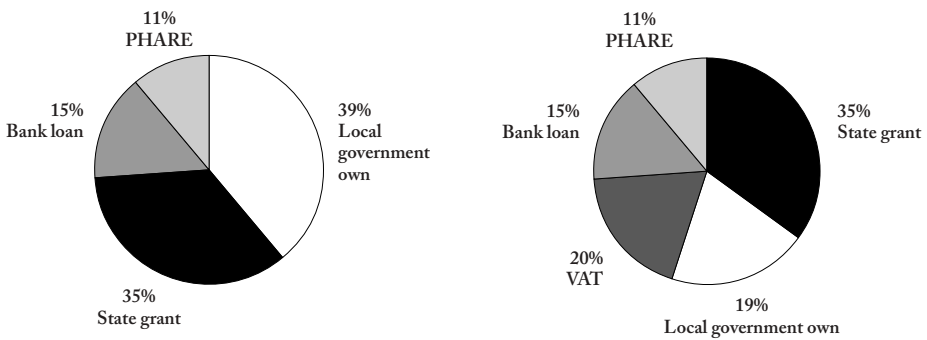
The largest owner of the wastewater work was the local government, with 27 percent stake, and 45 other local governments shared the rest of the stake. User fees included a

profit margin of 3–5 percent, sufficient to cover minor repairs but not development. The utility company not only operated but also owned the facilities, so it could finance capital improvements from depreciation allowances. Because of regulation of state grants, the upgrade and expansion would result in the local governments taking possession of the new facilities directly.

This local government, in contrast to the previous example and unlike the general approach in Hungary, planned to use an extraordinary proportion of its own funds. The total project cost was approximately Ft 1.3 billion (see figure 28.2). Despite the Poland-Hungary Assistance the Restructuring of the Economy (PHARE) loan and funding from the Water and Environment Funds, the city covered 39 percent of total capital costs from its own sources, 11 percent from a cheap PHARE loan, 15 percent from a bank loan, and the rest from state grants. If we include value added tax (VAT) refunds, then the state portion rises to 55 percent (as the second pie chart in figure 28.2 shows), still very different from a typical majority state finance case.

Sources of repayment for the PHARE and the bank loan are portions of the user fee and a rental fee paid by the utility company to the local government. The rental fee includes depreciation, interest, and capital repayment, so in essence the operating company also contributes to repaying the municipal loan. This project did not require the usual bridge loan, nor did the city need to borrow for liquidity purposes. The city had a long-term strategic plan and sound environmental reasons to expand capacity. Another lesson learned is that despite success in obtaining a cheap PHARE loan, the city had to wait two years for the PHARE decision, which delayed the project seriously.

Figure 28.2 Financing of a Sewage Development Primarily from Own Resources in City EG



Source: Municipality of EG data.

Public–Private Partnerships

Partnerships in this context mean both a cooperative and a non-cooperative involvement of large commercial and industrial polluters in the financing of wastewater facilities. In the cooperative case, the local government and large users jointly planned, discussed, and implemented the project that resulted in significant benefits for both parties. In the non-cooperative case, the local government often needed to coerce the polluter into contributing to the project. In this case communication did not take place before a municipal decision and was certainly not interactive.

Cooperative Involvement of Large Users in City DH

In the cooperative case the project received a relatively small capital grant from the state, and the large users essentially financed the project. In this example, a well-located city of 15,000 inhabitants decided to develop an industrial park on its periphery in 1993. The park soon created a need for modern sewage treatment because good road access, tax breaks, and good infrastructure brought a major multinational firm as an anchor tenant. The city and other potential tenants in the industrial park also needed sewage treatment capacity. The large user desperately needed it to obtain an operating license on short notice and had several options: (a) purchase additional land and build its own treatment plant; (b) wait for the city to build a municipal plant; (c) jointly build a plant with the city, agreeing to purchase a portion of treatment capacity, essentially becoming a steady source of user fees for the operator. An important feature was timeliness, because any delay in plant operations because of a missing piece of infrastructure would cause significant losses for the user.

The local government had a vested interest in helping the multinational investor solve its problem, partly because it was thinking about the municipal sewage program because of the favorable grant environment and partly because it knew that infrastructure was needed to attract additional tenants to the industrial park. The local government involved the multinational company from the planning stage forward, and the planned investment was only the treatment plant, with the collection system to follow. The parties agreed to build the plant and completed it in early 1998.

The cost of the joint treatment plant was Ft 800 million. The local government applied for and received a targeted grant of Ft 200 million. This proportion was low compared to the usual 40–60 percent support for sewage projects. The large user, through a series of financial transactions, provided the balance of Ft 600 million. The municipally owned water utility issued a 20-year, non-interest-bearing bond to the large user. The local government managed the construction and the treatment plant became its property; however, the user signed a 20-year contract to use 80 percent of the built capacity of the plant. Both parties were aware of the fact that the user fee would have to cover operations, capital, and financial expenses. Thus, the user essentially became the prime source of repayment of its own loan to the municipality. The large user got its plant built in eight months instead of three years.

The Ft 200 million targeted grant from the state could be drawn down only over a three-year period. The vendor, who wanted the plant finished as soon as possible, issued a Ft 200 million three-year zero-interest loan to the local government. The source of repayment was the capital grant drawn down over three years. In 1999 the State Audit Office put a question mark on this economically impressive financing scheme; its view was that the state grants should not be used for debt repayment but exclusively for direct financing of the investment. This decision made the Ft 200 million bridgeloan retrospectively illegal, and the municipality had to repay one-third of the state grant that was disbursed after the investment was fully completed.

By calculating the net present values, we could compare the three alternatives.

Option one. The large user, if it decided to go alone, would have to build a plant costing at least 80 percent of the Ft 800 million, or Ft 640 million. Because of the high fixed cost of land (which in the joint project was provided by the municipality), this option would have cost about Ft 740 million.

Option two. By relying solely on the local government for construction financing, the large user would have paid capacity and hook-up charges of about Ft 200 million. To this, one would add user charges over 20 years, which would come out to Ft 198 million in net present value. These expenses totaled to Ft 398 million for the large user if the local government built the plant on its own. The cost of waiting three years for the plant was not calculated, yet this added expense was obviously large enough to convince the investor not to choose this option.

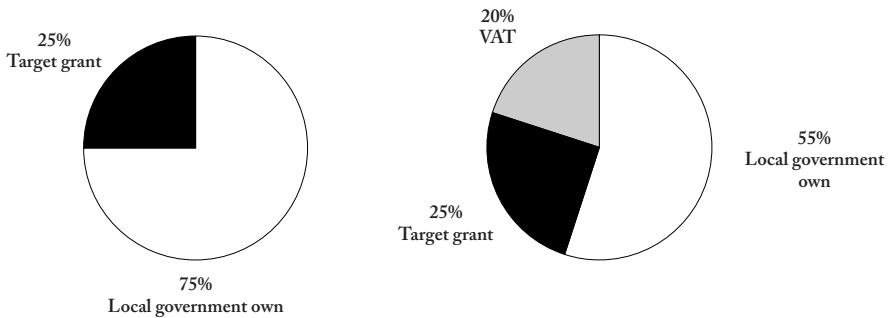
Option three. The user and the local government jointly financed the treatment system, and the net present value of the user's total contribution was less than Ft 600 million. The large user provided a one-time loan of Ft 800 million to the local government. By deducting the present value of the stream of loan repayments from the Ft 800 million, we arrived at the net present value of the large user's contribution. The present value of the 20-year, non-interest-bearing bond is Ft 199 million. The three-year bridge loan at zero interest equals a present value of Ft 134 million. By deducting Ft 199 million and Ft 134 million from the Ft 800 million cash loaned to the project, the large user's contribution equals Ft 467 million in net present value term. In other words, the large user benefited from cooperation with the local government because it obtained a plant for Ft 467 million in present value terms, instead of spending over Ft 700 million on a plant of its own, or waiting three years or more for the municipality to finish one on its own.

The local government enjoyed several advantages from the participation of the large user in planning and financing the project. For its own purposes, the local government would have built a Ft 200 million sewage treatment plant, which would have called for at least Ft 100 million in cash from the local government. In contrast, a much larger plant was built without any local government cash outlay, and the plant became the property of the municipality.

The larger plant has excess capacity that could make the local industrial park more attractive to other investors. Based on a Ft 800 million project cost, the local government

gained a VAT refund of Ft 160 million within eight months. So this alternative even generated a sizable positive cash flow for the municipality. Taking into account opportunity costs the advantage to the local government of using this option estimated in net present value terms was around Ft 260 million. In addition, it was critical that a large user contracted to use 80 percent of the plant's capacity over the next 20 years, and the repayment of the debt over the same period is to be covered by user fees. The municipality of DH essentially issued a virtual revenue bond.

Figure 28.3 Financing Sewage Development in Cooperation with a Large User in City DH



Source: Municipality of DH data.

Non-cooperative Partnership in City G

City G is a medium-sized settlement in a less developed area and is home to several sizable food processing companies. The municipality has a relatively large budget for its 36,000 population—Ft 3.5 billion—but only 5 percent comes from local taxes. The city has no privatization or capital income, and it is a typical grant seeker. Unlike several previous examples, the local government did not negotiate with large users prior to the sewage development decision in 1997. It happened because they had no regular communications with the large users and because the idea of building a new sewage plant emerged from the hope of receiving a huge state grant rather than from a thorough assessment of need, capacity, and technical properties. This approach resulted in a suboptimal solution and an endless debate into 2000 about the responsibility of the mismanaged development.

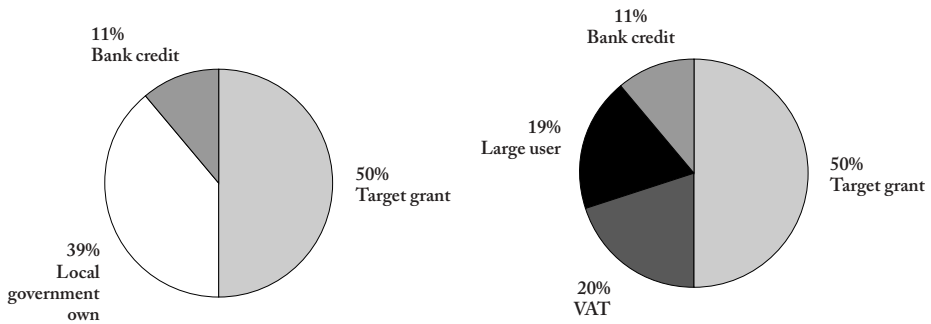
Before this investment, sewage treatment was provided by a wetland-type facility, and over 65 percent of the homes were connected to the sewer system. The availability of grants motivated the city management to develop a plan quickly for a new treatment facility (Ft 560 million total budget) and to apply for the grants. As a result, the municipality totally ignored the issues of optimal capacity and fluctuating discharge quality, although that would justify a timely and close cooperative effort with the largest users.

Professional opinions were considered only after the development decision. One option was to build a small biological plant costing Ft 100 million, without state grants, that would not offer a long-term solution. This plant could have provided adequate treatment if one of the foreign-owned dairies had been consulted about pretreatment experiences they had had abroad in similar situations.

The construction cost for the city’s sewage project was calculated on the basis of a list of unit costs of sewage treatment development published by the Ministry of Water, Transport, and Telecommunications (see box 28.2). Likewise, the city assumed it could receive up to 50 percent in targeted grants. Detailed planning began with these parameters predetermined—but now involving the large users who accounted for over two-thirds of the total sewage load.

The remaining key question regarding financing was who would cover 50 percent of the capital costs. Of the missing Ft 280 million, Ft 120 million could be recouped through VAT refunds, leaving Ft 160 million of own-source funds to identify. The city decided to obtain these funds from the large users and acted in a confrontational manner. Initially, the city decided to set the large users’ hook-up fee to collect exactly Ft 160 million. When the large users refused to pay, the city threatened to impose environmental fines in the same amounts. In the end they agreed on the bond format, “necessary due to lack of trust,” as the large users expressed it. The city issued a private placement bond to the large users, paying no interest, with a 10-year maturity and a face value of Ft 100 million. The municipally owned operating company borrowed the remaining Ft 60 million backed by mortgages on municipal property completely unrelated to this project (figure 28.4).

Figure 28.4 Financing Sewage Development in a Non-cooperative Partnership in City G



Source: Municipality of G data.

The above scheme forced the municipality into a liquidity trap since state grants were paid only against invoices, and VAT refunds similarly required that cash be used to pay invoices that were reimbursed with a time lag. In this project the interest-free bond

provided the only liquidity besides another interest-free loan from the prime contractor, who asked for mortgages on municipal property and agreed to buy, then sell back, a piece of forest. Repayment of the loans and bonds is expected from user fees, when three-quarters of the user fees are to be paid by the users themselves. So the solvency of the treatment plant depends on the ability and willingness of the largest users to pay far into the future.

This conflictual case illustrates the need for good communication even in the conceptual stage of a planned project to prevent costly capital projects from getting out of control. From the large users' perspective, this process contains several important lessons learned:

- The large users need to be involved at the conceptual stage, because they have precise data on wastewater parameters, and prospective data on future flows. Involving their sewage plant specialists would enable precise planning and would keep the project appropriately sized.
- In this specific case a smaller and less expensive option would have been optimal had large users been involved from the outset.
- Treatment facility phasing could have been optimized because, in the large users' opinion, the existing facility could have served for another one to two years while the plant expansion was planned and constructed.
- The management of the large users expressed a concern that because they had been a part of the community for several decades, they expected some cooperation in an earlier phase.
- A significant distortion has been that the existing facility could have been optimized for one to two years in a transition period, but the “grant-seeking temptation” was too large, and the city sought to maximize pitfall funds instead of fully using existing local professional capacities.
- The technical content of the funded project proposal is not the same as the realized project. In other words, “value engineering” is applied in a negative sense, with funded features reduced in size and quality, and the funds used for other purposes. In the opposite direction, more expensive and more profit-laden components are added during construction, denying efficiencies that may have been contained in the original plans. This approach creates an unnecessary burden on the central budget.

Lessons from the Public–Private Partnership

The unit-cost ceilings set by the Ministry of Water, Transport, and Telecommunications do not reflect the geographic and technical diversity of real construction costs. The ceilings are maximums, and the rational local government “tunes up” project size and cost to obtain the maximum amount of cash flow, regardless of the availability of lower cost technologies. Because capital costs are matched to maximize available funding programs, operational expenses and depreciation costs are not optimal, causing sewer charges in some cases to be higher than would be otherwise justified.

From an economic perspective, involving municipal assets, such as real estate (the forest in city G) not related to a specific service as collateral for loans to municipal infrastructure projects is not justified. The municipality bears the opportunity cost of mortgaging assets better suited for other projects, and these pledges also remove the direct need for the project to generate or provide the asset-based or revenue-based security for loan repayment. These hidden opportunity costs and guarantees do not show up as operational or capital cost in project budgets, distorting project financial projections and decision-making processes. Sectoral- and state-level financial and technical regulations, as well as grant programs, distort local government project planning away from optimal solutions and appropriate technologies.

The cooperative model described previously was motivated by the real needs of the project sponsor and the largest users, while the suboptimal, confrontational public-private partnership was motivated solely by grant maximization. In the cooperative case, the large industrial user that accounts for 80 percent of waste flow could have built its own plant because the need for a municipal treatment plant was not proven. The industrial user had the state capital grant program pay for 80 percent of a plant's capacity that did not serve predominantly municipal purposes.

Vendor Financing

In 1992, one village and three neighboring communities in central Hungary agreed to pursue a grant from a foreign donor to finance up to 50 percent of the costs of a preliminary operating permit to build a 6,500 cubic meter wastewater reuse system. In 1993 the donor awarded a planning grant and the four villages decided to form a Regional Wastewater Association to build the system. The communities received the preliminary permit in 1993, and decided to apply for a targeted grant for 1994. In the meantime, two more communities joined the association. The association also applied for targeted grants for a sewer system in 1994, which was rejected because the association was formed only to build a treatment system.

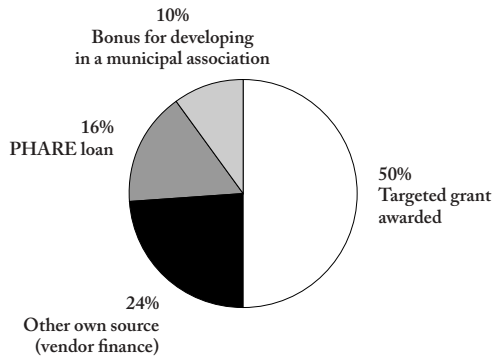
In 1995 the association was awarded a targeted grant for the treatment plant and selected general contractor. It also modified its charter to include the collection system and applied for a targeted grant that was awarded in 1996. Two additional communities joined the association in 1997. Construction on both systems began in 1996. The treatment system was completed in April 1998 and began operations in May. The collection system was completed in 1999.

Treatment and Collection System Construction Finance

The design, financing, construction, and future operation of this wastewater collection and treatment project took place in essence with virtually no cash contribution on the part of the eight members of the association. This case demonstrates the state of the art in grant

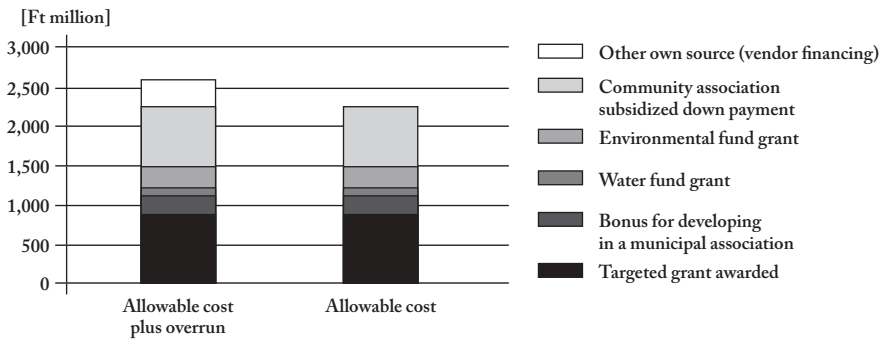
maximization and careful cash flow management (see figures 28.5 and 28.6). The project needs, missing cash-flow and unique legal and tax situations prevalent in the early 1990s led to the creation as project manager of a limited liability company owned by the initial six community members.

Figure 28.5 Financing Sources of the Treatment Plant



Source: Municipality of DV data.

Figure 28.6 Financing Sources of a Sewage Development



Source: Municipality of DV data.

The association, through its lead member, applied for and received the maximum allowable targeted grants for the treatment and collection systems. The association assumed responsibility for coordination of what ultimately became an eight-village project. The association and its designated chairman, the mayor of the lead municipality, handled all regulatory liaison duties such as negotiations with vendors, financiers, regulators, contractors, and state authorities

The grant formula changed during the course of the project. At its inception, targeted grants for the treatment plant covered up to 50 percent of unit-cost ceilings. By the time the association applied, targeted grant support dropped to 40 percent. Regional utility associations subsequently received an extra 10 percent support, so for this association, the targeted grant amount increased to 60 percent for treatment and 50 percent for collection.

Other grants were applied for and awarded to the association, one from the Water Fund and two from the Environmental Fund. Because the association did not have its own tax and statistical number at the time of fund disbursement, the grants were paid through the bank account of the lead village. The village incurred administrative, bank, and other expenses that it could not recover from the other members.

In terms of financing the own-source or, more precisely, the non-state-grant component of the treatment and collection systems, several types of subsidized and vendor loans were involved.

The Ft 133 million PHARE loan with zero interest and an initial three-year maturity was made to the association, with each community assuming responsibility in proportion to the number of hook-ups. In this case, each community is assuming a portion of the liability for the one lump sum payment of principal due on maturity, initially at the end of 1998, but subsequently rescheduled to 2001. Two vendor loans—one for Ft 199 million from the treatment plant general contractor, the other for Ft 300 million from the collection system general contractor—covered the balance of own-source funds. These two loans have unknown implicit interest rates. Overall, debt of all types accounts for 39 percent of total project costs, including cost overruns, and for virtually all of non-grant own sources of construction funds.

In addition, a unique financing mechanism, a Ft 711 million subsidized loan, was granted to the Community Water Association, which is a temporary financing association of citizens to provide a down payment to the investment based on the valid signatures of 60 percent of the households of each involved community. The Community Water Association was used to generate funds for the collection system. This unique loan made through a commercial bank involved a highly subsidized interest rate, a 10-year maturity, and a guarantee of the municipalities in question. Essentially, each member municipality collected signatures on a petition, and then received its proportion of the Ft 711 million loan.

Sources of Repayment

This arrangement is an inverse build-operate-transfer scheme in that the local governments obtained funds to build a system that was to become their property, only to seek a concessionaire for operating the system since the association members could not come up with their own sources of funds. In essence, they lost the usual advantages of build-operate-transfer during the construction process, but at the same time bore all financial risk of the development.

The population will directly repay the Community Water Association loan in a special assessment as part of the future sewer charge. The PHARE loan is an on-balance-sheet item of each community, to be repaid from general revenues or included in a potential concession fee. The two vendor loans (plus interest) amount to Ft 499 million and will be included in an up-front fee to be paid by the winning concessionaire. The eventual sewer charge is expected to include a capital charge to finance the up-front concession fee that essentially converts the debt of the eight municipalities into the debt of the selected concessionaire operating company.

Lessons Learned from the Vendor Finance Scheme

The two vendors have an uncertain source of repayment, since repayment or assumption of accumulated debt is a part of ongoing negotiations with potential operator concessionaires. The association's cash flow problems during construction were significant and illustrative, however. The association as representative of the eight villages could draw down the various forms of state grants only if it could demonstrate cash balance amounting to, on average, about 40 percent of the invoice. The state agency would pay its share of each invoice if the association could show that it had its 40 percent on hand. Several sources of liquidity were used.

The association's members, as mentioned, created a project manager company (PMC), under the control of the member communities. The proceeds of various loans were used to provide the 40 percent own share to draw down the state grants. Thus the vendors loaned the association an amount that could cover 40 percent of the vendors' own invoice for services, but the association subcontracted management to its PMC, which received loan proceeds as payment for services, and then the vendor invoiced the PMC. The advantage to this method was generating liquidity. Namely, the PMC was entitled to get VAT reimbursements for each invoice it paid to the vendor, and use those VAT refund proceeds as loans back to the association, which then ordered the next round of services from the vendor through the PMC.

Of the Ft 3.4 billion all-inclusive costs, about 20 percent or Ft 680 million in VAT was ultimately paid back to the state tax office. Using the VAT reimbursement method, however, the association, through the PMC, used the refunds as temporary liquidity, in essence not having to generate 40 percent of the VAT (Ft 272 million) as an own-source contribution. Thus, realized interest earnings on this cash flow were also used as own-source revenues for the project.

During the operational phase, the Regional Wastewater Association will maintain ownership and the overall statutory service provision obligation. The association and its members assume responsibility for repaying the PHARE and Community Water Association subsidized loans, with payment streams from general revenues, concession fees, and user fees. The two large vendor loans amounting to Ft 500 million, or 19 percent of the total project cost, including the cost overrun, were a delicate part of negotiations with concessionaire operators. A key element of the concession fee was to repay the loans.

A group of communities can still optimize the grant-driven infrastructure financing system without much cash of their own despite a high, 40 percent own-source requirement. Nearly 85 percent of the total project cost was provided by soft money in terms of subsidized loans and grants. About 15 percent of the total cost came from vendor financing. The other important lesson is that the excess profit or capacity included in a system subject to such a high level of grants is about 15–20 percent, based on international experience. In other words, the hard loan or vendor finance portion of this project provided not only much needed liquidity, but also a profit source to be financed through user fees and general revenues far into the future.

The key problem with this method is not the level of subsidies or subsidized loans, but the unit-cost ceiling. These figures are taken as givens, regardless of the genuine cost of construction. If the entire cost were hard money, or harder money, about a 20 percent cost savings could be extracted. We believe that in this case the treatment system cost overrun was justified. In the case of the collection system, however, the allowable cost (that is, the project cost calculated with the centrally set unit costs) was about 15–20 percent higher than the lowest possible cost. In other words, the allowable cost figure is not accurate enough given competition among various technologies and construction firms, and the entire price could be biased upward.

The soft money nature of the overall sources of revenue for projects such as this provides a strong disincentive for value engineering. Capital cost is assumed to be bearable by the population far into the future if the concessionaire and the association can set a sewer charge that is high enough, and extract up-front payments or refinancing from the potential concessionaire.

Conclusions

The above cases support conclusions with respect to: planning and pre-financing, the role of own-source revenues; the role of credits; fees and charges paid by the citizens; state grants; and the answering why did the grant system also support suboptimal projects.

Planning and Pre-financing

Local governments must demonstrate in their grant applications that own-source funds are available, and must pre-fund technical design and engineering (between 1 percent and 5 percent of total project costs).

Local governments rarely have enough reserves to invest in technical design and engineering costs up front; thus, they must decide whom to involve in pre-funding these expenses (vendors, prime contractors, large users).

In most cases these actors provide some form of bridge or liquidity loans backed by assets and real estate unrelated to the facility being constructed.

Starting in 1999, targeted grant applications require a technical and economic feasibility study. According to 1998 government decree number 104, this study should include a description and evaluation of project alternatives, and the technical, operational, financial, and economic aspects of the one selected. The economic comparison must take account of investment costs as well as future yearly operation costs and projections on user-fee revenues.

Own Sources

Municipalities define own sources of funds as any source independent of the current source being sought in an application, allowing double-counting and total awards sometimes exceeding 100 percent of allowable project costs.

Regulations in force since 1999 define own sources in targeted grant applications as those funds specifically identified in a city council budget resolution, or as a line item of a budgetary agency. A documented loan commitment from a financial institution or approved plans for the collection of hook-up fees could also be considered as own-source revenue.

Regulations state that funds from the state budget, regional development money, and foreign donor funds should not be considered to be own sources.

The Role of Credit

Bank loans and bond issues by municipalities, which have had a modest role in municipal project financing to date, will become more significant in future projects because of the following:

- Budgetary agencies such as municipalities have modest resources available to prefinance engineering and design and other forms of project preparation.
- European Union requirements for environmental upgrades, as well as mandated cost sharing, generate demand for own sources.
- Monies to serve as matching funds for European Union grants are not available from the central state budget.
- Inflation in Hungary declined to 10 percent by 2000, and further decreased afterward. This drop will make fixed-rate instruments more feasible and likely in the near future.
- Mandatory and voluntary pension funds and other institutional investors seek fixed income instruments to complement government bond and equities portfolios.
- Municipal budgeting regulations and accounting practices do not allow for capturing or recording accrued principal payments and balloon payments on bonds and loans outstanding.

- From an economic perspective, involving municipal assets, such as real estate, not related to a specific service as collateral for loans to municipal infrastructure projects is not justified.

Fees Paid by the Citizens

The population participates in financing municipal infrastructure projects by paying one-time hook-up fees and continuous user fees.

User fees are set on a political basis by city councils, and do not always cover full capital costs, such as depreciation, interest, and principal payments, in addition to operations and maintenance costs.

State Grants

Local governments undertake projects to maximize state funding in the form of grants and subsidized loans. State grants and soft loan programs are uncoordinated, resulting in duplication and over-engineered projects. Funding goals and mechanisms among grantors are divergent, and funding decisions are rushed given the volume of applications.

The overall grant system often creates wrong incentives, for example, requiring an estimate of operational expenses but not demonstrating coverage of all costs, including replacement and capital. Hence, municipalities do not always select the most economical option.

Starting in 1999, project applications are to be submitted to the largest funding agency, which is then responsible to evaluate and pass on the materials to other grantors. This requirement is designed to prevent parallel applications to a variety of funds.

Funding of Suboptimal Projects

Obtaining funding for projects that are over-engineered, inappropriately sized, use the wrong technology, and will have technical and financial difficulties during the operational phase is still possible.

The pressure to submit plans and specifications within project funding deadlines negates opportunities to research alternative, lower cost solutions, thus favoring prepackaged technical solutions that meet grant criteria but do not necessarily offer the best solution for the municipality.

The new feasibility study requirement calls for a comparison of prospective operational as well as capital cost scenarios, including fee impact analysis as well as a study of the population's ability to pay.

The pressure to create regulations that conform to European Union requirements can also have unwanted consequences.

Other Challenges

Normative unit-cost ceilings do not take into account geographical, technological, and cost diversity.

Monitoring by the State Audit Office is *ex post* and amounts to a compliance audit that does not question the rationale behind spending decisions.

Local governments seek VAT refunds on projects that will produce revenues. These VAT refund schemes have the effect of reducing the actual cash outlay a local government needs to pay as an own source.

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The Prospects for Municipal Revenue Bonds

Mátyás Makay

During the first decade of economic transition, most countries in central and eastern Europe made major progress in introducing financial market instruments. Municipal finances, however, are seriously lagging behind this overall trend. Even in advanced economies, municipalities have a negligible presence in the credit market. Although this situation might sometimes be because of unfavorable exogenous factors (for example, high inflation, economic depression, or fiscal squeeze), it is also because of the fact that municipalities do not have sufficient capacity to tackle and use advanced debt instruments. Despite Hungary's overall progress during the transition, its municipal debt market has remained at an embryonic stage. An increasing number of factors, however, on both the supply and demand sides, support a dynamic development of the municipal credit market in the near future.

This chapter discusses the potential for financing municipal utility projects with revenue bonds in Hungary. The first section examines the basic concept of revenue bonds. The next section provides an overview of the regulatory environment for securities issues. Finally, the applicability of revenue bonds to the Hungarian capital market is examined.

Municipal Bonds

Traditional subsovereign bonds are securities issued by provincial, special district, and municipal governments. They come in a variety of types, with different redemption features, and have different characteristics in terms of credit risk and marketability. Most of these instruments are issued without sovereign guarantee or without recourse to the national government. Municipal bonds are basically of two types: general obligation bonds, backed by all kinds of municipal revenues (for example, asset proceeds, taxes, and fees) and

* This chapter is based on Makay 1998.

revenue bonds, to be repaid exclusively from the revenue stream of the financed project (see chapter 27).

Municipal Bonds in the 1990s

Municipal bonds issued between 1990 and 2000 are a hybrid type, because several laws limit revenue streams and assets available for debt service (see chapter 19). The securities issued by local governments have been of the general obligation type in that they offered the full faith and credit guarantee of legally available municipal assets and income streams, regardless of potential project revenues. These municipal bonds have been slightly less than general obligation in the sense that, although the municipality pledges all of its assets, ultimately no covenant calls for increases in local taxes and other fees to the extent required making debt service payments.

Genuine project financing is done within the context of separate, off-budget entities or municipal enterprises in which the municipality may have controlling, complete, or partial interest and which borrow as corporate entities. If these municipal enterprises issue bonds (see chapter 17), they would be straightforward corporate bonds, whose prudential requirements, disclosure standards, and so forth, are no different from other commercial issues. These potential corporate bonds, however, carry a special risk element because the municipal government sets or approves the fees and charges of local public utilities in the service area over which it has sovereignty.

The local government council and the mayor are allowed to borrow for short-term liquidity purposes and to engage in long-term borrowing through bond issues or bank loans within certain legal limits. Bond issuance, when the issuer is the municipality per se, requires an exclusive decision of the local government. Municipal budgetary agencies do not borrow long term on their own. The regulatory and legal environment encourages revenue bond borrowing by off-budget agencies and enterprises, rather than by the municipality itself (see chapter 28).

Issuance of project-supported bonds with the municipality proper as the issuer did not take place in the 1990s. Municipal involvement with revenue bonds may be greater when the municipality acts as a guarantor or provides a user-fee covenant to the bond issue or borrowing, which actually takes place on behalf of a separate legal entity (that is, a municipal enterprise).

Municipal risk in these types of projects stems from unpredictable pricing policies or from inability to enforce user-fee price-setting commitments because of political pressure on the city council. If and when the municipality itself is the borrower, cash flow alone is rarely the only or primary guarantee for loan or bond repayment. Rather, financial institutions demand collateral, the liquidation value of which would be in excess of the total borrowing in nominal terms. In other words, those bond issues and loans that are placed on commercial terms by financial entities are over-insured and underleveraged.

Regulation of the Municipal Securities Market

Issues of securities are regulated by the 1996 Act on Securities. The main authority governing capital markets is the State Financial Markets Supervision. As for the issue of securities, the law differentiates between public issues and private placements for both fixed income and equity-type securities. Because revenue bonds may be issued by municipalities themselves, but also (in most cases) by special-purpose (vendor) companies, regulations on both municipal and corporate fixed income issues are reviewed in this section.

According to regulations, municipalities are allowed to arrange public issues and private placements (see boxes 29.1 and 29.2). Public issues involve higher costs, more intensive administrative efforts, a more detailed prospectus, and generally more disclosure. Furthermore, in the case of a stock exchange listing, a more integrated financial information system is necessary to meet the stringent reporting requirements of the Budapest Stock Exchange. In the case of private placements, the cost and administrative factors are more favorable, though the limited investor base might be a serious shortcoming.

Box 29.1 Regulating Public Offerings

- The issuer must publish a prospectus and make a public announcement of the securities issued.
- The issuer must entrust a licensed investment enterprise with the offering.
- One full calendar year in operation for the issuer or its legal predecessor is required.
- Stock exchange listing must be initiated within 60 days if the face value of the issued series reaches or exceeds separately or together with the securities, representing the same rights and issued publicly earlier, Ft 200 million.

The law also elaborates on all the necessary items to be detailed by the prospectus. The prospectus and the public announcement require prior approval by the supervision. The time limit for approval by the supervision is 60 days; the approval fee is Ft 500,000.

Box 29.2 Regulating Private Placements

- A minimum of Ft 5 million par value is required.
- The issuer must prepare an information memorandum and the description of the main features of the issue must be submitted to the supervision at least 15 days before the issue. The issuer must not, however, publicly announce the issue.
- The issuer must entrust a licensed investment enterprise with the offering.

In addition, certain regulations govern the maximum outstanding debt for both corporate and municipal issuers. The maximum level of outstanding public debt for enterprises other than banks is the amount of their own capital. If the public debt of an enterprise is guaranteed by a bank, however, this regulation is void. The level of privately placed debt has no maximum limit.

The maximum amount of annual total debt for municipalities is 70 percent of net own revenues and includes public and private debt (bank loans, securities, leasing arrangements, and guarantees). Own-source revenues are fees, capital income, business income, and local taxes that are imposed, set, collected, and spent at the city council's discretion. No shared tax, grant, or transfer payment may qualify as own source according to the Act on Local Government that defines this debt service limit (see chapter 11).

In terms of revenue bonds, if the project's revenues flow to the borrowing (bond issuing) municipality, then they would be considered own-source revenues available for debt service. An example would be concession fees or leasing payments made by an operating company in return for the right to use municipally owned assets (see chapter 28). In this case, the operating company or concessionaire collects user fees and other revenues, then forwards a portion to the municipality to support capital costs, such as depreciation and debt service, or a replacement fund. If the municipality collects the user fees directly and pays the operator for the service, then the user fees are also an own-source revenue available for debt service.

Alternatively, if a project company is the borrower or bond issuer, then the bond is a straightforward corporate bond. This bond could have a municipal guarantee and would entail legislative risk in the sense that the city council controls user fees, and therefore enterprise revenues, directly. The municipal guarantee, of course, is subject to the debt service limit and the availability of net own-source revenues. An operating enterprise or project company subject to legislative-appropriation risk would not likely be able to issue a bond without at least a moral, if not a full faith and credit, guarantee from the price-setting municipality. As of 2000, no examples of project companies borrowing exclusively against cash flows with municipal guarantees had occurred.

The Issuer's Political Environment

A municipal bond issue has four unique aspects of due diligence:

- The integrity and professionalism of the public servants employed by the issuer, clearly defined public goals, a track record of successful management of public institutions, and commitment to professional and fiscally stringent operations are highly relevant.
- A highly charged, militant, or chronically unstable political situation is a negative sign that should deter investors. Thus, when assessing revenue bonds, not only potential political conflict among members of the bond-issuing body but also the relationships and conflicts among those who make the appointments to the body are important considerations.
- The investor should determine whether the issuer must seek prior approval from another governmental jurisdiction before user fees or other charges can be levied. If so, then the stability of the political relationships between the two units must be determined.

- In addition to the institutional and political concerns, and for revenue bond issuers in particular, the technical and managerial abilities of the staff should be assessed. Issuers with a history of high management turnover or project cost overruns, or those who have little experience, are usually avoided by conservative investors.

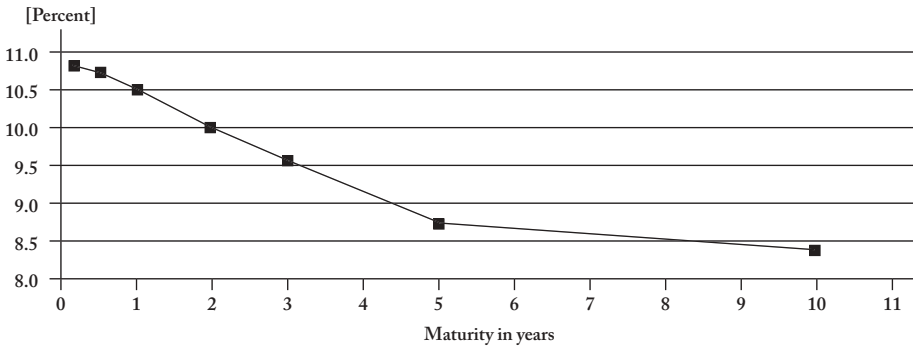
The Fixed Income Market

The Hungarian capital market was reborn in the 1980s with the first bond issues, many of which were actually municipal issues guaranteed by the state. The real revitalization came in 1990 when the first Act on Securities and Act on the Stock Exchange came into force. Although the capital market has experienced immense development in sophistication and depth since then, it still bears several characteristics of a developing market. The fixed income market is dominated by government issues. Only a limited number of corporate and municipal issues were arranged, mostly in private placement form. Although Treasuries are considered as the most liquid investment, corporate and municipal bonds have basically no secondary market.

The first and most important issuer on the fixed income market is the government. Treasuries are issued in the form of three-month, six-month, and twelve-month Treasury bills and Treasury notes with maturities of two, three, five, seven, and ten years. Gross government debt was Ft 6,900 billion at the end of 1999, amounting to 60 percent of gross domestic product. In 1999, 61 percent of new government debt issued had maturities of over one year, 22 percent of new issues had maturities of two to three years, and 10 percent of new issues had five or more years' maturity. Of gross government debt, 14 percent or Ft 439 billion was held by foreigners and around 50 percent of new net borrowings had maturities of five to ten years in 2000.

Treasuries are issued at regular auctions and subscriptions organized by the State Debt Management Agency. Publicly issued Treasuries are listed on the Budapest Stock Exchange and are also heavily traded on the over-the-counter market. Liquidity is further enhanced by some 20 primary dealers (mainly securities firms of large banks) who continuously provide bid and ask prices on Reuters. Treasuries, especially on the shorter end, are considered the most liquid investments on the Hungarian capital market. Treasury issues create benchmarks for all other fixed income issues. Starting in the late 1990s, Hungary has experienced a negative yield curve (see figure 29.1) that presents a rather unfavorable environment for fixed income issues with longer maturities.

Domestic corporate bond financing is still very limited, only 1.6 percent of gross domestic product. The reasons for this situation are numerous and include factors from both the demand and supply side.

Figure 29.1 Forint Yield Curve for Government Securities, April 2000

Source: National Bank of Hungary monthly reports.

Supply- and Demand-side Factors of the Fixed Income Market

The fixed income market depends on some general financial and capital market factors, but a number of specific factors play a decisive role and largely influence the role and performance of the municipal sector in the fixed income market.

Demand-side Factors

The demand-side factors show that the capital market for fixed income securities is in its early stage of development, the depth of the market is limited, and large corporate issuers tap foreign currency denominated bond markets.

- The large quantity and high yield level of Treasuries are crowding out corporate debt securities.
- Most corporate bonds are issued in private placement form. Important segments of institutional investors are presently allowed to invest only in public issues (such as insurance companies, mutual funds, and pension funds).
- Rating agencies play a limited role.

Supply-side Factors

The supply side factors are not yet favourable.

- For blue-chip companies, bank loans are relatively cheap because of the fierce bank competition in that market niche.
- Because of more advantageous cost, time, and administrative factors, private placements are favored to public issues.

- The high yield environment and inverted yield curve created an unfavorable environment for long-term issues.

Municipal Demand

The municipal sector has a very limited presence on the fixed income market. Despite the continuously shrinking availability of funds and the decreasing share of central government funding, the sector has not shown significant demand for borrowing. As privatization draws to a close, however, the share of asset sales in municipal budget revenues will drop dramatically. Furthermore, because of the sale of income producing municipal assets, some revenues may also decrease. Currently, the bulk of financing instruments is provided predominantly by banks, except for a few rather small municipal bond issues (up to Ft 1 billion). These issues are usually bank-guaranteed and placed privately with a limited number of institutional investors, mainly insurance companies. So far, these issues added nice shades to the general picture, but were of rather limited financial significance.

Because of municipalities' increasing long-term financing needs, general obligation bond financing could very likely become more important, although the economic limitations will remain substantial. Considering a Ft 300 million to Ft 1 billion issue (this size range is determined on the low end by economies of scale and capped by market depth factors), the annual budget of the issuer should be a minimum of Ft 2 billion. Since 30–35 municipalities belong to this league, the number of municipal general obligations issuers is likely to be limited to this number.

The situation for revenue bonds is slightly different. Because revenue bonds are project driven, the economic limit is set by the financial viability of projects and not by municipal budgets. The main constraint here is the economy of scale of projects that, in the case of the sewer and solid waste projects in particular, have a strong relation to the population served by the plants and tend to be large. These factors underline the need for strategic municipal coordination in the design and implementation of utility projects.

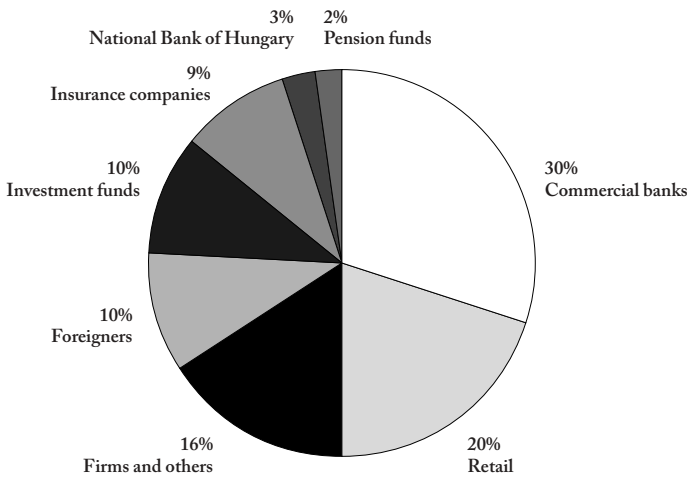
Investors on the Fixed Income Market

Since the Treasury market is the broadest investment arena, basically all groups of investors are quite active there (see figure 29.2). The fact that an investor group is heavily engaged in Treasury investments, however, does not necessarily mean that it can rationally be seen as a potential creditor for municipal bonds. Historical experience and economic and legal factors suggest that the following types of investors may be interested in municipal bonds: banks, pension funds, insurance companies, and mutual funds.

The potential interest and role of other investor groups would need to be assessed in light of regulatory constraints and business objectives. Thus, the National Bank of Hungary can invest only in Treasuries. Retail investors can take only public issues, and the costs and administrative efforts involved can be justified only when large amounts are involved.

Foreign investors do not seem to be ready to take municipal risks; furthermore, they attach great significance to liquidity, which is difficult to ensure in the case of municipal bonds. Enterprises usually invest in Treasuries to manage their liquidity, so their investment horizon is short and liquidity is also important for them.

Figure 29.2 Ownership Structure of Outstanding Treasuries, 1999



Source: State Debt Management Agency data.

Insurance Companies

Foreign-owned companies dominate the insurance market in Hungary, and these entities play an important role in the fixed income market. Their market sentiment can be characterized by the following considerations:

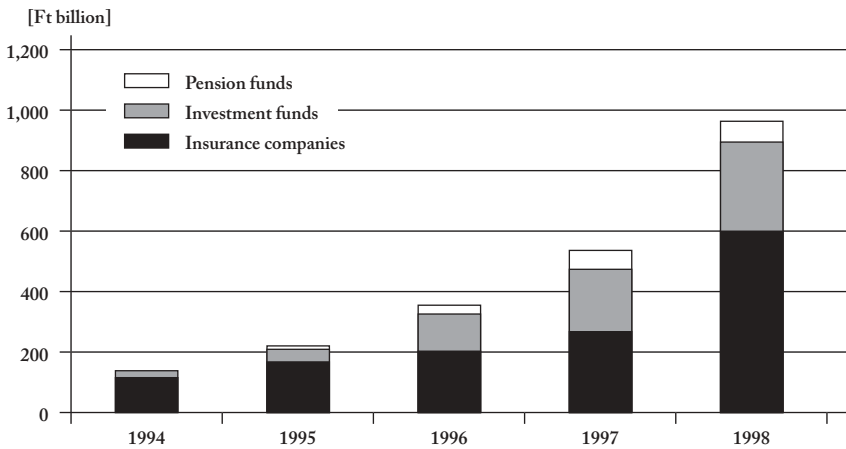
- Because of the nature of their assets (and future liabilities), insurance companies, especially life insurance groups, tend to have the longest available investment horizon.
- Insurance companies are usually highly conservative and have a risk-averse investment policy enforced by their multinational parent companies.
- Insurance companies are allowed to purchase both public issues and private placements.
- Liquidity is of secondary importance.

Insurance companies constitute the single most important target group for the private placement of corporate and municipal bond issues (see figure 29.3). Their portfolio managers have good knowledge and understanding of sophisticated bond structures and

their asset portfolio is large enough to take sizable issues. The duration of their portfolio is relatively long, which creates demand for long maturities; at the same time, liquidity is of limited significance. By contrast, they usually have a conservative investment policy, which in most cases requires some kind of bank guarantee for nongovernmental issues. They also tend to be highly demanding as far as pricing.

Although insurance companies are presently the most important purchasers of corporate and municipal bonds, the growth of their assets is moderate, and no significant changes can be envisaged in the medium term.

Figure 29.3 Invested Assets of Institutional Investors, 1994–1998



Source: Boston Consulting 1998.

Investment Funds

Capital under the management of investment funds grew considerably in the last years, providing the most dynamic expansion of available assets on the market. The investment fund market is concentrated, and though it is shifting toward equity funds, the majority of the investment is still in fixed income instruments. Although equity funds have become more popular, all fund managers run at least one fixed income fund. Their approach can be characterized by the following factors:

- Their appetite for longer maturities is governed by their longer term market expectations.
- Investment funds can invest only in publicly issued securities.
- Their investment limits are regulated by law.

Within the limits provided by law, investment fund companies define their own investment policies and strategies. They are ready to take longer maturities and corporate and municipal risks if conditions are adequate. A major disadvantage is that presently they are allowed to invest only in public issues. Although investment funds have shown outstanding real growth, the market still has upside potential for them.

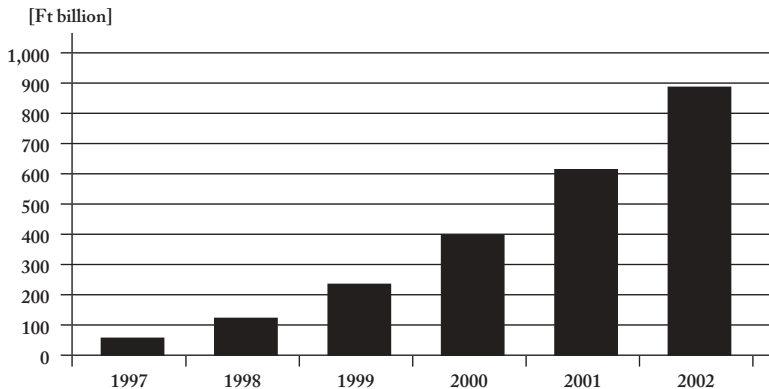
Pension Funds

With a high dependency ratio, high costs, and chronic pension deficits, Hungary faced significant challenges in this field. To shift to a more viable structure, the following three-pillar system was introduced in 1997:

- Pillar I—the original state pay-as-you-go system;
- Pillar II—compulsory funded pension savings with private fund management;
- Pillar III—voluntary mutual pension funds.

If present trends were to continue, pillars II and III are likely to grow to the largest investment group within five years (see figure 29.4). Asset management of pension funds is outsourced in most cases. In the past, mandating that securities companies manage funds was common, and that mandate created serious conflicts of interest. In the medium term, asset management companies will likely take over this task. Investment limits of private pension funds and voluntary mutual pension funds are regulated by government decrees. Presently, private pension funds (pillar II) are allowed to purchase private and public issues, but mutual pension funds are restricted to public issues. These regulations seem to be inconsistent and will likely change in the future.

Figure 29.4 Projections of Pension Fund Assets, 1997–2002



Source: Boston Consulting 1998.

Commercial Banks

Commercial banks do not belong to the traditional circle of institutional investors; nevertheless, they may play an important role in the municipal bond market for three reasons.

- Because of their exposure and involvement in municipal financing, banks may have a better understanding of municipal risks and project risks of municipally owned enterprises.
- Banks usually play an important role in securities underwriting.
- Besides being direct investors, banks may contribute to municipal issues by providing partial or full guarantees to issuers, making them attractive to more conservative investors.

Because commercial banks cannot be considered traditional institutional investors, they have short investment horizons and usually require firm exit options.

Viable Revenue Bond Options

Some of the most important factors considered by potential investors when deciding on fixed income investments are

- default risk of issuer (credit risk)
- yield (reward for risk)
- maturity and duration (market risk)
- exit (liquidity risk).

At first glance, municipal (revenue) bonds may not readily appear to be the most desired investments. Revenue bonds are new on the market, and as with all new instruments, investors need time to get accustomed to them. Project risks are not easy to evaluate, and most investors have not developed the necessary skills and knowledge to do this. Maturities of revenue bonds tend to be long because they are determined by the projects rather than by the absorbing capacity of the market. Liquidity is likely to be low, because most issues are private placements. Nevertheless, a number of structures may, by adding enhancement features to the securities, neutralize or mitigate most of these difficulties.

The introduction of this new instrument to the market was made with strategic views in mind. In the beginning, the market will probably take only fire-sure bonds, but it is also likely that, as the market advances along the learning curve and as more and more comprehensive track record of revenue bond issues will emerge, non–plain-vanilla issues will also become marketable. The following section of the study will elaborate on structures and different enhancement features, which may provide solutions to specific problems.

Enhancement of Credit Risk

Obtaining government guarantees for municipal issues used to be the most common credit enhancement feature. A strong tendency exists, however, against central government providing either explicit or implicit guarantees to municipal issues as a matter of policy. This tendency is likely to continue, so with the exception of few special cases, this enhancement will no longer be available for issuers.

Bank guarantee is another commonly used instrument. Several bank-guaranteed general obligation and revenue bonds are available. Bank guarantees eliminate the issuer's credit risk and are widely accepted by institutional investors. Guarantees can cover both principal and interest payments, but they also can take a form of partial guarantees when the bank guarantees only the principal but not the coupon payments. Guarantees can also be limited in time: in some structures, the guarantee comes into effect after a certain period (for example, after 10 years). This solution is a good one when investors are ready to take the issuers' credit risk within a defined period shorter than the maturity of the bonds.

Bank guarantees do not come easy and do not come cheap. The most likely guarantors are the banks that are already familiar with the project or the municipalities involved when the parties already have a solid track record of successful cooperation. The fee for a bank guarantee usually ranges between 1–3 percent annually depending on the project, the structure of guarantee, and the quality of the beneficiary of the guarantee. Because a better quality bond can be sold at lower yields, the guarantee fee and the achievable cost decrease and the nonguaranteed issue must always be compared.

Rating of Municipalities

Rating agencies evaluate the probability of default of the issuer and rate fixed income issues accordingly. Although they do not eliminate or transfer risk—and do not substitute for the investors' own financial evaluation—ratings are widely accepted by institutional investors. In most cases, institutional investors have limits based on the investment categories of the largest rating companies. Although the domestic municipal bond market is too small to have issues rated by the large rating companies, the following four points are very important.

- One or more domestic rating agencies exist on the market in 2000 and are ready to rate municipal issues. Focus Ltd. has just started operations in Hungary and is determined to extend its services to the municipal bond market. Municipal (that is, revenue) bond issuers have their bonds rated by these agencies.
- The rating process takes time and administrative effort, and requires comprehensive and reliable data collection and processing. Rating also means an immediate cost factor for the issuer, and yet the potential reward of rating (lower coupon) will have effect only in the future. The short-term and strategic benefits of rating must be intensively marketed toward municipal financial decision-makers by road shows, seminars, workshops, and so forth.

- Laws and regulations on the investment activities of institutional investors start to use these ratings as investment criteria. Directly affecting institutional investors, this factor plays a critical role in the general introduction of a rating culture in Hungary. It will also present a very strong and clear reason for issuers to have their issues rated. Rating should become one of the investment criteria for investment funds, insurance companies, and pension funds.
- Institutional investors develop the culture of rating. Because of the heavy supply of high-yield Treasuries, institutional investors have not developed individual project-risk evaluating capacities, and developing them will not likely happen in the near future. Rating, however, is a well-known concept to them and, most important, to their owner-companies. Marketing efforts should be made by the rating companies to present their activity on the market and their rating methods for municipal issues.

Cash-flow Profiles

The two basic cash-flow profiles of a bond are the bullet and the amortizing structures (see box 29.3). In a bullet structure the bond pays interest at certain intervals and the principal amount is paid back at maturity. In most cases in which the cash-flow structure of the bond is bullet repayment, the reasonable assumption is that the project will be able to generate a cash flow adequate to pay coupons. Making sure that at the end (this end may well be in a quarter-century) sufficient reserves will be available to repay the total principal amount is always difficult, however.

Amortizing structures eliminate some of this risk by providing a smoother cash flow for the investor. These bonds also pay regular interest, but at the same time they pay back some of the principal. Another newly developed scheme to avoid the risk of the bullet repayment is the Zero Coupon Collateral (ZCC) structure. In this case, the issued amount covers not only the financing needs of the issuer but also the price of a zero coupon Treasury bond (with the same maturity as the issue itself) whose value at maturity will be equal to the principal amount to be paid back. At issue, the zero coupon Treasury is purchased and deposited in a segregated account and will be used at maturity for principal repayment (El Daher 1997).

The major benefit of the ZCC structure is that payback of the principal amount is guaranteed by a government paper bearing the minimum possible default risk. The ZCC structure requires stronger cash-flow producing capacity from the project, but the real cost of the design is the difference between the interest paid by the issuer and the (accrued) interest of the zero coupon Treasury. This promising instrument is not yet applicable, since no zero coupon or discount Treasury bills in Hungary have maturity longer than 12 months.

Box 29.3 Model Cash-flow Profiles of Possible Municipal Bonds

The model below presents the cash flow (from investors' point of view) of a bullet issue. Ten percent interest is paid every year, and at maturity the capital is paid back.

Cash-flow Profile of a 10-year 10-percent Bullet Issue

| | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
|-----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Cash flow | -100 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 100 |

The next model presents a bond that pays back 20 percent of the capital amount in years 6, 7, 8, 9, and 10. Note that, for example, in the eighth year beyond the repaid 20 principal only 6 percent interest is paid upon the remaining capital (60).

Cash-flow Profile of a 10-year 10-percent Amortizing Bond

| | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
|-----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Cash flow | -100 | 10 | 10 | 10 | 10 | 10 | 30 | 28 | 26 | 24 | 22 |

In the following zero coupon collateral (ZCC) structure the issue amount is 220 from which 100 goes to project finance and 120 goes for buying 10-year zero coupon Treasury note with discount rate of 8.3 percent. The issuer pays 10 percent on the bonds equaling 22 annually. At year 10 the ZCC Treasury bill matures at a value of 220 providing full coverage of the principal amount of the issue. Note, however, that the project must be able to generate a minimum 22 percent per annum cash flow (on the 100 allocated for project finance).

Cash-flow Profile of a Zero Coupon Collateral (ZCC) Structure

| | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
|---------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Project | -100 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 22 |
| ZCC | -120 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 220 |
| Total | -220 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 22 | 242 |

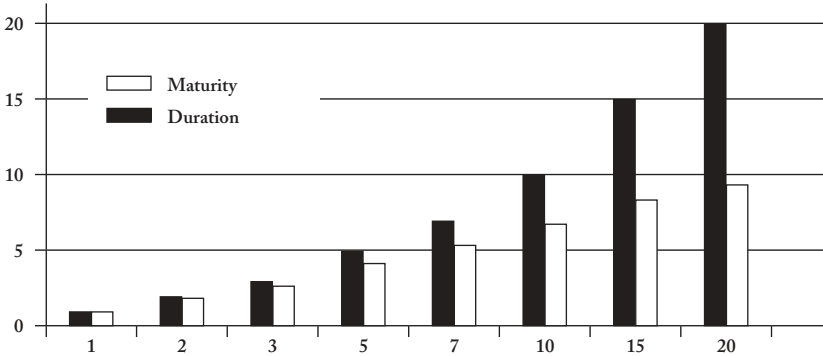
Source: Author's calculations.

Coupon Structures

Bonds pay interest (coupon) during the maturity at predefined periods (usually annually or semiannually). These coupons can be fixed rate or floating rate. In the case of a fixed rate issue, coupons are predefined at the date of the issue and will remain the same for the whole life of the securities. In this structure, on the one hand, the issuer runs the risk that, because of the decreasing yields on the market, obtaining cheaper finance than taken at the time of issue would be possible. On the other hand, the issuer is protected against a potential increase of yields. The investors run significant market risk in buying a fixed rate bond. If the yield level on the market increases, the value of the bonds will decrease. The longer the maturity (duration) of the bonds, the more significant the change in value (price volatility) will be (see chapter 27).

Maturity relates to the timing of the final cash flow only, and the duration includes all cash flows time-weighted, so that duration carries more information and is more relevant than maturity (see figure 29.5). Accordingly, taking duration into account, we see (see box 29.4) that a 20-year bond, for instance, is only 2.2 times riskier than a five-year bond, though its maturity is four times longer (El Daher 1997).

Figure 29.5 Comparison of the Maturity and Duration of a 10-percent Bond



Source: Author's calculations.

Box 29.4 The Duration of a Portfolio Investment

| Percentage distribution of the portfolio | Instrument | Duration |
|--|---------------------------------|------------|
| 20 | Cash | 0 |
| 60 | 1-year Treasury bill | 1 year |
| 20 | 15-year 10-percent revenue bond | 8.4 years |
| 100 | The portfolio | 2.28 years |

The duration of a portfolio of securities is equal to the sum of the market-value-weighted durations of its component securities. Accordingly, the average duration of the portfolio is $(0.2 \cdot 0) + (0.6 \cdot 1) + (0.2 \cdot 8.4)$ equaling 2.28 years, which may be within the risk tolerance of the investor.

The portfolio concept is essential for investors for whom revenue bonds are only a part of a diversified basket of investment instruments. Besides factors attributable to market expectations (decreasing yield level), some specific reasons explain why a floating rate can be the preferable structure for revenue bonds.

- In the case of project financing, tailoring financing so that its structure reflects the cash-flow profile of the project is prudent.

- Revenue bonds are usually issued for utility projects where, in most cases, operation costs, user charges, and fees are exposed to inflation.
- The level of inflation in Hungary is still significant.

From the investors' point of view, floating rate instruments eliminate market risk to a large extent because their coupons are adjusted periodically. The coupon structure of a floating rate security contains a base rate and a premium above the base rate. The premium on the base rate is designed to compensate for the risks attached to the issue; the higher the risk, the higher the premium. Several instruments are usually used as base rates for issues:

- In many cases, individual Treasuries (for example, Treasury bills) are used for the base rate. This structure ensures that the bond will always pay yields similar to those available on the Treasuries market.
- It is also possible to use some index or basket for the base rate (for example, Frankfurt or Budapest Stock Exchange indices: DWIX, BUBOR). This design offers basically the same benefits, but is much less exposed to an individual security or auction.
- The third possibility is to link the coupon to some macroeconomic figures, usually the consumer price index (CPI). In this structure, the coupon will follow the inflation trend.

The coupon structure of a floating rate revenue bond must be designed in a way that synchronizes the cash-flow profile of the project and the coupon structure of the issue. User fees and charges usually follow inflationary trends, so a CPI-based structure is in many cases the first solution to be considered. If changes in the project cash flow follow the yield environment, then the base also should mirror this phenomenon.

Other Enhancing Structures

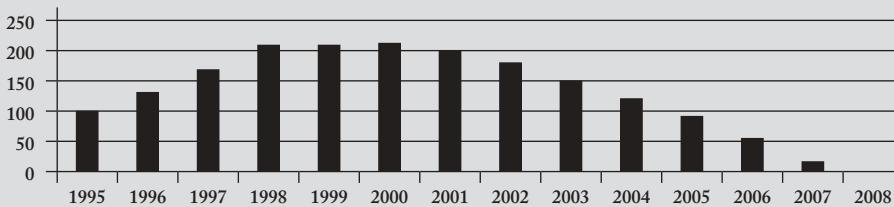
Many more enhancing techniques can be used either to make the bond more tailor-made to the project or to make it more appealing to investors. Some of them are used on the Hungarian market, but others are not yet present. The two examples below are tested in the domestic market (see boxes 29.5 and 29.6).

A substantial amount of time usually passes between the date of the issue (financing need) and the date when the project starts to generate substantial cash flow. The deferred first payment structure mirrors this cash-flow profile, with the first (annual or semiannual) coupon payment due after a certain period from the issue date (for example, three years). The bond is either issued at discount and reaches par at the date of the first coupon payment or bears accruing interest. The deferred first payment structure is especially advantageous in case of financing projects that are in the construction phase, or when cash flow starts to be generated after a certain period of time.

Box 29.5 Financing Structure of the ELMKA Highway Development

One of the ELMKA bond's interesting features is the discounted future payment structure. The bond was issued at par and capitalized interest (28.5 percent) for three years after which it pays CPI + 4.5 percent on the principal (including capitalized interest). The bond also features an amortizing structure in which the principal amortizes at predefined, but not equal, annual rates.

| <i>Year</i> | <i>Payment year</i> | <i>Interest due</i> | <i>Principal</i> | <i>Interest paid</i> | <i>Cash-flow (interest + principal due)</i> |
|-------------|---------------------|---------------------|------------------|----------------------|---|
| 1995 | 0 | — | 100 | — | -100 |
| 1996 | 1 | 28.5 | 128.5 | 0 | 0 |
| 1997 | 2 | 28.5 | 165.1 | 0 | 0 |
| 1998 | 3 | 28.5 | 212.2 | 0 | 0 |
| 1999 | 4 | CPI + 4.5% | 212.2 | CPI + 4.5% | CPI + 4.5% |
| 2000 | 5 | CPI + 4.5% | 212.2 | CPI + 4.5% | CPI + 4.5% |
| 2001 | 6 | CPI + 4.5% | 200.7 | CPI + 4.5% | 11.4 + CPI + 4.5% |
| 2002 | 7 | CPI + 4.5% | 176.1 | CPI + 4.5% | 24.6 + CPI + 4.5% |
| 2003 | 8 | CPI + 4.5% | 149.6 | CPI + 4.5% | 26.5 + CPI + 4.5% |
| 2004 | 9 | CPI + 4.5% | 120.7 | CPI + 4.5% | 28.9 + CPI + 4.5% |
| 2005 | 10 | CPI + 4.5% | 91.1 | CPI + 4.5% | 29.6 + CPI + 4.5% |
| 2006 | 11 | CPI + 4.5% | 55.8 | CPI + 4.5% | 35.3 + CPI + 4.5% |
| 2007 | 12 | CPI + 4.5% | 19.3 | CPI + 4.5% | 36.5 + CPI + 4.5% |
| 2008 | 13 | CPI + 4.5% | 0 | CPI + 4.5% | 19.3 + CPI + 4.5% |

ELMKA bond principal due, 1995–2008

Source: ELMKA Rt. Data.

Some bonds are callable, which means that the issuer can—in line with a process defined in the prospectus—redeem the bonds before the final maturity date. The call may take place because of cheaper refinancing possibilities or because external financing is no longer necessary. Because the call is usually not favored by the investor in many cases, the issuer must pay a premium in redeeming the bonds. Call options are especially difficult to

design in a negative yield curve environment (which exists in Hungary), in which market participants expect decreasing trend, and long-term yields are lower than short-term yields. Suppose that an investor buys a five-year bond with a yield of 10 percent when a one-year Treasury bill is sold at a yield of 8 percent. Because the investor anticipates a falling trend and believes that in the five-year period this bond will be earning better yield and the bond is called after a year, then the investor has a straight opportunity loss of 200 basis points.

Box 29.6 Municipal Bond the City of Pécs

The five-year Pécs bond has an interesting call feature: the bonds can be called by the issuer every year. When the bond is called, however, the issuer pays a premium on the last coupon, and the premium is determined so that the total yield of the bond will be same as if the issuer invested in a bond with maturity up until the call. For example, if this five-year bond is called after three years, then the last coupon will be 22.12 percent giving a total return of 18 percent on the bond. This yield is about the same as the investor would have received if he or she had invested originally in a three-year bond. Percentage yields are shown below.

| <i>Call premium percent</i> | <i>1999</i> | <i>2000</i> | <i>2001</i> | <i>2002</i> | <i>2003</i> | <i>Yield</i> |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|--------------|
| After year 1 | 20.95 | — | — | — | — | 20.95 |
| After year 2 | 16.40 | 23.09 | — | — | — | 19.45 |
| After year 3 | 16.40 | 16.40 | 22.12 | — | — | 18.00 |
| After year 4 | 16.40 | 16.40 | 16.40 | 20.79 | — | 17.25 |
| No call year 5 | 16.40 | 16.40 | 16.40 | 16.40 | 16.40 | 16.40 |

Source: Pécs municipality data.

Policy Implications

The introduction of revenue bonds to the Hungarian market needs strategic thinking from many market participants. Below we list the key actions to be made at central and local government level.

Central Government Level

The Central government is responsible for creating a favorable legal, institutional and regulatory environment that includes the following measures:

- Further strengthening of the institutional investment sector (pension funds in particular) is of critical importance. Individual investors in funds should be provided with meaningful tax shelters.
- Favorable taxation of municipal bonds would significantly decrease the cost of capital market financing for municipalities and municipal projects.

- As soon as credible rating agencies start to operate, investment limits of institutional investors should be formulated using ratings. Besides having a clear effect on institutional investors, this measure would also encourage issuers to have their bonds rated.
- Organizing special capital market seminars and workshops for municipal decision-makers and financial officers would be a key tool in strengthening local management capacity.

Municipal Level

The major action at municipal level would be to build local capacity for developing and advanced financing of large projects.

- Capacities for municipal revenue and debt management, investment programming, project financing, and financial policy management must be strengthened.
- Municipal staff responsible for investment programming and project financing should prepare for a decreasing trend of central funding and obtain adequate loan market, capital market, and project finance knowledge to be able to finance the project through the market.
- Both utility projects and capital market financing tend to have large economies of scale, and that condition underlines the importance of cooperation between municipalities to use resources in the most efficient way.
- Revenue bonds require revenues that are paid by the community within the boundaries of the municipality. Political courage is often required to introduce or increase user fees and charges, but this increase is inevitable if projects are planned.

Conclusions

A number of trends present in the municipal financing arena will have strong and permanent effects on municipalities:

- Decreasing central government contributions to municipal budgets
- One-time asset sales no longer generating large incomes
- Increasing needs for project and infrastructure development.

These factors will dramatically increase the need for stronger financing capacity, as well as for new financing techniques, instruments, and tools. New finance will, in the first place, come from the equity and financial markets. Revenue bonds are capital market instruments designed specifically for financing municipal utility projects. Projects to be financed by revenue bonds must meet strict economic and administrative standards. The project must be economically viable at the planning stage, and reasonable guarantees should ensure that it remains so until the debt is fully repaid at the time of bond maturity.

Structuring a revenue bond requires considerable qualifications in terms of engineering, and legal and financial expertise. Revenue bonds are new on the market and, in most cases, are rather sophisticated instruments with significantly more risk elements than plain vanilla Treasury issues. Project risks are difficult to evaluate, and the available track records are less than impressive. The maturity of revenue bonds tends to be long, because it is determined by the projects rather than by the absorption capacity of the market. Also, liquidity is likely to be low because most issues are private placements.

The investor base for nongovernmental fixed income issues is still limited, although it grew considerably in the second half of 1990s. Most investors have not yet developed the necessary skills and knowledge to perform their own evaluation of project risks inherent in revenue bonds. Another problem is that a sizable segment of institutional investors can purchase only public issues, whereas revenue bonds are most likely to be privately placed.

Considering these factors, one can reasonably argue that the domestic capital market is still premature to accommodate classic revenue bonds in significant amounts. A number of structures are already available (for example, guarantees, floating rate, amortizing schedules, and call options) that may, by adding enhancement features to the bonds, decrease some of these risks.

Several actions must be taken to facilitate the growth of the market in: (a) introducing changes to the legislation (for example, taxation and rating), (b) increasing capital market know-how in municipalities by organizing seminars and workshops, and (c) strengthening marketing efforts aimed at market promotion.

The introduction of this new instrument to the market must be made with a strategic perspective. In the beginning, the market will take only guaranteed bonds, but this situation likely will no longer be required as the market advances along the learning curve and a more comprehensive track record of revenue bond issues emerges.

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Municipal Bankruptcy Framework and Debt Management Experiences 1996–2000

Charles Jókay, Gábor Szepesi, and György Szmétana



With the advent of the 1990 Act on Local Government, Hungary's local governments became independent entities subject only to the supervision of Parliament, with no intermediate layer of government or administration to approve, intervene, or monitor their activities. The State Audit Office (SAO) monitors and investigates the technical, accounting, and reporting aspects of using state funds. The SAO issues opinions on the use of state funds by local governments, but cannot sanction violations. The public administration offices issue opinions about the formal legal compliance of local government decisions with the Constitution and other laws, but do not comment on the effectiveness, content, or rationality of local government actions.

Municipalities received virtually all local public assets as part of their responsibility to provide and finance local services and functions. They are authorized to conduct profit-making businesses, to own and manage commercial property and portfolios of securities, and to borrow for capital investment projects freely, without approval from or registration with a higher level of government. Given virtually unlimited freedom to manage assets and to conduct business, local government operational budgets and mandated activities could be threatened without proper prudence and experience. As a reaction to the economic depression and fiscal squeeze, local governments started to borrow too much, so that by the end of 1994 the central government considered methods to rein in irresponsible local borrowing and activities. This led to approval of the 1996 Act on Municipal Bankruptcy.

This chapter summarizes the experiences of municipal debt settlements over 1996–2000. The findings suggest that, in the Hungarian context, the Act on Municipal Bankruptcy has become a key instrument as a framework for court-led settlement of troubled debt and as a tool to encourage early preventive measures, including out-of-court settlement between municipalities and their creditors

* This chapter is based on Jókay, Szepesi, and Szmétana 2000.

Arguments for Municipal Bankruptcy Legislation

In the euphoria of the early 1990s, besides budgeting for the 25 basic tasks, municipalities began to invest in and borrow funds for profit-seeking activities, endangering mandatory tasks and solvency in many cases. Borrowing exceeded the total budgets of some smaller municipalities, and the economic viability of non-mandatory infrastructure was often questionable. Given the unfettered freedom of local governments to manage their assets and budgets, the central government faced the possibility of having hundreds of cases of contingent liabilities and of directly carrying out mandatory local tasks if local governments failed (see box 30.1).

Box 30.1 Municipal Borrowing Restrictions in Place, 1990 to March 1995

- No absolute or formula limits municipal borrowing within one budget year or on a multiyear basis.
- Central government shared revenues, transfer payments, normative grants, and infrastructure grants cannot be used for loan repayment (implicitly, the central government would not finance a local government's debt).
- The municipality may borrow for whatever purpose at whatever terms the city council approved in a local resolution.
- The Act on Local Government states that the central government will not assume responsibility for local debt.

Need for Changes in 1995

By 1995 Hungary's trade, budget, and current accounts deficit placed such pressure on the government that in March it enacted a series of fiscal restrictions known as the "Bokros package." Combining a one-off devaluation, a pre-announced 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 (government decision number 1092) of municipalities due to their own fault. These communities included Bakonszeg, Nágocs, Bátorliget, and Páty, all of which eventually underwent a debt adjustment process.

The availability of these funds to municipalities in distress threatened to set a bad precedent and incur immeasurable contingent liabilities for the central government. The eventual repayment to the central government of these temporary bridge grants was to be addressed in a future debt adjustment law in which the central government would assume the role of a creditor. Because the International Monetary Fund and other international organizations wanted 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 became unavoidable within the policymaking Interior and Finance Ministries.

Although municipalities receiving these emergency funds were restricted to performing a short list of mandatory tasks (see box 30.2), the precedent of central funds being available at all posed a real danger for the state budget and gave no incentive to the local level to make more reasonable investment decisions.

Box 30.2 Eight Mandatory Tasks

The tasks applied to the five 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
- Operating the local fire department and ambulance service (where appropriate).

Annex to 1995 government decision number 1092.

Note that drinking water and sanitation services were exempted temporarily.

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 (that is, in activities that were voluntarily assumed, not mandated by the state). This debt was rolled over year to year, and in 1994–1995, prevailing short-term interest rates on Treasury securities were between 25 and 30 percent. Some localities began to make late payments (that is, in technical terms defaulted), and creditors and debtors began to lobby for wide-scale state bailouts. Representatives of several commercial banks explicitly stated that these loans were in essence for the public benefit and deserved bailouts by the state.

Representatives of the ministries responded that loans entail risk since Hungary was already a market economy. 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 keep tight control on local 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.

Few Policy Options Available

In late 1994 and 1995 the central government had few realistic policy options to control municipal borrowing and to protect the overall solvency of the state budget. It could declare no responsibility for borrowing by local governments (despite their inclusion in the level of overall state debt). A second option would have been to impose restrictions within existing legislation and to create a new monitoring and enforcement mechanism. A third option would have been to rely on an informal agreement with the major financial institutions involved with local governments, essentially asking them to enforce debt limits and to restrain overeager borrowing by their clients. A fourth, not necessarily freestanding, option would have been to rely on market discipline and transparency to screen out risky clients and to sanction bad decisions by borrowers and lenders.

A coherent policy would have to address debt adjustment procedures, the method of allocating normative grants for operational purposes, the hidden burden sectoral laws placed on service delivery units and financial and cash management tools to optimize the system. In the end, 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 allocation regulations known in Europe, the Hungarian government decided that both lenders and borrowers should be held responsible for their decisions, while the central government put in place mechanisms for ultimately protecting mandatory services.

The Act on Municipal Bankruptcy

The Act on Municipal Bankruptcy (Law on Municipal Debt Adjustment, Law XXV of 1996) was approved by the Hungarian Parliament on March 26, 1996, by an 84 percent to 16 percent margin, and went into effect in June. Contrary to expectations among experts and in the press during the period of fiscal restrictions, in four years only a handful 11 of municipalities filed for bankruptcy protection and creditors did not initiate any proceedings. Strong evidence indicates that the Act on Municipal Bankruptcy preempted additional filings, because both creditors and debtors were encouraged to seek redress outside the court system and to take other steps to ensure solvency and operational efficiency. Within the overall legal framework and capital market, municipalities stopped borrowing in excess of their capacity to service debt (Kopányi and others 2000). Other fiscal restrictions (debt service limits, changes in normative grants, and shared revenues) and developments in the capital markets also turned the municipal sector into net lenders to the financial sector between 1996 and 2000.

Since 1996 overall annual municipal borrowing of all types ranged between Ft 50 and Ft 70 billion, reflecting a drastic decline in real terms. Some critics have cited the virtual cessation of long-term municipal borrowing (from 1996 to 2000) as a negative consequence of the Act on Municipal Bankruptcy. The state's intention, however, was to

avoid any contingent liabilities on behalf of local governments, and to ensure continuity of vital public services without additional strain on the national budget. Instead of revamping task allocation because of political obstacles, Hungary's approach has been to regulate when possible and to allow market actors to assume risk.

By early 2000 only nine municipalities had filed for municipal bankruptcy and about 60 bankruptcy threats resulted in out-of-court agreements. All the municipalities except Nágocs, which filed for bankruptcy for a second time in August 2000, recovered. Another municipality (Gilvánfa) suffering from protracted operating deficits filed for bankruptcy in September 2000 for reasons entirely unrelated to debt, borrowing, or capital projects. Therefore, this first analysis of the four-year experiences would be instrumental for Hungary in the process of subnational modernization and in creating a competitive municipal credit market. Summarizing Hungary's experiences would also be invaluable for the neighboring transition economies in modernizing their intergovernmental systems.

Objectives and Roles of a Bankruptcy Act

In the course of the policy debate surrounding the creation of the Act on Municipal Bankruptcy, policymakers in the Finance and Interior Ministries and experts appointed to perfect the proposal (including practicing commercial bankruptcy trustees and judges, and volunteer foreign experts in municipal finance) concluded that, if the state is not willing to control the risks of municipal borrowing administratively or legislatively (box 30.3), then an unambiguous law would need to serve the basic protection purposes.

Box 30.3 Risks Associated with Municipal Defaults and Financial Stress

Borrower local government:

- Inability to make timely payment; penalties and sanctions imposed
- Strain on operational budget
- No returns paid on halted or partially finished investment projects
- Assets and collateral lost
- Disruption of essential public services
- Risk of losing next election
- Sanctions from national government (eligibility for other grants, criminal prosecution, and so forth)
- 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, International Monetary Fund, and so forth)
- Bad precedents set in case of repeated bailouts
- Lose value of grants and investments already made if projects halted midstream
- Service provision obligation reverting 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; accounts receivable written off)
- Provisioning and regulatory problems
- Cost of managing bad assets
- Negative publicity for banks “pressuring” municipalities
- Risk of losing entire asset or loan in a resolution agreement or liquidation procedure
- Lost future business with municipal sector
- Cost of maneuvering to shift cost to taxpayer (bank bailouts; selling off loans)

The following key functions of bankruptcy legislation have been identified: (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 resolution procedures; (d) make certain that the national government will not guarantee local borrowings, because sovereign guarantees need an act of Parliament and specific authorization in the annual budget; (e) maintain public services; and (f) 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.

Petition and Commencement of Bankruptcy

If a municipality does not pay an acknowledged obligation to a creditor, vendor, or another party (either 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 bankruptcy court within eight days. The mayor faces strict financial sanctions as a private person if a bankruptcy process is not initiated due to delays on his or her part. A creditor may also petition the court if a municipality is in arrears more than 60 days.

The court has 15 days to examine the petition and to ask for more information and corrections. The mayor has eight days to respond to the court’s requests. The court, at its option, may reject a bankruptcy 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.

If the court concludes that the municipality is truly insolvent, it declares the commencement of the bankruptcy process and appoints a trustee. A host of obligations is then imposed on the mayor and the city council, and a separate set of actions is required of the creditors. The commencement of bankruptcy triggers a moratorium: no creditors may file suit, and all claims are to be reported to the bankruptcy trustee.

Phases of the Court-led Bankruptcy Procedure

In a court-led resolution we first summarize the key steps after declaration of a bankruptcy, then show what happens if the creditors and the debtor can not come to an agreement on debt resolution.

Declaration of Bankruptcy

The declaration of bankruptcy by the court means that a legal notice is published in the *Enterprise Gazette* and public notices are placed in several newspapers. The court simultaneously appoints a trustee, and the municipality has eight days from inception to form a crisis committee. The municipality then has 30 days to prepare a bare bones emergency budget that finances only mandatory tasks (see box 30.4). These mandatory services do not necessarily have to be performed directly by the municipality, but may be outsourced to neighboring towns, private firms, nongovernmental organizations, the county, or a regional association of municipalities. The services simply must be made accessible to the citizens of the municipality in bankruptcy.

Box 30.4 Mandatory Services during Bankruptcy

The Annex to the Act on Municipal Bankruptcy, on commencement of bankruptcy, bans optional, non-mandatory services voluntarily assumed by a municipality, and mandates that a local government only performs the following tasks:

1. Maintaining cemeteries
2. Providing for chimney sweeping
3. Providing and maintaining septic 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
7. Local road maintenance, snow removal
8. Public lighting
9. Removal of animal carcasses, animal control, and removal of diseased animals
10. Protection of fauna and flora
11. Rodent control
12. Fire protection and rescue
13. Provision of preschools, elementary schools, and educational facilities for national and ethnic minorities
14. Facilities for handicapped children
15. Dormitories for nonresident students, secondary and vocational education, adult education, basic artistic training, speech therapy, and so forth
16. Special educational services for hospitalized children, and handicapped children who cannot be schooled together with other students, and so forth
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, and so forth
22. Rehabilitation
23. Access to special rehabilitation services
24. Unemployment compensation, social assistance, public aids, 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. Social benefit for long-term unemployed

The municipality stops payments on all debts and finances only the mandatory functions. 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 necessary. The trustee must endorse all invoices prior to payments made by the municipality during this period. The trustee gathers contracts, liens, mortgages, and so forth, and examines them for legality.

If the municipality does not pass an emergency budget, a reorganization plan, and a resolution plan within 60 days of the bankruptcy commencement, the trustee recommends to the court that the process skip directly to asset liquidation (box 30.5). In this case creditors are given an opportunity to suggest asset liquidation favorable to them. In most cases bankruptcy commencement also means that, simultaneously, resolution negotiations begin between a committee of creditors and the municipality, led by the mayor and supported by the trustee.

Box 30.5 Options and Responsibilities for Creditors

Creditors have 60 days to file claims. If they miss the deadline, they may press these claims only after a two-year moratorium on lawsuits that goes into effect as the bankruptcy process is closed. Claims that are reduced or excluded from a resolution agreement that all parties sign, and the court approves, may not be sued for even after the end of the two-year moratorium. If a debtor does not live up to the terms of a resolution agreement, then the creditor may sue the debtor after the moratorium expires, but only for those claims that were a part of the mutually agreed upon resolution agreement. Of course, if the creditors and debtor do not come to an agreement, and the court enforces liquidation, then unpaid or partially unpaid claims may not be sued for in the future (paragraph 11, Act on Municipal Bankruptcy)

The resolution agreement must be reached 210 days after bankruptcy commencement or else the trustee will prepare an asset and debt adjustment plan that may not be favorable to either the debtor or the creditor. In practice, the municipal crisis committee and the debtors have nearly 210 days to form an agreement, given that discussions and crisis management take place simultaneously. In theory, the negotiation process can be wound up in less than a month in a cooperative scenario. In other words, both parties are encouraged to come to an agreement as soon as possible, because a court-ordered liquidation of assets and debts entails risk, and the municipality is taken over by the trustee who can veto the mayor and the city council.

If No Agreement Is Reached

In an uncooperative scenario in which the debtor and the creditors cannot come to an agreement, allowances are made for public auctions of assets and for numerous appeals, public notices, and so forth. In the most difficult situations, the court can request the Parliament to dissolve the local government 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 resolution agreement, and forced asset liquidation has not taken place. The entire process, including appeals and, if needed, public auctions of municipal assets, is set to take place within 270–300 days of commencement, depending on whether the municipality, the court, and the trustee use their full allotment of processing time.

The framers of the law were aware of the negative effects of delays and stalling by legal representatives of all parties, and built in sanctions and incentives at each stage: first, to encourage quick resolution agreements; second, to support tax increases, rationalizations, and the elimination of luxury spending while guaranteeing the public health and welfare functions required by law; and third, to allow for criminal and civil prosecution of corrupt, fraudulent, and reckless decisions to borrow for non-mandatory purposes that endanger public services.

Court Restructuring and Successful Preventive Cases

In this section we summarize experiences of actual court cases, and then we address the issue why so few formal bankruptcy cases occurred in the 1990–2000 period. Among the underlying factors we discuss the very positive preventive effect of the bankruptcy code, the preemptive actions at the local level, and some regulatory shortcomings that soften the bankruptcy regulation.

Actual Court Cases

We break our analysis of the workings of the Act on Municipal Bankruptcy into two phases. First, we analyze the actual bankruptcy filings and their resolutions to demonstrate causality and experiences in resolution negotiations and crisis management (table 30.1). Second, we focus on the preemptive effects and out-of-court resolutions in practice from a few detected financial crises.

In the nine cases of municipal debt adjustment declared and processed from July 1996 to the end of 1998, the law met its objectives (see boxes 30.6 and 30.7). The bankruptcy trustees were able to supervise emergency budgets and to reorganize municipal services, and seven of the cases resulted in resolution agreements that were approved by the court and published in the *Enterprise Gazette* in 1997 and 1998. In two cases the courts had to liquidate assets and liabilities on the recommendation of the bankruptcy trustee and the creditors.

Table 30.1 Petitions for Municipal Bankruptcy in Hungary, 1996–2000

| <i>Defaulted Municipalities</i> | <i>Population</i> | <i>Difficulty began</i> | <i>Debt (Ft million)</i> | <i>Petition filed</i> | <i>Process end</i> | <i>Result</i> |
|---------------------------------|-------------------|-------------------------|--------------------------|-----------------------|------------------------------|---------------------------------------|
| Bakonszeg | 1,330 | 1995 | 154 | August 1996 | June 1998 | Liquidation |
| Bátorliget | 777 | 1995 | 65 | August 1996 | March 1997 | Resolution agreement |
| Nágocs | 820 | 1995 | 123 | September 1996 | May 1997 | Resolution agreement |
| Páty | 4,605 | 1995 | 400 | August 1996 | October 1997 January 1999 | Liquidation |
| Csány | 2,312 | 1994 | 46 | August 1996 | April 1997 | Resolution agreement |
| Egerszólát | 1,120 | 1996 | 24 | August 1996 | April 1997 | Resolution agreement |
| Kács | 684 | 1996 | 32 | December 1996 | July 1997 | Resolution agreement |
| Domaháza | 1,061 | n.a. | 22 | September 1997 | June 1998 | Resolution agreement |
| Somogyudvarhely | 1,218 | 1997 | 31 | January 1998 | October 1998 | Resolution agreement |
| Nágocs 2 | 820 | 1995 | n.a. | August 2000 | April 2002 | Residual claims from 1996 |
| Gilvánfa ^a | n.a. | n.a. | n.a. | September 2000 | Ongoing | 100% unemployment, persistent deficit |

Note: a. Gilvánfa has no debts, because its municipal government has been essentially inoperable since 1998 and has received many bailouts as a village with a 100 percent Roma population with highly sensitive political overtones. It is by no means typical, and its debt adjustment filing is because of payments long overdue to vendors.

Note: Although precise numbers are not available, budgets for these communities ranged from Ft 30 million at the low end to about Ft 80 million at the high end in 1995 and 1996.

Source: Jókay, Szepesi, and Szmétana 2000.

These nine cases demonstrate that the central government avoids debt adjustment process at all costs unless the local government has lost its ability to deliver the most fundamental services, for example, when schools and health clinics lost their access to public utilities and key staff had to go without pay. A local government in bankruptcy does not have access to construction or development grants or equivalent subsidies. Therefore, maintaining potential access to these funds is another incentive to take operational cutbacks; avoiding the bankruptcy is only a secondary benefit.

The Act on Municipal Bankruptcy caused no domino effects. In the first quarter of 1996 before the act 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, and the Finance and Interior ministries had no

information as to how these numbers were derived. On the other hand, the deficit grant program eventually handled 700–1,000 applications (out of 3,200 municipalities) annually, and one can safely assert that the deficit grant is an active tool in bankruptcy prevention.

Box 30.6 Cases Resulting in Liquidation of Assets and Claims

Bakonszeg (population 1,330). Located in an impoverished area of Hungary, Bakonszeg engaged in a variety of profit-seeking business activities in the period from 1990 to 1995. These activities included establishing a spa company, guaranteeing the debts of several other commercial companies, and borrowing significant amounts to finance the construction of a resort village. In 1995 the State Audit Office uncovered evidence of fraud and illegal activity, including the falsification of signatures on municipal guarantees. The bankruptcy commenced soon after the law came into force. At that time, creditor claims amounted to Ft 154 million, and only Ft 2 million in collateral was available. This shortfall meant that 1.2 percent 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 petitioned for bankruptcy in August 1996. The bankruptcy trustee, the creditors' committee, and the municipality could not come to an agreement, so the court began to process the forced liquidation of debts and assets on December 22, 1996, which ended in 1998 on payment of the trustee.

Páty (population 4,605). This village, located in a fast growing semi-rural area near Budapest, engaged in intensive infrastructure projects starting in 1991 that included gas supply and a sewer system in 1994. By 1995 the village faced financial difficulties and its debt neared Ft 600 million. The 1995 budget was in crisis. The village applied for deficit grants and could not perform the most elementary functions because the lender bank intercepted the revenues and paid itself first, leaving few funds for basic tasks. The mayor and the administrative notary were forced to resign because of this and other business activities, and an entirely new government was elected in January 1996. This time, the village was for five months overdue in making utility and other payments as the bank continued to remove funds from the village's account. The County Treasury and Information Service Offices finally stepped in and intercepted all funds flowing to the village from the central government, and this measure stopped the bank from depleting the village's accounts to the detriment of public services. Of the Ft 600 million in estimated debts, Ft 200 million were owed to the bank, Ft 26 million to the tax office, and Ft 14 million to the Interior Ministry.

Bankruptcy was petitioned in August 1996, with the appointment of a bankruptcy trustee. On further investigation, of the estimated Ft 600 million in debt, the trustee determined that only Ft 400 million were justified and legitimate and owed to 53 creditors. The village was 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 basic activities. The resolution agreement was approved by the court in April 1997, and this step started a nearly two-year asset liquidation phase. The local government held three auctions to raise funds, at which 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 Ft 300 million, but because assets built in part with state funds could not be sold, 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.

Despite significant claims with doubtful sources of repayment, neither vendors nor banks petitioned for bankruptcy. These creditors probably assumed that the local governments had few negotiable assets available and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims.

The small size of villages that petitioned for debt adjustment suggests that large infrastructure projects, such as gas supply and piped sewage collection, were not just technically but financially unrealistic. Mayors seek “political rent” by borrowing to build

such projects that neither user charges, local taxes, nor capital income on other assets can finance.

Box 30.7 Cases Concluded with Resolution Agreements

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

Nágocs (population 820). The State Audit Office investigated this village in May 1995 and ruled 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 caused the village to default on Ft 123 million in debt. The central government provided deficit grants to the village in 1995 and 1996 in the amount of over Ft 25 million. As the Act on Municipal Bankruptcy went into effect in June 1996, the village filed its petition. Twenty-three creditors submitted claims for Ft 78 million in principal and Ft 45 million in interest. The resolution process resulted in Ft 63 million 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 Ft 50 million at book value, most of them industrial land belonging to a defunct shoe factory that could only be sold for Ft 20 million. These funds were distributed proportionately among the creditors. Other assets to cover the debt amounted to only Ft 13 million. The bankruptcy process was declared closed by the court in May 1997, less than a year after filing.

Csány (population 2,312). The village built a natural gas distribution system in 1994. This project led to Ft 46 million in debt that could not be serviced in 1996. Bankruptcy was petitioned in August 1996, and the resolution agreement was finalized in February 1997. At that time, the salvage value of the completed gas supply system was nearly Ft 50 million. The system was sold and the creditors satisfied. In April 1997 the case was closed. The village lost Ft 27 million from its balance sheet because of the low price 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 making negotiations simple.

Egerszólát (population 1,120). The village's gas supply project led directly to default in 1996 on Ft 24 million in debt ultimately accepted by the bankruptcy trustee. The village had Ft 1.7 million in cash and negotiable assets of about Ft 23 million. The resolution agreement called for selling the gas network, worth Ft 45 million, at a 75 percent discount for Ft 11 million. The local government paid off the debt, but suffered a loss of Ft 21 million on its balance sheet. The case was closed and approved by the court in April 1997.

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

Domaháza (population 1,061). In September 1997, Ft 16 million in unpaid claims came due, and the mayor petitioned for bankruptcy. By December 1997 legitimate claims against the village amounted to Ft 22 million. The court approved the resolution agreement in 1998.

Somogyudvarhely (population 1,218). The village borrowed Ft 20 million from a bank in 1994 to build a gas supply system. The Ft 20 million were borrowed despite difficulty in servicing an existing Ft 11 million debt. After cost-cutting measures and tight budgets, the mayor petitioned for bankruptcy in January 1998. The court approved the resolution agreement and the case wound up in October 1998.

Why So Few Formal Debt Adjustment Cases 1996–2000?

The recent experiences suggest that, as a result of the Act on Municipal Bankruptcy, effective preventive measures are being put in place even in the smallest communities to avoid the risk of asset liquidation. Also, since 1996, financial institutions are a lot more prudent in lending to municipal gas and wastewater projects. Furthermore, given the new provisions of the deficit grant system, local governments must cut back non-mandatory and optional activities and rationalize their operations in order to qualify. The deficit grant system intends to ensure financing basic services to which the population is entitled (paragraph 87, 1990 Act on Local Government). Experts close to the process, both within and outside the public administration, are convinced that the deficit grant system and its rationalization have prevented many bankruptcy situations from taking place. The annual 700–1,000 applications for a deficit grant, however, suggest that service delivery and financing reforms are urgently needed for the smaller settlements (Kopányi and others 2000).

Deficit Grant: A Hard Alternative

Deficit grants are given to 500–800 small villages annually, signaling that the smallest villages cannot provide their mandatory services given inadequate scale economies under the current transfer payment system that relies on per capita normative grants. Those who apply for emergency grants are discouraged from making new investments, because borrowing or producing matching payments for drawing down investment grants would strain operations, and emergency grants are not intended to support capital investment.

Over the six-year period 1993–1998, more than one-third of Hungary's municipalities have received emergency grants, most of them repeatedly (table 30.2). A particularly alarming tendency is that one-quarter of cities and two-thirds of counties received emergency assistance in 1998, 1999, and 2000. The municipality requesting such emergency payments must demonstrate that it has rationalized its institutions and maximized local taxes, and that its portfolio of real and financial assets is managed to generate income for financing core services.

Table 30.2 Deficit Grant Program, Grants, 1993–1998 (Ft million)

| Year | Number of counties | Amount | Number of cities | Amount | Large villages | Amount | Small villages ^a | Amount |
|------|--------------------|--------|------------------|--------|----------------|--------|-----------------------------|--------|
| 1993 | none | none | 12 | 405 | 5 | 26 | — | 469 |
| 1994 | 8 | 560 | 30 | 911 | 21 | 143 | — | 1,478 |
| 1995 | 16 | 1,600 | 48 | 1,809 | 46 | 376 | — | 2,513 |
| 1996 | 11 | 880 | 34 | 1,200 | 35 | 238 | — | 2,100 |
| 1997 | 11 | 540 | 53 | 2,200 | 46 | 406 | — | 2,900 |
| 1998 | 14 | 1,187 | 59 | 2,520 | 45 | 494 | — | 3,500 |

Notes: a. Approximately 800 villages per year receive grants. A total of 16 different counties, 87 cities, and 1,131 villages have received these grants 1993–1998.

Source: Interior Ministry data.

Applicants are screened at the County Treasury and Information Service offices, which make recommendations on reorganization and local taxes. Smaller villages are required to form notary districts and to join neighboring villages in associations for the delivery of services. Once these cost-cutting measures have been exhausted, the village is eligible for a deficit grant. Payment on debt and expenses related to capital investment that provides a mandatory service is a legitimate expense under the deficit grant program.

Deficit Grants and Bankruptcy

Identifying the causal relationship between making adjustments to qualify for the deficit grants and the small number of bankruptcy cases is an uncertain proposition. The existence of the deficit grant program and the necessary steps to qualify has positively reinforced the rules of bankruptcy legislation. It has reduced the number of potential bankruptcy candidates by preempting bad investment projects and encouraging smaller municipalities to concentrate on mandatory operations and cost-sharing options. Beyond these, the persistent inability of smaller villages to finance purely mandatory services has not led to defaults on debt payments. The deficit grant program specifically addresses operational deficits, and the restrictions in place starting with the 2000 budget require radical cutbacks in spending and reorganization of service delivery (box 30.8).

The Act on Municipal Bankruptcy was not designed to address persistent deficits caused by inadequate scale economies and other inefficiencies. Conversely, the deficit grant program was not designed to head off debt service problems. The increase in the number of municipalities applying for an ever-larger pool of deficit grants and the dearth of bankruptcy filings has a spurious relationship. The number of bankruptcy filings is negligible since January 1, 1999 (see table 30.1), just as the deficit grant program imposed stricter qualification criteria. If deficit grants “cause” fewer debt adjustment filings, then stricter standards and fewer awards would increase the number of bankruptcy filings. This increase has not occurred. The key role of the deficit grant is simply to put off the decision to reallocate functions and tasks in the municipal sector, a decision that is not plausible politically without a solid two-third government majority. (The Socialist–Liberal coalition between 1994 and 1998 had a 72 percent majority and decided not to alter task allocation.)

Box 30.8 Deficit Grants—Soft Money for Hard Policy Choices?

Supplementary funds are available for local governments that, after fulfilling strict conditions, are still not able to finance their mandatory operations or need assistance in financing a court-approved resolution agreement (resolution loan interest subsidy). The annual Budget Act, in this case annex 6 of the 2000 state budget (Law CXXV of 1999), contains the conditions for awarding deficit grants and loan subsidies for carrying out court-approved resolution agreements. These conditions include the following:

- A village with fewer than 500 inhabitants is disqualified if it has not joined a notary district (that is, still has its own administrative notary), unless it has signed an agreement to join a notary district by January 1, 2001.

- A village is disqualified if it does not finance any other institution besides a village hall, unless it is a member of a service delivery association.
- A village with fewer than 1,100 residents may not have usage rates below 50 percent in its health, social welfare, and educational institutions. For villages with over 1,100 residents, the usage rate must be at least 70 percent (stricter than the Act on Municipal Bankruptcy). Exceptions are those villages with fewer than 500 residents where only one such institution of each type exists or where the facilities are operated jointly with other villages in a service delivery association.
- An applicant is disqualified if it has not initiated joining a service delivery association if its own usage rates fall below the standards.
- An applicant is disqualified if it has time deposits exceeding three months in term, including its institutions, that exceed its authorized reserves set aside for capital projects, then it is disqualified.
- An applicant is disqualified if it has not imposed a local tax and is not planning to do so, the annual Budget Act (annex 4) contains a taxing power calculation formula for each municipality. This local tax calculation applies only to the local option business turnover tax, but it is used to determine the estimated revenue that could be raised locally. This amount is deducted from the potential amount of the deficit grant. (The principle of estimating taxing power is to reduce central grants or to support a potential redistribution of local taxes is under court challenge and is expected to reach the Supreme Court.)
- An applicant is disqualified, if its planned capital expenses exceed its sources of capital income, including grants, cash on hand, loans.
- The County Treasury and Information Service Office calculates an adjusted budgetary gap that is not covered by the various current normatives for a village, and is corrected by a variety of cost factors, cash on hand, and administrative tests listed above. The County Treasury and Information Service Office also makes suggestions for budget cuts and other restrictions before approving and submitting the deficit grant application to the Interior Ministry. Deficit grants may not be used to pay principal or interest on short-term loans. The municipality must document all the claims it makes pertaining to policy decisions, such as joining association and so forth after receiving the funds.

The Interior Ministry also grants a refundable interest subsidy for commercial loans taken by local governments to finance the implementation of a court-approved resolution plan. These loans are essentially short-term liquidity loans to finance settlements as assets are liquidated and other measures implemented to satisfy creditors. The Interior Ministry also provides grants capped at Ft 2.5 million to pay the bankruptcy trustees once the court has approved and published the conclusion of the bankruptcy process.

Preventive Effects of the Bankruptcy Law

One of the most important consequences of bankruptcy legislation worldwide is that it generates strong motivation at both sides of the market to avoid, prevent and preempt bankruptcy petition with internal measures as well as by out-of-court resolution agreements. Though difficult to measure due to the confidential nature of these kinds of agreements, anecdotal evidences suggest that dozens of municipalities have successfully avoided bankruptcy with negotiated resolutions.

Capacity and Compliance

Given the large number of smaller villages that annually request deficit grants and the low number of bankruptcy procedures, other evidence for the successful preemptive nature of the Act on Municipal Bankruptcy can be found in a rarely cited passage. Paragraph

18 of the act 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 finance 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 percent or more.

Anecdotal evidence indicates that municipalities-in-crisis prevention measures are applying these two standards of the Act on Municipal Bankruptcy. In other words, political and professional leaders cite this standard when preparing a deficit grant application or taking other steps to prevent default and continue financing mandatory tasks. Even if a municipality in financial crisis is not considering a deficit grant application, emergency budget capacity standards could be used to justify politically controversial preventive cutbacks in local budgets.

Another explanation for the low number of bankruptcy filings may come from a lack of compliance (box 30.9). Because creditors hesitate to petition the court in the hope that they may achieve some type of preemptive settlement, debtors may ignore the triggering conditions in the law. Unless the municipality is randomly selected for inspection by the SAO or another authority, or is reported by a watchdog organization, these failures to invoke the debt adjustment process will go undetected and unpunished.

Box 30.9 Lack of Filings—Lack of Compliance?

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 percent of comprehensive audits, or three to five municipalities per year, should have petitioned for bankruptcy, 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, because preventive and compensatory measures are implemented immediately. These figures should not be projected on the entire population of municipalities, but are indicative of the compliance problem.

Detecting Near-defaults

The preventive capability of the Act on Municipal Bankruptcy cannot be ascertained from any register of municipalities in distress (box 30.10). If a municipality does not apply for a deficit grant and the press is quiet about its financial difficulties, then no source of reliable information is available on which to estimate the volume and nature of municipalities in near-distress situations. In general, all municipalities have a difficult time balancing their operational budgets and maintaining a certain standard of services while keeping the number and extent of institutions unchanged.

Box 30.10 The Sample for Detecting Municipalities in Distress

We relied on our own experience as financial advisors to municipal development projects and to cities in distress. The sample chosen includes large villages and small towns, ranging in population from 4,000 to 27,000. This category is one notch above the villages described in the section on deficit grants, and their budgets and service delivery mechanisms are perhaps slightly less complicated than the larger cities that operate extensive and duplicative institutions. In those cases more sophisticated methods such as internal controls and cash pools (local treasuries) could be implemented to ensure both liquidity and the ability to service debt and operations.

Interviews were conducted with the professional and political leadership of the following municipalities (populations are in parentheses): Békésszentandrás (3,984), Nagykőrös (26,565), Szécsény (6,894), Szerencs (10,208), Tápiószentmárton (5,094), and Tokaj (4,500). Despite an empirical definition of “nearly in default,” these large villages and small cities had all amassed debt and had incipient payment problems, but all of them managed to avoid the bankruptcy process by reaching preemptive agreements with their creditors.

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 also makes guessing the number of near-bankruptcies rather difficult. The law gives a clear definition of when a municipality must petition for bankruptcy and under what circumstances a creditor may file such a petition. The law does not define any pre-adjustment disclosure or registry requirement.

Evidence for bankruptcy prevention, however convincing, is circumstantial and haphazard at the macro-level, and individual cases of municipalities negotiating with creditors and passing difficult budgets with real cutbacks seem to imply that creditors and municipalities want to avoid the bankruptcy process (including choosing noncompliance as an option). The level of municipal debt can only be assembled after the fact from projected figures in budget resolutions and from annual reports that are filed six months after the close of the calendar year. Both sources of information are used unwisely for making projections in real time about incipient debt service difficulties.

Municipal debt to finance development projects cannot be an indicator of future financial stress unless the particulars of the project, the balance sheet of the municipality, and its predicted or expected revenue stream are well known.

Typical 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, and the town’s institutional structure remained extensive and overstaffed. Because of a wage increase granted centrally for political reasons, the town nearly defaulted on its loans in the second half of 1996.

Tokaj faced similar problems in 1995, when its large network of institutions employed nearly 10 percent of the total population. Tokaj was running a large, close to 10 percent, operational deficit caused by overstaffing and the fixed cost of the municipal buildings. Hence, local services became jeopardized and the city's liabilities rose dangerously.

Szerencs made environmental and infrastructure investments in 1995 using state grants that it had to match with own-source revenues; hence, it borrowed. 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 gas network. The total cost of these investments was underestimated, and the city had to borrow additional funds to complete the projects. Higher interest payments placed stress on the budget that tried also to finance an oversized and overstaffed government inappropriate 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 that had a much higher own-source requirement than the addressed grants used to finance these types of projects. Because of ambitious borrowing, the city's interest payments caused a financial crisis by 1995.

Tápiószentmárton also borrowed excessively in 1994 to finance infrastructure projects, and debt service was not in line with its operating budget or with its ability to generate capital income.

Preemptive Methods in Practice

We also analyzed the methods and interventions that were carried out by distressed local governments so that court restructuring could be avoided. The following last-minute measures addressed overdue debt service payments and other liabilities.

Budget Cuts and Municipal Treasuries

Tokaj municipality worked out a multistep reorganization plan in 1995. First, an independent consulting firm conducted an internal audit on city institutions and management policies. The city 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. With 580 public employees in a city with 5,000 inhabitants, about half the population had an immediate family member whose salary came from the city budget. Besides making decisions and actions to sharply reduce the labor force and the number of institutions to a satisfactory level, the municipality merged organizations and institutions with similar fields of operation (see chapter 22). An effective management information

system was established, introducing zero-based budgeting and working out a new financing policy with a municipal treasury that made it possible to deliver up-to-date information to decision-makers at different levels.

Negotiations with Creditors

In Békésszentandrás, the most important action was an agreement with the creditor bank to reschedule debt repayments. The municipality asked for restructuring of its debt and sold some of its securities portfolio and real estate.

Szécsény also had an internal organizational audit, and the outcome resulted in harsh saving actions at all levels. The previously independent budgetary agencies were merged with a common financial administration, a municipal treasury. The municipality also rescheduled its liabilities and chose a new lead bank in 1997 (rather rare in the municipal sector at that time). The network of institutions was rationalized through closings and mergers, and some service institutions were handed over to the county government (see chapters 5 and 14).

Szerencs also urged restructuring of its debt and conducted an internal audit. This municipality, however, was recipient of deficit grants in 1995. The lobbying landslide that followed the bailout of Szerencs and other municipalities accelerated the formulation of the bankruptcy act. The four other municipalities covered by the one-time deficit grant underwent debt adjustment as the law came into force in June 1996.

Tápiószentmárton, like all other distressed local governments, adopted saving actions in the village budget and the institutions. The measures included labor force and municipal service reductions. As a consequence, mandatory tasks are executed with fewer financial sources than before. The village's financial difficulties continued throughout 1999, but the mayor managed to avoid having to file for bankruptcy.

Key Factors in Avoiding Bankruptcy Petition

After 1996 municipalities routinely introduced a number of procedures to avoid bankruptcy petition. Their learning curve is steep and profound:

- Debt restructuring and rescheduling of liabilities with all lenders and vendors
- Conscious rationalization and restructuring of budgetary institutions aimed at eliminating parallel functions by closings, mergers, or handing them over to the county government
- Establishment of a local treasury to reduce the need for cash and short-term borrowing, and to capture interest income across the administration and budgetary institutions of the local government
- Labor force reduction at all levels based on thorough internal performance audits
- Decrease of voluntary municipal services

- Efforts to increase local taxes and to set realistic fees for local services
- Applications for deficit grants that essentially force examination of capacity usage, per capita service costs, and options to join associations and notary districts
- Enhanced internal control and debt monitoring.

Debt accumulation and debt service problems flow, nearly without exception, from financing the own-source portion of local infrastructure projects. When debt service payments to lenders began to threaten other vendors and mandatory operations, municipalities petitioned for bankruptcy. Much of the debt owed to vendors is invisible in the form of registered overdue liabilities and vendor loans that are packaged in a series of progress invoices spread over three-year financing grants. Thus, the extent of potential debt owed to vendors that may be in default is objectively difficult to measure.

Vendors and implicit lenders to date have not petitioned against municipalities out of fear that their claims would enjoy a lower priority than taxes, wages, and other obligations. A potential for more bankruptcy filings still exists if all vendors decided to press valid claims and stopped overlooking overdue receivables.

Local governments reported that the County Treasury and Information Service Offices and private consulting firms were the most helpful in both preventing bankruptcy and providing technical assistance for debt restructuring. Most banks and creditors were willing to cooperate in out-of-court restructuring, and none of them has filed a petition against a municipality.

All the analyzed local governments replied that after these interventions their liquidity was gradually improving and the operating deficit decreasing, because their institutions were operating with higher efficiency. It became obvious that many of the examined localities have no real chance to engage in new development projects or investments because their financial skills are still very weak and vulnerable although they have no day-to-day liquidity problems.

Regulatory Shortcomings Softening the Bankruptcy Law

The 2000 state budget contains strict provisions for funding deficit grants as well as for interest subsidies available for supporting debt conciliation loans. This amendment to the state budget also contains line items for paying bankruptcy trustees on declaration of the closing of bankruptcy cases. The deficit grant program for 2000 amounted to Ft 9.6 billion (about US\$ 35 million) including payments for the bankruptcy trustees and the interest subsidies. For the 2001 and 2002 budgets, these amounts rose to Ft 10.5 billion and Ft 11.4 billion respectively.

A third category for assisting municipalities in fiscal distress could result in further softening the discipline of lenders and local governments. The 2000 budget set aside a discretionary fund of Ft 1.2 billion (over US\$ 4 million) to be used at the discretion of the

Interior Minister to provide grants (or interest-free loans) for municipalities that do not qualify for assistance under bankruptcy or deficit grant. These funds are for unspecified “temporary liquidity problems” and the Interior Minister is only required to report on its usage in January 2001. Certainly, these discretionary liquidity grants, which should be monitored, pose a risk of loosening the positive restrictive regulatory environment in effect in Hungary since March 1995.

Conclusions

The municipal bankruptcy framework has performed effectively in Hungary’s rather market-oriented legislative and institutional environment. Many situations have neither room nor need for such bankruptcy legislation. For instance, when constitutional structure does not allow subnational units to borrow for capital projects, the state controls municipal borrowing or borrows for municipalities. In other cases the state automatically guarantees municipal borrowings or acts as a lender to municipalities. In the central and eastern European countries, one can find all kinds of the above-mentioned methods often used jointly, inconsistently, and with severe shortcomings. The positive Hungarian experiences might be applicable in a number of other central and eastern European countries.

Local Management Capacity and Systemic Faults

The municipal bankruptcy law has been criticized for essentially eliminating municipal capital borrowing, though in our view this trend is a result of many factors related to infrastructure grants, fiscal restrictions, and many local capacity questions. The law also seems to favor the debtor, giving it the option to reschedule debt indefinitely because creditors are hesitant to file petitions because of the uncertain outcome of resolution negotiations or forced liquidation. By contrast, the entire local government system works from a holistic perspective, albeit not fully effectively, and it may be expensive.

The Act on Municipal Bankruptcy has been effective because it is not used as a sole last step in a theoretical series of unintentionally related preventive measures, but rather lenders and 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, and so forth are related questions that the Act on Municipal Bankruptcy cannot address. It can only repair situations that went out of control.

Project management skills are clearly lacking at the local level, which faces difficult technical and financial tasks, such as coordinating state grants, private funds, service enterprise funds, and the down payments of citizens. The SAO pointed out that rarely do local assemblies fully consider the implications of debt service obligations nor do they request feasibility studies or conduct similar calculations. Furthermore, projects funded by grants and debt are often oversized and will operate at a suboptimal level (SAO 1998b).

Perhaps these types of skills could be improved by the upcoming local governments or conducted by professional organizations serving for regional service associations of municipalities.

Reaction of Lending Institutions

The Hungarian Savings Bank holds a near monopoly of the municipal market, controlling 90 percent of accounts but only 70 percent by volume. Several major cities have switched accounts to competitor banks. The Hungarian Savings Bank is reported to have begun to ask loan applicants to sign a declaration that they consider themselves exempt from the borrowing limit paragraph of the local government law, thus enabling the bank to lend in excess of the limit. This administrative barrier to excess lending does not seem to work in practice because no one ensures the legality and validity of these declarations and the accounting system cannot give a real-time and accurate calculation of compliance.

The lead bank that handles a municipality's current account is familiar with its financial status, spending patterns, and risk profile. The existence of the Act on Municipal Bankruptcy and the borrowing limit thus limit the most egregious examples of inappropriate lending, and 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 Act on Municipal Bankruptcy is not an effective factor in making lending decisions. A risk factor, however, is the legislative redefinition of what funds are available for debt service. For example, rumors of centralizing the business tax altered the funds available for debt service in a five-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 Act on Municipal Bankruptcy does not necessarily protect their interests in a resolution negotiation or forced liquidation because negotiable assets available to settle debts are usually not sufficient, and projects funded do not generate sufficient revenues. 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 resolution agreements mandate tax and rate increases. In other words, a legitimate criticism of the Act on Municipal Bankruptcy is that it fails to protect fully the rights of creditors, especially those who rely on revenue-generating projects and not liens on property as security. As a result, banks have begun to require 200–300 percent collateral, which ties up assets as security and hinders development.

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 municipality and the lender.

Reaction of Municipalities

The Act on Municipal Bankruptcy does not prevent local governments from borrowing for infrastructure projects; rather this borrowing is curtailed by the dearth of freely available cash generated either by a project or other local revenues, such as tax collections and capital income. According to Ministry of Finance data, the local government sector reached only 19–30 percent of its legal borrowing limit during the years 1996–2000.

Those who are not creditworthy even in the creative sense (self-exemption from various debt service limitations) do not receive bank loans, and the strict prerequisites of the deficit grants are forcing staffing and other cutbacks in smaller communities with persistent operating deficits. The various steps taken to avoid bankruptcy petition evidence the most vivid reaction of municipalities to the Act on Municipal Bankruptcy. According to the SAO, the act and the restriction on debt service convinced local governments to be more prudent in their borrowing, and preventive measures included tax increases and service cutbacks at the city level. Such measures have little effect or are difficult at the village level (SAO 1998b).

Overall, excessive indebtedness was caused in part by political pressure from the population and inexperience on the part of elected officials.

Projects in Hungary are not of a sufficient scale to generate enough revenues to support stand-alone financing, while localities cannot capture the economic benefits of better infrastructure through value-related property taxes to support a general obligation-type debt structure and the covenants usually used to mitigate risk. Operating budgets are under stress and do not generate surpluses sufficient for large-scale borrowing.

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 maturity of the usual loans. (Because the asset is constructed partially from state funds, it cannot be offered as collateral because it cannot be sold off in a liquidation scenario or privatized for 10 years).

Policy Issues for Further Research

The bookkeeping and accounting, reporting, and disclosure requirements for local governments are due for reform. Local governments are acting essentially as holding companies, budgetary agencies, authorities, and the ultimate arbiters of local democracy and self-rule. Under these circumstances, 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 (see chapter 19).

Financial and securities services should not be exempted from public procurement rules. In the municipal sector, given the scale of environmental infrastructure, financial intermediaries are responsible for funding.

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. At least one rating agency is active in rating municipal issues, having just rated a five-year fixed interest rate bond issued by Budapest District IV in June 2000.

The economic and operational characteristics of the 1,300 or so local governments that have applied for deficit grants between 1993 and 1999 (including many repeat applicants) should be analyzed in an attempt to model, perhaps predict, the parameters of the typical future applicant.

Collection, evaluation, and dissemination of the experiences of bankruptcy trustees and judges would be instrumental in clarifying the effects of Act on Municipal Bankruptcy.

Options should be considered for introducing the personal liability of professional staff, elected officials, and others involved in grossly negligent decisions to borrow.

Examination of the few long-term borrowings (both bank loans and bonds) would reveal how debt is secured and 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 to attract more private capital into the municipal sector.

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Local Government
and Public Service
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Local Government and Public Service Reform Initiative (LGI), as one of the programs of the Open Society Institute (OSI), is an international development and grant-giving organization dedicated to the support of good governance in the countries of Central and Eastern Europe (CEE) and the Newly Independent States (NIS). LGI seeks to fulfill its mission through the initiation of research and support of development and operational activities in the fields of decentralization, public policy formation and the reform of public administration.

With projects running in countries covering the region between the Czech Republic and Mongolia, LGI seeks to achieve its objectives through:

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- assistance to Soros foundations with the development of local government, public administration and/or public policy programs in the countries of the region;
- publication of books, studies and discussion papers dealing with the issues of decentralization, public administration, good governance, public policy and lessons learned from the process of transition in these areas;
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