

Krisztina Beer-Tóth

Local Financial Autonomy in Theory and Practice

The Impact of Fiscal Decentralisation in Hungary

Thesis presented to the Faculty of Economics and Social Sciences
at the University of Fribourg Switzerland
in fulfilment of the requirements for the degree of
Doctor of Economics and Social Sciences

Accepted by the Faculty Council on 27 May 2009 at the proposal of
Professor Dr Bernard Dafflon (first advisor) and
Professor Dr George Guess (second advisor)

Fribourg 2009

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The Faculty of Economics and Social Sciences at the University of Fribourg neither approves nor disapproves the opinions expressed in a doctoral thesis. They are to be considered those of the author. (Decision of the Faculty Council of 23 January 1990)

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Berne, in September 2009

Abstract

Although financial autonomy is a recurrent notion in the literature on fiscal federalism and decentralisation, it has seldom been the focus of scientific analysis. This book explores the meaning of financial autonomy at subnational levels of government, its relationship with the principle of subsidiarity, as well as its impact on the three economic branches of government activity: allocation, distribution, and stabilisation. The major contribution of the book is a structured overview of the factors that may potentially impinge on the freedom of subnational authorities with regard to their budget decisions. This analytical tool may help pave the way towards the elaboration of more accurate techniques for measuring subnational financial autonomy in future. A tentative application of the new theoretical framework is provided in the second part of the book that delves into the complex issues of municipal revenue and expenditure autonomy in Hungary after 1990.

Résumé

Bien que l'autonomie financière soit une notion fréquemment utilisée dans la littérature du fédéralisme financier et de la décentralisation, elle a été rarement au centre de l'attention scientifique. Ce livre explore les acceptions du terme de l'autonomie financière, sa relation avec le principe de subsidiarité, ainsi que son impact sur les trois branches de l'activité économique du gouvernement : l'allocation, la redistribution et la stabilisation. L'apport principal du livre est un synoptique des facteurs ayant la capacité de restreindre la marge de manoeuvre des collectivités locales dans la prise de décisions budgétaires. Cet outil d'analyse peut contribuer à tracer la voie vers le développement de techniques de mesure d'autonomie plus précises dans l'avenir. Une ébauche d'application du nouveau cadre théorique est proposée dans la deuxième partie du livre qui offre également une analyse approfondie des défis complexes relevant de l'autonomie budgétaire des communes de la Hongrie depuis 1990.

Ismertető

Noha a költségvetési önállóság fogalma a fiskális föderalizmus és decentralizáció irodalmában rendszeresen felmerül, a témáról eddig ritkán készült tudományos elemzés. A jelen kötet tüzetes vizsgálatnak veti alá a helyi önkormányzati költségvetési önállóság mibenlétét, a szubszidiaritás elvéhez való viszonyát, valamint a helyi autonómiának az állami gazdaságpolitika három alapvető feladatára, az allokációra, a disztribúcióra és a stabilizációra gyakorolt hatását. A tanulmány fő eredményként rendszerezett áttekintést nyújt mindazokról a tényezőkről, amelyek korlátozhatják a helyi önkormányzatok önállóságát egyes költségvetési döntések meghozatalában. Ez az elemző eszköz a szerző reményei szerint a jövőben támaszul szolgálhat a mainál pontosabb mérési technikák kidolgozásában. A kötet második része kísérletet tesz az új elméleti keret alkalmazására és egyúttal részleteiben tárgyalja a magyarországi települések 1990 utáni kiadási és bevételi autonómiájának komplex összefüggésrendszerét.

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List of Abbreviations

AFV	adjusted fair value
ALG	Act LXV of 1990 on Local Governments
ATC	Act XX of 1991 on the Tasks and Competences of Local Governments and their Bodies, the Commissioners of the Republic and Selected Deconcentrated Authorities
CDSF	county directorate of the social security funds
CDT	county directorate of the Hungarian State Treasury
CEE	Central and Eastern Europe
CG	central government
CPE	Constitutional Political Economics
DUM	deconcentrated unit of a line ministry
EU	European Union
FOCJ	Functional, overlapping and competing jurisdictions
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual
HST	Hungarian State Treasury
HUF	Hungarian forint
IMF	International Monetary Fund
IPA	local business tax (iparűzési adó)
LAU	Local Administrative Unit
MSG	minority self-government
NFB	net fiscal benefit
NGO	non-governmental organisation
NHIF	National Health Insurance Fund
NIE	New Institutional Economics
NPE	New Political Economy

xxiv	NUTS	Nomenclature of Territorial Units for Statistics
	OECD	Organisation for Economic Co-operation and Development
	<i>önhiki</i>	deficit grant (önhibájukon kívül hátrányos helyzetben lévő önkormányzatok támogatása)
	PAO	public administration office
	PC	Public Choice
	PIT	personal income tax
	PPP	public-private partnership
	SCG	sub-central government
	SNG	subnational government
	VAT	value-added tax

Introduction

The daily political discussion about the decentralisation of the public sector in Hungary features autonomy as one of the most frequently mentioned but most poorly defined terms. Much of the disagreement between the central government and the elected local authorities results essentially from the lack of consensus about the meaning of this key term. Local governments complain about having autonomy in virtually all local affairs except for financial ones. The central government, in turn, refers to the numerous laws and decrees that establish local autonomy in expenditure, revenue and budgetary issues and deplores the fact that local governments do not make sufficient use of their legal rights. Municipalities consider their autonomy seriously restricted by the decrease in the proportion of central funding for local public goods and services. The centre finds, however, that local autonomy can only emerge through increased participation of local governments in raising funds for their activities. It expects local policymakers to assume more responsibility for their decisions and actions, while the latter find that responsible behaviour is conditional upon unfettered autonomy. Although the centre pursues the objective of empowering local governments, mayors feel increasingly powerless to perform their mandate.

The arguments on both sides contain at least a grain of truth, yet the battle is idle because the underlying notions are fuzzy. Reviewing the press and various platforms of the academic debate in those nearly two decades that followed the adoption of the Act LXV of 1990 on Local Governments (ALG), one has the impression that much of the energy wasted on the controversy about local financial autonomy could have been channelled into more constructive undertakings. As

- 2 most of the scientific investigations pursued throughout the world, the present piece of research was motivated by the quest for truth: Is local financial autonomy in Hungary shrinking or growing nowadays? Which party is closer to the truth? To what extent are the arguments on either side justified?

These questions cannot be answered without a thorough analysis of the contents of local financial autonomy. Although it is an essential feature of fiscal decentralisation and a recurrent notion in the literature about fiscal federalism and decentralisation, local financial autonomy is seldom treated as a separate subject and has never been investigated systematically in the context of post-socialist decentralisation in Hungary. Particularly since 2000, researchers in and outside Hungary as well as government institutions and international organisations have made a sizeable effort to provide an overview of the decentralised intergovernmental fiscal system in Hungary (e.g. KUSZTOSNÉ NYITRAI, 2004; KECSKÉS et al., 2005; GURNIK et al., 2005) and to analyse some of its particular aspects or problems (e.g. VEREBÉLYI, 2000; KOPÁNYI et al., 2004; BALÁZS, 2005). However, these studies focus on the institutions and processes of decentralisation without explicit reference to how they affect the autonomy of local governments. The present paper takes therefore local financial autonomy as a starting point for the discussion of intergovernmental arrangements. This change of perspective leads us to formulate the following research questions:

1. Is there a workable solution to define local financial autonomy? What conclusions can be drawn from the comparison of existing definitions? How does local financial autonomy relate to the concurring economic and other objectives of a decentralised fiscal system? Which factors can constrain local financial autonomy? How is local financial autonomy currently measured?
2. Is it possible to capture the development of local financial autonomy in Hungary throughout the 1990s and 2000s? If the conditions for a dynamic analysis cannot be met, what results can be expected from a snapshot view? More particularly, if we consider local financial autonomy as not only the right but also the ability to manage local expenditures and revenues and balance the budget independently (COUNCIL OF EUROPE, 1985a), who is actually providing for the necessary capacity? To what extent are the legislative and executive powers at both national and local levels (thus the Parliament, the central government, mayors and voters) responsible for empowering the lowest level of government to be responsive to citizens' preferences?

Correspondingly, this research project has two objectives. The first one is the

systematic accumulation and dissemination of state-of-the-art wisdom about local autonomy in general and local financial autonomy in particular. This is done through an exhaustive literature review as well as through the development of a set of matrices that capture the various constraints on the specific components of local financial autonomy.

The second objective had to go through several modifications and compromises in the course of the research. Initially, the objective was the establishment of a dynamic overview about the financial autonomy of the various categories of local governments in Hungary whereby (i) autonomy would be captured in its process and (ii) classification would be made not only along the official (constitutional) categories of administrative units, but also along their population size, geographic location and urban versus rural character. Such a comprehensive dynamic analysis would allow us to answer the *gretchenfrage* of whether the room for manoeuvre of local communities has become larger or narrower since 1990, or more precisely, which aspects of local financial autonomy have changed in which direction. It turned out soon, however, that such an analysis requires an immense database with micro-level data of the approximately 3,200 municipalities from 1990 to present time, whereby data should be based on a constant methodology in order to be comparable throughout the period under review. Accepting the system of clusters applied by the Győr-Moson-Sopron County Directorate of the Hungarian State Treasury for collecting and editing financial data about subnational governments in the framework of a contract with the Ministry of the Interior could have potentially facilitated the job. However, their statistical yearbook titled *Major Local Government Indicators on Public Finance, Infrastructure and Real Estate* does not provide sufficient detail on several aspects that would be essential for the analysis of local financial autonomy, and their micro-level data are hardly accessible.¹

Narrowing the scope of the analysis was thus inevitable. The first idea in this direction was to focus on a single policy area. Primary education has the distinction of being one of the few expenditure domains with abundant datasets of fair quality. However, in order to find out to what extent the autonomy of local authorities increased or decreased in the years following the decentralisation of this function, one should first comb through the entire legislation and identify each provision touching upon the responsibilities of local governments or any of their subcategories with regard to primary education, and then estimate the marginal cost of complying with those provisions. In the context of incremental (rather

¹According to an insider, the printed datasheets fill an entire room, and the compilation of an electronic dataset according to pre-defined characteristics is labour-intensive and hence expensive.

4 than ‘big bang’) decentralisation such as the one in Hungary, the first working step would already demand several years of work. While the responsibilities of local authorities concerning primary education emerge from the ALG and the Act LXXIX of 1993 on Public Education, the terms of service provision are specified in a multitude of decrees published by the central government and the Ministry of Education. Moreover, the attempt to seize the development of local government responsibilities in primary education is comparable to shooting on a moving target, as the legislation is subject to frequent amendments. Estimating the costs of compliance in a second step is even more difficult, if not impossible. Although the Ministry of Finance regularly prepares such estimates in order to calculate the marginal increase in the amount of grants, these estimates are seldom based on true cost calculations; such an exercise would anyway lead to different results in the various clusters of local governments, since the conditions of service provision vary across the country.

Finally, for each measure restricting expenditure autonomy with a cost effect higher than zero (i.e. new mandates), one should be able to find out whether the loss of expenditure autonomy has been compensated by an increase in revenues. If the new mandate is fully funded, it is a step towards centralisation: it restricts local autonomy but has a neutral effect on the local budget. By contrast, if municipalities need to co-finance the task from their own resources, then the interference with expenditure autonomy is no longer neutral for their budget. Because of the dominance of unconditional grants and the principle of the unified budget in Hungary, however, any investigation into this direction is doomed to failure: local governments may compose their preferred funding mix out of own and transferred revenues. Besides, even micro-level data are silent about which share of the total expenditure on primary schools in a given year was due to mandatory tasks and which part reflected the particular preferences of the local constituency.

These recognitions have finally called for a radical change in the second research objective. The initial plan of investigating how the financial room for manoeuvre of local governments in Hungary developed throughout the years gave way to another idea, namely to exploring the contents of local financial autonomy and its major institutional constraints. In order to channel our research in this otherwise immense field, we have formulated a set of assumptions:

1. While autonomy may be *de iure* identical for all local government units (as is stipulated in the ALG), its actual content (*de facto* autonomy) is a function of the existing legal, political, economic and other framework conditions.
2. Both constitutive elements of local financial autonomy, namely the *right*

and the *ability* to manage local revenues and expenditures and modulate the local budget constraint, are subject to various exogenous and endogenous restrictions.

3. Exogenous legal restrictions impose a limit on the rights, while exogenous non-legal (political, demographic, socio-economic, etc.) restrictions reduce the ability of local authorities to manage local financial affairs. Both types of restrictions may affect local governments either directly or indirectly. Together with the endless variety of endogenous constraints, they determine the effective financial autonomy of municipalities.

At the methodological level, the change of the subject necessitated a switch from the idea of a quantitative dynamic analysis to that of a qualitative study of economic institutions. Correspondingly, New Institutional Economics provides the cognitive framework of this paper, completed by relevant insights from Constitutional Political Economics and the theory of Public Choice. The analysis is positive in the sense that it describes the actual situation instead of prescribing what should be done. It is qualitative insofar as only descriptive statistics are used, with the purpose of underpinning some of our statements. The quality (structure, comparability, etc.) of the currently available data does not permit any sophisticated econometric modelling; anyway, such an approach is not essential for a purely institutional analysis of local financial autonomy.

Nevertheless, as any other scientific work, the present study is subject to a number of limitations.

First, the focus of the study is on *financial* autonomy. Political, administrative, cultural and other aspects of local autonomy may have a varying degree of influence on the financial room for manoeuvre. Some of these impose endogenous constraints on local financial autonomy and will be treated as such. For time and space limits, however, these other aspects will not be elaborated systematically.

Second, the various categories of local governments (capital city, capital districts, towns with and without county rights, and villages) will not be regularly distinguished throughout the paper. The structure of the available data seldom allows a separate study of these constitutional categories. However, wherever it is possible to detect a significant difference between these categories in terms of local financial autonomy, we will deal with it explicitly.

Third, we abandoned the idea of a dynamic analysis because it is impossible to track all changes that occurred to local financial autonomy during the 1990s and 2000s. However, we are aware of the fact that also the contents and constraints of local financial autonomy change over time, following logically from the

6 ever-changing nature of institutions. Therefore, the paper considers only those institutions that existed throughout most of the period under review. Short-lived measures are excluded from the scope of the study. By contrast, institutions that have been going through gradual improvement (e.g. local taxation) are examined upon their changing impact on local financial autonomy. Statistical time series from 1995 (or 1990 in some cases) to 2006 are provided only where they serve the purpose of illustrating a change; otherwise, statements are underpinned by snapshot data from selected years of the period under review.

Fourth, we assume that local governments are benevolent actors whose only objective is the satisfaction of citizens' needs. The assumption that the local community and the mayor have perfectly identical views about how local financial autonomy should be filled with content exempts us from the need to look behind potential interest conflicts between the two parties. Correspondingly, we also ignore whether voters exercise their right of controlling the local executive via instruments of direct democracy (initiative, referendum, assembly, etc.) or via representation.

The study is divided in four major parts. Following this Introduction, Part I provides a theoretical framework for the analysis of local financial autonomy. The aim of Chapter 2 is to position the present study both in the worldwide research on fiscal decentralisation and in the context of political economics. With regard to the first issue, we present the neoclassical approach to fiscal federalism and decentralisation as well as its limitations, the recognition of which has marked the more recent discussion of multi-level government systems. Three important departures from the orthodox neoclassical economics provide the closer scientific context of our study. To what extent the theory of Public Choice, New Institutional Economics, and Constitutional Political Economics are relevant for the study of local financial autonomy, is discussed in the second part of the section. Chapter 3 offers a comprehensive overview of the theory of local autonomy in general and local financial autonomy in particular. It starts with an investigation on why local autonomy is generally associated with positive values. This introduction is followed by a literature review with particular emphasis on the various definitions and interpretations of local (financial) autonomy. Local autonomy is then brought into relationship with other (competing) objectives generally pursued in decentralised systems. In a following step, we propose a working definition for each of the three components of local financial autonomy (expenditure autonomy, revenue autonomy, and budgetary autonomy) and draw up a matrix-type inventory of the exogenous and selected endogenous constraints on each of these components. Chapter 3 continues with an overview about the existing techniques for

measuring the individual components of local financial autonomy and concludes with a section about the relationship between local autonomy and the principle of subsidiarity.

Part II is dedicated to the study of local financial autonomy in practice. With an introduction into the legal and institutional framework of decentralisation in Hungary, Chapter 4 lays the fundament for the discussion in the subsequent chapters and clarifies some of the key terms that are unique to the intergovernmental fiscal system in Hungary. Chapters 5 to 7 constitute perhaps the most important part of the entire study. They investigate the way in which the various intergovernmental institutions and arrangements increase or restrain local expenditure autonomy, revenue autonomy, and budgetary autonomy. The matrices of exogenous and endogenous constraints developed in Chapter 3 serve here implicitly to ensure that nothing is omitted, while the discussion deliberately follows a different structure that is better adapted to the respective domains of local financial autonomy. Local expenditure autonomy in Chapter 5 is analysed under two aspects: (i) autonomy in expenditure decisions and (ii) autonomy in service delivery. The structure of Chapter 6 is based upon the classification of local government revenues. Finally, Chapter 7 explores the sources of vertical fiscal imbalance in local budgets and examines the available policy instruments to restore equilibrium. All three chapters focus implicitly on rights, ability, and the various constraints imposed upon these, even though the discussion might occasionally seem to be detached from the methodological framework elaborated in Chapter 3.

In Part III, we return to the three matrices in order to see which of the potential constraints on local financial autonomy affect local governments in Hungary and which intergovernmental institutions represent these constraints. Chapters 8 and 9 serve also to formulate a set of conclusions and to provide some ideas for future research.

PART I

**Theoretical Approaches to
Local Financial Autonomy**

The Changing Perspective on Fiscal Decentralisation

The role of Chapter 2 is to present the broader scientific context of our study and to mark those strands of research that provide the methodological background for the more specific analysis of local financial autonomy. Section 2.1 will thus briefly summarise the assumptions and logic of the neoclassical theory of fiscal federalism and decentralisation and address its major limitations. Section 2.2 discusses three alternative approaches that are decisive for the present investigations, namely the theories of Public Choice, New Institutional Economics, and Constitutional Political Economy.

2.1 The neoclassical approach to fiscal decentralisation

2.1.1 Elements and assumptions The quality and quantity of public services provided in a country depends on the financial rules and incentives that govern the interactions among the various actors of the public sector. System characteristics such as the actual number of hospital beds in a given region, the quality of primary education, the size of unemployment benefits, the timeliness of disaster recovery interventions or the efficiency of waste collection and public transport find their explanation partly in the constitution of the government and the formal and informal fiscal interactions among its various levels. The actual pattern of interactions and the underlying

12 rules also affect macro-level characteristics like the volume of national debt, the extent of economic disparities, growth rates or competitiveness.

Academic interest in intergovernmental fiscal relations emerged as early as in the 1950s. TIEBOUT'S (1956) seminal article on the theory of local expenditure prepared the ground for a never-ceasing debate on the welfare gains and losses of decentralisation. Three years later, Richard A. Musgrave published *The Theory of Public Finance* (1959), the first systematic overview about the functions and working mechanisms of the public sector, without actually discussing the specific case of multi-tier government systems. Confronted with the reality in industrialised countries during the 1960s and 1970s, OATES (1972), KING (1984) and MUSGRAVE and MUSGRAVE (1973) did considerable pioneer work in applying Musgrave's initial theory of fiscal functions to the more realistic situation of multi-level government. Their major concern was to find out more about the appropriate way of decentralisation as well as the optimal assignment of responsibilities and resources among the different government tiers. The result of these inquiries, the so-called neoclassical model of fiscal federalism, is often criticised today for its excessively normative character; nevertheless, it induced further reflection among public finance scholars about the particularities of multi-tier government systems. Oates' interpretation of 'federalism' acted as a catalyst for the worldwide research of intergovernmental fiscal relations. He envisioned

[...] a spectrum of structures of the public sector along which the difference is essentially one of degree rather than kind. At one end of the spectrum is a unitary form of government with all decisions made by the central authority, and at the opposite pole is a state of anarchy. Aside from the two polar points themselves, the other positions on the spectrum represent federal organizations of the public sector moving from a greater to a lesser degree of centralization of decision-making. (OATES, 1972, p. 18)

Stipulating that '*in economic terms* most if not all systems are federal' (ibid.), Oates opened the way to a worldwide academic discussion on the application of Musgrave's theory in a huge variety of political, social and economic contexts represented by a multitude of countries. Primary interest was directed on the responsibilities that the various levels of government need to assume in order to fulfil the three traditional fiscal functions (also called objectives) of the state; namely, resource allocation, income and wealth distribution, and macroeconomic stabilisation (MUSGRAVE and MUSGRAVE, 1976, p. 3 ff. and 611 ff.). The set of institutions

that determined these roles and responsibilities were called intergovernmental fiscal relations. These consist of seven major theme blocks:¹ 13

1. Legal and institutional framework
2. Assignment of expenditures
3. Tax assignment
4. Intergovernmental fiscal transfers
5. Territorial structure and the size of jurisdictions
6. Fiscal equalisation
7. Budgeting, borrowing and bailout.

The neoclassical model of fiscal federalism relies, as its name suggests, on the premises of the neoclassical (also called orthodox, or mainstream) welfare economics whose main objective is to explore the behaviour and interactions of economic agents within a given institutional system (OATES, 1999). The neoclassical welfare economics relies on three fundamental assumptions:

- The institutional environment is exogenously given or, at least, it has a neutral effect on the economy.
- The entire economy is a market where the price system coordinates demand and supply. Prices reflect the individual valuations of marginal utility and marginal cost, thus inducing economic actors to make rational choices.
- The state resembles a benevolent dictator who is fully informed about the preferences of individuals and seeks to maximise the benefit of the entire society.

The neoclassical model of the correct design of intergovernmental fiscal relations, as developed by Tiebout, Musgrave, and Oates, rely on three additional hypotheses:

¹The proposed theme blocks result from a combination of several different views about the content of intergovernmental fiscal relations; see e.g. MUSGRAVE and MUSGRAVE (1976, p. 611 ff.), KING (1984), EBEL and YILMAZ (1999, p. 2 ff.), and DUNN and WETZEL (2001, p. 2). Some authors treat tax assignment (3) and intergovernmental fiscal transfers (4) under the collective term ‘revenue assignment’. Others split up the legal and institutional framework (1) in a way that each of the thematic blocks includes the rules and institutions pertaining to that specific block. For BOADWAY et al. (1996, p. 36 ff.), intergovernmental fiscal relations consist only of intergovernmental transfers as well as arrangements for tax harmonisation and coordination.

- Capital and labour are perfectly mobile.
- The frontiers between jurisdictions are not yet drawn, or at least they can be modified any time without excessive costs.
- Intergovernmental fiscal institutions designed and implemented according to the propositions are functional and stable over time and space.

Starting from these premises, the neoclassical model regards subnational jurisdictions as small and open economies whose abilities and interests do not necessarily coincide with those of the central government. First, interjurisdictional disparities in the ability to provide local public services induce undesirable internal migrations that result in social and political tensions. Second, subnational expenditures that have a significant impact on demand or are particularly sensitive to cycles (e.g. unemployment benefits) may run counter to the stabilisation objective of the centre. By contrast, the closeness of decentralised governments to their electorate permits a more sensitive adaptation of the offer of public services to the interregional variations in preferences and a higher accountability and responsiveness of policymakers. Additional gains can be realised from experimentation and innovation at subnational levels. For these reasons, and in order to maximise efficiency in a decentralised system, the neoclassical model proposes to assign the allocation function to the subnational governments while keeping the stabilisation and distribution functions at the central or federal level (MUSGRAVE and MUSGRAVE, 1976, p. 19). According to the recommendations of this model for the revenue side of the budget, the assignment of taxes should take account of the differences in taxpayer mobility among the various levels of government; horizontal and vertical fiscal gaps that necessarily arise from such an exercise should be filled with transfers and grants-in-aid. These latter instruments can also be used in a way to neutralise external effects resulting from the decentralised provision of public services. Finally, the neoclassical theory proposes to create optimal size jurisdictions that ensure a coincidence between the groups of decision-makers, taxpayers, and beneficiaries ('principle of fiscal equivalence'; OLSON, 1969).

2.1.2 Limitations and challenges In his later years, Musgrave realised that ‘the economic rationale for fiscal policy is one thing, and the existing set of fiscal institutions is another. These institutions [...] are the product of a multiplicity of historical forces, not necessarily well suited to perform the normative tasks set in the preceding discussion’ (MUSGRAVE and MUSGRAVE, 1976, p. 22). WISEMAN (1964) was the first economist to take a clear distance from the pure normative approach inherent to the neoclassical model. Two decades later, reflecting about how to design or operate a system of devolved government *in practice*, King found that ‘the balance of the arguments may well tilt one way in one country and another way elsewhere, and it may move from time to time even within a particular country. Thus an attempt to find a unique definitive system would be absurd’ (KING, 1984, p. 2).

Other authors followed suit, abandoning the normative approach in order to provide descriptive analyses of the practice of intergovernmental fiscal relations. Two decades had passed before the spirit of ‘learning from each other’ conquered the academic thinking about fiscal federalism and decentralisation (BLINDENBACHER and WATTS, 2003, p. 16 ff.). An overview of the literature on the practical aspects of fiscal federalism in general, and decentralisation processes in Eastern Europe in particular, reveals two kinds of departure from the neoclassical approach.

The dynamics and diversity of decentralised systems Studying the process of decentralisation in post-communist transition countries, BIRD et al. (1995b, p. 1) found that some subnational government structure (and accordingly, some kind of intergovernmental fiscal relations) existed there already under the centralised unitary system. However, the political and fiscal autonomy of lower-level authorities was severely limited, which left them the role of simple executive agents of the centre. Today, parallel to the changes in the political regime in recent decades, intergovernmental relations are undergoing a thorough change resulting from an extensive political and fiscal decentralisation. This change conduces not only to more autonomous but also to more responsible governance at all levels. The deepening integration with the European Union and the perspective of joining the euro zone also act as catalysers in this process.

Nearly twenty years after publishing his seminal work on fiscal federalism, OATES (1990) acknowledged that the vertical structure of government is not static. Whether a state has a long-standing tradition in fiscal federalism or has just recently started to decentralise powers, intergovernmental fiscal relations are under continuous change. Ronald L. Watts speaks in this context about the *dynamics* of decentralisation (WATTS, 2001, p. 15). Both the influence from the outside envi-

16 ronment and systemic interactions inside the government structure may make it necessary to adapt intergovernmental fiscal relations to the changing circumstances. Developments in the national and international market environment induce fluctuations in public sector revenues, which may necessitate the revision of the existing revenue assignment scheme. Technological innovation may raise demand for additional public services, which eventually spurs the central government to consider the questions of which government tier or other economic agent should provide these services and how they should be financed. External rules such as the deficit and debt criteria applying to the member states of the Economic and Monetary Union have increased pressure on central governments to coordinate borrowing practices between the different government tiers, thus controlling the accumulation of debt. Other exogenous factors include subtle changes in the common value system of the society (especially the subjective importance attached to equity and efficiency) that may ultimately call for adjustments in the interregional redistribution policy or in the funding of service-providing facilities. In Central and Eastern Europe (CEE), the relatively fluid and sensitive character of the political balance adds to the uncertainty. As HORVÁTH (2000, p. 25) notes, the models of public administration reform vary from one government period to another. GUESS (1997) speaks in this context about different political regimes having different priorities with regard to decentralisation. Endogenous changes in the vertical structure of government include, for instance, the territorial reorganisation aimed at higher efficiency in the provision of local public goods and services.

Beside their inherent dynamics, intergovernmental fiscal systems are also characterised by spatial diversity. Notwithstanding the similarity of the paths of decentralisation followed after 1990 and the resulting common problems (e.g. fuzzy expenditure assignment, unfunded mandates, unpredictable revenue flows, transfer dependence of subnational levels), transition countries also demonstrate a great variety of intergovernmental fiscal institutions. One of the most fundamental differences lies in the economic constitution of the state. While most states adopted a decentralised unitary model, a few opted for a federal system (Serbia and Montenegro from 2003 to 2006, Bosnia and Herzegovina, and Russia). Beyond this major difference, the form and the content of actual intergovernmental arrangements vary with the actual geographic and demographic characteristics, the political and institutional context as well as the actual stage of decentralisation. In addition, since the reforms are complex and lengthy by nature, decentralisation progresses at a varying pace across the countries of the region (PÉTERI and ZENTAI, 2002, p. 17). Consequently, each building block of intergovernmental fiscal relations represents a multitude of national variations at any point of time during the overall decen-

tralisation process in the region (DUNN and WETZEL, 2001, p. 2; BIRD and SMART, 2001, p. 8 ff.). While it is undoubtedly reasonable to apply uniform policy advice to such common problems as transfer dependence or interregional spillovers, difficulties resulting from the particular setting of one country or another call for more differentiated solutions.

The impact of local autonomy on the fulfilment of fiscal and other functions of the state

From the 1960s, various authors especially from Europe (SCOTT, 1964; DAFFLON, 1978; WISEMAN, 1964, 1987; TER-MINASSIAN, 1997b; BIRD et al., 2003) realised that the state of the American economy in the 1950s—characterised by nearly perfect mobility and competing jurisdictions—had a limited validity for the study of intergovernmental fiscal arrangements in practice.

According to these authors, the mere fact that the subcentral units in any decentralised system enjoy a certain level of autonomy puts into perspective the validity of the neoclassical normative teaching on the appropriateness of assigning specific fiscal functions (objectives) to the various levels of government. Notably, respecting the autonomy of decentralised jurisdictions implies allowing them to have a different view than the one held by the centre about the optimal pattern of intergovernmental fiscal relations. Moreover, the continuous debate between and within government tiers about the content and relative importance of the three main objectives of the state, namely allocative efficiency, distributional equity, and macroeconomic stability, is an inherent feature of decentralised systems. Social development and economic growth improve the technical efficiency of public service provision, which makes that some of the responsibilities that were once assigned to the centre for efficiency reasons may now just as well be met by lower-level governments. Against this background, Scott and others consider that it may be justifiable to devolve both the redistribution and stabilisation functions to the lower levels of government.

This argument receives further support from two recognitions. As for the redistribution function, experience tells that labour in Europe is only imperfectly mobile (SCOTT, 1964, p. 264). Hence, income redistribution policies pursued by lower-level governments do not necessarily induce distortional migration; moreover, additional benefit may be reaped from the proximity of decision-makers to beneficiaries. As for the objective of macroeconomic stabilisation, a strictly centralised policy—however efficient—imposes an inequitable burden on those constituent units that are not responsible for the macroeconomic imbalance. Instead, a stabilisation policy involving the participation of lower levels is likely to

18 be more equitable than a strictly centralised one, and it may help avoid adverse cyclical behaviour of subnational governments.

As DAFFLON (1978, p. 136) observes, the adherents of the normative neoclassical economics have made little effort to analyse the divergent views, the relative competence and the responsiveness of the various government tiers with regard to the three main objectives of the state. However, the recently emerged positive approach to fiscal federalism could possibly close this gap. The recognition that the objectives of allocative efficiency, distributional equity, and macroeconomic stability, receive different weights in the various countries depending on the specific historical, political and social situation of the latter is well documented in TER-MINASSIAN (1997b, p. 21) and BIRD et al. (2003). Furthermore, every country exhibits a specific pattern of how the different levels of government value these objectives in relation to each other.

In Spain, for instance, the intermediate level of government is becoming increasingly active in social policy without experiencing any 'welfare tourism' (MORENO, 2000). As for stabilisation, especially in countries struggling with macroeconomic imbalances (such as those in CEE), central governments are being advised to invite subnational authorities to help shape macroeconomic management (TER-MINASSIAN, 1997b, p. 21). In the early stages of decentralisation, the national government can effectively master stabilisation policy (even counteracting the cyclical policies of subnational governments) due to its substantial influence on the overall public budget. However, as decentralisation is progressing, maintaining control over the macroeconomic situation becomes increasingly difficult as the financial autonomy of lower level governments continue to grow, and bailout grants prove to be unsustainable in the long run. Introducing cooperation in the stabilisation policy is all the more important as the integration of these countries in the Economic and Monetary Union implies shared responsibility for fulfilling the Maastricht criteria. As TER-MINASSIAN (1997b, p. 22 f.) argues, the devolution of the functions of distribution and macroeconomic management does not necessarily hurt equity and stability objectives if it is accompanied by corrective measures (equalisation grants and a hard budget constraint) and if labour is relatively immobile.

Along with the growing diversity of the views on who should do what in a federal system, different opinions are likely to emerge about the optimal size of jurisdictions; yet, the reorganisation of the existing constituent units may prove difficult (if not impossible) for historical and political reasons. There are essentially two distinct ways of consolidating fragmented territorial structures: (i) through the amalgamation of the existing local government units (see COUNCIL OF EU-

ROPE, 1995 and DAFFLON, 1998), and (ii) through the establishment of functional, overlapping, and competing jurisdictions (FOCJ, see DE SPINDLER, 1998; FREY and EICHENBERGER, 1999). While amalgamations occur in most decentralised countries, real-life examples of FOCJs are rather sporadic because of the vested interests that tend to block such reforms (PERRITAZ, 2003, p. 134 f.).

However, the design of intergovernmental fiscal relations cannot be based on the sole arguments of allocative efficiency, distributional equity, and macroeconomic stability. Since regions are the products of history and politics, and not of simple economic rationality, constitutional, historical, political, social and cultural factors have an equally important role to play.

WISEMAN (1964, 1987), PEACOCK (1972), DAFFLON (1977, 1978), and BRETON and SCOTT (1978) were the first authors to consider objectives other than efficiency, equity, and stability, in the analysis of intergovernmental fiscal relations. They recognised that efficiency could be defined in various ways depending on the stakeholders' perspective. Besides, they noted that policies founded upon the sole criterion of efficiency were likely to come into conflict with various political objectives of federalism such as local autonomy or the protection of ethnic minorities, and each of these alternative objectives can be interpreted in a number of different ways. In order to make federalism politically acceptable for all constituent units, some degree of economic efficiency may need to be sacrificed. Notably, decision-makers are often forced into a trade-off between autonomy and efficiency. Obviously, the decision about the actual content and the weighting of these two objectives depends on a multitude of value judgments and not on pure economic rationality. Whose value judgment will then prevail in a government system where subnational tiers are vested with particular powers? In normal conditions, neither tier can effectively impose its view on the others, so that a common position about the actual balance between conflicting objectives can only arise through negotiations.

The overall economic development of the country may also induce changes in social attitudes towards the weighting of the various economic, political, and social objectives. This necessarily leads to a debate about the aims of intergovernmental fiscal relations. Against this background, it is not surprising that the procedure of creating and amending the constitution in federal and decentralised systems has received particular attention for the last forty years (BUCHANAN and TULLOCK, 1962; BRETON and SCOTT, 1978; POSNER, 1987; VOIGT, 1999).

Consulting various government strategy papers and academic studies, HORVÁTH (2000) and DAVEY (2002) reveal a multitude of objectives that national decentralisation programmes in CEE pursue. Figure 2.1 provides a tentative classification.

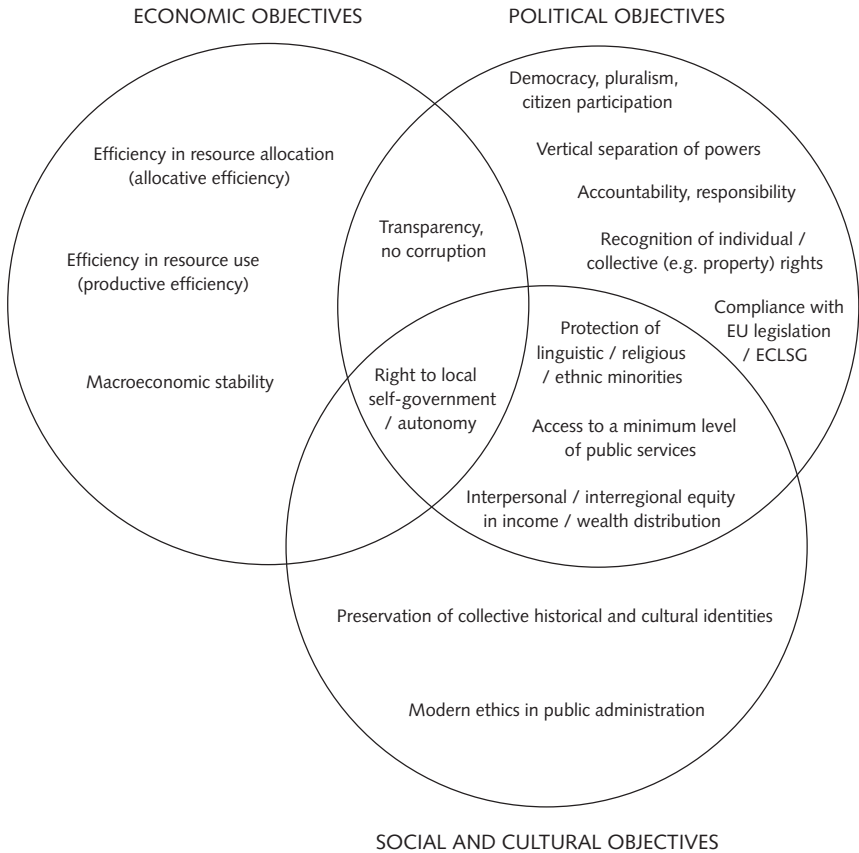


Figure 2.1: **The objectives of decentralisation in Central and Eastern Europe**
 [Source: the author, based on Horváth (2000) and Davey (2002)]

Not surprisingly, the right to local self-government (local autonomy) as the central objective of decentralisation is at the cross-section of economic, political and social/cultural objectives. At the same time, local autonomy is the objective that puts into perspective the neoclassical teaching on the role of the state (fiscal functions) and the question of who should do what in a federal system. As soon as the centre grants a certain degree of autonomy to subcentral units, chances are high that the latter will have a different view about the proper design of intergovernmental fiscal relations and demand to be involved into the negotiating process in which the centre can no longer dictate the rules and priorities. On the other hand, autonomy also requires local policymakers to develop a sense of responsibility for their actions. The centre can ultimately use this sense of responsibility when pursuing public policies (such as distribution or stabilisation) in the interest of the society.

2.2 The New Political Economy approach to fiscal decentralisation

2.2.1 Premises and directions The observation of the practice of intergovernmental fiscal relations has delivered a significant input but is surely not the only factor to influence recent theoretical thinking on fiscal federalism and decentralisation. The new pragmatic approach to the study of multi-unit government systems coincided with the emergence of a general trend in economic sciences that turned away from the mainstream neoclassical line to open the horizon for political and constitutional considerations in economics.

From the 1970s, several different approaches challenged the orthodox framework that were ultimately summarised under the label of New Political Economy (NPE). One common feature of the various strands of NPE is that they reject the assumption of a benevolent government whose only interest is to maximise the social welfare function. Furthermore, all of these strands attempt to explain actual economic policies that the mainstream theory used to consider as historically given and hence exogenous.

Figure 2.2 proposes a simple framework that highlights three different directions in which the NPE departs from mainstream neoclassical economics and that brought a significant input to the study of intergovernmental fiscal relations. We may capture the differences along two main dimensions: whether the theory in question focuses on individuals or rather on institutions, and whether it deals primarily with economic or political markets.

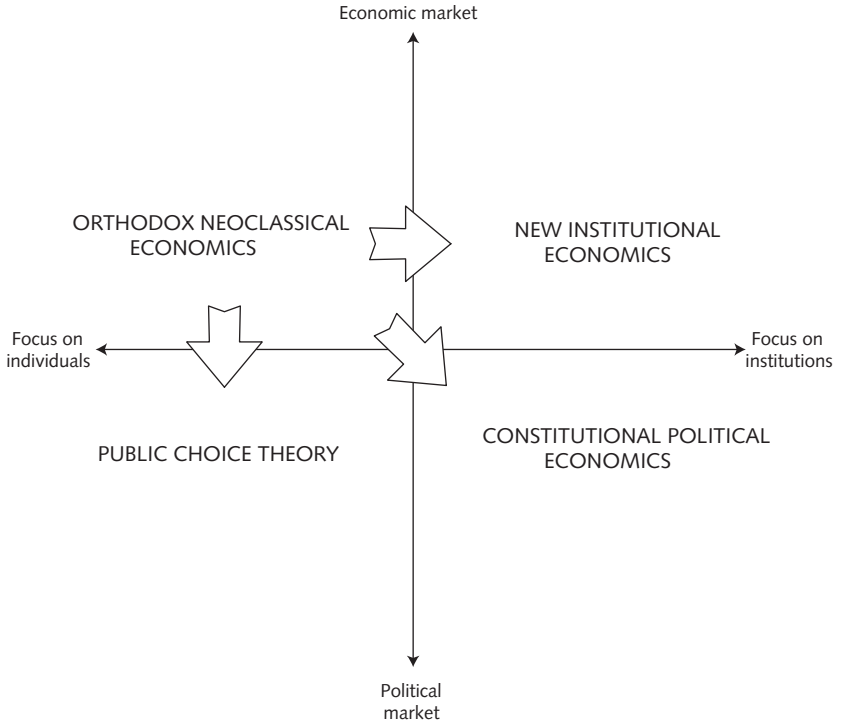


Figure 2.2: **The orthodox neoclassical economics and its challengers**
[Source: the author]

Public Choice Theory The adherents of the theory of Public Choice (PC) agree with the neoclassical economic theory of individual behaviour and the related principles of marginal analysis, rational choice, self-interested utility-maximising individuals, voluntary exchange, methodological individualism, and general equilibrium, but they reject the assumption of a benevolent state. In claiming that political actors do not significantly differ from economic actors in their behaviour, they attempt to extend the scope of neoclassical theory beyond the limits of the narrow economic market. According to MUELLER (2003, p. 1), PC is ‘the economic study of non-market decision making, or simply the application of economics to political science’. PC examines the collective political decision-making and coordination processes within a given set of institutions (formal and informal constraints), assigning a rational, utility-maximising behaviour to policymakers, bureaucrats, voters, and economic agents alike (KIRSCH, 2004).

New Institutional Economics Largely simultaneously to PC, another distinct research programme appeared under the label of New Institutional Economics (NIE). It departs from the orthodox theory in a different direction than PC. While accepting the basic neoclassical principles related to the behaviour of economic agents, the scholars of NIE do not quit the realm of the economic market. However, they claim that the market itself is an institution in continuous interaction with other institutions of the society, such as norms and traditions, laws, property rights, bureaucracy, or the horizontal and vertical distribution of powers. The specific legal and institutional framework of the market creates particular incentives that influence the decisions of individuals, so that the choices of two individuals in similar exchange situations may be quite different from one market to another. The adherents of NIE played a pioneer role in laying down a common definition and a typology of institutions. According to NORTH’s classical definition (1990, p. 3), institutions are ‘the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social or economic’. They consist of informal constraints (such as customs, norms, traditions, taboos, religious beliefs, and codes of conduct) and formal constraints (such as constitutions, laws, and property rights), as well as their enforcement characteristics. In the past thirty years, North’s fundamental tenet claiming that institutions matter for economic performance (which paved the way for the ‘old’ institutional economics) was completed with another thesis, particular to NIE, according to which ‘the determinants of institutions are susceptible to analysis by the tools of economic theory’ (MATTHEWS, 1986, p. 903). These propositions triggered the development of a distinct school of heterodox

24 thought in economics which was primarily represented by NORTH (1990, 1991, 1994), MILLER (1997), FURUBOTN and RICHTER (1997), and WILLIAMSON (2000), and whose fundamental achievement was the 'endogenisation' of economic institutions and the research into the way they emerge. Much of the research activity in NIE today is spurred by the worldwide interest in development economics. While neoclassical theory was mainly concerned with the operation of the market, it failed to explain how markets develop, why institutions in developing countries and transition economies are different from those in industrial countries, how they evolve over time and how they enhance overall economic development (NORTH, 1994, p. 359; AHRENS, 2002, p. 48 f.).

Constitutional Political Economics Finally, a third group of scholars criticise both the assumption of a benevolent dictator and the hypothesis of exogenously given institutions. Their forerunner is Knut Wicksell who, in search for a just principle of taxation, observed that the traditional methods of public finance research were inadequate under modern political conditions. He advised scholars to stop taking the state for a benevolent despot and observe reality instead (WICKSELL, 1896, p. 108 f.). To lay the ground for what is called today Constitutional Political Economics (CPE), Buchanan developed Wicksell's incidental observation to a more general command, according to which it is essential to postulate some model of the state and examine the constitution of the economic policy before evaluating alternative policy measures (BUCHANAN, 1988, p. 104). CPE represents therefore a third kind of departure from orthodox theory but is nurtured by both PC and NIE (VOIGT, 1999, p. 62 ff.). In contrast to PC, CPE focuses on the choice *of* constraints as opposed to the choice *within* constraints (BUCHANAN, 1987, p. 585). In contrast to NIE, CPE is more interested in political institutions such as constitutions, electoral systems and direct democracy, than in market organisations such as firms, antitrust regulations or multilateral trade conventions. As for the underlying scientific approach, CPE has a normative and a positive branch. While the major endeavour of the normative branch is to legitimate state activity by means of a theory of social contract (BUCHANAN and TULLOCK, 1962), the positive branch seeks to explain why and how constitutional rules emerge and change over time and where they lead in practice (VOIGT, 1999).

2.2.2 Relevance Also called a ‘theory of collectives’ (KIRSCH, 1977, p. 9) dealing with the questions of collective needs, goods, and decisions, PC theory had a determinant role to play in the recognition that the state is not a monolithic block but a structure of widely different groups of actors linked to each other in a ‘variable geometry’. According to the representatives of PC, it is essential to analyse the relationship among these groups of actors, or communities, in order to get a better understanding of how the state operates. This implies investigations on the way they are created, their diversity in terms of size, decision-making structures, quality and quantity of the provided public services, and the role of local bureaucracy. PC also provides an insight into the dynamics of federal structures, notably into the centrifugal and centripetal forces that determine the trends of centralisation and decentralisation in a multi-level government system (KIRSCH, 1987). Mancur Olson raises the question about the optimal pattern of assigning responsibilities (OLSON, 1965): if collective action is needed, which type of government or which institutions should be involved? Is it ever possible to achieve Pareto optimality? Is negotiation an appropriate instrument for reaching a compromise if transaction costs are high? Based on the studies of BUCHANAN (1965), BUCHANAN and WAGNER (1970), BUCHANAN and GOETZ (1972), and BRETON (1987, 1996) on the interjurisdictional competition for taxpayers and beneficiaries and the efficiency limits of fiscally induced mobility of individuals, some researchers search for potential gains from transforming historical jurisdictions into purely functional ‘clubs’ (DE SPINDLER, 1998; FREY and EICHENBERGER, 1999). Given the large international and interregional variation in mobility and the difficulties of estimating its costs, the debate on this matter is far from the end.

Another strand of PC deals with the effect of decentralisation on the behaviour of politicians (GALEOTTI, 1992; HETTICH and WINER, 1987; DOLLERY and WALLIS, 2001), voters and bureaucrats (TULLOCK, 1969; NISKANEN, 1971; BRETON and WINTROBE, 1975; WINTROBE, 1987). Its insights are particularly valuable for exploring the background of inefficient administration, vertical fiscal imbalance, the transfer dependence of local governments and the (in)effectiveness of local pressure groups against central authorities. WINER and SHIBATA (2002) even suggest that PC arguments are indispensable to a normative study of public economics.

Although the adherents of NIE are essentially concerned with the institutions of economic markets, they play a significant role in locating governments and other public authorities in the broader context of social, political, and economic institutions. In his sketch of the four levels of social analysis, WILLIAMSON (2000, p. 597) identifies the vertical distribution of power (federalism) as being part of the second level, namely the institutional environment, which consists of the ‘formal

26 rules of the game' such as constitutions, laws, and property rights. Unlike in the case of first-level informal institutions such as customs, norms, and traditions, here it is difficult to engineer a progressive and cumulative change. Yet, moments of political upheaval such as breakdowns or revolutions (typical starting points in the transformation process of CEE countries) may occasionally open up a window of opportunity that allows the implementation of key reforms.

Perhaps the most significant contribution of NIE to the study of fiscal federalism and decentralisation consists of the insights on the impact of economic and political institutions on the fiscal performance of national and subnational governments. Notably, the debt and spending behaviour of different government tiers have been examined as a function of budgetary procedures (POTERBA, 1994; VON HAGEN and HARDEN, 1995; FELD and KIRCHGÄSSNER, 1999; ALESINA et al., 1999), balanced budget rules (EICHENGREEN and BAYOUMI, 1994; POTERBA, 1995; DAFFLON, 2002a), direct democracy and other political institutions (FELD and MATSUSAKA, 2000; FELD and KIRCHGÄSSNER, 2001; POMMEREHNE and SCHNEIDER, 1978). These results are of particular interest to transition economies where, for historical reasons, governance and institutions have been relatively poor (COASE, 1992, p. 714; SACHS, 2003, p. 39). NIE may also help identify the reasons why successful institutions in Western Europe do not necessarily bring similarly good results in transition economies and what can be done for a better adaptation of institutional structures to the existing historical, political and social context (NORTH, 1994; AHRENS, 2002).

Finally, insofar as constitutions provide for an assignment of revenues and expenditures as well as intergovernmental oversight competences, the research output of the CPE, particularly that of the positive branch, is of a great value in the study of decentralised systems. This output includes important insights about the optimum size of government (BRENNAN and BUCHANAN, 1977, 1980) and the related discussion on cooperative versus competitive federalism in which the adherents of PC had similarly deep interest. At a time when transition countries in CEE are struggling to redefine the role of the state and the relations between various government tiers, the outcome of these debates appear to be particularly important. Other valuable contributions of CPE include the theory of intergovernmental grants (BRETON, 1965), the theory about the optimal assignment of expenditure functions as a result of a 'trading' between governments (BRETON and SCOTT, 1978), and some insights on the trade-off between local autonomy and income equality or uniformity of living conditions (ZIMMERMANN, 1987). Beside autonomy and equality, stability is a key determinant of success in any decentralised system. WEINGAST (1995) sees the major challenge in finding the optimal set of constitutional arrangements in which political institutions can credibly commit themselves to limiting government and

preserving markets. The particular interest for transition economies stems from the underlying motivation of the inquiry: a government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens; this dilemma is particularly relevant in the context of early post-Soviet history. Moreover, however serious is the commitment of political actors to create a market-preserving constitution, existing informal institutions partly inherited from the socialist era can severely compromise the result. A most recent distinction between *de iure* and *de facto* constitution by VOIGT (1999, p. 108 ff.) draws the attention to the fact that the effectiveness of a formal constitution may be weakened by 'extra-constitutional' factors such as unwritten norms, expectations and attitudes of economic actors, or the lack of trust among the members of the society.

As the above explanations suggest, there is significant overlapping among PC, NIE, and CPE in their approach to fiscal decentralisation. Yet, there are a number of phenomena related to intergovernmental fiscal relations and local autonomy that cannot be explained satisfactorily with the set of arguments pertaining to a single strand of NPE. For the rest of this study, we hope therefore to benefit from the synergy effect arising from the similarities among the different approaches.

Local Financial Autonomy

29

A closer look at the way academics and politicians perceive the worldwide trend towards decentralisation and judge the performance of already existing decentralised government systems suggests two fundamental observations. First, decentralisation is most often associated with an increase in local autonomy. Second, the connotations and values attached to decentralisation and local autonomy are almost exclusively positive.

To what extent is this universal support for local autonomy justified? Indeed, transferring a certain amount of power from the central government to lower-level territorial organisations is the very meaning of decentralisation. But does this transfer of power always imply some sort of autonomy for the lower levels, and if yes, what is the real extent of this autonomy? May we content ourselves with the idea that local autonomy is an inherently good thing? Or do we have a good reason to believe that under certain circumstances, less autonomy would bring more?

These inquiries suggest that no rational debate about the desired state of affairs can do without some way of measuring local autonomy. Particularly in the domain of local financial autonomy, a number of qualitative and quantitative indicators have been developed in the past few years to measure the relative position of individual territorial units on the continuum between perfect sovereignty and full financial dependence. Many of these indicators are criticised on the grounds that they neglect one important component of local autonomy or another; however, the proposed alternatives are seldom convincing. The utmost complexity of the concept of local autonomy makes it difficult, at least at the present state of economic research, to establish a genuinely satisfactory measure.

The objective of this chapter is to explore the notion and the value of local autonomy in general and local financial autonomy in particular, and to identify possible measures of the latter. Section 3.1 provides an overview of the various definitions of local autonomy that emerged throughout the past twenty years of literature on decentralisation. Local autonomy is generally perceived as a good thing that should be preserved at any price, even though it might be put into perspective in times of threatening or creeping centralisation, or when planned intergovernmental reforms promise a better alternative to the maintenance of autonomy in terms of results. The pivotal question in Section 3.2 is therefore not whether local autonomy is a good thing or a bad thing, but *how* the normative belief in local autonomy as something *a priori* good could become so popular. Section 3.3 suggests that local autonomy hardly deserves to be a valence issue: it can potentially conflict other policy objectives such as economic efficiency, equity or democratic participation. In the sections that follow, the analysis is limited to one particular aspect of local autonomy, namely local *financial* autonomy. Section 3.4 postulates local financial autonomy as being the combination of expenditure autonomy, revenue autonomy, and budgetary autonomy. Each of these components is then described with the help of a two-dimensional matrix of constraints that provides a basic methodological tool for the analysis in Part II. In a quest for some more tangible means of definition, Section 3.5 discusses past and current approaches to measuring local financial autonomy. Finally, Section 3.6 is devoted to the principle of subsidiarity as a special guiding rule of local (financial) autonomy and shows how a vague definition can give rise to several different interpretations in practice.

3.1 The concept of local autonomy

3.1.1 Early definitions: local autonomy as a right Although the notion of local autonomy occupies a central position in the literature on political and fiscal decentralisation, the recurrent use of the term did not contribute much to the clarification of its meaning. Obviously, it has something to do with the freedom of sub-central government units to manage their affairs in a way that is not entirely dictated and controlled by the central government. Yet, up to this date, the study of decentralised governance still lacks an established definition of local autonomy and there is no clear consensus about which elements could actually constitute it or how it could be measured. Also, as we will see in the following section, the different groups of policymakers (political parties, government actors, etc.) unequivocally support

and appreciate local autonomy, however, they usually do not mean the same thing by this term and seldom agree on which field of public activity is suitable for local control.

Local autonomy alone rarely constitutes the subject of scientific analysis. As Clark observes, ‘most academic theorists place their work in the context of an existing, albeit unacknowledged, institutional framework that assumes some kind of local autonomy’ (CLARK, 1984, p. 196). One of the classic examples is the model of spatial competition by TIEBOUT (1956) that postulates the existence of several autonomous, competing territorial jurisdictions. If these jurisdictions had not even a limited degree of autonomy, this would invalidate the principal assumption of the model according to which the jurisdictions respond to the preferences of local residents. However, the model is silent about where this autonomy stems from and whether it is limited in one way or another.¹

Probably one of the most renowned early attempts to theorise local autonomy appears in CLARK (1984). Clark’s theory places local (municipal) power in relation to higher tiers of government, laying the cornerstone for what is still referred to as the traditional view of local autonomy, namely, that local autonomy is not an absolute but a relative concept. Clark assumes that local governments are goal-oriented, rational actors who strive to maximise their power. Further, he postulates that democracy and democratic procedures do not require a specific form of government. In this setting, he defines local autonomy along two specific powers (or principles). The *power of initiation* is the power of local governments to regulate and legislate in their own interests, or the power to act in carrying out rightful duties. The *power of immunity* is the power of local governments to act without fear of oversight; it means immunity from the authority of higher tiers of the state. Both powers can be circumscribed extremely broadly or narrowly in the initial intergovernmental arrangements for power sharing.

For Clark, these two basic principles give rise to a two-dimensional matrix accommodating four extreme types of local autonomy. Figure 3.1 provides an overview.

For the historical and philosophical discussion of these ‘ideal’ types, we refer the reader to the original paper. One finding of the model that certainly merits to be quoted, however, is that the real powers of American local governments are far away from those assumed in the Tiebout model of interjurisdictional mobility. In line with the so-called Dillon’s rule (DILLON, 1911, cited by CLARK, 1984, p. 203),

¹It is perhaps interesting to note that also the theory of Functional, Overlapping and Competing Jurisdictions (DE SPINDLER, 1998; FREY and EICHENBERGER, 1999) that is closely related to the Tiebout model circumvents the question about the source and the limits of jurisdictional autonomy.

32 municipalities in the US have only those powers that are explicitly granted by state legislatures as well as (secondary) powers related to the execution of these. Thus, local governments are ‘creatures of the state’ with very limited initiation powers. Immunity is virtually inexistent in this system: as Clark reports, Dillon’s rule ensures that courts severely punish all municipal deviations from the letter of the law. Thus, at the time when Tiebout presented his seminal model supposing the competition among jurisdictions that enjoy at least the power of initiation (Type 2), US municipalities in reality were already much closer to Type 4 of local autonomy.²

Clark’s finding should not surprise the reader, since Tiebout never actually related his model to the reality in the US. In fact, he even warned that it was ‘an extreme model’ (1956, p. 419). However, because of the assumptions of unrestricted mobility and competition, later theorists tended to see in the Tiebout world an abstract model of the American reality.

Clark also introduces the notion of *local discretion*, although the way he delimitates it from the concept of local autonomy is not entirely clear: ‘Discretion, or the ability of local governments to carry out in their own manner their own particular objectives in accordance with their own standards of implementation, depends on the prior specification of local autonomy’ (CLARK, 1984, p. 199). He says that in a world where both initiation and immunity are limited, local discretion is doubly constrained and autonomy can hardly exist. For him, local autonomy (or the way it is specified in terms of immunity and initiation powers) determines the extent of local discretion.

It is also unclear whether in the definition above, Clark employs the expression ‘ability [...] to carry out’ in the sense of an *effective* (administrative, financial, technical, etc.) *capacity* or something else. Clark says: ‘[...] if local initiative were tightly circumscribed and *the conditions in which local powers are exercised* were similarly prescribed, then local discretion would be severely limited’ (CLARK, 1984, p. 199, emphasis added). This formulation leaves the reader uncertain about whether these ‘conditions’ could include, for instance, the degree of financial autonomy. Even if this were the case, though, the financial conditions *prescribed* by the law or a higher tier of government (e.g. formal rules of local taxation or revenue sharing) would not necessarily correspond to the actual financial circumstances of local authorities, as these are also influenced by socioeconomic, demographic,

²Clark supposes that local governments in the Tiebout model have limited immunity, thus they cannot be of Type 1. Limiting immunity is necessary in order to restrict local governments from coercing their residents and other local governments. Any pressure exerted by the local authority could hinder voters from expressing their preferences, e.g. by voting with their feet.

		Immunity	
		yes	no
Initiation	yes	Type 1 'Autonomous city-state' e.g. historical Venice and Florence	Type 2 'Decentralised liberalism' e.g. competing jurisdictions in the Tiebout model
	no	Type 3 'Mill's model' e.g. US state governments vs. federal government	Type 4 'Bureaucratic apparatus' e.g. local councils in the former USSR; US municipalities vs. states

Figure 3.1: **Clark's typology of local autonomy [Source: the author, based on Clark (1984)]**

topographic, etc. factors. Anyway, Clark's definitions of initiation and immunity suggest that both terms are primarily conceived as *powers* and not as *capacity*.

Regrettably, some scholars of later generations interpreted Clark's model in an unduly selective manner. From his suggestions that the extents of initiation and immunity had to be specified beforehand and that US local governments were mainly directed 'from above', DEFILIPPIS (1999, p. 979) concluded that 'autonomy is only something granted (either actively or passively) from "above" in limited amounts.' For PRATCHETT (2004, p. 362), 'local self-government in both unitary and federal systems occurs only because a higher-level authority delegates some of its sovereign powers and responsibilities.' In contrast, Clark stated said explicitly that the *source* of initiation remained an open question: 'It is entirely plausible that initiation powers are assigned by local residents. Alternatively, it is also plausible that initiation powers are assigned by states or provinces or even the nation-state' (CLARK, 1984, p. 198). Such a blatant oversimplification of the original model is incomprehensible. Clearly, if local governments' initiation powers are assigned by the province or the central government, then effective local autonomy is limited because it depends on higher-level legislation. This is certainly true for local governments and counties in Dillon's United States (although most states have already made provisions for municipal or county 'home rule') and for British municipalities, boroughs and counties under the supremacy of the Crown in Parliament that is the single source of sovereignty. However, it certainly does not

34 apply to the Swiss cantons that *inherently possess* (rather than receive from above) the powers of initiation and immunity.³

The discussion about *who assigns* the power of initiation is interesting for two reasons. First, if local government have no possibility to define or structure their own initiation powers, then any attempt to define exclusive areas of local affairs will fail. The answer to the question as to *what* constitutes a local affair will be dictated by a higher-level authority or the national legislation. Second, the source of the power of initiation has important legitimacy implications: when the limits to action are imposed not by other institutions but by the local residents (Clark's Types 1 and 2), then legitimacy flows from the bottom up; that is, local government bears full and ultimate responsibility for its actions. In the opposite case (Types 3 and 4), legitimacy is top-down in the sense that both authority and responsibility for local actions are centralised. This reveals the inherent connection between autonomy and responsibility. As Hinings puts it aptly in his commentary on the early phase of decentralisation in France, 'in every decentralised system there is an internal tension between the definitions of freedom defended by the local authorities and the definitions of responsibility defended by the central government' (HININGS, 1982, p. 34, translation by the author).

One of Clark's major contributions to the history of local government theory is the recognition that local autonomy requires a 'freedom to' and a 'freedom from' simultaneously. This idea has largely influenced not only the ensuing academic discussion about local autonomy but also the political thinking. On the other hand, as PRATCHETT (2004) points out, in defining local autonomy as a 'freedom from', there is inevitably a systemic concern with centralisation. The implicit message of such a definition is that any loss of local autonomy is a threat to local democracy. Clark accepts the normative value of local autonomy without examining its consequences, thus reinforcing the trend that would like to regard local autonomy as a valence issue (see Section 3.2).

While for Clark, the only thinkable constraint to local autonomy is the higher-level authorities' reviewing of municipal decisions with the aim to enforce their own standards, GURR and KING (1987) go a step further. In their taxonomy of municipal ('local state') autonomy, Type II partly corresponds to Clark's immunity principle:

³According to Art. 3 of the Swiss Federal Constitution, 'the Cantons are sovereign insofar as their sovereignty is not limited by the Federal Constitution; they shall exercise all rights which are not transferred to the Confederation.' At the same time, their sovereignty is limited only as far as the cantons have voluntarily transferred part of their sovereignty to the federal level at the moment of drafting the Constitution in 1848. Thus, the residual power (of initiation and immunity) is vested in the cantons and not in a central organ. See also FLEINER (2000).

‘The local state is autonomous to the extent that it can pursue its interests without substantial interference by the national state’ (GURR and KING, 1987, p. 62). Here, however, national interference includes not only the explicit oversight function of higher tiers and the review of local decisions, but also national political pressures affecting local policies, as well as legal conditions or guidelines accompanying central government grants. In contrast, the authors define Type I autonomy as a power of local government to ‘pursue its interests without being substantially constrained by local economic or social conditions’ (ibid, p. 57). These conditions are of three kinds:

- limits on the revenue-raising potential of local government;
- organised local economic interests diverting municipal power and policies to their own purposes;
- local political organisations and social movements attempting to influence the content and execution of local public policies.

An important feature of this model is the recognition of a trade-off between Type I and Type II autonomy, particularly in the domain of economic constraints. Shortfalls in local revenues can be overcome (increasing Type I autonomy), but only at the cost of increased dependency from higher-level governments (decreasing Type II autonomy). A local government soliciting a grant sees its Type II autonomy decrease because it is obliged to respect the conditions of eligibility and use (spending target) imposed by the grantor.

The last strand of classical theories defines local autonomy as the ability of local governments to have an impact on the well-being of their citizens. WOLMAN and GOLDSMITH find that previous interpretations of local autonomy as the power to act according to own objectives and without constraints from higher-level government or from economic and social factors are insufficient because they neglect the *consequences* of local autonomy. For them, the fundamental question is the following: ‘Do local governments in urban areas have autonomy in the sense that their presence and activities have independent impacts on anything important? Does urban politics matter?’ (WOLMAN and GOLDSMITH, 1990, p. 3). The most important variable for WOLMAN and GOLDSMITH is the aggregate well-being of local residents. By means of their autonomy, local governments are able to exert some influence on this variable. They can shape the levels and the distribution of income through taxes and transfer payments and increase citizens’ satisfaction derived from local public services by bringing the spending pattern in line with

36 community preferences. To a minor extent, they can also attain improvements in other aspects of welfare. Locally funded child-care services may improve the quality of family life, while zoning plans can help to preserve the physical environment primarily given by nature. Clearly, the scope of local government's potential to affect local welfare is subject to a variety of constraints of an economic, social, legal or political order. Yet, the novelty of this theory is in the *outcome orientation*: once all external constraints are taken into account, the residual local autonomy is justifiable only if it contributes to the well-being of those who provide legitimacy to local government, namely the local population. For the first time in the literature, the value of local autonomy is put into perspective. The only problem with the theory of Wolman and Goldsmith—and the reason why it found hardly any echo in the subsequent literature—is that of measuring the aggregate well-being of a local community.

3.1.2 Recent definitions: local autonomy as right and ability The question of financial capacity that the early models of local autonomy had surprisingly circumvented became a pivotal issue in the second wave of theories emerging from the late 1990s. An apparent driving force behind this development was the European Charter of Local Self-Government (hereinafter: the Charter) drawn up within the Council of Europe in 1985. This is the first document that defines *local self-government* (i.e. local autonomy) along the double characteristics of *right* and *ability* to manage local public affairs.⁴ Box 3.1 gives back a part of the original text that is a binding convention for all states that sign and ratify it.

**Box 3.1: Text of the European Charter of Local Self-Government, Part I (art. 2–11)
[Source: Council of Europe (1985a)]**

Article 2 – Constitutional and legal foundation for local self-government

The principle of local self-government shall be recognised in domestic legislation, and where practicable in the constitution.

Article 3 – Concept of local self-government

1. Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

⁴The Charter employs the term *local self-government* in the sense of *local autonomy*. Nothing proves this better than the French title of the convention: 'Charte européenne de l'autonomie locale'.

2. This right shall be exercised by councils or assemblies composed of members freely elected by secret ballot on the basis of direct, equal, universal suffrage, and which may possess executive organs responsible to them. This provision shall in no way affect recourse to assemblies of citizens, referendums or any other form of direct citizen participation where it is permitted by statute.

Article 4 – Scope of local self-government

1. The basic powers and responsibilities of local authorities shall be prescribed by the constitution or by statute. However, this provision shall not prevent the attribution to local authorities of powers and responsibilities for specific purposes in accordance with the law.
2. Local authorities shall, within the limits of the law, have full discretion to exercise their initiative with regard to any matter which is not excluded from their competence nor assigned to any other authority.
3. Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy.
4. Powers given to local authorities shall normally be full and exclusive. They may not be undermined or limited by another, central or regional, authority except as provided for by the law.
5. Where powers are delegated to them by a central or regional authority, local authorities shall, insofar as possible, be allowed discretion in adapting their exercise to local conditions.
6. Local authorities shall be consulted, insofar as possible, in due time and in an appropriate way in the planning and decision making processes for all matters which concern them directly.

Article 5 – Protection of local authority boundaries

Changes in local authority boundaries shall not be made without prior consultation of the local communities concerned, possibly by means of a referendum where this is permitted by statute.

Article 6 – Appropriate administrative structures and resources for the tasks of local authorities

1. Without prejudice to more general statutory provisions, local authorities shall be able to determine their own internal administrative structures in order to adapt them to local needs and ensure effective management.

2. The conditions of service of local government employees shall be such as to permit the recruitment of high quality staff on the basis of merit and competence; to this end adequate training opportunities, remuneration and career prospects shall be provided.

Article 7 – Conditions under which responsibilities at local level are exercised

1. The conditions of office of local elected representatives shall provide for free exercise of their functions.
2. They shall allow for appropriate financial compensation for expenses incurred in the exercise of the office in question as well as, where appropriate, compensation for loss of earnings or remuneration for work done and corresponding social welfare protection.
3. Any functions and activities which are deemed incompatible with the holding of local elective office shall be determined by statute or fundamental legal principles.

Article 8 – Administrative supervision of local authorities' activities

1. Any administrative supervision of local authorities may only be exercised according to such procedures and in such cases as are provided for by the constitution or by statute.
2. Any administrative supervision of the activities of the local authorities shall normally aim only at ensuring compliance with the law and with constitutional principles. Administrative supervision may however be exercised with regard to expediency by higher-level authorities in respect of tasks the execution of which is delegated to local authorities.
3. Administrative supervision of local authorities shall be exercised in such a way as to ensure that the intervention of the controlling authority is kept in proportion to the importance of the interests which it is intended to protect.

Article 9 – Financial resources of local authorities

1. Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.
2. Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.
3. Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

4. The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.
5. The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.
6. Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.
7. As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction. For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

Article 10 – Local authorities' right to associate

1. Local authorities shall be entitled, in exercising their powers, to co-operate and, within the framework of the law, to form consortia with other local authorities in order to carry out tasks of common interest.
2. The entitlement of local authorities to belong to an association for the protection and promotion of their common interests and to belong to an international association of local authorities shall be recognised in each State.
3. Local authorities shall be entitled, under such conditions as may be provided for by the law, to co-operate with their counterparts in other States.

Article 11 – Legal protection of local self-government

Local authorities shall have the right of recourse to a judicial remedy in order to secure free exercise of their powers and respect for such principles of local self-government as are enshrined in the constitution or domestic legislation.

Compared to previous attempts to theorise local autonomy, the definition laid down in art. 3 para. 1 of the Charter contains three new elements (COUNCIL OF EUROPE, 1985b):

- The legal right to regulate and manage certain public affairs must be accompanied by the means of doing so effectively ('ability'; in the official French-language version: 'capacité effective').
- This right and ability may be defined more closely by legislation ('within the limits of the law').
- Local authorities should not be limited to acting as the agents of higher authorities ('under their own responsibility').

The assumption that 'ability' is a new element in the history of defining local autonomy can be accepted only under the reserve that CLARK (1984) did not mean the same thing when he described local discretion. Recalling the discussion from Section 3.1.1, Clark understands local discretion as 'the ability of local governments to carry out in their own manner their own particular objectives in accordance with their own standards of implementation' (CLARK, 1984, p. 199). This rather vague definition could lead the reader to the assumption that Clark was the first author to define local autonomy (actually local discretion, though the difference is not clear) along two aspects:

1. the freedom to decide about the range of local public services to be provided;
2. the freedom to manage the production function, in the sense of an effective capacity to produce those services.

Accordingly, when Clark speaks about 'to carry out [...] their own particular objectives', in reality he means the same thing as the Charter with 'the right to regulate and manage', namely, aspect 1 of local autonomy. Similarly, Clark's 'to carry out in their own manner' and the expression 'means of doing so effectively' in the Charter could both refer to aspect 2. However, the fact that Clark completely ignores the questions of production function and effective capacity in the rest of the article (his only concern being the formal power) might somewhat weaken this argumentation.

Another novelty, one that is unquestionably attributed to the Charter, is the careful avoidance of the terms 'own interests' and 'own objectives' so frequently used in the earlier theories and the rejection of such vague expressions as 'local affairs' or 'own affairs'. According to the Explanatory Report accompanying the Charter, 'it is not possible to define precisely what affairs local authorities should be entitled to regulate and manage. [...] The traditions of member states as to the affairs which are regarded as belonging to the preserve of local authorities

differ greatly. In reality most affairs have both local and national implications and responsibility for them may vary between countries and over time, and may even be shared between different levels of government' (COUNCIL OF EUROPE, 1985b).

Beside the explicit definition of local autonomy (art. 3 para. 1), the Charter introduces a number of principles upon which this autonomy should be based:

- *Legal stability*: The basic powers and responsibilities of local governments should not be assigned to them on an *ad hoc* basis but be anchored in the constitution or an act of Parliament (art. 4 para. 1);
- *Residual competence*: Local authorities should have the right to assume any function that has not been excluded from their competence or assigned to other authorities (art. 4 para. 2);
- *Principle of subsidiarity*: Unless there are 'overriding considerations of efficiency or economy' (COUNCIL OF EUROPE, 1985b), tasks should be assigned to the lowest level of government (art. 4 para. 3; see further Section 3.6);
- *No overlapping responsibilities*: Overlapping should be avoided. Shared competences, if they are necessary, should be assigned in accordance with clear legislative provisions (art. 4 para. 4);
- *Delegation with local discretion*: Top-down delegation should not excessively impinge on the sphere of independent authority of the local government (except where uniform regulations are needed) (art. 4 para. 5);
- *Consultation*: Local authorities should have a real possibility to exercise influence in matters that affect them (art. 4 para. 6);
- *Shifting boundaries*: Local governments should be consulted prior to amalgamations or other planned changes in boundaries (art. 5);
- *Freedom of organisation*: Local authorities should be free to organise their administration according to their preferences (art. 6);
- *Supervision of legality*: The decisions and actions of local authorities should normally be controlled only upon their conformity with the law (*contrôle de tutelle*); for delegated functions it is also possible control expediency (art. 8 para. 2);
- *Tax and budget autonomy*: For local autonomy to be meaningful, local authorities must be given control over a sufficient amount of financial resources (art. 9; see further Section 3.4.3);

- *Co-operation and association*: Local authorities can co-operate with other local authorities and join national and international associations (art. 10);
- *Legal protection*: Local governments should have the right of recourse to a judicial remedy (art. 11).

During the first twenty years of application of the Charter, some of these terms and expressions proved to be too vague, so that the Congress of Local and Regional Authorities ultimately decided to revise the convention, among others on the following points (CLRA, 2005):

- The expressions ‘in due time’ and ‘in an appropriate way’ in relation to local authorities’ right to be consulted (art. 4 para. 6);
- The term ‘normally’ concerning the supervision of legality of local government actions (art. 8 para. 2): in which cases of delegation is a control of expediency justified?
- The desired character of financial systems described as ‘sufficiently diversified and buoyant’ needs to be reformulated in a way to entail the levying of taxes and/or the making of transfers, and that local taxes must be reasonably stable and have a certain degree of flexibility at the same time.

Notwithstanding these imperfections, the Charter brought significant improvements in the definition of the concept of local autonomy compared to previous theories. The most important one is the introduction of financial autonomy as a *conditio sine qua non* of a meaningful local autonomy. In addition, the Charter described several further (legal, territorial, administrative, etc.) aspects of local autonomy in unprecedented detail.

By the end of February 2009, out of the 47 member countries of the Council of Europe 44 ratified the Charter. In the new democracies of Central and Eastern Europe, it served as the fundamental model of legislative reform and shaped national constitutions and laws on local government substantially.

From 1985, scholars writing about local government autonomy could no longer ignore the innovations brought by the Charter. Alternative definitions did emerge, however. One of the most remarkable attempts is the one made by MARCOU (1999, p. 34 ff.) who defines local autonomy along four characteristics:

1. *The right to self-government* in the sense of art. 3 para. 1 and art. 9 para. 1 of the Charter, which implies thus both the right and the effective capacity to decide and act within the limits of the law;

2. *The democratic character of local institutions* that is manifest in the free elections, the organisation of the municipal executive, and the participation of citizens in the decision-making;
3. *The residual competence of local authorities*, in the sense of art. 4 para. 2 of the Charter;
4. *The control by higher tiers of government* that is indissolubly related to local autonomy. The extent of autonomy depends on the intensity of the control.

Other scholars were more interested in the *nature* of local autonomy than in its components. DEFILIPPIS (1999), for instance, criticises all the earlier theories on the grounds that they consider local autonomy as a static ‘*thing*’ that can be granted to and possessed by local authorities. For him, autonomy is more an expression of power and thus a relational construct. Consequently, autonomy cannot exist in itself but only in the context of complex extra-local relationships. And since municipalities are so deeply embedded in their institutional environment (consisting of other municipalities, regional and central government, civil society, business enterprises, etc.) that they can never realise complete autonomy. Also, like all forms of power, local autonomy is inherently met by opposition and contestation. Hence, local autonomy is ‘the ever-contested and never complete ability of those within the locality to control the institutions and relationships that define and produce the locality’ (DEFILIPPIS, 1999, p. 980). The main message of this (almost philosophical) definition is the *impossibility* of local autonomy as perfect independence and isolation from the environment. PRATCHETT (2004) joins this assumption asserting that the levels of local autonomy may alter over time and issue even within the same constitutional system of government.

Practice suggests that the notion of autonomy is not only relative but also subjective. Voters in a jurisdiction are likely to perceive and evaluate the extent of their autonomy (or the marginal increase or decrease in autonomy) differently across the various policy areas.⁵ For instance, the adjustment to centrally imposed environmental norms is likely to be perceived as less painful than the loss of autonomy in social affairs. There are two main factors that are likely to influence the perception of local autonomy. The first one is the extent to which local residents and policymakers can identify themselves with the objectives or national priorities

⁵Here as well as in the rest of this study, we start from the hypothesis that the local government unit (or more precisely, its executive body which is usually the council) is a ‘benevolent’ actor who pursues no other goal than the strict implementation of the mission received from the local electorate. This hypothesis might be strong, but at least it ensures that voters and their elected representatives have a similar understanding of autonomy.

44 behind the norm. People would uniformly like to live in a safe and clean environment, whereas they tend to disagree on the social legitimacy or the optimal degree of income redistribution. The second factor is the degree to which local residents and policymakers are affected by the restrictions imposed on their autonomy. Restrictions on air pollution are likely to affect some industries but impose no drastic limitations on the lifestyle of individuals. By contrast, an expanding social aid programme takes away useful resources from the realisation of other objectives that could potentially benefit a larger share of the local constituency.

Certainly, the quality of policy instruments that local governments apply in order to comply with the norm also influences the perception of autonomy of the local population. Imagine, for instance, that residents are allowed to dispose of glass, paper and plastic for free on condition that they throw them into separate containers in signalled public areas. As long as this regime prevails, they will consider waste reduction norms, not as a constraint on their autonomy, but rather as an opportunity to economise on user charge liabilities. Another example is the range of financial incentives that local governments in several countries receive from the centre as a reward for horizontal co-operation in the provision of local public goods and services. Here again, local voters weigh the loss of decision-making autonomy induced by co-operation against the gain in the financial power of the municipality. In summary, by using well-designed incentives, higher authorities can neutralise the loss of autonomy that lower-level governments and their electorates necessarily incur when higher-level priorities are enforced.

Finally, a sizeable amount of written research on federalism and decentralisation is concerned with the question of how sovereignty is devolved from the central government to, or constitutionally shared with, lower tiers.⁶ From the perspective of autonomy, one remarkable achievement of this strand of literature is that it considers not only the local (municipal) tier but also the intermediate (regional, provincial, district, etc.) tiers. While focusing on the analysis of local (municipal) autonomy may be absolutely legitimate, it would be an error to neglect the impact of municipal autonomy on the autonomy of other actors in a multi-level system of governments. Nevertheless, as has been mentioned in Chapter 1, the present study focuses on the financial autonomy of the lowest (municipal) tier because of time and space limitations.

As for the sharing of sovereignty among the government tiers, BIRD (1993) appears to be the first author to split up the notion of *decentralisation* into three

⁶We use the term *sovereignty* in the sense of an exclusive right to exercise supreme political authority within a given territory. Hence, it is not a synonym of autonomy.

different concepts depending on how much power and responsibility the central government retains when transferring a competence to lower levels. He distinguishes between three forms of decentralisation, each of which involves a different level of subnational autonomy.

Deconcentration means that the higher-level authority keeps its powers and responsibilities for a given public function while leaving the execution to the lower authorities. This happens most often through precisely defined mandates to the regional and local offices and line ministries of the central government, or to the appointed prefects or governors of subnational jurisdictions. According to a more recent definition (EBEL and YILMAZ, 2007, p. 62), deconcentration may take place with or without giving a minimum of authority (independent decision-making capacity) to the territorial branch offices. In both cases, the higher authority remains responsible for the general management and funding of the task, as well as for the co-ordination and supervision of the deconcentrated agencies.

In the case of *delegation*, the lower authority has considerable discretion as to how to carry out the delegated task, but it is fully accountable to the higher authority which retains ultimate responsibility for what is done and provides some or all of the necessary funding. GAUTHIER and VAILLANCOURT (2002) emphasise that the recipient of the delegated competence is a locally or regionally elected, independent self-governing organisation and not a relocated executive agent of the higher authority. The higher and the lower authority find themselves in a principal-agent relationship in which the major challenge facing the principal (the higher authority) is the lack of information about the agent's actual capacity, his decisions and actions, as well as the real costs of executing the task. Because of this informational asymmetry, the principal is interested in negotiating a service contract with the agent. As for the accountability of the agent, BIRD (2001a) notes that if delegation is accompanied by political decentralisation so that local (regional) politicians are elected rather than appointed, then confusion may arise since accountability runs in two directions, namely, upwards to the higher authority and downwards to the voters.

Finally, *devolution* is the most complex form of decentralisation in which the responsibility for a particular function is entirely transferred to the lower authorities that are, in this case as well, elected, independent self-governing entities. Along with the competence transfer, these local governments are also given authority to levy taxes and fees to finance the service (EBEL and YILMAZ, 2007, p. 63). GAUTHIER and VAILLANCOURT (2002) add that with this type of transfer, the higher authority abandons its right of oversight over the quantity and the quality of public services offered by the lower authorities. Devolution thus also implies that the

46 lower authorities are free to decide whether they wish to offer the given service to their constituency or not. According to BIRD (2001a), pure devolution is seldom found in practice, mainly because even the most decentralised regional and local governments remain to some extent dependent on central government funding also for their optional tasks and, in exchange for grant money, they are supposed to follow the rules dictated by the grantor.

Clearly, local governments enjoy the largest possible degree of autonomy in the case of devolution and are fully dependent on higher-level authorities in the case of deconcentration, while delegation grants them a limited degree of autonomy. However, even if the best way to maximise local autonomy is through devolution, it is neither realistic nor desirable to envisage an intergovernmental system in which all public affairs with a regional or local scope are systematically devolved to the lower tiers. Such a strategy would possibly compromise other important objectives such as interjurisdictional equity or economic efficiency. In practice, deconcentration, delegation and devolution are simultaneously present in every decentralised government system and the choice between them depends on the nature of the given public good or service and the actual demographic, geographic, socio-economic and political context in which it has to be provided.⁷ And since the degree of local autonomy is a function of this choice, it follows that the levels of local autonomy can change over time and issue, in conformity with PRATCHETT'S thesis (2004) cited above.

⁷GAUTHIER and VAILLANCOURT (2002) propose a matrix that compares the advantages and drawbacks of deconcentration, delegation, and devolution. Their explicit aim is to assist national governments in selecting that form of decentralisation which best suits the history, size, topographic conditions, and the ethnic, linguistic and religious structure of their country. The proposed approach of maximising the net benefit (advantages minus drawbacks) is at least questionable. First, if the solution was as simple as that, every then national governments would be well advised to opt for devolution which, not too surprisingly, would ultimately emerge as the absolute winning solution. In reality, however, not even mature federal systems devolve the totality of public service functions to the lower levels. Second, in practice, one single form of decentralisation is usually not sufficient to take account of the diversity of the various spheres of public intervention; a reason why in most systems deconcentration, delegation and devolution strategies are employed simultaneously at any point of time.

Local autonomy is a value that seems to be acknowledged in all European democracies, even though the ways it is interpreted and implemented differ widely across the continent. We can also observe divergent policy responses being given to similar problems. The differences in the understanding of local autonomy are to a large part due to the various paths of historical and institutional development that the individual countries were undergoing in the past few decades. Institutional development is notably responsible for the diversity of objectives and motives with which the governments pursued their recent territorial reforms.

In Great Britain, decentralisation tendencies were most often accompanied by arguments such as enhanced diversity in service provision and a more balanced relationship between the centre and the local communities (PAGE, 1982). Accordingly, the discussion about the objectives and instruments of decentralisation was largely depoliticised and technical in nature. In France and in Eastern Europe, by contrast, the issue was highly ideological, abolishing the ‘ancien régime’ of centralised state power and granting liberty and responsibility to lower level territorial units being the key objectives of the reform (HININGS, 1982).

Whatever the nature of the issue in the different countries, decentralisation was legitimated by the overall consensus that anything that is decentralised must be *a priori* ‘good’. From the scientific side, this normative belief found additional support in the literature of fiscal federalism emerging from the 1970s. With his Decentralization Theorem, Oates set out the theoretical foundations for a decentralised provision of public services:

The Decentralization Theorem: For a public good—the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government—it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions. (OATES, 1972, p. 35)

Although Oates took great care to explain not only the case for decentralised government but also the one for centralised government (we will discuss both in Section 3.3.1), the actual political context in most West European countries made the advocates of territorial reforms more receptive to the pro-decentralisation

48 arguments than to the pro-centralisation ones. This is how local autonomy has ultimately become a *valence issue*.⁸

The process of European integration in general, and the weakening role of nation states and the emergence of regions in particular, have greatly contributed to the strengthening of local autonomy as a universal value and as a desired state of affairs in central-local relations. This trend culminated in the issue of the Charter of European Local Self-Government in 1985 (already introduced in Section 3.1.2), in which the Council of Europe labelled local authorities as ‘one of the main foundations of any democratic regime’ and proposed to elevate local self-government to a fundamental legal or constitutional principle (COUNCIL OF EUROPE, 1985a).

In the early 1980s, when France was just at the beginning of the decentralisation process and people in the East European communist bloc could not yet even dream about such changes, the time in Great Britain was already ripe for breaking the taboo on local autonomy. During those years, the British national government gradually trimmed local autonomy that decentralised authorities had always perceived as an immemorial right dating back to Victorian times. Centralisation took place as part of a large-scale reform aimed at reducing the functions and the size and simplifying the structure of decentralised units. The experienced increase in the central control over local government affairs provided an opportunity to academics to revise and challenge the prevalent and overwhelmingly favourable view on local autonomy. Is local autonomy (and hence, decentralisation) a ‘good thing’ and everything that limits it (centralisation) a ‘bad thing’? With but a few exceptions, academics had tended to see it this way and devoted much effort to document precisely how central government had diminished local autonomy over time. Critics found, however, that two implicit assumptions behind this reasoning were at best doubtful (PAGE, 1982, p. 29):

1. The observer should identify with the interests of the local policymakers and defend their room for manoeuvre as something inherently ‘good’.
2. The existence of this room for manoeuvre produces better government because it is more efficient, allows for greater local participation or produces policies that are consistent with local needs and preferences.

While 1 makes an unfounded claim about the observer, 2 lacks sufficient empirical evidence even today, as we will see in Section 3.3.

⁸According to Stokes’ valence model, a valence issue is one that is uniformly liked or disliked among the electorate. Most voters would agree that corruption and unemployment are ‘bad’, while democracy and low inflation rate are ‘good’. Position issues, in contrast, are those on which opinion is divided (STOKES, 1963).

The uncritical assumption according to which everything that is centralised is 'bad' was further attacked on four grounds.

First, using the term *local autonomy* as an evaluative criterion tends to reduce all political conflicts to one dimension, namely to the confrontation between centralisers and autonomists, or between central government and local government, as if other actors did not exist. Moreover, this conflict creates the impression as if local government *as a whole* were a loser of certain central government decisions, although the costs of such decisions are very often allocated disproportionately among the different groups (types, size categories, regional clusters) of local authorities. For instance, a cut in central government grants is almost unequivocally interpreted as a reduction of local autonomy, although local governments could potentially adjust to such restrictions (e.g. through more efficiency in resource use) without compromising autonomy. In other words, dismissals in local government institutions should not be regarded as an inevitable consequence of central government policies.

Second, territorial diversity in the provision of local public services is generally desirable. However, there is a need for a degree of uniformity with regard to certain services, and here the centre should have the role of *setting the framework* for local service delivery. The desired state of local autonomy is neither one of 'rampant and uncontrolled localism and the sharpening of geographical inequalities' (JONES and STEWART, 1981, cited by PAGE, 1982, p. 30), nor one of isolation and independence from central government. Although this proposition is an adequate counterweight to the autonomist position, its practical relevance is limited for at least two reasons:

1. No reliable indicator can tell when diversity is necessary and desirable and at which point it turns into 'rampant localism', and, conversely, when central policies setting the framework turn into a direct control over local government affairs;
2. Intergovernmental relations most often correspond to the marble cake model in which layers are intermingled in a complex pattern so that a clear separation of national and local responsibilities is usually impossible.

As Webb put it, 'there is nothing that local governments do that cannot be construed, in some way, as having national implications or national importance' (WEBB, 1911, cited by PAGE, 1982, p. 32).

Third, there is no *a priori* reason to suggest that giving local government greater autonomy would automatically lead to more accountability⁹ and responsiveness in

⁹ Accountability is meant here in the sense of a responsibility towards local voters. This requires the

50 public decision-making. It all depends on the interest and participation of local citizens. According to some views, when an issue becomes a local issue, it enters a 'lost world' in which there is little public interest.¹⁰ Thus, if one is interested in improving the accountability of policymakers and the transparency of their decisions, then it would be more appropriate to centralise decision-making in order to ensure greater publicity. One flaw in this assumption is that the term *public interest* makes reference to general interest, whereas local interest for local issues is generally high by nature. And as long as local interest is high, the proximity of citizens to politicians ensures a tight control over local public decisions and hence a satisfactory level of transparency and accountability. Nevertheless, local citizenry can indeed lose their interest in local affairs if they are denied the right to vote on meaningful issues.¹¹ It is also true that low levels of local autonomy are likely to reinforce the 'cultural disdain' for local government (i.e. the poor knowledge about and the weak participation in local politics) and enable the centre to usurp the powers of local councils even more.

According to the fourth and last argument against the autonomist position, widening the room for manoeuvre of local authorities may lead to 'bad' government if it allows governments to deliver lower levels or a poorer quality of services than under a regime with more limited autonomy. This argument is misleading, however, because it ignores that lower service levels are presumably matched with a lower tax price, otherwise the citizens and businesses (unless they are captive) would have already left the jurisdiction. Disapproving the possibility of having different levels of public services in different jurisdictions also implies the nullification of an important advantage from decentralisation, namely, the interjurisdictional competition in terms of tax/benefit ratios.

A similar discussion about whether local autonomy is worth to be protected at any price or not, emerged toward the end of the 1990s in France (MARCOU,

local government to pass on revenue consequences of locally determined spending programmes to the local electorate through taxation or user charges and to manage these revenues in a responsible way and in the interest of the electorate. OWENS and NORREGAARD (1991) describe two further types of accountability, namely financial and managerial accountability. Both of these imply a responsibility towards a *higher level* of government.

¹⁰There is one objection against this argument. If local interest for a specific issue is so low that some well-organised interest groups can easily gain influence over local decision-making, then their success is likely to alert the majority population and spur them to fight for a withdrawal of the privileges acquired by those minority groups. Interest in local affairs is thus automatically restored. GURR and KING (1987) touch upon this issue in their autonomy model (Section 3.1.1).

¹¹This is the case in Hungary where the Act LXV of 1990 on Local Governments (art. 46 para. 4) prohibits local authorities from holding a referendum about the local budget draft and on proposals modifying the types and parameters of local taxes.

1999; GILBERT, 1999). By that time, French local governments were enjoying a relatively vast autonomy in virtually all domains of intergovernmental fiscal relations. For the execution of their fairly extensive public service competences, they benefited from an intergovernmental transfer system that was dominated by general (unconditional) non-matching grants. Borrowing decisions were only controlled upon their conformity with national laws concerning the balanced budget requirement, specific debt repayment rules and some other norms of fiscal prudence. Yet, a series of endogenous and exogenous factors, namely some recent developments in the domains of local public finance, national economy and European institutions, pointed into the direction of a possible narrowing of the room for manoeuvre of local authorities in the future. Two questions arose. First, is it possible to preserve the status quo characterised by a vast local autonomy, and if yes, under which conditions? Second, even if local autonomy should be constrained, is there a reason to worry about it? In other words, is autonomy worth being elevated to a fundamental right and guaranteed to every local government at any price? These questions, as their author himself admitted (GILBERT, 1999), risked to be perceived as too theoretical and without any practical relevance, maybe also premature and highly provocative less than two decades after the dawn of decentralisation in France. On the other hand, Gilbert estimated that decentralisation in France had reached what he called the age of reason and the accumulated experience had finally made it possible to raise questions that could not be put on the agenda at the moment of the great reform. Having examined the endogenous and exogenous variables that were supposed to modify the extent of local autonomy in the near future, Gilbert arrived at two conclusions. First, the considerable room for manoeuvre of local authorities in France could not plausibly be maintained without a reform of the territorial organisation. Second, local autonomy was to be preserved only to the limit where it did not compromise other important objectives such as allocative efficiency and territorial equity. MARCOU (1999, p. 33) pointed out that the real question was not what the future of local autonomy looked like but what kind of autonomy the local communities actually needed and whether their aspirations were justified or not. He added that local autonomy in France, originally conceived and encouraged by the centre, was all too often understood in a defensive way (as something that needs protection from stronger forces) rather than in a participative and proactive sense.

Behind this view on local autonomy, there are two centuries of French history in which decentralisation was equivalent to the devolution of power from the central state to local communities, which placed thus the national government in the centre of gravity of the society. One of the aims of the constitutional reform of

52 2003 was to break with this traditional concept and to provide local authorities more flexibility in the exercise of their competences, while depriving the central state of some of its territorial functions and limiting its competence to economic regulation and minority protection (NEMERY, 2004). The jury is still out on the question whether the desired change in the view of local autonomy has taken place in reality or not.

The defensive interpretation of local autonomy is characteristic of unitary states in general and thus of most countries of the world. Local autonomy is traditionally established *in* the state and *by* the state (MARCOU, 1999, p. 32). It is thus not an absolute but a relative concept: it is defined in confrontation with the central power that is embodied by the nation state. The recent emergence of regions and urban agglomerations in Europe (many of which reach beyond provincial or national frontiers) has somewhat weakened this bipolarity, releasing local governments from their oppositional role vis-a-vis the centre. At the same time, however, regionalism has also imposed some new constraints and dependencies on local communities.

3.3 The relative importance of local autonomy

3.3.1 The benefits of local autonomy In the previous section, we presented local autonomy as a valence issue in the sense that, regardless of their political or ideological affiliation, politicians and voters unanimously view it as something that merits support. Logically, the question arises why local autonomy is such a cherished value in our societies and, if local autonomy is such a good thing, why national governments and legislatures in virtually all decentralised countries restrain it in one way or another, instead of allowing it a free play.

The reason for such an overwhelming support for local autonomy is what the classical theory of fiscal federalism has long studied under the label 'advantages of local autonomy'. In some instances, the same range of arguments carries the title 'the benefits of decentralisation', suggesting that the very sense of decentralisation is granting autonomy to local communities. OATES (1972, p. 11 ff.) limits his analysis to the economic case for decentralised government, whereas JONES and STEWART (1981), KING (1984, p. 20 ff.) and BOADWAY (2001) introduce some political arguments as well.

1. Local autonomy caters to varying needs and preferences

Local governments are closer to the citizens and therefore more sensitive to regional variations in tastes and needs. Thus, if they are allowed to act autonomously, they

are likely to provide goods and services whose quality and quantity vary across jurisdictions in accordance with the varying needs and preferences as to how these needs are to be met. Central provision, by contrast, would necessarily tend towards uniformity and induce compromises in the levels of consumption, and is therefore less efficient than decentralised provision (see Oates' Decentralization Theorem in Section 3.2). The underlying reasons are (i) information asymmetries resulting from the differing proximity of central and local authorities to the electorate,¹² and (ii) political pressures and/or constitutional constraints that limit the capacity of the central government to provide different levels of public services in different jurisdictions (OATES, 1999).¹³

Tiebout-type mobility may, but does not necessarily, promote a better tailoring of local outputs to local preferences. The TIEBOUT model (1956) stipulates that decentralised decision-making contributes to the rise of more or less homogeneous communities by virtue of the free migration of individuals. Citizens who are unsatisfied with the net fiscal benefit offered in their own jurisdiction may move to any area that promises a more attractive fiscal package. This incites local governments to consider the demand of their constituency, while at the same time this demand becomes more transparent compared to the situation of zero mobility. However, there are two problems with this argument. First, the efficiency impact is dampened by the collateral problems caused by migration (e.g. congestion in the 'winner' jurisdictions, inefficiencies due to small scales of production in others). Second, in practice, mobility is never as significant as what would be necessary in order to facilitate the formation of optimal communities. Furthermore, the model assumes that preferences for public goods are heterogeneous and stable over time. If this were not the case, all local governments would seek to copy the strategy pursued by their most successful rival and the interjurisdictional diversity in terms of expenditure and revenue policy would drop to zero.

¹²It is, however, not clear how the central government can determine the correct level of matching grants for local outputs that generate spillover benefits, if it is poorly informed about the preferences of individuals for local public services (OATES, 2005, p. 359). By contrast, it can efficiently deal with negative production externalities such as environmental pollution: knowing the production function of the polluter it can calculate the spatial dimension of the externality.

¹³Oates observed later that even central government programmes often led to varying levels of certain public services across jurisdictions, resulting from pork-barrel politics (OATES, 2005, p. 353). This is also the case when the centre imposes restrictive norms or launches benefit programmes (particularly in the framework of equalisation and regional policy) whose validity is limited in space.

54 2. Local autonomy brings responsibility and cost-efficiency

As we saw in Clark's theory about top-down and bottom-up legitimacy (Section 3.1.1), local autonomy and responsibility are inevitably interconnected. They are two sides of the same coin. In order to enjoy unfettered autonomy in the domains where this is formally granted to them, local politicians have to assume full responsibility for their fiscal decisions. This implies a careful consideration of the costs and benefits of local programmes. Whenever local expenditure programmes are financed from own-source revenues, there are natural incentives for responsible fiscal behaviour: local politicians have a self-evident interest in managing the funds properly, as raising revenues at the margin requires the consent of the local electorate. Citizens, too, become more aware of the real resource costs and the benefits of the programmes and are therefore in a better position to evaluate political decisions. Thus, goods and services whose production costs are borne by the local constituency are more likely to be provided cost-efficiently. This corresponds to the ownership argument raised by TANZI (1996, p. 300): 'individuals who are responsible for the results of their actions, and who thus have ownership rights over the outcome, are likely to have stronger incentives to perform better'. By contrast, reliance on transfers and grants from higher authorities destroys the incentives for responsible local fiscal behaviour and creates fiscal illusion among the citizens because there is little real cost associated with the decisions.¹⁴ This provides an incentive to expand the levels of public services beyond the social optimum, since the local community may bear only a negligible part of the costs. This is particularly true in the presence of bailout grants.

3. Local autonomy improves citizen participation and democratic control

Thanks to their proximity to citizens, local politicians are likely to have a better understanding for electors' wishes than national politicians are. At the same time, electors have better opportunities to signal their needs and preferences and express their approval of, or dissatisfaction with, local policy decisions. For JONES and STEWART (1981), local government is a means through which citizens can influence and control the decisions that affect them collectively. A better democratic control makes in turn local government more accountable, that is, more responsible for its decisions that become more transparent in consequence (GILBERT, 1999).

As has been discussed in Section 3.2, effective citizen participation and democratic control are conditional upon the genuine interest of citizens in local affairs (in order to prohibit the dominance of specific interest groups) and a permis-

¹⁴See also OATES (1990, p. 51).

sive national legal framework that tolerates or even encourages the expression of individual preferences in critical issues such as local tax policy and budgeting. 55

4. Local autonomy can serve to tame the Leviathan

According to BRENNAN and BUCHANAN (1980), the competition among decentralised governments can limit the ability of the monopolistic central government, the 'Leviathan', to control a too large share of the available resources in an economy. In BOADWAY'S words (2001), decentralisation constrains the opportunity of local government to extract resources from an unwitting electorate, and this is primarily due to the mobility of individuals: by means of their 'exit' option, voters can penalise those local governments that unnecessarily inflate the size of the public sector. Later empirical research (RODDEN et al., 2003) detected that the 'taming the Leviathan' hypothesis was only true under the condition that local governments rely primarily on own-source revenues; otherwise, local policymakers would have an incentive to expand public programmes as far as possible. As a further condition, one could add the effective democratic control of local government decisions by the electorate.

5. Local autonomy allows efficiency improvements through benchmarking

The local government may have a monopolistic position in the delivery of certain public services at the local level, particularly in drinking water provision, sewage, and other natural monopolies involving a large network infrastructure. However, this does not exclude the possibility of cross-jurisdictional comparisons of the quality of the delivered services as well as their tax price. The local electorate is likely to question any deviation from the best practice (or at least from the average price/performance ratio) and force the local executive to eliminate the unexplained difference. Nevertheless, effective benchmarking is conditional upon a harmonised accounting system that makes the collection and comparison of data neither too costly nor time-consuming (DAFFLON, 1994).

6. Local autonomy promotes experimentation and innovation

Decentralised decision-making leads to the emergence of a variety of approaches in any decentralised policy area. Experimentation and innovation on a small scale (in a municipality or a region) allow policymakers to try out new policy strategies and instruments without imposing undue risk on the rest of the society: in any case, the central or federal government will normally not have to bear the cost of the failure of a local experiment. In this so-called 'laboratory federalism' (OATES, 1999, p. 1131 ff.), all government units can learn from each other, as successful innovations diffuse horizontally as well as vertically. Competitive pressure resulting from the

56 multitude of jurisdictions (and thus public service providers) and the mobility of individuals and businesses are likely to reinforce the laboratory effect as they drive local governments toward more efficiency in experimentation and better policies (OATES, 1972, p. 12 f.). On the other hand, laboratory federalism also creates information externalities: innovative local authorities that develop and adopt new and successful policies generate valuable information to rival jurisdictions, thus encouraging these latter to become free riders. Therefore, a highly decentralised public sector might ultimately generate even less innovation than a centralised system, unless specific grants are put in place in order to reward the experimenters for assuming the risk of failure (OATES, 1999).

Reviewing the six benefits of decentralisation, local autonomy appears to lead to enhanced allocative (1) and productive (2; 5 and 6) efficiency. Since decision-makers are closer to the electorate, thus better informed about their needs and preferences and also more easily controllable, they are likely to offer exactly those public services that citizens need, at the lowest possible cost. Enhanced efficiency (compared to centralised service provision) is the main argument for decentralisation. Even the political arguments (3 and 4) indirectly serve the realisation of the efficiency objective.

It does not follow, however, that decentralised service provision is the most efficient solution under *all* circumstances. Local governments provide efficient levels of public services only if the consumption of those services is limited to their own constituency and there is no waste of resources. Furthermore, decentralised service provision is likely to have adverse effects on both redistribution and macroeconomic stability. For PRUD'HOMME (1996), all these impacts together constitute the inherent contradiction of decentralisation.

The following four sections give an insight into possible trade-offs between local autonomy and various other objectives.

3.3.2 Trade-off with economic efficiency Beside its efficiency-enhancing effect, local autonomy also generates allocative and productive inefficiencies. A part of the allocative inefficiencies occurs in form of externalities. Figure 3.2 provides an overview.

Externalities resulting from local autonomy can be structured along three types of distinctions:

1. Fiscal externalities vs expenditure externalities, according to whether they are related to the tax policy or the expenditure policy of the local government;
2. Direct vs indirect externalities, depending on whether they affect non-

		Horizontal	Vertical
Fiscal externalities	Direct	Tax exporting (-)	
	Indirect	Tax competition (+/-)	Overlapping tax bases (-)
Expenditure externalities	Direct	Benefit spillover (+) Free-rider behaviour (-) Congestion costs (-)	
	Indirect	Expenditure competition (+/-)	Expenditure interdependence (+)

Figure 3.2: **Positive and negative externalities arising from local autonomy**
[Source: the author, based on Gilbert (1996)]

residents' choices through a change in the price of consuming or producing public and private goods (direct externality), or through the revenue and expenditure policies of other jurisdictions (indirect externality);

3. Indirect externalities can be distinguished according to whether the influence is exerted upon other jurisdictions at the same level (horizontal externality), or upon another level of government (vertical externality).

Direct externalities may take two different forms: tax exporting and benefit spillovers.

On the revenue side, local fiscal autonomy may lead to *tax exporting* if the local government excessively taxes those services that are to a large proportion consumed by non-residents. While it is absolutely justified to ask non-residents to pay for the part of the benefit they receive from the provider jurisdiction or for the part of the costs they provoke at the margin, as soon as this balance is hurt, tax exporting becomes a problem. Beside the fact that it breaks the link between those who decide on local tax rates and those who bear the tax, it may also result in excessive service levels in the taxing jurisdiction due to fiscal illusion, and incite the local government to continue exploiting the 'exportable' tax bases. Tax exporting is also the major reason why sales taxes and certain types of business taxes are

58 not adapted for the local level. But it may also exist in the domain of benefit taxes; here, the extent of tax exporting depends on the substitutability of the taxed public good. If the local government taxes goods or services for which its 'market power' is relatively weak, it must reckon with competition from the neighbouring jurisdictions. If taxpayers are mobile enough, they will escape from tax exporting by choosing another location. Thus, tax exporting and tax competition are two sides of the same coin (GILBERT, 1996, p. 335).

On the expenditure side, while some non-residents might be required to pay more than what would be proportional to the benefits they derive from local goods in a jurisdiction (the case of tax exporting), others might benefit from certain public goods (particularly infrastructures) provided by that same jurisdiction without paying for them. The theory of public economics distinguishes between two types of *benefit spillover*. A production spillover occurs when the public service provided by one jurisdiction benefits the residents of one or several other jurisdictions; mosquito control programmes belong to the classical examples. Consumption spillover arises when non-residents travel to the provider jurisdiction in order to benefit from a collective or mixed good such as a theatre or a park, without paying the total unit price of service provision including investment costs. In both cases, non-resident beneficiaries exhibit *free rider behaviour* and face no incentive to reveal their true preferences with regard to the public good in question. Depending on the actual capacity limits of the given service or infrastructure, the presence of non-residents may also generate *congestion costs* that are ultimately borne by residents and non-residents alike. Nevertheless, if the demand for the local public good decreases with growing geographical distance from the provider jurisdiction (which is the case with most local public goods), then the benefit spillover is limited to the close-by areas. The effect may also be symmetrical or reciprocal between jurisdictions, so that an intervention by a higher authority is not always considered necessary. However, benefit spillovers are in any case inefficient insofar as they destroy the link between beneficiaries and taxpayers and incite the local government to provide the given service under the socially optimal level.

Indirect externalities exhibit greater variation. *Tax and expenditure competition* occurs when modifications in the tax (spending) policy carried out in one jurisdiction affect the tax (spending) policy of another jurisdiction. For both tax and expenditure competition, *some* competition is generally considered to be desirable as it makes citizens' preference patterns more transparent and encourages local governments to improve their performance in terms of quantity and quality of the provided local public services. Yet, local autonomy and the resulting competition also produce allocative inefficiencies in that they induce fiscal disparities in terms

of tax capacities and expenditure needs, and hence differences in the net fiscal benefit (NFB), across the jurisdictions. In reaction to these NFB differentials, individuals and enterprises will tend to move to areas with a higher NFB. From an efficiency point of view, this situation is undesirable because there will be more production factors located in the high-NFB areas compared to what would be rational regarding the long-term economic perspectives of the given area.

Although migration seem to benefit both the initial population of the jurisdiction (because the fiscal burden will be divided among a larger number of taxpayers) and the newcomers (because their NFB is higher than before), excessive competition is likely to be self-defeating. Tax competition imposes a downward pressure on tax rates, as a result of which the tax revenues will not cover but a part of the initial volume of local public services, while at the same time the higher concentration of the population would call for a higher level of government spending. Briefly, local tax rates are below the level that would be optimal for the satisfaction of the local demand for public services.

According to GILBERT (1999, p. 180 f.), it is not the decrease in tax revenues and public goods in itself that makes fiscal competition potentially harmful but rather the resulting *net effect*. In order to judge to what extent a specific situation of competition is harmful, the loss in terms of economic efficiency (suboptimal allocation of production factors, possible waste of public money in a jurisdiction) must be weighted against the beneficial effects of competition (e.g. decrease in the costs of taxed economic activities).

Expenditure competition encourages the overprovision of those activities (particularly infrastructure investments and the provision of direct subsidies) with which local governments can attract new individuals and enterprises to their jurisdiction. This type of competition may also become self-defeating and ineffective if, as a result of the mimicking of expenditure strategies, taxpayers are offered the same level of subsidies and very similar infrastructural advantages in every jurisdiction.

Indirect externalities exist also in the vertical relationship between different government tiers. A region may produce a vertical fiscal externality by increasing the rate of a regional tax whose tax base is co-occupied by the central government. While the region might raise more revenue through this measure, at the same time it will cause the common tax base to shrink and thus indirectly reduce the tax yield for the central government. This mechanism may work in the opposite direction as well. The problem with *overlapping tax bases* is that one government level sets its tax rates inefficiently high or low, ignoring the effect of its policy on the tax revenues of another government level. This phenomenon occurs also when the

60 local level cedes one of its competences to a higher level of government or when the task becomes centralised by power of a law. The higher level taking over the function will have less tax revenue to cover a unit of expenditure than before, while the lower level will enjoy the benefit of the marginal tax revenue it could save for other purposes. In order to avoid the vertical externality, the two tiers may make a sort of exchange agreement: the lower level must decrease its tax rates in order to allow an increase at the higher level. As a result, the original balance positions are restored while the overall fiscal burden on the taxpayers remains the same.

Finally, local autonomy generates vertical expenditure externality, or *expenditure interdependence*, when the expenditure decisions of decentralised authorities affect the budget constraint of the central government and vice versa. With every additional unit of resources spent by a lower-level government on productivity-enhancing activities such as education, the centre can realise additional revenues through the higher income (and hence, enhanced tax capacity) of educated individuals. Not being compensated for this positive external effect, the lower authority is not interested in providing such activities at the socially optimal level.

Other possible externalities include regulation externalities (regions impose regulations that affect non-residents; BOADWAY, 2001) and cost externalities (a change in the local fiscal policy affects the resource costs that are critical for the production of a public good in another jurisdiction; GILBERT, 1996, p. 332).

Apart from externalities, there are several other hurdles to allocative efficiency in a decentralised framework of public service provision. Quoting the example of developing countries, PRUD'HOMME (1994) states that centralised service provision (if sufficiently diversified) can potentially guarantee a better resource allocation also for the following reasons:

- If the main interjurisdictional differences are not in needs or preferences but in (household or tax) income, then the potential welfare gain from a better match between demand and supply is not very large, as the needs are already well known and thus need not be revealed.
- Locally elected mayors (i) may not have the necessary resources to satisfy local preferences, or (ii) they may not be sufficiently motivated to do so (if they do not run for re-election, or if re-election depends on personal sympathy instead of performance), or (iii) they may have to work together with a bureaucracy that does not follow their instructions.

Beside the obstacles to maximising allocative efficiency, local autonomy might also be contrary to the objective of productive efficiency:

- Local public goods and services whose production is characterised by important economies of scale are better provided in co-operation or by a higher-level of government. Primary education might be an example; however, the economies that a municipality can potentially realise from a higher scale of production must always be weighted against the arguments of accountability and geographical proximity (PRUD'HOMME, 1994).
- Many more local public services are characterised by economies of scope. Regional and national bureaucracies can work more efficiently as they have the opportunity to apply the same technology, strategy, staff, etc. to a range of different goods and services (PRUD'HOMME, 1994).
- Another type of inefficiency arises from shared responsibilities: designing a clear expenditure assignment system in which every tier has separate functions is difficult and leads unavoidably to overlapping responsibilities. Duplications may also occur horizontally: the major criticism pronounced against the so-called laboratory federalism is that each local government tries to 'reinvent the wheel' (DE VRIES, 2000).

OATES (2005) himself recognised that his earlier Decentralisation Theorem, according to which decentralised service provision is always more efficient than (or at least as efficient as) central provision, does not hold in all circumstances. If the centrally determined outcome might suffer from various kinds of inefficiencies, it is also true that these inefficiencies must be weighted against the misallocations occurring under a decentralised regime where local governments ignore the external effects of their actions or other implicit assumptions of the economic model of fiscal federalism are not met.

The trade-off between local autonomy and efficiency can be summarised as follows: centralisation allows a better co-ordination of public policies and thus an internalisation of spatial externalities and the exploitation of potential economies of scale and scope, whereas decentralisation fosters political accountability and innovation. How much local autonomy is desirable in a specific policy area depends on the balance of these two effects.

62 3.3.3 Trade-off with equity In the domain of equity, the discussion needs to be conducted at two different levels, namely, interpersonal and interjurisdictional equity.

Much has been said in the classical theory of fiscal federalism about why *interpersonal* redistribution policies should remain in central government hands. One of the main arguments is that decentralised income redistribution is likely to be less redistributive in the end than a centrally managed policy. While both reduce the maximum/minimum ratio of individual income compared to the initial situation, a more significant reduction can be achieved with central redistribution measures because average incomes are higher in the rich regions than in the poor ones (PRUD'HOMME, 1994). The other, more compelling argument is that decentralised interpersonal redistribution policies tend to be self-defeating: a local government that pursues an active redistribution policy is likely to induce an emigration of rich individuals and an immigration of the poor. With the decrease in the per capita income of the local constituency, the local government will find it difficult to sustain its redistribution policy (OATES, 1972, p. 7).

The question of *interjurisdictional* equity is quite a different one. It is not *why* decentralised governments are little adapted to pursue interjurisdictional redistribution (logically, none of them is rationally interested in designing such policies, if not for the sake of solidarity), but rather *how* local autonomy and decentralised service provision affect the distribution of welfare across the jurisdictions.

Today there is a consensus about the fact that fiscal decentralisation (and thus granting financial autonomy to local governments) inevitably leads to economic disparities between the jurisdictions. The early literature, however, was not undivided about the issue.

According to BUCHANAN (1950, p. 583), the core of the problem lies in the fact that every government unit is operating in a geographically limited territory and thus cannot withdraw more resources than those available in that territory.¹⁵ If government units are obliged to finance independently some of their functions, fiscal inequalities are not to be avoided unless fiscal capacities are equivalent across jurisdictions.¹⁶ We are confronted with a vicious circle. Rich jurisdictions have large tax bases that allow them to set their tax rates equal to the rates in other jurisdictions and provide more (or better) public services, or, alternatively, to offer

¹⁵Buchanan's model ignores, of course, the possibility of tax exporting which is anyway not the ideal answer of a local government to the problem of locally limited resources.

¹⁶By 'capacity', BUCHANAN (1950, p. 589) means simply income, but we could also add the endowment of the jurisdiction in natural resources, labour, capital, and other factors that facilitate economic development.

an identical level of services at a lower tax rate. Consequently, they can attract more households and enterprises than other jurisdictions can, thus further enhancing their tax base and the corresponding budgetary autonomy. As the size of the locally available tax base continues to diverge across regions, the gap between rich and poor jurisdictions becomes wider.

Fiscal inequalities as such do not constitute a problem: richer jurisdictions could have higher government outlays than poorer ones, possibly financing a greater volume of public services. The problem starts where the ‘social state’ intervenes in order to provide a wide range of public services, either equally to all citizens or upon the basis of individual need. Hence, the notion of fiscal justice has occupied a prominent position in the societal value system for decades, demanding an ‘equal treatment of equals’ not only *within* a jurisdiction but also *across* jurisdictions. As for the meaning of equal treatment, rather than considering only the tax side (equal tax burden for equals) as did the orthodox concept of fiscal justice, one should take into account both taxes paid and benefits received. According to BUCHANAN (1950, p. 588 f.), ‘[the] balance between the contribution made and the value of public services returned to the individual should be the relevant figure. This “fiscal residuum” can be negative or positive. The fiscal structure is equitable in this primary sense only if the fiscal residua of similarly situated individuals are equivalent.’ This equivalence should apply to the ‘combined fisc’ including the taxes and benefits offered in each of the superposed government units (e.g. municipality, region, and nation state) to which the citizen belongs.

In contrast to Buchanan who acknowledged interregional fiscal inequality as a necessary consequence of decentralisation, TIEBOUT (1956) regarded it as an abnormal phenomenon that can arise only temporarily, notably when the economy is hit by asymmetric shocks. Indeed, if the mobility assumption of the Tiebout model were realistic, the migration of production factors would automatically eliminate interregional disparities. Key to this mechanism is the variation of *fiscal pressure* across regions. People in low capacity jurisdictions are subject to greater fiscal pressure (i.e. higher taxation or fewer benefits from public services) than people in high capacity areas are.¹⁷ The differential provides an incentive for individuals and enterprises to move to the areas of least fiscal pressure, and migration will continue until the point where fiscal pressure becomes identical across all jurisdictions.

This mechanism works fine in the context of perfect and costless mobility, even

¹⁷The term ‘fiscal pressure’ is closely related to the notions of ‘fiscal residuum’ and ‘net fiscal benefit’ (NFB): high fiscal pressure corresponds to a low or negative fiscal residuum or NFB (the latter is a net burden) and vice versa.

64 though it is likely to lead to distortions in the optimal allocation of resources and hence produce an inefficient outcome. Just as differentials in the fiscal pressure (or NFB) induce fiscal inefficiency, so they lead to fiscal inequity. However, as BOADWAY (2001) puts it aptly, while NFB differentials cause inefficiency to the extent that they induce the migration of people and capital, they cause fiscal inequity to the extent that this migration *does not occur*. Hence, the principles of fiscal efficiency and fiscal equity are intrinsically interrelated.

In reality, mobility is far from being perfect, which explains why virtually all countries in the world struggle with substantial (and in some cases, growing) interregional disparities. Besides, a poor region is usually not only poor in terms of income but also in terms of natural resources, infrastructure, economic opportunities, agglomeration economies and other factors (PRUD'HOMME, 1994). Differences often have their origin in the history of the various regions (experience with specialisation, industrialisation, etc.). Even if mobility were perfect, it is hard to believe that it could eliminate the existing inequalities stemming from such a variety of circumstances. The existence of horizontal fiscal disparities is thus a natural and necessary consequence of fiscal decentralisation in a setting without perfect mobility, and the role of the central government is to eliminate, as far as possible, the inequitable part of these disparities.

The question of *what* counts as inequitable and needs to be corrected has been studied with various approaches.

First, the principle of horizontal fiscal justice, i.e. the equal treatment of equals across all jurisdictions, can be differentiated upon whether one envisages actual or potential equality. According to the first interpretation of the principle, any individual should have the assurance that in whichever region of the country he may desire to live, the overall fiscal treatment he receives will be approximately the same. The second, weaker interpretation relies on a practical compromise: the equity objective is reached when all jurisdictions have the necessary resources to implement policies that are horizontally comparable, though they may choose not to do so.¹⁸

The implications for local autonomy are different in the two cases. If local governments are required to offer comparable net fiscal benefits, they need to harmonise their policies with regard to taxes and expenditures, which implies a major cutback on their autonomy. In the second case, they simply receive an opportunity to achieve similar results as other jurisdictions, but it is up to them to decide whether they wish to make use of this opportunity or not. Inequalities resulting

¹⁸BOADWAY (2001) reserves the term 'fiscal equity' for this second interpretation of the principle.

from a non-use of the granted opportunity are not considered as inequitable and hence do not need any further correction.

Second, as DAFFLON and VAILLANCOURT (2003) point out, one has to distinguish between ‘natural’ inequalities that are related to the respective *situations* of local governments and those inequalities that arise from their (management) *choices*. Situational factors such as topographic and demographic conditions constrain the ability of local governments to provide an attractive combination of taxes and public goods; therefore, reducing situational inequalities is most often the first and most important domain of national equalisation policies. By contrast, inequalities resulting from a free choice need not be corrected by the centre.¹⁹

Third, a similar distinction can be made with regard to the citizens’ choice of location. The individuals’ choice of a region or city of residence mainly depends on their private or professional situation (‘localisation subie’), but within an urban agglomeration, they base their choice upon the relative performance of competing municipalities in terms of taxes and public services (‘localisation choisie’). According to GILBERT (1999, p. 184), fiscal equalisation policies should aim to correct interurban inequalities but not intra-urban ones.

The three approaches partly contradict each other. For instance, a small municipality in the periphery of a large urban area might be afflicted with a high rate of unemployment and therefore obliged to spend a significant share of its budget on social aid. This situational disadvantage makes the municipality unattractive to potential in-migrants; yet, according to Gilbert’s proposal, the jurisdiction should not benefit from any equalisation measure, since intra-urban migration decisions are always discretionary and not depending on exogenous factors.

In summary, owing to the imperfect mobility of production factors, decentralisation (and hence local autonomy) fosters regional economic segregation. Local autonomy and horizontal interjurisdictional equity are thus competing objectives and normally none of them is unilaterally privileged in practice. How much inequity is tolerable and at what price (in terms of gain in local autonomy) depends on the prevalent value judgments in the society.

¹⁹See also GILBERT (1999, p. 183 f.) and DAFFLON and MISCHLER (2008)

66 3.3.4 Trade-off with stability Just like the trade-off between local autonomy and equity, the trade-off with stability can be analysed from two perspectives: first, the capacity of local governments to pursue macroeconomic stabilisation policies, and second, the impact of local government action on the stabilisation efforts of the centre.

The classical literature of fiscal federalism (see e.g. OATES, 1972, p. 4 ff., or MUSGRAVE and MUSGRAVE, 1976, p. 624 f.) is mainly concerned with the question why the macroeconomic stabilisation function should be centralised rather than decentralised. As for the monetary policy, if each government unit were allowed to create money, this would generate an incentive to rapid and irresponsible monetary expansion with serious consequences for macroeconomic stability. The other option, stabilisation through decentralised fiscal policy, is doomed to failure because local jurisdictions are typically small and open economies. The spending and taxing measures of municipalities have a negligible impact on national global demand, and even if they had an impact, it would be outside their jurisdiction. A local authority pursuing a policy of macroeconomic stabilisation should bear the full cost of its action while reaping only a small part of its benefits. For this reason, decentralised governments have no incentive to undertake any stabilisation measure, so that this task must necessarily be assumed by the centre. Anyway, in order to affect aggregate demand in an economy, the authority in charge of the stabilisation policy needs to control a significant part of the total taxes and public sector outlays, which is obviously not the case at the local level of government. These traditional views have been partly challenged by KING (1984, p. 37 ff.) who advocated a role of local governments in shaping the national stabilisation policy. Views and preferences related to the choice of a macroeconomic policy may vary from one area to another. Taking them into consideration could cater variations in local tastes concerning the rates of growth, inflation and unemployment that behave similarly as public goods (characterised by non-rivalry and non-excludability).

What is more interesting in the context of local autonomy, however, is the second aspect of the trade-off, namely, the *impact* of local autonomy (and decentralisation) on the macroeconomic stability of the country. Here, four factors should retain our attention:

1. On the expenditure side of the local budget, overlapping responsibilities and weak accountability may create an upward bias in local spending, with potentially serious consequences for the position of the overall national budget (OECD, 2003, p. 155 f.). Massive open-ended grant programmes are likely to reinforce this effect. However, not only the absolute growth of local govern-

ment outlays can jeopardise the national balance of payments but also the changes in the composition of these outlays, even if the local budget remains in balance. The structure of local expenditures could shift in favour of items that have a substantial impact on aggregate demand (such as transfers to individuals with a high marginal propensity to consume) or are particularly sensitive to business cycles (such as unemployment benefits). For the sake of macroeconomic stability, the centre should retain responsibility for such functions (TER-MINASSIAN, 1997b, p. 5).

2. On the revenue side, if local governments rely heavily on grants and transfers for financing their budget, this again can have a negative impact on macroeconomic stability (OATES, 2005). Weak accountability, fiscal illusion and the resulting expansion of local spending provide here for a lever effect. Extensive borrowing and the accumulation of debt may be equally dangerous if the local operational budget is too thin to cover debt repayment and interest costs.
3. Both sides taken together, macroeconomic imbalances often find their origin in unfunded mandates assigned to lower authorities. If local units are to prevent deficits in their own accounts, they may choose between raising additional taxes and cutting expenditures. When both options have been exploited to the maximum and there is still a deficit, or when the local government is reluctant to finance the mandate out of its own revenues, it is likely to request a bailout from the higher authority.
4. A decentralisation of the borrowing power to lower-level authorities may also lead to macroeconomic imbalances, particularly if borrowing limits are inexistent or ineffective and the budget responsibility of policymakers at the local levels is weak. Again, heavily indebted local units can temporarily solve their problems by requesting a bailout from the central government, but the overall impact on the national economy can be devastating. A vast literature has emerged from the 1990s to deal with the issues of hard budget constraints and the attitude of central governments towards bailout. The details are not considered here, as they would bring us far away from the question of local autonomy versus stabilisation.²⁰

Nevertheless, points 3 and 4 allow us to make an important point: the larger the share of local spending financed by own-source revenues, the more a local authority

²⁰For a most recent overview combined with country experiences, see VIGNEAULT (2007).

68 in financial distress can be expected to make the necessary adjustments itself by raising additional taxes. By contrast, where the local public sector depends heavily on grants and transfers, the centre cannot credibly deny bailout, as otherwise local governments would have to curtail some important local public services (VON HAGEN and EICHENGREEN (1996)). A cross-national data analysis by RODDEN (2002) reveals that long-term balanced budgets among local authorities are found either when the centre imposes borrowing restrictions or when the decentralised governments have a high degree of both tax and borrowing autonomy. Large and persistent deficits occur when municipalities are dependent on intergovernmental transfers but, at the same time, free to borrow. This combination is found most frequently in developing countries and post-socialist transition economies as well as among the constituent units of some federations.

Another issue related to the trade-off between local autonomy and stability is the co-ordination of national and local fiscal policies. In countries with explicit balanced budget rules prohibiting a deficit (such as Switzerland or the USA), the fiscal stance of decentralised governments can be inherently pro-cyclical. However, in most other countries, local fiscal policy (if it exists) is rather counter-cyclical or follows its own rhythm that does not necessarily correspond to the national cycles. As long as the economy faces no serious imbalances, national stabilisation policy can be more successful if the centre involves local authorities in macroeconomic management and gives them a share of the responsibility for the achievement of national macroeconomic objectives (TER-MINASSIAN, 1997b, p. 23).

Another argument in favour of a broader co-operation among government levels in macroeconomic stabilisation derives from the limited capacity of the central government to act alone (AYRTON, 2002; DAFFLON, 2006, p. 276 ff.). Even if one is willing to admit the central government's prerogative of managing the overall demand and recognise its full legal, institutional and managerial capacity to react rapidly to cyclical movements, it is not sure that the centre alone would have the necessary budget size to perform this task. Decentralisation may be such that the centre commands only a small fraction of public revenues and expenditures or these factors are too rigid and cannot be mobilised for macroeconomic purposes on the short term, whereas municipalities control a substantial share of consumption and public investment, but being small and open economies, they are not interested in pursuing stabilisation because of the externalities that such an action would produce. In such a setting, stabilisation policy requires consensus and co-operation among the government tiers.

3.3.5 Trade-off with political objectives

Even though two of the main arguments in favour of decentralisation are to foster citizen participation and to improve democratic control over public policies, under certain circumstances, local autonomy may compromise also these political objectives. Two phenomena merit our attention here.

1. Local elections and referenda tend to have lower turnout rates than regional and national ballots, owing to the fact that complex national policy issues with multiple consequences generally capture citizens' attention more than the small-scale problems of their own local community (see Section 4.4 and DE VRIES, 2000). Hence, even though people can exert a greater influence on local affairs due to their proximity to municipal decision-makers, the 'interest effect' may offset a part of this advantage.
2. Especially the smallest local government units experience what the Swiss call 'tacit elections'.²¹ Elections are tacit if there are more mandates (seats) to be allocated than there are candidates, so that the local electoral committee has to declare all persons named for the local council to be elected. This is likely to occur when the municipality is so small that it is difficult to find a sufficient number of suitable candidates for political functions. The fragmentation of the territorial structure of a country increases the likelihood of tacit elections. Beside the absolute size of the village, two further factors explain the difficulty to find motivated and skilled persons. First, the mayor's position that used to promise some social reputation a few years ago becomes now less and less attractive because of the increasing personal responsibility, the growing complexity of projects and political procedures, and the lack of technical, human and financial resources available to the incumbents. Second, as the size of the jurisdiction decreases, the local government's effective room for manoeuvre is reduced; consequently, future mayors cannot expect to provide a satisfactory level of local public services through the independent management of local affairs. The outlook of losing a part of their autonomy in the event of a co-operation with other municipalities is not necessarily attractive. Yet in the end, tacit elections jeopardise the local supply of public policies, so that such a situation cannot persist but for a short period of time, after which the amalgamation with a neighbouring municipality might seem to be the only viable option.

²¹The term is originally used in the context of National Council elections (see the Federal Act on Political Rights of 17.12.1976, status on 22.10.2002, no. 161.1, art. 45), but today it is increasingly used to indicate similar problems at the local level (CANTON DU JURA, 2003).

70 3.4 The concept of local financial autonomy

3.4.1 Components and constraints We saw in Section 3.1.2 that local autonomy cannot be meaningful unless local authorities possess adequate sources of financing. Whether a given competence is delegated from a higher-level government or assumed voluntarily by the local authority, it necessarily gives rise to certain expenditure needs. In order to satisfy these needs at a given cost, local authorities must design specific expenditure programmes for which they need financial resources. Finally, they must have sufficient capacity and flexibility in budgeting so as to ensure a match between the level of resources and the actual spending level.

Based on these interrelations, we may define local financial autonomy as the combination of the following three elements:²²

1. *Local expenditure autonomy*: the right and the ability to determine the nature and size of overall local public expenditure and its breakdown in various public goods and services in accordance with the demand of the local constituency, as well as the right and the ability to manage local property;
2. *Local revenue autonomy*: the right and the ability to determine the origin and the amount of financial resources, the rate at which the various groups of beneficiaries shall contribute to the common pool, as well as the way the pool (or specific types or units of resources) are used;²³
3. *Local budgetary autonomy*: the right and the ability to adjust revenue levels to spending levels across the various domains of public intervention, both within one generation of taxpayers (via taxes and fees) and between successive generations (inter-temporally, via debt). Budgetary autonomy is thus the right and the ability to modulate the local budget constraint both statically and dynamically. Additionally, it requires local authorities to assume (financial) responsibility for their decisions in front of their constituency.

²²This typology is adapted from an article published by GUENGANT and UHALDEBORDE (2003, p. 428 ff.) who drew inspiration from GILBERT (1999). Their definitions treating autonomy as a *right* are completed here with the notion of *ability* in the spirit of the European Charter of Local Self-Government. There are several other typologies in the literature as well, e.g. DELLA SANTA (1996, p. 98 f.), DAFFLON and PERRITAZ (2000, p. 4 ff.). In addition to the multitude of approaches to classify local financial autonomy, there are also disagreements on the definition of key terms; conversely, sometimes several different labels are attached to the same concept.

²³Decisions on the way financial resources are used pertain, from a theoretical point of view, to both expenditure and revenue autonomy. In order to avoid duplications, we will treat them under revenue autonomy.

In practice, not even in mature federal systems can perfect sovereignty in all three domains ever be achieved; on the other hand, full dependence is also extremely rare if it exists at all. With regard to each component of local financial autonomy, local authorities are normally situated on a continuum between these two extreme positions. Like local autonomy in general, local financial autonomy is not a question of all or nothing but a question of degree.

The decisive factor that determines the actual position of a local government unit in the spectrum (and thus its effective autonomy) is the totality of exogenous constraints imposed on its revenue autonomy, expenditure autonomy, and budgetary autonomy. Exogenous constraints are limits imposed by factors or agents from outside the local government unit. In order to capture their great diversity, we propose two dimensions of classification.

According to their nature, exogenous constraints can be of

- *legal* nature, if they emanate from written legislation. Considering local autonomy as the right and the ability to manage local affairs, the totality of legal restrictions determines the first part of the definition, namely, the *right*.
- *non-legal*, e.g. geographic, demographic or socio-economic nature. Non-legal constraints determine the second constitutive element of local autonomy, namely, *ability*.

According to their effect, exogenous constraints can be

- *direct*, if they apply to the local government unit itself;
- *indirect*, (a) if they apply to another government unit (either at the same level or at a different level of government) directly but have an impact on the autonomy of the local government itself; or (b) if they apply to one domain of intergovernmental fiscal relations but have an indirect impact on the local government policy in another domain.²⁴

²⁴An earlier draft of this thesis distinguished only between formal and informal constraints. It defined formal constraints as those emanating from the design of intergovernmental fiscal institutions and thus being anchored in the higher-level legislation (similarly to legal constraints in the present draft). Informal constraints were defined as those having a more subtle (in any case, not formalised) character. In that model, formal restrictions ('deduced' in some way from the state of perfect sovereignty) determined the *formal autonomy* of a local government unit. Informal restrictions imposed an additional limit that ultimately led to the *effective autonomy*. The approach was perhaps closer to the concept of formal vs informal institutions elaborated by the adherents of the New Institutional Economics (a constraint being also a sort of institution), but it did not allow a distinction as to whether the constraint applies to local governments directly or indirectly.

By definition, legal constraints are invariably exogenous, since they result from higher-level legislative procedures. Citizens may be, but need not be, directly involved in these procedures. However, even direct participation would not make these constraints endogenous: if a decision is taken through regional or national referendum, the influence of an individual voter and even that of a local community is negligible. Citizen participation at the higher level is thus not a form of local self-determination.

As for the non-legal constraints, the picture is more differentiated. While topographic and climatic constraints cannot be but exogenous, the demographic and socio-economic situation of a local community is (at least in part) a product of former decisions taken by the same community. For instance, by pursuing an innovative child and youth policy, a local government is likely to attract young families into the jurisdiction, thus improving the demographic profile (and possibly the socio-economic situation) of the latter.

If exogenous constraints are those that derive from outside the local government, endogenous constraints emerge from inside, namely from the present and past choices of decision-makers within the organisation. The latter include, by way of example, spending commitments, horizontal yardstick competition (in tax or expenditure policies) and go/no-go decisions concerning interjurisdictional co-operation. To give a more tangible example, even if local governments are permitted by law to introduce a certain category of tax with a rate of up to x per cent, some of them will decide not to make use of this right in order to stay attractive in the interjurisdictional competition for mobile taxpayers. Hence, the economic environment may be such that it encourages or discourages certain choices within the framework of exogenous constraints. In this and the following chapters, we will treat exogenous and endogenous constraints differently. While exogenous constraints will be investigated systematically, endogenous ones will merely be illustrated with a non-exhaustive series of examples. There are two good reasons for this methodological choice.

First, exogenous constraints may be numerous but they are never countless; in addition, they can be clearly identified and, in some cases, even their effect can be measured. By contrast, there is an infinite variety of endogenous restrictions on the financial autonomy of local governments: there can be virtually as many of them as there are particular decisions of particular local governments in response to a particular situation or economic environment.

Second, the local community may well see its room for manoeuvre being reduced by the consequences of decisions taken by either the incumbent local decision-makers or their predecessors. However, these decisions are genuinely autonomous;

they have their origin in an act of sovereignty, even if the current incumbents had no opportunity to participate in the decision-making. Therefore, we do not consider them as veritable restrictions on local autonomy.

In the following sections, we are going to take a closer look at the exogenous and endogenous constraints in each of the three domains of local financial autonomy.

3.4.2 Expenditure autonomy In very general terms, the sense of expenditure autonomy is the right and the ability of local governments to manage public property and funds in the interest of the local community. The latter term implies that public resources are to be spent on goods and services in a way to meet the demand of the local constituency. Therefore, first, local expenditure autonomy is equivalent with the freedom to decide *which* goods and services shall be financed from the local public budget and how much money shall be spent on each of them. Second, expenditure autonomy also includes the freedom to decide *how* these goods and services shall be produced or delivered. With regard to both questions, autonomy also implies the ability of the local government to implement the decisions.

The distinction between expenditure responsibility (what to provide) and service delivery (how to provide) is an important one. The assignment of a public expenditure function to a local government unit does not automatically mean that the latter will carry out all related tasks on its own. In the modern public sector, the production of goods and services is separated from the policy decisions concerning the choice of public services to be provided. In their vision of a catalytic government, OSBORNE and GAEBLER (1993, p. 25 ff.) see the local government as the steering organisation that defines policy objectives and priorities on a democratic basis and cares about the fundraising that allows their realisation. The (physical) delivery of goods and services that serve these objectives and priorities can be assumed by agents other than the municipality, such as public and private enterprises, non-profit organisations, (a bureau or an enterprise of) another local council or another level of government. These are called the rowing organisations. As DAFFLON (1999, p. 107) observes, one of the major differences between the markets of private and non-private (public or mixed) goods and services is that in the former one, the functions of demand ('fonction de demande') and supply ('fonction d'offre') meet directly, whereas in the latter one, they are most often separated by a third function, namely service delivery ('fonction de production').

Figure 3.3 demonstrates the relationship between the three forms of decentralising public expenditure functions, on the one hand, and the dichotomy of steering vs rowing, on the other.

Form of decentralisation	Type of expenditure function	Steering organisation	Rowing organisation
Deconcentration	Mandatory functions	Central government	Central government / prefect / local agency of line ministry (alternatively: subnational government)
Delegation	Mandatory functions	Central government, subnational government	Subnational government
Devolution	Demand-driven mandatory functions	Subnational government	Subnational government
	Optional functions		

Figure 3.3: **Steering and rowing in decentralised systems [Source: the author]**

By means of deconcentration and delegation, the central government imposes mandatory functions on local governments. There are, however, differences in both steering and rowing. Deconcentrated tasks are managed by the central government and executed (uniformly) by either a local agent of the central government or the municipality itself which then usually employs its own administrative capacity. In the delegated functions, the local government may decide to ‘buy’ the related services from another provider, but it remains accountable to the higher level government for meeting some pre-defined quality and quantity targets. For sure, every municipality has the option to provide more and/or better services than the compulsory minimum, but this alone does not turn a mandatory function into an optional one. Optional functions can only be created through genuine devolution. Their key characteristic is that municipalities are free to assume or abandon them according their preferences (more precisely, according to the preferences of the local constituency) and that there are no higher-level targets to respect with regard to quantity or quality.

A specific expenditure category that we call ‘demand-driven mandatory functions’ is situated on the borderline between delegation and devolution. The functions belonging to this category are related to local public goods and services that municipalities are not obliged to provide unless a certain share of the population (as specified in the relevant national law) demands them explicitly. The fact that

	Exogenous		Endogenous (examples)
	Legal	Non-legal	
Direct	Statutory assignment of responsibilities (devolved vs delegated or deconcentrated functions) Quality and quantity standards; other sector-specific regulations on service delivery	Topographic, demographic, socio-economic, environmental etc. conditions Small jurisdiction size in absence of a potential for efficient co-operation	Spending commitments resulting from past decisions Interjurisdictional co-operation
Indirect	Competence transfer		Interjurisdictional yardstick competition Spatial spillover effects

Figure 3.4: **Constraints on subnational expenditure autonomy**
 [Source: the author]

these responsibilities are in principle optional (devolved) but may become mandatory explains why they are on the borderline between delegation and devolution. In Switzerland, for instance, day care for babies and toddlers falls into this category of public goods.

In a decentralised system of government, both the steering (supply) and rowing (production/delivery) autonomy of local authorities are subject to certain constraints. Figure 3.4 provides an overview.

Direct legal constraints on expenditure autonomy The autonomy of local authorities to manage the expenditure side of their budget (steering) depends to a critical part on the *statutory assignment of responsibilities* among the different government tiers. In the domains assigned to higher levels of government for reasons of efficiency or interregional equity, local authorities can at best serve as executing agents of the higher authority. In this deconcentrated part of public expenditures, both service supply (steering) and service delivery (rowing) are determined by higher-level legislation. While local agents are involved in the delivery of the given services and participate in their financing, they have no power to influence the overall supply. In some cases, they do not participate in the delivery but are obliged to contribute to the costs incurred by the higher (executing) government.

Local expenditure autonomy is also compromised, though to a lesser extent, in the domain of delegated services. Clearly, the steering autonomy is reduced insofar as the law obliges municipalities to provide these services regardless of the actual preferences of the local constituency. At the same time, the rowing autonomy is compromised, too, notably through *quality and quantity standards* and *other sector-specific regulations* that define various service parameters of service delivery, such as teacher selection and working conditions, or the maximum number of pupils per class. Sector-specific regulations affect local expenditure autonomy insofar as they do not allow the volume of spending on the given function to drop under a certain minimum level. The rules may be so stringent that they leave hardly any leeway to local governments (MARCOU, 1999, p. 39 f.). Full autonomy concerning the questions of whether to provide a particular service and if yes, how, is realised only in the domain of genuinely devolved functions. Such functions, however, are extremely limited in number. Correspondingly, only the share of spending on devolved functions in total outlays can give a reliable indication of local expenditure autonomy. As soon as delegated tasks are also considered, the result will be biased.

Indirect legal constraints on expenditure autonomy Such a restriction could arise from a legal rule that applies to one local government category but affects another one, or from a rule that restricts local autonomy in an expenditure domain other than the one in which the rule applies. Chapter 5 will demonstrate the system of *competence transfers*, a specific rule applied in Hungary that allows municipalities to shift competences to, and take over competences from, the counties, with significant consequences for the autonomy of both tiers.

Direct non-legal constraints on expenditure autonomy *Topographic, demographic, socio-economic, environmental and other conditions* exert an influence on both the expenditure needs and the costs of service provision, and hence on the nature and volume of local public expenditures. For instance, villages situated directly along riverbanks need to spend more on flood protection than others situated further inland. Towns coping with structural economic problems need to spend a larger share of their resources on unemployment benefits and social services than municipalities without such difficulties. Constructing roads and bridges in a mountainous area involves higher costs than the same investment in a flat area. Sewage treatment is likely to be more expensive in sensitive geographical areas. A village that, for historical reasons, happens to be

situated in a water protection area (an area declared as such by upper-level legislation) can hardly lobby at the ministry against its classification as a sensitive region, and thus it sustains a loss in terms of expenditure autonomy for environmental reasons. Since water protection is subject to national environmental regulation in most countries, the direct non-legal (geographical) constraint in this case is matched with a direct legal constraint.

Second, in policy areas characterised by growing economies of scale (e.g. primary schools, sewage systems), *small jurisdiction size* imposes a natural limit on local spending decisions: the above-average costs of service provision drain away useful resources from other policies. One means of overcoming this natural limit is to co-operate with the neighbouring jurisdiction(s), which is also the most reasonable option as long as the costs of this action do not exceed the benefits (or the loss suffered from non-action).²⁵ Therefore, low economies of scale resulting from small jurisdiction size become a hindrance to expenditure autonomy if, and only if, topographic or other exogenous conditions prohibit the small community from co-operating with its neighbours. A remote village at the back of a deep valley can hardly be expected to run the primary school in collaboration with municipalities that are situated in a parallel valley over the mountain: the cost of co-operation in this case would most probably exceed the loss incurred through small-scale service provision.

Selected endogenous constraints on expenditure autonomy Even if the law provides local authorities a certain degree of expenditure autonomy (and it usually does, otherwise decentralisation would be hollow) and in the hypothetical case that this is not compromised by any demographic or socio-economic factor, a local government unit might decide *not* to make use of certain elements of this autonomy for various reasons.

One such reason is a *spending commitment* made by the local legislative in an earlier period that has an effect on the expenditure plan in the current period (DAFFLON and PERRITAZ, 2000). A mandatory outlay of this type restricts the room for manoeuvre of the local executive insofar as the earmarked resources are not available for alternative purposes. If, for instance, a local government decree prescribes the categories of personnel that need to be engaged in the different municipal institutions, then the salaries might be determined independently by

²⁵Here, we leave aside the question about the new constraints that a co-operation agreement can possibly impose on the participating local authorities. As has been explained in Section 3.4.1, normally it is up to the local governments to decide whether they wish to work together or not, and the decision itself is an act of exercising local (political) autonomy.

78 the incumbent local executive, but the payroll tax is a compulsory expenditure item over which the executive has no control. The interest and repayment rates related to debt incurred in an earlier period offer another example, as well as the maintenance and operation expenses of the infrastructure that was financed with the debt.

An example of a possible constraint emerging not from past but from current decisions is the suboptimal jurisdiction size that prohibits certain local governments from providing local public services in an efficient and cost-saving manner. Unless there are overriding political or cultural considerations or objective physical (e.g. topographical) obstacles, small local communities could eliminate this kind of constraint by seeking co-operation with other jurisdictions.

If insisting on self-sufficiency is likely to reduce the local government's room for manoeuvre, this does not mean, however, that *interjurisdictional co-operation* will invariably increase it. A local authority that signs a co-operation agreement with one or more neighbouring jurisdictions is expected to give up some of its autonomy for the sake of the common interest.²⁶ The quality and quantity of the supplied public goods will be a result of negotiations in which the parties cannot enforce their preferences to the same extent (DAFFLON and PERRITAZ, 2000). In spite of this fact, co-operation among municipalities and regions is relatively widespread in some countries and strongly encouraged by central government in others because of the positive impact of co-operation on the efficiency of local service provision and even on local autonomy. The positive impact is manifested in an increasing room for manoeuvre for the member municipalities due to greater economies of scale, reduced competition among the partners (insofar as competition was rather harmful than beneficial), and a possibly enhanced fiscal attractiveness of the combined jurisdiction. Also the fiscal incentives provided by the centre may partly compensate for the loss of autonomy incurred at the institutional level of co-operation. It seems that whether the municipality co-operates or not, it will lose part of its autonomy, but in the case of co-operation, the short-term loss of direct (decisional) autonomy is likely to be compensated in the medium and long run. This is why voluntary intermunicipal co-operation for GILBERT (1999, p. 171) is a process of 'creative destruction' of local autonomy: by abandoning the quest for individual sovereignty, municipalities develop and strengthen their common room for manoeuvre within a larger territory.

Interjurisdictional yardstick competition in expenditure policies typically leads

²⁶The rare case of forced co-operation is not treated here, but logically, it would constitute a direct legal constraint on local autonomy.

to situations where the participating local governments deliberately choose *not* to exploit their formal spending powers in order to keep up with their competitors. Municipality A may have little interest in offering a generous welfare policy to its constituency if the surrounding jurisdictions B, C, and D are parsimonious in this respect; otherwise, the needy would migrate from all directions to A, creating there additional demand for these costly services. Even if A cannot influence the behaviour of the neighbouring local governments, this type of constraint is endogenous: the migration effect would not appear if the local governments chose not to compete against each other (if, for instance, a higher-level authority systematically compensated for the additional costs incurred by A). Doing less than what is in one's power is also a manifestation of autonomy.

Certain *spatial spillover effects* may also induce horizontal strategic interactions in which the autonomous decision of one local government unit restrains the freedom of the neighbouring jurisdictions with regard to the choice and volume of local public expenditures. If, for example, municipality A manages to chase away criminals through increasing local spending on police, this is likely to induce the nearby municipalities B and C to increase police expenditures on their turn in order to keep the migrating criminals off (ELHORST and FRÉRET, 2007). The expenditure autonomy of B and C is indirectly restricted insofar as they have fewer resources left for other expenditure programmes. It is important to note, however, that B and/or C could also decide *not* to increase spending on police, although in this case, they could see the escalation of criminality in the subsequent years, inducing further costs (that may exceed the costs of crime prevention) and possibly negative externalities as well.

Yet, not every spillover effect reduces local expenditure autonomy. The air pollution abatement undertaken in jurisdiction D creates a positive spillover effect that allows the neighbouring jurisdictions E and F to spend less on the same task than they would spend in the absence of the externality (BRUECKNER, 2000, 2001). In both cases, E and F could very well decide to spend more (hence their expenditure autonomy is intact) but, understandably, they have no incentive to do so.

80 3.4.3 Revenue autonomy Revenue autonomy allows local governments to finance independently, and according to the local preferences, the plan of voluntary and delegated expenditures approved by the voters.

Concerning the voluntary expenditures, revenue autonomy includes the freedom to decide about the redistributive character of local taxes and fees as well as about the way the revenues are used. The decision about the redistributive aspect implies the choice between benefit principle and ability-to-pay principle with regard to the form of taxation, as well as the design of rates and deduction rules that ensure an efficient and equitable allocation of the fiscal burden among taxpayers (DAFFLON, 1992, p. 27). For the capital budget in particular, revenue autonomy means the right to choose the funding source and, in case of debt financing, the right to define an amortisation policy for each investment programme. Here again, an autonomous local government is free to decide whether, and if yes, how to share the financial burden of the investment among current and future generations of taxpayers.

As for the delegated expenditures, the higher-level government that delegates the task and retains ultimate responsibility for its execution normally offers some co-financing to the lower level in the form of a grant. It is most likely to provide further assistance in order to compensate for vertical fiscal imbalances possibly resulting from the mismatch between the financial means and the expenditure needs of a local government unit, as well as for the horizontal fiscal imbalance arising from the inconsistency between revenue-raising ability and spending needs of authorities at the same level.²⁷ Revenue autonomy in the context of intergovernmental transfers and grants means the influence of local governments on the size of the distributable pool and the distribution formulae as well as their level of discretion with regard to the use of transferred resources.

The origin and the amount of local revenues, the way of sharing the fiscal burden within and among generations of taxpayers, as well as the use of specific revenue categories and individual revenue units are again subject to a variety of constraints (see Figure 3.5).

²⁷For an overview of the instruments correcting vertical and horizontal fiscal imbalance in the decentralised budget, see e.g. BOADWAY (2007) or DAFFLON and MADIÈS (2008).

	Exogenous		Endogenous (examples)
	Legal	Non-legal	
Direct	Statutory assignment of resources (own vs. transferred revenues) Statutory rules on local taxes and user charges Conditions on grant eligibility and spending purpose Fiscal equalisation	Ignorance of local government interests in higher-level negotiations about grant parameters Low productive efficiency of own-source revenues Demographic and socio-economic conditions	Fear of loss of popularity as a consequence of increasing taxes / user charges
Indirect	Frequent amendments to the legislation on local taxes and grants Weak local tax effort due to penalising grant system Weak local tax effort due to 'fiscal crowding-out' Overlapping tax bases	Low productive efficiency of revenues feeding the grant system	Interjurisdictional tax competition

Figure 3.5: **Constraints on subnational revenue autonomy** [Source: the author]

82 *Direct legal constraints on revenue autonomy* Contrary to the statutory assignment of expenditure responsibilities where local autonomy was unfettered for the devolved functions and limited for the delegated and deconcentrated functions, the *statutory assignment of resources* provides only a preliminary and not truly reliable impression of local revenue autonomy. The classical textbook theory pretends that, from the point of view of local autonomy, own-source revenues (local taxes, user charges, fines, revenues from leasing and sale, loans, etc.) are always preferable to transferred ones. Practical experience shows, however, that a well-designed transfer system can grant a higher level of autonomy to local governments than an overly restrictive national legal framework on local own-source revenues.

Statutory rules on specific parameters of local taxes and user charges (tax base assessment, exemptions, deductions, rates, earmarking of user charge revenues, etc.) impose a direct constraint on local revenue autonomy. The rules may be even so stringent that local taxation hardly enhances revenue autonomy at all. National or regional laws on local revenues may enumerate the admissible tax types, set upper or lower limits to rates, define the rules of tax base assessment, or oblige local governments to earmark revenues from user charges for the respective policy area. In more extreme cases, tax or user charge regulations adopted by the local legislative are subject to formal approval by higher authorities.

The degree of autonomy that *intergovernmental transfers* provide to municipalities depends on the *legal specifications concerning the size of the grant pool, eligibility, and spending purpose*. Grants are particularly supportive of local autonomy if the eligibility criteria are determined in an objective way and the allocated amounts are not earmarked for specific spending purposes. Likewise, a revenue sharing arrangement (normally consisting of block grants) can give local governments an almost complete control over their revenue flows if the sharing rule is laid down in the constitution or another organic law and/or municipalities can negotiate the size of the pool and the distribution formula (OWENS and NORREGAARD, 1991). Also a local surcharge on a regionally or nationally administered tax (the so-called piggyback tax) can be regarded as a local own-source revenue if local governments are free to determine the rate and to collect the tax on their own, or, in case it is collected by the regional or national authority, if the redistribution of the revenues to local governments follows the origin principle. By contrast, the power to vote on the local tax rate, commonly considered as an essential attribute of local tax autonomy, does not automatically ensure a sufficient amount of revenues to offer a satisfactory level of public services (GUENGANT and UHALDEBORDE, 2003, p. 430; MARTINEZ-VAZQUEZ et al., 2006, p. 21).

Does revenue structure matter for local autonomy? The classical literature is divided about this question. King starts from the idea ‘that the authorities *are in receipt of grants* to encourage them to take externalities into account when deciding on their service levels, and, perhaps, some grants to enforce grantor preferences. The question then arises of how they should finance the *rest* of their expenditure requirements’ (KING, 1984, p. 199; emphasis added). For financing this residual amount of spending, he proposes five possible sources: revenue sharing, tax (base) sharing, local taxes (accompanied by a system of equalisation grants), user charges, and loans.

The more widespread reasoning goes the other way round. Based on the principle of fiscal equivalence (OLSON, 1969) and the notion of budget responsibility, it holds that ‘regional and local governments should ideally fulfil mainly allocational functions by providing services that accrue primarily to the local population, *services whose costs the local constituency bears as far as possible*’ (NORREGAARD, 1997, p. 50, emphasis added).

As one of the basic principles of revenue assignment, BIRD (2000) postulates that “‘own-source’ revenues should ideally be sufficient to enable at least the richest local governments to finance from their own resources all locally provided services primarily benefiting local residents’. According to this line of reasoning, to the greatest extent possible, each government should finance both optional and mandatory expenditures from its independent revenues. Fiscal transfers and grants should merely serve as subsidiary funds to encourage the production of specific public goods, to correct inherent inefficiencies in the resource allocation (spillover and congestion effects), or to attenuate horizontal and vertical fiscal imbalances. Correcting vertical fiscal imbalances is all the more important as the independent revenue sources (mainly taxes and user charges) traditionally assigned to local governments are often inadequate to the task of financing such major social expenditures as health care, education, or social services (BIRD, 2001a, p. 2).

Considering the variety of approaches to revenue assignment is important because it allows us, to a certain extent, to detach the question of revenue structure from the question of revenue autonomy. It appears that the origin of the funding sources (own-source vs transferred) and their relative weight within the local budget say just as little about the actual room for manoeuvre of the local authority as, in the domain of expenditure autonomy, the number of expenditure functions that the law assigns to the local tier. What counts in the end is the *quality* of the revenue sources, notably their predictability, adequacy (in terms of amount)²⁸ and

²⁸Whether the adequacy criterion is met depends also on the actual buoyancy of the revenues that,

84 flexibility (in terms of use) with regard to the assigned expenditure responsibilities. The notion of quality (and of different possible qualities) implies that the autonomy of the recipient authority may be subject to a number of legal and non-legal, direct and indirect constraints.

From the 'user side', an obvious direct legal restriction on the revenue autonomy of grant recipients consists of the conditions on grant use. Intergovernmental transfer systems usually contain a certain amount of earmarked (conditional) grants, which sets a natural limit to the autonomy of the recipient governments.

Beside the conditions of use, the rules on whether the recipient municipality is required to co-finance the grant (matching vs non-matching grants) and whether the availability of funds is limited or not (closed-ended vs open-ended grants) have a further impact on local revenue autonomy. The more generous the grant system towards the beneficiaries (dominance of open-ended and non-matching grants), the higher is the degree of revenue autonomy. Table 3.5 in Section 3.5.3 will show a taxonomy of grants that signals the various levels of autonomy attached to each grant type.

In countries or regions operating a vertical or horizontal *fiscal equalisation system*, prosperous local governments lose control over a part of their revenues insofar as they are obliged to cede it to poorer jurisdictions (directly, or by some kind of a central allocative mechanism) in the name of interregional solidarity. This implies not only a loss of influence on how these revenues are used but also an absolute loss of revenues so that the net contributor municipality cannot realise the same volume of public expenditures as it could in the absence of equalisation. In the same measure as it reduces the revenue autonomy of rich municipalities, fiscal equalisation increases the autonomy of beneficiary jurisdictions, so that the overall impact on the local public sector is neutral.

Indirect legal constraints on revenue autonomy Perhaps the most powerful indirect legal constraint that can be imposed on local autonomy is the right of the national legislative to revise the laws on local taxation and grants every year or even more frequently. In the field of transferred revenues, *frequent revision* might occur when the rules related to pool size and distribution of certain grants flowing to local governments are laid down in the annual budget law instead of an organic law (whose amendment requires a qualified, e.g. two-thirds, majority) or the national constitution. The adverse effect on local

however, cannot be influenced with formal rules (except that the centre should delegate revenue sources that are at least *potentially buoyant*). The question of revenue buoyancy falls under the indirect non-legal constraints of revenue autonomy.

autonomy is somewhat attenuated if local governments have an informal channel and the necessary power for influencing the legislative procedure.

Frequent amendments especially to the rules on intergovernmental transfers can make revenue flows so inconstant and fuzzy that they become a real hindrance to multi-annual budget planning in the recipient local government units. This is likely to induce and perpetuate vertical imbalance particularly in jurisdictions with low financial capacity.

As for the own-source revenues, even if the national framework legislation on local taxation is relatively liberal in the sense that it imposes few or no restrictions on raising taxes, local governments may feel constrained in their fiscal autonomy if other laws make it difficult for them to exploit their maximum tax potential. The actual volume of tax collection and, hence, the effective revenue autonomy of municipalities depends not only on direct formal rules on taxation but also on the efforts made by the local government to find the optimal tax rate and base that, together with other revenues, are likely to ensure the achievement of local spending targets.²⁹ A *weak local tax effort* and a corresponding low volume of tax collection are notably observed in two cases.

First, *penalising grant systems* in which the available grant quotas are inversely related to own revenue collections reduce the interest of municipalities in raising taxes and fees. It is an indirect constraint because it works via another domain of intergovernmental fiscal relations (namely the grant system) than the one that it ultimately affects (taxation).

Second, the central government and the social security funds together may occupy too much tax room compared to the volume of their spending responsibilities. In the event of what could be called a '*fiscal crowding-out*' effect, local authorities in their own competence will refrain from imposing a higher tax rate (even if this is formally allowed) for fear of overtaxing the local constituency. Some of them will not levy any tax at all. A mayor overtaxing the local constituency is likely to face a loss of votes at the subsequent elections or an out-migration of taxpayers to other jurisdictions. Whatever the reason behind the weak local tax effort,³⁰ unused taxing power represents an efficiency loss in the intergovernmental fiscal system,

²⁹Beside the choice of tax rates and base, tax effort also includes various measures of tax enforcement such as the fight against tax evasion.

³⁰Clearly, the reasons of weak tax effort may also be endogenous, i.e. related to an autonomous decision of the local council. A case in point is the engagement of a local government unit in interjurisdictional tax competition (implying a race-to-the-bottom in local tax rates). Another example is the consideration that the political costs of increasing taxes could exceed the marginal financial benefit derived from such a measure.

86 particularly if it contributes to the perpetuation of a vertical fiscal imbalance that ultimately calls for an intervention by the centre.

Finally, *overlapping tax bases* can produce vertical fiscal externalities which, under certain circumstances, reduce the room for manoeuvre of local governments. This is notably the case where a higher-level government makes the shared tax base shrink by taxing it at a higher rate than before. Municipalities that do not adjust their rates will experience an immediate fall in tax collections. Those that adjust their rates will only exacerbate the situation: in a response to the repeated rate increase, local taxpayers will try to escape from the tax, so that the tax base (for all levels of government) shrinks further.

Direct non-legal constraints on revenue autonomy Even if the legislation on revenue assignment in general and local taxation and grants in particular, is relatively stable over time, it is possible that central government interests dominate the parliamentary debate during the design of these systems and municipalities are too weak to defend their interests. The probability that *local government interests are ignored* is higher if the size of the transfer pool and the distribution formulae are determined on an *ad-hoc* basis, implying either circumvention of the formal legislative procedure, or a frequent and unilateral amendment of the written rules. In most countries, local governments maintain some sort of an interest association in order to minimise their dependence on such ad-hoc arrangements, but the strength with which they can enforce their claims varies from one association to the other.

Second, the *productive efficiency* of certain categories of own-source revenues assigned to local governments may be so poor that they hardly enhance revenue autonomy. They might even reduce it if the central government is convinced that, by delegating these resources to the lower levels, it has successfully met the demand for a framework regulation on local taxation. The actual volume of tax collections, however, is not only a function of the formal liberties such as setting the rate and base of the taxes, but also a function of the *quality* of the assigned taxes. Quality includes buoyancy (the yield can keep up with rising expenditure levels) and administrative efficiency (the costs of assessment and collection are below the level of the collected revenues). The volume of local tax revenues depends further on taxpayers' discipline (that the collecting authority can influence to a certain extent) and the fluctuations of the local economy.

Socio-economic and demographic factors may also have a direct impact on the revenue autonomy of decentralised authorities. Towns hit by a structural economic crisis see their tax base shrink rapidly as businesses close down operations and

individuals go on unemployment benefit or choose early retirement. Under such circumstances, a local government decision to increase tax rates or cut deductions would probably only reinforce tax evasion and out-migration instead of boosting the local revenues. Similarly, village A where seventy per cent of the residents are retired cannot hope to collect as much tax revenue per capita as village B with a more favourable age structure; consequently, A's room for manoeuvre will necessarily shrink.

Indirect non-legal constraints on revenue autonomy The productive efficiency of revenue sources plays a role not only in the sphere of own revenues but also in the sphere of grants and transfers (including revenue sharing arrangements). The size of the distributable pool depends on the volume of taxes and other revenues collected by the higher-level authorities. Collection at these levels is again a function of several factors such as buoyancy, productive efficiency, taxpayers' discipline and the fluctuations of the regional or national economy. Put it differently, the *quality of public sector revenues that feed the transfer system* is decisive for the revenue autonomy of those municipalities that benefit from the transfer system, but the impact is not as direct as with own-source revenues. Since the revenues feeding the transfer system are administered by the centre, local governments bear the consequences of all exogenous circumstances that reduce the size of the distributable pool, without having any control over these. Consequently, in a revenue sharing system, for instance, even the constitutional guarantee of transferring a fix percentage of the national tax yield from the centre to the municipalities does not automatically lead to a given level of local revenue autonomy.

Returning to the initial discussion about the importance of own-source vs transferred resources for local revenue autonomy, we can conclude that the decisive factor is not whether a given amount of revenue is raised in the own jurisdiction or received as a transfer from above, but it is the nature and importance of the constraints attached to the revenue category. In terms of revenue autonomy, a well-designed and not overly restrictive transfer system has just as much to offer as a well-designed local tax system, and certainly more than what an ill-designed and overly restrictive local tax system would ever be able to provide. The dominance of transfers in local government finance is thus not necessarily harmful.

On the contrary, harmful transfer dependency, that is, when decentralised governments live at the mercy of higher-level authorities over a longer period, hinders local governments from meeting the preferences of their constituency, thus nullifying an important efficiency advantage of decentralisation. It also represents

88 a challenge for macroeconomic stabilisation, particularly when bailout grants become a regular (structural) revenue source for local governments.

However, even in systems with perfectly predictable flows of unconditional (non-earmarked) transfers, the 'gift money' can reduce the sense of accountability of local policymakers towards their electorate (OECD, 2002, p. 14). If the decision about the level of collected tax revenue and the responsibility for the tax administration is detached from the decision on how to spend the tax revenue (because they are taken at different levels of government), the fiscal illusion of the local constituency may ultimately lead to an overprovision in public goods and services. Unfettered revenue autonomy can thus compromise both the accountability and the efficiency objective.

Selected endogenous constraints on revenue autonomy Particularly in the field of own-source revenues, we can observe a great diversity in the way local authorities make use of their formal revenue-raising competences. If the law authorises, for instance, local property tax up to a maximum rate of two per cent of the market value, then some jurisdictions will still set a rate that is below the ceiling, and some others will even decide not to tax property at all. This has mainly to do with the objective of a better positioning in the competition for taxpayers. Depending on the degree of taxpayer mobility, the municipality is likely to ignore or consider the tax rates applied in the neighbouring jurisdictions. Yet, the outcome is the same.

If interjurisdictional mobility is limited but various parties or political groups within the jurisdiction compete for a limited number of council seats, then the incumbents might wish to keep the rate of the local tax(es) as low as possible in order to be re-elected for the following term. The *fear of political unpopularity* imposes a direct constraint on revenue autonomy. More precisely, the incumbents will refrain from tax increases as long as the political cost of such a measure (in terms of loss of votes) exceeds the expected marginal benefit (in terms of additional tax revenues).

In regions where taxpayer mobility is significant, the local government is again likely to keep local tax rates low, but this time in order to avoid an outflow of taxpayers to the neighbouring jurisdictions; thus, the constraint works indirectly. Yet, a *race to the bottom with tax rates* is reasonable only if the baskets of public goods offered in the different jurisdictions are comparable: in the end, the competitiveness of a jurisdiction depends not on the absolute or relative level of taxes but on the level of the net fiscal benefit (NFB, public goods and services minus tax price) that it is able to offer.

3.4.4 Budgetary autonomy Local budgetary autonomy is the power to act simultaneously on both the revenue and expenditure side of the budget in order to avoid or correct vertical fiscal imbalances. By virtue of the principle of budget responsibility, local budgetary autonomy is a direct logical consequence of local expenditure and revenue autonomy. Local authorities are expected to assume responsibility for their spending decisions as far as these are voluntary (and not imposed by a higher authority); in other words, they cannot carry out such expenditure programmes unless they have the necessary funding (DAFFLON and MADIÈS, 2008, p. 63).

In periods of fiscal distress, local governments can operate on the revenue side of their budget by raising taxes and user fees or soliciting additional grants from the central budget. Alternatively, they might sell some of their assets within the limits of legality and rationality.³¹ On the expenditure side, they may cut or postpone planned current and capital expenditures. They might also consider signing short-term loans in order to bridge the gap, as far as the legislation provides for such a possibility. For financing new infrastructures, they may again make use of their tax power, apply for investment grants, make savings on the recurrent expenditures, or borrow.

As far as budgetary autonomy involves policy actions on the revenue and/or expenditure side of the budget, the restrictions on revenue and expenditure autonomy described in the previous sections will influence the degree of budgetary autonomy as well. There is, however, another group of constraints that apply specifically to budgetary autonomy. Figure 3.6 provides an overview.

Direct legal constraints on budgetary autonomy For the reasons explained in Section 3.3.4, a lax local budget policy can seriously compromise the stability of the national economy. Since this impact is generally estimated to override the benefits of decentralisation and local autonomy on the level of society as a whole, local deficit and borrowing as well as bailout grants are prohibited or at least subject to stringent regulations in most countries. These so-called ‘fiscal rules’ are imposed either by the local authority itself or by a higher-level government.³² Compliance with the deficit and debt rules imposed by the Economic and Monetary Union is a further factor that puts local budgetary auton-

³¹The privatisation of useful and otherwise well-functioning core assets is self-defeating, as it induces only a one-time revenue increase and what is sold cannot be used for revenue generation in the future (e.g. through rental).

³²For a typology of fiscal rules in OECD countries, see SUTHERLAND et al. (2005b). For the practice of controlling local borrowing and debt in Western and Eastern Europe, see DAFFLON (2002a) and SWIANIEWICZ (2004b), respectively.

	Exogenous		Endogenous (examples)
	Legal	Non-legal	
Direct	Statutory rules on deficit, borrowing and debt Credible no-bailout policy	Poor access to borrowing High cost of debt service	Political risk of indebtedness Lack of capacity to manage debt Small jurisdiction size
Indirect	Fiscal imbalance resulting from a mismatch between mandated expenditures and grants Poor reliability of resources completing debt	Low productive efficiency of revenues feeding the grant system	

Figure 3.6: **Constraints on subnational budgetary autonomy** [Source: the author]

omy under pressure particularly in those countries where the central government involves the lower tiers into the implementation of the Stability and Growth Pact (e.g. Austria and Italy).

The first group of direct legal constraints treated below consists of *statutory rules on local deficit, borrowing and debt* imposed by a higher level of government, while the second one consists of no-bailout rules.

For a classification of existing zero-deficit (balanced budget) rules according to their stringency, DAFFLON (1996, p. 240 ff.) laid down an algorithm with the following elements:

1. Is equilibrium required only for the budget or for the accounts as well?
2. Is equilibrium required only for the current budget (and account) or for the capital budget (and account) as well?
3. Should the balanced current budget include the amortisation of the debt?
4. Is it permitted to smooth the budget over the medium term?
5. If yes, how is this medium term defined?
6. Is non-compliance sanctioned in any way?

According to Dafflon, rules that require a balance of the current budget over the medium term without explicitly defining the beginning and length of the period, as well as rules that fail to impose a penalty in the case of non-compliance, are ineffective and allow local governments to pursue any budget policy. A balanced budget is unlikely to occur except in local governments that voluntarily impose an effective rule on themselves.

Local public sector accounting frameworks that do not distinguish between current and capital budgets, view their *raison d'être* in the argument that a distinction would unnecessarily restrain the budgetary autonomy of local governments. According to this argument, decentralised authorities are served best (and their autonomy is maximised) if they are free to finance any expenditure item from any resource at their disposition. However, the fungibility of current and capital revenues is not beyond controversy. Even if a local authority were allowed to use capital revenues (particularly debt) to fill the gap in the current budget, it should better not do so, otherwise, it risks sacrificing intergenerational equity for the sake of unrestricted local autonomy.

Concerning borrowing, PRUD'HOMME (1994, p. 4) holds that '[in] addition to the power to spend and the power to tax, other important attributes of sovereignty are the power to borrow and the power to regulate. The power to contract, or the power to change, or the power to own, can be seen as combinations of the four basic attributes mentioned'. Whether the power to borrow is a boon or a bane has long been discussed in the literature of fiscal federalism and decentralisation (for an overview, see e.g. ROSSI and DAFFLON, 2002). While pay-as-you-use finance facilitates the funding of vital infrastructures at the local level, a poor management of debt obligations inevitably contributes to macroeconomic difficulties at the national level. It appears that there is not much to say against local borrowing as long as the recurrent revenue flows are sufficiently abundant to cover both principal and interests over the entire period of debt service. There are some normative propositions trying to restrain the scope of borrowing to the sole purpose of financing investments whose lifetime expands over several generations, and in countries where the so-called 'golden rule' applies to the local level of government, these propositions have become the norm (see DAFFLON, 2002a). Other countries are more permissive, admitting local borrowing for bridging short-term fiscal gaps as well, especially if such gaps arise temporarily as a result of economic development efforts. In principle, borrowing becomes a problem only when it is paired with irresponsible fiscal behaviour, notably when recurrent revenues fall short of what is needed to cover the debt service. This tends to occur in countries where the local public sector is overly dependent on intergovernmental grants.

Whether there is a restriction on the borrowing purpose or not, borrowing is an important means of budgetary adjustment. Yet, it cannot be considered as a revenue source. The borrowed amount and the interests must be paid back to the lender in due time, which is why borrowing never figures under the elements of local revenue autonomy in the economic literature, in contrast to own revenues, revenue sharing and grants.

Another direct legal constraint on local budgetary autonomy is the central government's declared commitment not to bail out insolvent local authorities. A *no-bailout policy* represents an effective constraint only if it is credible and if there are no exceptions from the rule. In some countries, central governments have not yet been able to declare and pursue a full-fledged and credible no-bailout policy, although some of them (e.g. in Hungary) chose to assist only those local authorities that failed 'through no fault of their own' (with or without specifying what 'own fault' means).

As long as bailout grants conserve their discretionary character and are provided only in exceptional circumstances, the centre can still impose (though to a lesser extent) its priorities concerning macroeconomic stability and thus constrain local budgetary autonomy. An essential condition is, however, that bailout is not recognised as a recurring revenue source. Municipalities normally should not be allowed to count on it in advance or to include it into their budget for the following year. If bailout is provided at all, it should be provided at the end of the fiscal year in order to correct for that year's deficit.

Empirical observations cited by VON HAGEN (2003, p. 388) suggest that bailouts often follow an increase in unfunded (or poorly funded) mandates. However, unfunded mandates are not the only reason for local authorities to expect a bailout. The centre could even take full account of the costs of mandates and provide for adequate resources in order to ensure a balance between revenues and expenditures in the local budget; the demand for bailout grants would still persist. This kind of penury has to do with expansionary spending policies and an accumulated debt the costs of which the local government is unable to finance on its own. More generally, the existence of bailouts is the sign of a soft budget constraint at the local level that can become even softer if the centre cannot demonstrate a credible commitment towards a no-bailout policy.

The question whether the balanced budget is achieved through the use of regular revenues (taxes, recurring grants, etc.) or irregular revenues (loans and bailout), has a crucial impact on the nature of local budgetary autonomy. Local authorities that are allowed to borrow without any restrictions, those that are not subject to a zero-deficit rule, and those that have a real chance to get bailed out when in crisis,

clearly enjoy a higher level of budgetary autonomy than those that are obliged to tighten the belt in times of economic depression. But even in the absence of top-down legal constraints, a municipality may decide to maintain strict budget discipline and to abstain from borrowing and bailout, thus voluntarily accepting a more restricted room for manoeuvre than those of its counterparts that are not subject to any self-imposed fiscal rule.

While a high probability of being bailed out seems to enhance local autonomy at first sight, PISAURO (2001, p. 12 ff.) reminds that bailout also involves some costs for the beneficiary in terms of sovereignty. First, in the event of an intervention by the centre, local economic activities are likely to be disrupted or reduced. Second, bailed-out municipalities experience a loss of expenditure autonomy because the centre takes control over local spending decisions. Furthermore, the intervention induces a distortion in the composition and the inter-temporal distribution of local expenditures. Nevertheless, when the bailout is generous enough and when the shift of control over local spending to an outside agency is not too costly to local residents, then the municipality is likely to demand for a bailout and ignore the loss of efficiency that the society has to bear in consequence.

Indirect legal constraints on budgetary autonomy An intriguing question in connection with local budgetary autonomy concerns the correction of *local fiscal imbalances* that result from a mismatch of mandated responsibilities and intergovernmental transfers. Some normative propositions start from the premise that, if a higher authority delegates a new expenditure to a lower authority, it should also provide for the necessary funding in the form of an intergovernmental transfer, whereas the primary function of own revenues is to cover optional expenditures that reflect the specific preferences of the local constituency. As the argument goes, such a solution would truly reflect the distinction between the choice and agency functions of local governments and at the same time conform to the principle of ‘he, who pays the piper, calls the tune’.

However, this expectation is somewhat quixotic. In line with the recommendation of the European Charter of Local Self-Government, national constitutions and statutes in a number of decentralised countries stipulate that for any responsibility delegated from a higher to a lower level of government, the higher authority must *ensure the necessary means* of executing the related tasks. These means need not be limited to grants and transfers but may also include a statutory increase in the revenue raising powers of lower government tiers (e.g. an increase or removal of the upper limits of tax rates, more freedom in tax base calculation, etc.). In the presence of such autonomy-enhancing measures, it is perfectly conceivable and

94 justifiable for the higher-level government to expect local governments to finance part of their mandatory responsibilities from their own revenues. In this logic, ‘unfunded mandates’ would denote, not the volume of mandatory expenditures that the grants fail to cover, but the volume of mandatory expenditures that the sum of grants *and* own revenues fails to cover. Four problems arise, however:

1. Increased formal revenue powers do not automatically enhance the effective local revenue capacity in the presence of non-legal or indirect legal constraints (see Section 3.4.3).
2. Not every category of own-source revenue can reasonably be employed for financing unfunded (or co-financing poorly funded) mandates (see the fungibility argument elaborated under the heading ‘Direct legal constraints on budgetary autonomy’). Debt should particularly not be used for covering the deficit of the current budget.
3. There is a risk that some (or most) local governments will deliberately refuse to co-finance the mandatory expenditures directly from their pocket, expecting the higher-level government in a strategic game to finally cover the deficit. This is particularly true if the intergovernmental fiscal system provides for a formal bailout mechanism.
4. The higher authority might demand municipalities to co-operate with each other if they are otherwise unable to finance their mandatory tasks. However, there is no objective measure of whether there is a potential for co-operation (and if yes, how great) in a given geographic and/or policy area. This leaves both the principal and the agents without any useful and reliable argument in the negotiations about the appropriate level of subsidising public service mandates.

Pointing to the difficulties that may possibly arise from the ‘mixed financing’ of mandated responsibilities does not imply that we advocate full state funding of the local mandatory responsibilities. If the national grant for a newly delegated function covers only, say, 80 per cent of the production costs, then some municipalities will easily make up for the missing 20 per cent from their own budget while others cannot even close the fiscal gap caused by the previously delegated responsibilities. However, a well-designed system of intergovernmental transfers takes account of the interjurisdictional disparities in terms of financial capacity.

Another indirect legal constraint is related to borrowing. Ideally, investment programmes are financed exclusively from debt, although the scarcity of lenders or

the availability of other funding sources may prompt local governments to combine debt with other revenue sources.³³ These include for instance own-source revenues, investment aid from the European Union, development grants from the central government or private capital from an enterprise participating in a public-private partnership. However, *complementary resources* may not be reliable on the medium and long term which is the normal time horizon of an investment programme. This is the case if business cycles cause strong fluctuation in local tax revenues and shared revenues, if the national framework legislation on local taxation is amended every year, if the eligibility criteria for central government grants or the size of the available pool are subject to frequent modifications, or if private partners are difficult to find or to keep. The poor predictability of future revenue flows makes the entire investment funding plan uncertain, so that local governments cannot credibly negotiate a medium or long-term loan and thus postpone borrowing.

Direct non-legal constraints on budgetary autonomy A first example of direct non-legal constraints in the domain of local budgetary autonomy is *poor access to borrowing* in some countries. The difficulty to acquire additional funds through contracting loans and issuing bonds may arise from the underdeveloped state of financial markets or the poor borrowing capacity (credibility) of some or all local governments due to past insolvency crises.

Second, even if loans are easily accessible on the market, the *financial costs of the debt* may be prohibitive. This occurs particularly in the event of inflation (which devours current revenues rapidly) and soaring interest rates.

Selected endogenous constraints on budgetary autonomy Particularly in transition economies, the public opinion still thinks negatively about municipal borrowing. For some, it is a sign of financial insecurity if the local government is unable to cover the costs of investments from the available own and transferred revenues. For others, borrowing is a risky venture that should better be controlled by higher authorities. Yet others disagree with the idea to impose a burden on future generations of taxpayers without their consent. Even if these arguments may be contested, they imply *political risks* for the borrowing local executive, including the risk of not being re-elected. If the estimated political risks are higher than the chance to convince the voters and accomplish the planned investment programme with success, then the local executive is likely to refrain from borrowing.

³³For the arguments in favour of debt as an optimal source of investment funding, see e.g. COOMBS and JENKINS (1994, p. 182 ff.) or SWIANIEWICZ (2004c, p. 5 ff.).

Some municipalities lack indeed the **capacity to manage debt**. DAFFLON and BEER-TÓTH (2009) investigate the components of responsible borrowing behaviour at the local level. Favourable credit ratings and compliance with the fiscal rules (legal norms on borrowing, deficit and debt) are necessary but not sufficient conditions for municipalities to borrow. Successful financial management requires a more proactive attitude in which local governments adjust their investment policy to their financial capacity, assessing the costs and benefits of each investment project.

Finally, there is a certain interest in the literature for the question as to whether the territorial structure of the country and the **size of jurisdictions** have an influence on local budgetary autonomy (for a review, see e.g. PERRITAZ, 2003). Most authors argue that small jurisdictions have limited opportunity to realise economies of scale on the expenditure side and to raise taxes on the revenue side, which tendentially leads to vertical fiscal imbalances. According to this reasoning, a fragmented territorial structure combined with a high degree of budgetary autonomy is inefficient, which makes a strong case for interjurisdictional co-operation and amalgamation. On the other hand, analysing the relationship between the degree of local tax autonomy and the average population size of municipalities in the fifteen member states of the European Union in the mid-1990s, GILBERT (1999) finds no significant correlation.³⁴ Quoting the example of France, he argues further that territorial fragmentation may even promote local autonomy. Individuals and enterprises have a wider range of baskets of public goods (and thus of price/performance ratios) to choose from and can thus effectively ‘vote with their feet’ as TIEBOUT (1956) suggested. The resulting competition will reward the most innovative, efficient and financially responsible local governments, beside conveying useful information about the real preferences of citizens and businesses with regard to taxes and local public services. Nevertheless, Gilbert admits that a number of conditions must be met before the Tiebout-type mobility can make the economy work more efficiently. Besides, territorial fragmentation will automatically lead to an exacerbation of interjurisdictional disparities, which means that local financial autonomy serves as a magnifying glass for the ‘natural’ differences in terms of resources. However, the small size of a jurisdiction remains an endogenous constraint on local budgetary autonomy as long as the local government has a real opportunity to co-operate or amalgamate with other jurisdictions in order to reduce spending levels (see Section 3.4.2).

³⁴Gilbert defines the degree of local tax autonomy as the ratio of local tax revenues to total local revenues without borrowing. His results are similar to those found by DAFFLON and PERRITAZ (2000) for a group of Swiss municipalities.

3.5.1 General measures In an attempt to measure the relationship between fiscal decentralisation and various macroeconomic or other variables such as economic growth and public sector size, economists in the mid-1980s started to search for an appropriate quantitative indicator of local financial autonomy. Two and a half decades of intensive research, however, have not been enough to develop an indicator (or a ‘troika’ of sub-indicators of expenditure, revenue and budgetary autonomy) that would provide an unbiased picture of the reality. None of the existing formulae goes further than estimating the effect of direct legal constraints on autonomy, and the simple ones cannot even estimate this effect in an appropriate and reliable manner.

Until around the year 2000, nearly all studies used the Government Finance Statistics (GFS) of the International Monetary Fund as a starting point for the design of fiscal decentralisation measures.³⁵ The dominant model compared the volume of local expenditures (revenues) to general government expenditures (revenues) or, alternatively, to the Gross Domestic Product (GDP).³⁶ These simple indicators are still in use,³⁷ even though scholars have long identified their apparent weaknesses (EBEL and YILMAZ, 2002; MELOCHE et al., 2004; THE WORLD BANK, 2007) which are the following:

- *On the expenditure side*, the GFS fail to distinguish between mandated and optional expenditures of local governments. The outlays related to mandatory functions appear under local expenditures, even though the decentralised government units (acting merely as agents of the centre) have limited or no authority over these functions. Moreover, in addition to direct functional expenditures, the GFS data also include monetary transfers flowing from the local level to higher levels of government.
- *On the revenue side*, the GFS do not distinguish between the different sources of local revenue, although the nature and the degree of local autonomy may

³⁵The GFS were established in 1986 and partly harmonised with the 1993 System of National Accounts (1993 SNA). It is an integrated statistical framework whose role is to ‘enable policymakers and analysts to study developments in the financial operations, financial position, and liquidity situation of the general government sector or the public sector in a consistent and systematic manner.’ The harmonised methods of data retrieval and presentation allow a better comparability of statistics across different countries. For more details on the GFS, see IMF (2001).

³⁶The Organisation for Economic Co-operation and Development systematically calculates local revenues excluding transfers from other levels of government but including tax revenue sharing OECD (2003, p. 145).

³⁷See e.g. the World Bank database of ‘Fiscal Decentralization Indicators’ (THE WORLD BANK, 2007).

be very different from one revenue source to another. In addition, the GFS do not tell which percentage of the intergovernmental transfers is given for general and specific purposes and whether their allocation follows objective criteria or a discretionary measure.

Due to these inherent weaknesses, GFS-based indicators systematically overestimate the degree of decentralisation and local financial autonomy.

The major challenges in measuring local financial autonomy are the identification and quantification of the various exogenous constraints that are actually imposed on local governments in a given decentralised system.³⁸ As for the measurement of local tax autonomy, the Organisation for Economic Co-operation and Development brought a wind of change in 2001 by starting to produce a series of country surveys with a new data structure that was more adapted for subsequent investigations on tax autonomy than the simple GFS data (see Section 3.5.3). A similar development in the measurement of expenditure autonomy has not yet taken place.

3.5.2 Measuring expenditure autonomy As we saw in the previous section, simple GFS-based decentralisation ratios, such as local government expenditure to general government outlays or to GDP, lead to an overestimation of the expenditure autonomy of lower-level authorities. For a correct measurement, we should be able to identify and, more importantly, to quantify all those direct and indirect constraints (among the potential constraints presented in Section 3.4.2) that actually reduce the room for manoeuvre of a given authority on the expenditure side of the budget. Regrettably, however, it is not even possible to give an exact measure of the direct legal constraints, let alone the rest.

Identifying purely local expenditure functions and the related actual outlays is a relatively simple exercise. The most common proxies used for estimating this kind of autonomy have been presented in the previous section. Qualitative indicators are used even more frequently (see THE WORLD BANK, 2007). These show which level(s) of government is (are) responsible for which expenditure functions. The delimitation and quantification of local, regional and national responsibilities in the domains of shared competences (e.g. education) demands already more circumspection and, more importantly, a well designed reporting and accounting

³⁸Here we disregard all those endogenous constraints that arise from some present or past autonomous decisions of the local legislative or executive, e.g. decisions about the involvement of the municipality in interjurisdictional co-operation or competition.

system. Especially countries with little experience in decentralised government accounting lack the basic data that would be necessary for such calculations.

Another problem arises when we try to measure the impact of centrally imposed regulations and minimum standards on the cost of local service provision. Both the number and the nature of these norms vary across the functions. In the domain of primary education, for instance, the freedom of local governments may be constrained through rules on staff qualifications, wages and working conditions, number of pupils per class, equipment and buildings, curricula, etc. (DAFFLON, 2006, p. 296 f.). The norms in the domain of environmental protection for instance are not only very different from these but also a lot more in number. THE WORLD BANK (2007) proposes to look at four universal dimensions of public service provision—(i) setting the amount of spending, (ii) determining the structure, (iii) executing and (iv) supervising the task—to see which government layer has control over each of these dimensions. For sure, implementing such schemes in practice will always require some mapping between these dimensions, on one hand, and the prevailing account system (or expenditure classification) in the country, on the other hand. However, the dimensions may also prove to be insufficient in number, or imprecise in definition, for being used in practice.

BELL et al. (2006) propose a more sophisticated typology for describing the role of subnational governments in service provision (Table 3.1). Thanks to the clear description of the content of subnational autonomy in each of the six dimensions of service provision, this model is better suited to practical implementation. The authors attribute scores from 4 to 1 to the various degrees of subnational expenditure autonomy that roughly correspond to devolution [A], delegation [B, C] and deconcentration [D]. Together with a functional classification of public expenditures (Table 3.2), this provides a three-dimensional matrix that also allows cross-country comparisons.

The idea of Bell and his colleagues is to analyse each public service sector and sub-sector individually along the six dimensions of service provision and to evaluate subnational autonomy in each of these dimensions by means of the scores A to D (or 4 to 1). Calculating the average of the individual (dimension-related) scores in each sector provides an estimation of the level of subnational autonomy with regard to the given sector on a scale from 1 (no autonomy) to 4 (full autonomy).

According to the authors, the final step would be to develop a weighting of the various sectors that reflects the relative importance of each sector. This would provide something like a final score of subnational autonomy and at the same time resolve the question of large autonomy on ‘unimportant’ functions vs limited

Table 3.1: A typology of expenditure autonomy by Bell et al. (2006)

Factor influencing the degree of autonomy	Description of the factor	Full degree of sub-national autonomy (Score A=4)	SNG has high degree of autonomy under central supervision (Score B=3)	Central control while subnational has some degree of autonomy (Score C=2)	Central fully control with mere degree of autonomy at subnational level (Score D=1)
Broad control over policy and budget	Which government sets the main policy guidelines for a service (e.g., free primary education as a national policy)?	Policy planning, budget execution, and assignment of functions are set by the SNG (e.g., accounting systems, treasury operations, internal, and external audit). SNG has full degree of decision-making while CG acknowledges the planning.	Clearly delineated assignment of functions; SNG controls its own budget process and budget execution with influence and guidance from CG. Extra budget request can be easily changed according to local preferences.	CG sets main policy, budget, and implementation process, while SNG has some ability and flexibility over decision-making and execution as appropriate to the local demands. Some categories of extra budget can be requested according to CG's guidelines.	CG either makes or has final control over the local budget, and/or can override provisions of the local budget. SNG is delegated to execute the work which fully planned by the CG. Changing budget within the fiscal year is almost implausible.

Civil service	Control over the level of the wage bill and decisions with respect to hiring, promotion, and firing civil servants, as well as salary setting and condition of employment.	SNG controls over civil servants who are engaged in the delivery of local public goods and services. Includes agreements and settlements on wages and employment conditions.	SNG controls over the main part of civil servants who are engaged in the delivery of local public goods and services including wages and employment conditions. CG controls, supports, and directs SNG in some areas which SNG lacks of expertise.	CG controls over the main part of civil servants who are engaged in the delivery of local public goods and services including wages and employment conditions. SNG has some ability and flexibility over some decision making.	CG determines (perhaps through negotiation) the level and structure of civil servant salaries and the conditions of employment.
Standards setting and regulation	Which government sets the standards for the composition of local public services and the regulations that may accompany SNG spending programs?	SNG sets the standards and compositions of all public services which are consistent with compliance with the state law, constitutional principles, and international standards. SNG also has strong voice in helping national government setting the principles and standards when suitable.	SNG sets some standards, regulations, and compositions of public services under CG's supervision and influence.	CGt sets core standards, regulations, and compositions of public services. SNG has some flexibility in adopting and adjusting the standards that suit local circumstances.	CG sets standards, regulations, and compositions while SNG does not have voice or participate in the regulation and service designs.

Table 3.1: (cont.)

Factor influencing the degree of autonomy	Description of the factor	Full degree of sub-national autonomy (Score A=4)	SNG has high degree of autonomy under central supervision (Score B=3)	Central control while subnational has some degree of autonomy (Score C=2)	Central fully control with mere degree of autonomy at subnational level (Score D=1)
Administration	Administration of service delivery on a day to day basis.	SNGs determine their own internal administrative structures in order to adapt them to local needs and ensure effective management (European Charter, 1985).	SNGs determine their own internal administrative structures with guidance and influence from CG in order to adapt them to local needs and ensure effective management.	CG sets and determines administrative structures while SNG has some ability and flexibility in adjusting the administration of services to local needs.	CG mandates internal administrative organization and day to day expenditure and management basis including procurement practices.
Service delivery	Control over the priority of service, ensuring quality and standard, as well as delivery in a timely manner.	SNG fully controls on the standard of the service, set priority, as well as ensuring quality and timely delivery responding to the local needs.	SNG have most control over the standard of the service, set priority, as well as ensuring quality and timely delivery according to local needs under CG's guidance and planning.	CG controls over the standard of the service, set priority, as well as ensuring quality and timely delivery. SNG has some flexibility in adapting and adjusting the services according to the needs.	CG controls over the standard of the service, set priority, as well as ensuring quality and timely delivery.

Monitoring & evaluation	Which government monitors and evaluate SNG performance?	SNGs have full control over monitoring & evaluation used for future improvements in local institutional, administration, and service management.	SNGs have control over monitoring & evaluation, and the outcomes are reported to the CG for future improvements/guidance.	CG has control over monitoring & evaluation processes while SNG participates in some aspects along the processes.	CG fully monitors and evaluates the SNG performance. Full decision making and future work and improvement area is based on CG's justification.
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104 autonomy on important functions. A municipality may indeed have full control over spending on libraries, for instance, but a negligible influence on a far more important sector such as health care.

Up to this date, the approach proposed by BELL et al. (2006) has been certainly the most powerful one for measuring subnational expenditure autonomy vis-a-vis the central government. Nevertheless, four points merit some further reflection.

1. Among the six factors influencing the degree of autonomy (column 1 of Table 3.1), the elements related to expenditure responsibility (steering) are freely combined with those of service delivery (rowing), although a distinction would be crucial for the discussion of local expenditure autonomy for the reasons explained in Section 3.4.2. Only one out of the six factors is related exclusively to expenditure responsibility ('broad control over policy and budget') and two exclusively to service delivery ('civil service' and 'administration'). The remaining factors are mixed. 'Standards setting and regulation' has a steering component in that it determines what exactly subnational governments (SNGs) should provide. Within 'service delivery', setting service priority is part of the steering function while the rest is purely rowing. Finally, 'monitoring and evaluation' is an activity that ensures that the output (or outcome) of service delivery corresponds to the previously set expenditure objectives.
2. The judgement about whether subnational government units in a given decentralised system have a 'high degree' or just 'some degree' of autonomy (i.e. the choice between scores B and C) is highly subjective. Within 'civil service' for instance, control over the wages and working conditions appears as a key component of autonomy (columns B to D). In reality, however, the actual labour market conditions may limit the degree of control both for the central government and the SNGs. Good local government officials are tempted to quit the public sector if he latter provides poor remuneration, which explains the convergence between the public and private sectors in terms of salaries and employment conditions. Against this background, the control over these policy instruments is not as crucial for subnational autonomy as the matrix may suggest.
3. The level of aggregation of the public expenditure categories as proposed in Table 3.2 allows hardly anything more than a few generalised observations about subnational autonomy. In order to obtain more reliable information, every category has to be broken down into a set of subcategories. In the

Table 3.2: Degrees of SNG control over expenditure dimensions by public service sector [Source: Bell et al. (2006)]

	Policy making and budgeting	Civil service	Standards setting and regulation	Administration / Contracting	Service delivery and evaluation	Monitoring and evaluation	% of expenditures under SNG budget
Education							
Primary education
Secondary education
Health
Transport							
Roads (feeder/rural)
Roads (inter-states)
Roads (national)
Water & sanitations
Power							
Fuel & energy
Electricity
Housing & amenities
Other economic affairs & services

case of primary education for example, these could be teachers' qualifications, wages and employment conditions, education programmes, school organisations, buildings and equipment, etc. (see DAFFLON, 2006, p. 296 f.).

4. Finally, the idea of a weighting system that fits every country (in order to ensure that final scores are comparable across the borders) might turn out to be an illusion. Subnational influence on forest management for instance might be irrelevant in the Netherlands while it is a crucial element of subnational autonomy in Nepal.

The non-legal constraints on local spending autonomy are even more difficult to quantify than the legal constraints. To what extent special topographic, demographic, socio-economic or environmental conditions influence the production costs, and hence, actual expenditures, varies across public services as well as jurisdictions and can only be calculated case by case. External pressure on the local budget may also come from the development of new technologies (resulting e.g. in a growing demand for costly interventions in health care) or the general macroeconomic situation. Their impact on the local budget can only be captured in terms of shifts in the spending structure, but again, this impact cannot be clearly distinguished from other trends provoking similar shifts.

Furthermore, as has been suggested in Section 3.4.2, jurisdiction A may happen to be smaller than what would allow it to minimise the costs of certain mandatory services, while at the same time, a co-operation agreement with the neighbouring jurisdiction B is likely to generate more costs than benefits for A. In this case, the only way to measure the loss of autonomy in A is by quantifying the additional spending (on mandatory tasks) resulting from the missed opportunity of cost savings via larger production scales.

To sum up, since most of its determinants are unquantifiable, it is difficult to describe the extent of local expenditure autonomy in a specific country at a given point in time, let alone to make comparisons over different periods, public policy areas or countries. With the accumulation of statistical and factual information on a growing number of countries over longer time series, cross-country comparisons have become a very common instrument in public finance analysis; however, their practical use is contested. It is risky to compare local expenditure autonomy across different countries without taking into account the complexity of intergovernmental relations in which local expenditures are embedded.³⁹

³⁹For the measures that are necessary for the implementation of such comparisons, see BELL et al. (2006).

To our knowledge, DAFFLON and PERRITAZ (2000) have been so far the only authors to measure the extent to which local expenditures depend on decisions taken by a higher government. In an analysis of the accounts of all 247 municipalities of the Canton of Fribourg (Switzerland) for 1997, they considered three particular expenditure items: (i) the financial contributions to the cantonal or federal spending on regionalised or centralised tasks; (ii) the expenditures on services that the municipality provides in co-operation with other jurisdictions; and (iii) the interests paid and the prescribed minimum amounts of debt repayment related to past investments. Adding up the expenditure volumes in these categories, they took the result as a basis to determine the per-capita mandatory expenditure in absolute monetary terms, as well as its share within the local revenues and within the revenues from direct taxes. In principle, the approach could be applied to further cantons and time periods to enable comparisons, but such an exercise requires substantial effort that can only be made when all municipal accounts are registered in a standardised electronic reporting system.

3.5.3 Measuring revenue autonomy Since the mid-1980s, both qualitative and quantitative indicators of local revenue autonomy have undergone a profound development. Virtually all approaches seek to capture the most transparent and straightforward direct legal constraints on revenue autonomy, namely the statutory rules of local taxation and the conditions of eligibility and use of intergovernmental grants.

Qualitative indicators The earliest attempts to capture local revenue autonomy placed the various revenue sources in the centre of the analysis and characterised them from the perspective of the freedom of municipalities to modify or influence them. Thus, OWENS and NORREGAARD (1991) started by ranking and defining revenue sources by the degree of autonomy they ‘would normally provide’ to decentralised government, admitting that even the highest-ranking category, own taxes, are often subject to central government constraints applying to rates and base. Table 3.3 presents this classification.⁴⁰ In a following

⁴⁰The category of ‘shared taxes’ requires a short explanation. What is actually meant here is the situation in which the central government collects certain types of taxes and then distributes all or part of the yield among the subnational authorities. In order to distinguish this situation from the preceding category of ‘overlapping taxes’ (also ‘tax surcharge’ or ‘piggyback taxation’), we propose to refer to the former situation as ‘shared revenues’ (or ‘revenue sharing’) and to the latter one as ‘shared taxes’ (or ‘tax sharing’). Regrettably, these terms are often confused in the current literature. Drawing a dividing line between shared revenues and intergovernmental grants is another critical issue; for a first attempt, see BLÖCHLIGER and KING (2005).

Table 3.3: Ranking of local revenue sources by Owens and Norregaard (1991)

1	Own taxes	Base and rate under local control.
2	Overlapping taxes (tax surcharge)	Nationwide tax base, but rates under local control.
3	Non-tax revenues	Local government is able to determine the fee to be charged, although central government may specify whether such a charge can be levied.
4	Shared taxes	Nationwide base and rates, but with local government able to influence either the proportion of revenues attributed to the local government sector or the amount that each level of local government receives.
5	General purpose grants	Local government share is fixed by central government (usually with a redistributive element), but local government is free to determine how the funds should be spent.
6	Specific grants	The amount of grant may be determined by central government or may depend upon the spending decisions of local government, but in either case central government specifies how the funds should be spent.

step, they analysed tax revenues (categories 1, 2, and 4) and grants (5–6) with regard to the degree of control local governments have over selected parameters of these revenues (Tables 3.4 and 3.5).

In connection with tax revenues (Table 3.4), the authors specify that the tax autonomy of the local level is independent of the question as to which level of government administers the tax. Another assumption implicitly arising from the table is that if local government is allowed to determine the tax base, it also enjoys unlimited discretion with regard to the tax rates; hence the full control over tax level, rate structure and tax yield in the first row of the table. The opposite is not true: according to the matrix, unlimited tax rate discretion is not necessarily paired with full control over the tax base and hence local influence on the tax yield can be only partial.

Table 3.5 suggests that intergovernmental grants do not automatically reduce revenue autonomy at the lower levels; the effect depends on the type of grant. Owens and Norregaard add that capital grants usually provide less autonomy in spending than current grants because they are linked to specific projects or economic sectors. However, they do not consider the way in which grants are allocated, although

Table 3.4: Degree of subnational autonomy by type of tax revenue

[Source: the author, based on Owens and Norregaard (1991, p. 13)]

	Assessment	Collection	Tax base	Tax level	Rate structure	Tax yield
Tax base discretion						
choice of base	none / full	none / full	full	full	full	full
adjustment to central tax base	none / partial	none / partial	partial	full	full	partial
Tax rate discretion						
unlimited	full			unlimited	unlimited	partial
maximum	none	none / partial	none	limited	none	partial
minimum / maximum				limited	none	partial
Tax surcharge	none	none	none	partial	none	partial
Centralised tax sharing	none	none	none	none	none	none / partial

the objectivity of the procedure and the predictability of revenue flows can greatly influence the autonomy of the grantees. Nevertheless, Owens and Norregaard appear to be among the first authors in the literature to decompose local tax and grant autonomy into structured sets of parameters.

Virtually all recent classifications of tax autonomy are derivations of this early approach from 1991. The most frequently cited classification is the one that the OECD Committee on Fiscal Affairs developed in 1999. The novelty of the OECD taxonomy (Box 3.2) is that it views autonomy from the perspective of sub-central governments (SCGs, following the OECD terminology), contrary to Owens and Norregaard who organised their classification around tax types. This makes it possible to identify, for an individual country or a group of countries, the relative proportions of revenue (in percentages) over which SCGs have full, partial or no control, and thus to explore the development of local taxing power.

Table 3.5: Degree of subnational autonomy by type of grant
 [Source: Owens and Norregaard (1991, p. 15)]

Type of grant	Ability to influence directly	
	The level of the grant	How money is spent
General-purpose grant		
effort-related		
to tax	yes	yes
to needs	limited	yes
lump-sum	no	yes
Sector-specific grant		
matching	yes	limited
lump-sum	no	limited
Project-specific grant		
matching	yes	no
lump-sum	no	no

- a) SCG sets tax rate and tax base
- b) SCG sets tax rate only
- c) SCG sets tax base only
- d) tax-sharing arrangements
 - d.1) SCG determines revenue-split
 - d.2) revenue-split can only be changed with consent of SCG
 - d.3) revenue-split fixed in legislation, may unilaterally be changed by central government
 - d.4) revenue-split determined by central government as part of the annual budget process
- e) central government sets rate and base of SCG tax.

In the cases from *a*) to *d.2*), the local level of government is said to have total or a significant control over its taxes. In all the remaining cases, its tax autonomy is limited or zero.⁴¹

Based on a series of country studies carried out in Central and Eastern Europe from the early 2000s, the OECD Network on Fiscal Relations across Levels of Government refined and extended the initial framework in 2005–06, splitting the categories *a*, *b*, *c* and introducing *e* and *f* (the latter represents non-allocable taxes) in order to better capture reality (Box 3.3).

Beside the shift in the perspective of analysis from the tax types to the decentralised governments, the OECD taxonomy also contains new elements compared to the classification set up by Owens and Norregaard in 1991. A key novelty in the 1999 version is the set of indicators concerning the right and the procedures of determining and modifying the distribution formula in the domain of revenue sharing. The revised version of 2005–06 further differentiates the discretion over the tax base and introduces the parameter of consultation between national and

⁴¹A later version (OECD, 2002, p. 13) includes an additional category: ‘SCG sets tax base for SCG and central government tax(es)’. As this rarely occurs in practice, it was abandoned in the 2005 review.

Box 3.3: The OECD taxonomy of the taxing power of sub-central authorities, 2006 [Source: Blöchliger and King (2006, p. 159)]

- a.1 The recipient SCG sets the rate and any reliefs without needing to consult a higher level government.
- a.2 The recipient SCG sets the rate and any reliefs after consulting a higher level government.

- b.1 The recipient SCG sets the tax rate, and a higher level government does not set upper or lower limits on the rate chosen.
- b.2 The recipient SCG sets the tax rate, and a higher level government does set upper and/or lower limits on the rate chosen.

- c.1 The recipient SCG sets tax reliefs—but it sets tax allowances only.
- c.2 The recipient SCG sets tax reliefs—but it sets tax credits only.
- c.3 The recipient SCG sets tax reliefs—and it sets both tax allowances and tax credits.

- d.1 There is a tax-sharing arrangement in which the SCGs determine the revenue split.
- d.2 There is a tax-sharing arrangement in which the revenue split can be changed only with the consent of SCGs.
- d.3 There is a tax-sharing arrangement in which the revenue split is determined in legislation, and where it may be changed unilaterally by a higher level government, but less frequently than once a year.
- d.4 There is a tax-sharing arrangement in which the revenue split is determined annually by a higher level government.

- e. Other cases in which the central government sets the rate and base of the SCG tax.

- f. None of the above categories a, b, c, d or e applies.

local authorities for setting the tax base and the rates. The tax surcharge implicitly reappears in the categories *a.1* to *b.2* in 2005–06 (only *b* in 1999). 113

While the new classification gives the impression of being precise and exhaustive, any attempt to apply it in the practice will forcibly run into problems:

1. To *a.1* and *a.2*: It is not clear whether ‘consulting’ means a simple exchange of ideas between lower and higher authority (e.g. with the purpose of inter-jurisdictional co-ordination of tax rates) without any commitment on either side, or whether it implies that the higher authority can overrule a decision planned by the lower one.
2. Categories *b.1* and *b.2* do not reckon with the existence of what we could call a ‘deconcentrated tax’ in some countries, i.e. a tax that local governments are obliged to collect in the exact form prescribed by legislation, but the revenues from which accrue to the local governments themselves following the origin principle.⁴² In fact, one could also treat it as a tax sharing arrangement of type *d.3*, but the fact that the tax is collected by the local level and the legally determined revenue split is 100 per cent in favour of that level (thus it is ‘ceded’ rather than shared) places the ‘deconcentrated tax’ somewhere between own taxes and revenue sharing.
3. Categories *c.1* to *c.3* omit the possibility that a higher authority sets the tax relief or imposes an upper or lower limit to tax reliefs for the lower level. From the perspective of revenue autonomy, having full or only partial control over the deductible amounts is likely to be of higher importance than the question of which type of tax relief the SCG is allowed to set.⁴³
4. Block *d* is overly complicated and yet incomplete. A number of other combinations are conceivable, such as a revenue sharing arrangement in which the revenue split is determined in legislation and the Parliament is allowed to change it but the higher-level government is not; or even the Parliament can change it only with the consent of SCGs. The four questions as to (i) who determines the revenue split, (ii) who is allowed to change it and (iii) how often, and (iv) whether a consent of the SCGs is required, should be treated as four subsets of variables that can be freely combined within reasonable limits. This would make block *d* even more voluminous but at least systematic and exhaustive.

⁴²The luxury tax in Hungary (see Section 6.2) is one example.

⁴³Tax credits are deductions from the taxes due, while tax allowances are deductions from the taxable income.

5. Furthermore, block *d* is silent about the SCGs' control over the way the overall revenue share is allocated among them, although this is an equally important component of revenue autonomy that determines the disposable revenue for each jurisdiction.
6. Generally, the classification provides hardly any guidance on how to evaluate the different degrees of SCG involvement in the determination of the revenue split. Categories *d.1* and *d.2* can hardly be applied if the SCGs have no national association that would adequately represent their interests, or if there is disagreement among the existing lobby organisations. A revenue split determined by the legislation is not much better than a revenue split prescribed by the higher-level government if it is hard to find acceptance for SCG interests in the Parliament, even if we admit that parliamentary decisions are usually more democratic than those taken unilaterally by a higher authority. Furthermore, laying down any kind of rule in legislation does not automatically guarantee stability; it makes an enormous difference whether the revenue split is anchored in the constitution (or another organic law requiring qualified majority) or in the annual budget law.

In the revised version of 2005–06, a first attempt is made to draw a conceptual dividing line between revenue sharing and grants (BLÖCHLIGER and KING, 2005, p. 21) and to set up a new taxonomy of grants (Figure 3.7). With regard to the latter, the most important innovation compared to the classification by Owens and Norregaard is the distinction between mandatory and discretionary grants. The former ones (also called 'entitlements') are rules-based grants for which both the size of the grant and the conditions of availability are laid down in a law or statute.⁴⁴ Discretionary grants are distributed *ad hoc* and are often temporary in nature (e.g. aid in case of a natural catastrophe). Discretionary grants increase the room for manoeuvre for the grantee in a certain situation, but since they are unpredictable, they do not enhance his fiscal autonomy from the outset. In the group of not-earmarked grants, block grants provide less freedom than general-purpose grants; even though they are not earmarked for a specific expenditure programme, they are tied to a specific purpose and the output might be regulated through centrally defined minimum standards.⁴⁵

In another strand of research, DAFFLON (1992) and DAFFLON and PERRITAZ

⁴⁴Not-earmarked mandatory grants are what EBEL and YILMAZ (2002) and Meloche et al. (2004) call general grants whose allocation is based on objective criteria.

⁴⁵For a more detailed explanation on each category of the taxonomy, see BERGVALL et al. (2006, p. 115 ff.).

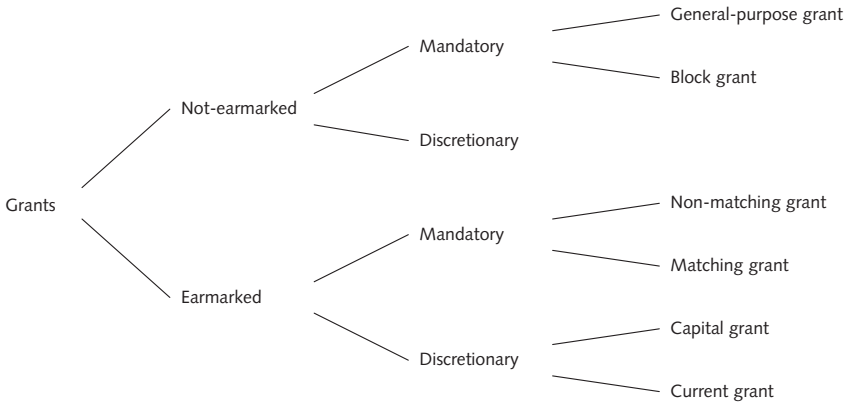


Figure 3.7: **The OECD taxonomy of grants, 2006**
 [Source: Blöchliger and King (2006, p. 172)]

(2000) limit their investigations to municipal tax autonomy and propose a framework that is inherently different from those presented above. Starting from the general formula

$$T = t \times (B - D) \times k \quad (3.1)$$

where T denotes the tax yield, t the tax rate (or rate structure), B the tax base, D the deductions, and k the annual tax coefficient, if municipalities are allowed to surcharge higher-level taxes (piggybacking), they draw up a list of 'elements of fiscal sovereignty' of municipal governments:

- a) choice between tax or user charge in financing a specific local public service
- b) items subject to tax or user charge ($B - D$)
- c) group of individuals liable to the tax
- d) method of calculating the tax or user charge
- e) rate structure (t), including the maximum payable amount
- f) annual tax coefficient (k)
- g) method of collecting the tax or user charge
- h) coordination of contentious issues.

Local governments that have control over the elements from a to g enjoy what the authors call ‘full fiscal sovereignty (or autonomy)’.⁴⁶ The right to influence a as well as some (but not all) parameters between b and e corresponds to ‘partial (or limited) tax sovereignty’. If local authorities can control only f and g but have no influence on the parameters from a to e, they enjoy ‘fiscal flexibility’. Finally, local tax autonomy is zero if all parameters from a to f are exogenous (defined by a higher-level government).

The model reflects the particularities of Swiss fiscal federalism. It breaks with the distinction by Owens and Norregaard between rate structure and tax level but reintroduces tax surcharge (piggyback taxation) as an explicit and distinct category. This practice appears in the freedom to determine the annual tax coefficient (k). Revenue-sharing arrangements do not appear directly among the elements of fiscal sovereignty but nothing hinders the application of the method on this category as well. The novelty of the Swiss approach is that it includes into taxing power the liberty of choice between taxes and user charges (i.e. non-tax revenues) in financing local expenditures and applies the same set of criteria to both sources of revenue. Applied to a specific tax or user charge, the liberty of choice means the freedom of not levying it at all.

An application of the model on the municipalities of the Canton of Fribourg (DAFFLON, 1992, p. 42) reveals that the degree of autonomy varies according to revenue type and also according to tax types, yet sovereignty over b, c, and d goes together for every kind of revenue: the municipality controls either all or none of these variables. What makes a difference between the revenue types is whether local governments are allowed to determine the rate structure (which occurs mainly in those revenue categories for which b, c, and d are in local competence) or whether they can merely (if at all) apply a piggyback rate to the cantonal or federal tax. Not surprisingly, neither the choice of the funding source nor the collection method shows any correlation with another element of fiscal sovereignty.

Table 3.6 provides a comparative overview of the four approaches based on the parameters they include or ignore.

Any of these approaches offers a more reliable result than the simple GFS-based decentralisation ratios presented in Section 3.5.1. However, they all overestimate the degree of local fiscal autonomy insofar as they do not take into account the effective power (the productive efficiency) of the decentralised revenue sources and their weight in the local budget in monetary terms. For instance, in most countries,

⁴⁶The authors admit that municipalities cannot have exclusive competence over the domain h, given that in a democracy characterised by the separation of powers, the judiciary must retain the ultimate authority over contentious issues.

Table 3.6: Comparative overview of the approaches to measuring subnational revenue autonomy [Source: the author]

Parameters of autonomy	Owens and Norregaard (1991)	OECD (1999)	Blöchliger and King (2005)	Dafflon (1992); Dafflon and Perritaz (2000)
Taxes*				
Choice between tax and user charge				×
Group of taxpayers				×
Base	×	×	×	×
types of tax reliefs			×	×
consultation with SCG			×	
Rate (tax level)	×	×	×	×
unlimited	×		×	
maximum	×			×
minimum / maximum	×			
consultation with SCG			×	
Rate structure	×			×
Tax surcharge	×	(x)	(x)	×
Calculation method / assessment	×			×
Collection	×			×
Contentious issues				×
Revenue-sharing arrangements				
Right to determine formula		×	×	
Right to modify formula		×	×	
Intergovernmental transfers and grants				
Grant level	×			
Spending target	×		×	

* For Dafflon (1992) and Dafflon and Perritaz (2000), this category includes user charges as well

118 property tax is an exclusive competence of local authorities and it could therefore be assumed to improve local autonomy considerably. The practice shows, however, that property tax is not as powerful as the classical literature has stated (BIRD, 2006). As for user charges, many local public services are ill suited for being financed from these sources (OWENS and NORREGAARD, 1991). Besides, local governments seldom have full sovereignty over them: the central government usually demands to set the minimum rate at cost-recovery level or imposes a maximum rate.⁴⁷ Hence, user charges do not *directly* increase local autonomy, although indirectly they do, as they liberate a corresponding amount of tax revenue that can thus be diverted into other policy areas. Yet, if even such ‘classical’ own-source revenues tend to escape the control of local governments, then any indicator of local revenue autonomy must be handled with great care. Furthermore, the qualitative indicators presented above ignore all the other legal and non-legal restrictions on local revenue autonomy that were elaborated in Section 3.4.3.

Quantitative indicators In contrast to the qualitative indicators of revenue autonomy that show what kind of control local authorities have over which type of revenue and to what extent these various types of revenues contribute to the local budget, quantitative indicators try to capture the degree of autonomy over the whole range of local revenues in percentage points.

As mentioned in Section 3.5.1, the traditional GFS-based indicators (local government revenue over general government revenue or over GDP) soon turned out to be inaccurate for the measurement of real revenue autonomy. It was not until the early 2000s, however, that the development of more sophisticated indicators could take wings.

Drawing on a more detailed data set delivered by the OECD in a series of country surveys from 2001 (‘Fiscal Relations across Levels of Government’), several researcher teams launched themselves in cross-country analyses of local fiscal autonomy. They sought to construct a more reliable indicator of revenue autonomy that would ultimately allow them to revise the results of earlier GFS-based analyses on the relationship between fiscal decentralisation and selected macroeconomic variables. The survey results that served as raw material for these post-2000 studies were a lot more detailed than any previous datasets and were arranged in the following structure:

⁴⁷It might also require revenues to be strictly earmarked to the service domain in which they were collected, but this belongs to the realm of expenditure autonomy, not revenue autonomy.

- *Tax revenues*
 - own tax revenues, if local governments have full or significant control over the tax base and rates;
 - revenues from tax sharing, if local governments have little or no control over the tax base and rates.⁴⁸
- *Non-tax revenues* include any income from business operations and property, administrative fees and duties, and fines.
- *Intergovernmental grants* (allocation based on objective criteria or a discretionary measure)
 - general purpose grants;
 - specific (earmarked) grants
 - conditional in their allocation across local governments⁴⁹
 - unconditional: this type of specific grant gives more autonomy to local governments.

By analysing the *composition* of local revenues, the researchers hoped to be able to correct the misrepresentation of the level of revenue autonomy that results from the use of simple GFS indicators. Notably, the OECD survey data demonstrate clearly that the level of revenue autonomy estimated with such ratios will be different as soon as one looks into the level of sovereignty over these revenues; besides, the two variables do not correlate with each other. For example, municipalities in Lithuania have a low degree of control over a large share of public revenues, which means that the classical GFS ratio overestimates the level of local revenue autonomy. In contrast, Slovakian local governments enjoy a very high degree of control over a small proportion of aggregate government revenues, suggesting that a simple decentralisation ratio would necessarily underestimate their autonomy. The survey data reveal unambiguously that the term ‘degree of control’ is meant here exactly in the sense of the OECD taxonomy of taxing power dating from 1999 (see Box 3.2), namely, as a control over the main revenue parameters, namely tax rates, tax base

⁴⁸In the latter case (no control by local governments), the centre determines tax base, tax rates and the revenue split. In fact, what the OECD calls ‘revenues from tax sharing’ has nothing to do with tax sharing but corresponds rather to a system of revenue sharing (or shared revenues); see Footnote 40 earlier in this chapter.

⁴⁹‘Conditional’ is probably meant here in the sense of ‘matching’: the amount of the grant depends on how much of its own revenue the grantee spends on the public service concerned.

120 (relief) and – in the domain of revenue sharing – the influence on the revenue split. It does *not* imply the freedom to decide how to spend these revenues.

The main difference between the post-2000 studies are in the choice of those revenue items that constitute local own revenues (the numerator of the autonomy indicator) and the broader category to which the sum of own revenues is compared (the denominator). It is important to note at this point that none of the models includes loans or bailout grants in the calculation, and rightly so. For the reasons explained in Section 3.4.4, debt and bailout cannot be handled on an equal footing with regular revenue sources; they are relevant for budgetary autonomy but not for revenue autonomy.

Out of the three models considered here, the first and the second one (EBEL and YILMAZ, 2002; MELOCHE et al., 2004) commit immediately the error of misinterpreting the notion of ‘degree of control’ over local revenues.

EBEL and YILMAZ (2002) propose a new ‘decentralisation variable’ that can be illustrated with the formula

$$SRA = \frac{OR_{SNG}}{TR_{SNG}} = \frac{[T_{discr} + NT_{discr} + GG_{obj} + SG_{uncond}]_{SNG}}{[T + NT + GG + SG]_{SNG}}, \quad (3.2)$$

where ‘Local Revenue Autonomy’ *SRA* is written as a quotient of own revenues OR_{SNG} and total revenues TR_{SNG} of subnational governments. T_{discr} denotes the tax revenues for which subnational governments have significant or full discretion over rates and/or relief, NT_{discr} are the non-tax revenues for which subnational governments have significant or full discretion over rates and/or relief, GG_{obj} are the general-purpose grants allocated according to objective criteria, and SG_{uncond} denote unconditional specific grants.

As for the composition of subnational own revenues, the authors exclude the allotments from revenue sharing but include those taxes over which decentralised governments have policy control as well as the totality non-tax revenues.⁵⁰ However, they also include non-conditional (i.e. non-matching) specific grants as well as those general-purpose grants whose allocation is based on objective criteria, thereby consciously risking an overestimation bias. Their argument is that ‘subnational governments have at least expenditure autonomy over these grants’ (EBEL and YILMAZ, 2002, p. 10).

⁵⁰The authors do not state explicitly that they include the *totality* of non-tax revenues and not only those over which local governments have significant or total discretion. This becomes visible only through a comparison with primary OECD data or with MELOCHE et al. (2004). Their choice is arbitrary, though, since central governments in several countries impose limitations on user charges and fees.

The problem with this approach is that it combines two different arguments to construct a single category of subnational own revenues. The reason why T_{discr} and NT_{discr} are included is that decentralised authorities have partial or full discretion over rates and relief, whereas GG_{obj} and SG_{uncond} are included because subnational governments are free to decide how to spend these revenues. The freedom of spending is actually true for T_{discr} and partly true for NT_{discr} as well (as long as the law does not oblige subnational authorities to earmark their user fee revenues), and if the authors had been truly consistent in their reasoning, they should have also included the allotments from revenue sharing. By contrast, it is hard to understand how decentralised governments could have expenditure autonomy over any kind of specific grants: these are *per definitionem* earmarked for a certain spending purpose (regardless of whether matching is required or not), as opposed to general grants that can be used freely.

Finally, GG_{obj} and SG_{uncond} should normally not feature under subnational own revenues unless the national constitution or another statutory law guarantees the size of the distributable pool so that it cannot be changed in the budgeting process every year. The model lacks this important specification.

Even with their generous definition of subnational own revenues and the resulting overestimation bias, the authors find that decentralised governments in a selection of six Central and East European countries (including Lithuania but not Slovakia) had far less control over their revenues in 1999 than what the GFS-based indicators had previously suggested.

Applying the same formula to four additional countries in the region (including Slovakia), MELOCHE et al. (2004) confirm that simple GFS ratios provide an imperfect measure of revenue autonomy. On the other hand, they criticise the decentralisation variable developed by Ebel and Yilmaz on the grounds that it ignores the size of the subnational government sector. They claim that Formula (3.2) is still not able to capture the difference between Lithuania and Slovakia in terms of the contents of their subnational revenue autonomy. Indeed, the value of the SRA indicator is 56.2 per cent for Slovakia and 7.1 per cent for Lithuania, but the SRA says nothing about the importance of these figures within the entire inter-governmental revenue system. In order to resolve this problem, MELOCHE et al. propose to make a change in the denominator. The new indicator that they call ‘Own Revenue Ratio’ is given by

$$\text{ORR} = \frac{OR_{\text{SNG}}}{TR_{\text{SNG}} + TR_{\text{CG}}} = \frac{[T_{\text{discr}} + NT_{\text{discr}} + GG_{\text{obj}} + SG_{\text{uncond}}]_{\text{SNG}}}{[T + NT + GG + SG]_{\text{SNG}} + TR_{\text{CG}}}, \quad (3.3)$$

122 where TR_{SNG} are the total revenues of subnational governments and TR_{CG} the total revenues of the central government.

For the sake of exhaustiveness, they develop an opposite indicator as well, the ‘Dependent Revenue Ratio’

$$\begin{aligned}
 DRR &= \frac{DR_{SNG}}{TR_{SNG} + TR_{CG}} \\
 &= \frac{[(T - T_{discr}) + (NT - NT_{discr}) + (GG - GG_{obj}) + (SG - SG_{uncond})]_{SNG}}{[T + NT + GG + SG]_{SNG} + TR_{CG}}
 \end{aligned}
 \tag{3.4}$$

measuring local dependency from the central government. The variable DR_{SNG} stands for the dependent revenues of subnational governments.

In the denominator of both formulae, (3.3) and (3.4), total subnational revenue is replaced with the total revenues of general government (the aggregate revenue of all government tiers). The innovation consists thus in the combination of the SRA indicator and the GFS indicator. Calculating the ORR values for Slovakia and Lithuania, we get 2.75 per cent and 1.63 per cent respectively, which suggests that the level of subnational revenue autonomy is comparable in both countries if one considers not only the degree of subnational control over specific revenue parameters but also the share of decentralised governments within the aggregate public revenues. ORR and DRR appear therefore to be more suitable for cross-country comparisons than the SRA. Nevertheless, by leaving the numerator of the SRA intact, the authors simply ignore the methodological error committed by Ebel and Yilmaz and thus cannot escape the overestimation bias.

BLÖCHLIGER and KING (2006, p. 179) are the first authors who do not fall into the trap of overestimation as their predecessors did. Instead of overloading the numerator with a variety of revenue categories that could potentially be considered as ‘own’ revenues for one reason or another, they reduce the scope of analysis to the single domain of *taxation* and propose to calculate the autonomous tax revenue of subcentral governments over general government tax revenue. They define autonomous tax revenue as the yield of those taxes for which subcentral governments are free to determine either the tax rates, or the tax base, or both. The motive behind constructing yet another indicator is similar to that of the previous studies, namely the recognition that subcentral authorities in some countries have wide discretion over a small proportion of tax revenues while their counterparts in other countries have little autonomy over a large share of tax revenues. According to the authors, their indicator comes closest to what could be called a ‘composite

$$CI_{SRA} = \frac{AT_{SCG}}{T_{SCG} + T_{CG}} = \frac{[T_{discr}]_{SCG}}{T_{SCG} + T_{CG}}, \quad (3.5)$$

as it combines the share of subcentral tax revenues with the autonomy over those taxes. In the above formula, AT_{SCG} denotes the autonomous tax revenues of subcentral governments and $[T_{discr}]_{SCG}$ the tax revenues for which subcentral governments have significant or total discretion over rates and relief.

Processing revenue data from twenty-one OECD countries, Blöchliger and King come to the conclusion that the share of subcentral tax revenue over general government tax revenue is hardly related to their autonomy over these taxes. The data suggest that in 2002, the subcentral levels in Australia controlled only three per cent of the total tax revenues but had full discretion over the rates and relief for the totality of these revenues. By contrast, decentralised authorities in Germany had a tax share of seven per cent but could not freely determine rates and relief for almost half of these revenues. Not surprisingly, the value of the composite indicator is similar in both countries: 3.6 and 3.0 per cent, respectively, since the denominator takes account of the importance of autonomous tax revenues over the totality of government tax revenues. However, the *quality* of fiscal autonomy is entirely different. The finding is similar to that described by MELOCHE et al. (2004) with regard to the broader category of subnational own revenues (the case of Slovakia vs Lithuania). The difference is that the calculation by Blöchliger and King does not contain the overestimation bias that could arise if unconditional grants and transfers were also included into the formula.

Summing up the insights from the three models, four conclusions can be made. First, any of these models provide a better estimation of subnational revenue autonomy than the simple GFS ratios. Second, any indicator featuring general government revenues or its respective subcategory in the denominator provides a holistic (and therefore more reliable) picture of subnational revenue autonomy, contrary to other indicators that compare own-source revenues (taxes) to total local revenues (taxes) of the subnational levels. The holistic indicators are also more suitable for cross-country comparisons than the partial ones. Third, two countries in which such a holistic indicator produces identical values do not necessarily provide the same *quality* (or content) of revenue autonomy to their decentralised units. Fourth, with a careful composition of the numerator that considers only the discretion over revenue parameters (and not over revenue use), one can eliminate an important overestimation bias.

With all due respect, we need to note here, however, that none of the three approaches can eliminate another overestimation bias, namely the one that results from the ignorance of other (not or not easily quantifiable) constraints on subnational revenue autonomy. These are the indirect legal constraints as well as all the non-legal constraints that were presented in Section 3.4.3.

3.5.4 Measuring budgetary autonomy

We saw in Section 3.4.4 that the main levers of local budgetary adjustment were revenue and expenditure policies. Borrowing and the outlook for a possible bailout may also create the impression of an enlarged room for manoeuvre but they cannot be considered as regular instruments for budgetary adjustment. Loans are temporary resources that must be paid back in due time, while bailout is a discretionary grant provided at the end of the year and as such it cannot be planned upon in advance. The threat they pose on the macroeconomic stability has led national legislations to impose strict rules or an outright ban on local borrowing and bailout. These obviously affect what decentralised governments perceive to be part of their budgetary autonomy.

Even though there is obviously much more to budgetary autonomy than the simple freedom to make a deficit or to borrow, the only aspect that scholars have tried to measure so far is the strictness of formal fiscal rules. The series of modern indices started with the ACIR index for strictness of balanced budget rules developed by the US Advisory Commission on Inter-governmental Relations in 1987 that is constructed from two scores. The first one is based on whether the rule is self-imposed or imposed by (or agreed with) a higher level of government, while the second one evaluates the strictness of the balanced budget requirement. Ten years later, the Inter-American Development Bank presented the so-called IADB index of borrowing autonomy composed of a variable that examines the explicit restrictions on borrowing and another variable assessing the extent to which ownership of public enterprises or banks may increase local borrowing autonomy (SUTHERLAND et al., 2005a).

In an attempt to assess how fiscal rules in a given country can contribute to restraining the size of the public sector, SUTHERLAND et al. (2005b) developed a composite indicator constructed from a two-level hierarchy of sub-indices. Recognising that the relative importance attached to different rule characteristics may vary both across countries and across time, they decided to adopt the random weights technique. The application of the sub-indices on a set of OECD country data reveals that local governments subject to strict balanced budget rules are also likely to face stringent controls on debt and in most cases rigorous accountability

rules. A further application of this work is found in BLÖCHLIGER and KING (2006) who create an indicator of budget and deficit autonomy as well as an indicator of borrowing autonomy through a simple linear transformation of the indices developed by Sutherland and his fellow authors; although it is not clear to which indices they are referring.

3.6 The principle of subsidiarity

3.6.1 Decentralisation—autonomy—subsidiarity At the end of Section 3.1.2, we saw that in any government system, some public sector functions are more decentralised than others are, and the degree of municipal autonomy is in a linear relationship with the degree of decentralisation. To put it differently, in terms of their mode of provision, public services are situated on an axis between full centralisation and full devolution, with deconcentration and delegation being two intermediate forms on the continuum that points towards a maximum degree of decentralisation, namely, devolution. Each point on the decentralisation axis (representing various public services) corresponds then to a certain degree of local autonomy that ranges from zero autonomy (for centralised functions) through partial dependency (deconcentrated and delegated functions) to perfect sovereignty (devolved functions). It is important to emphasise that the decentralisation axis consists of continuous rather than discrete values and hence autonomy, too, can be visualised as a continuous function of decentralisation.

Where exactly a given public task is situated on the decentralisation axis, i.e. to what extent it is centralised or decentralised, is a function of the actual assignment of responsibilities within the given government system and the underlying principles and value judgments. The first authors to pronounce themselves on the assignment of functions in decentralised systems, MUSGRAVE (1961) and OATES (1968, 1972), propose to keep stabilisation and redistribution functions of the state at the central level and to decentralise a part of the allocation branch, notably the provision of public services with regional or local scope, to lower tiers of government. According to Oates, the optimal size of government to perform a specific function depends, among other criteria, on economic factors such as the heterogeneity of preferences, the costs of information and decision, the potential for realising economies of scale, and the spatial distribution of the benefits provided by the service (the importance of spillover effects).⁵¹ However, taking account of

⁵¹Oates does not deny the importance of the political dimensions of the question about the optimal

126 all these factors would result in a territorial organisation with as many different sizes of authorities as there are public services.

In practice, expenditure assignment follows a more pragmatic approach based not only on economic but also on political, historical, ideological and on other criteria. A widely used criterion of expenditure assignment, at least in Europe, is the principle of subsidiarity. Put it simply, this principle holds that in a multi-level government system, every task belongs to the lowest competent level.

There are obvious links between subsidiarity and federalism. SANTER (1991) views federal systems as pyramids that can only be sound if their base is broad, that is, if the organisations at the base are left to do everything they can do. Higher authorities intervene only if the lower ones withdraw. The bodies closest to the base of the pyramid are also the ones closest to citizens. For such a pyramid to be realised, it is important that the residual clause of the expenditure assignment rule be in favour of the local or intermediate level of government.

For Santer, subsidiarity is thus a condition for sound bottom-up federalism. GRETSCHMANN (1991) joins this view affirming that subsidiarity represents a bottom-up approach in that it always empowers the respective lowest competent level. Indeed, in case of top-down decentralisation, the link with subsidiarity is less strong. According to FRASCHINI (2001, p. 58), ‘decentralisation does not request that the State is organised according to the principle of subsidiarity, but [...] subsidiarity is a principle which could well inspire any decentralisation exercise.’

3.6.2 The origins of the principle of subsidiarity The origin of the notion of subsidiarity (‘subsidium’ = aid) is still an object of debate among scholars of different backgrounds (see STAUFFER, 1999). Yet there is consensus about the fact that the point of departure for all modern interpretations of the concept dates back to Pope Pius XI who made subsidiarity to a cornerstone of Catholic social teaching in 1931. In his Encyclical on the Reconstruction of Social Order, *Quadragesimo Anno*, he wrote:

Just as it is gravely wrong to take from individuals what they can accomplish by their own initiative and industry and give it to the community, so also it is an injustice and at the same time a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organizations can do. For every social activity ought of its very nature to furnish help to the members of the body social, and never destroy and absorb them. (*Quadragesimo Anno*, para. 79)

size of government, yet he limits the discussion deliberately to the economic aspects OATES (1968, p. 53). For a good overview of the economic criteria discussed by Musgrave and Oates, see DAFFLON (2006).

Sixty years later, Pope John Paul II confirmed the idea of Pius XI with the following words:

A community of a higher order should not interfere in the internal life of a community of a lower order, depriving the latter of its functions, but rather should support it in case of need and help to coordinate its activity with the activities of the rest of society, always with a view to the common good. (Centesimus Annus, para. 48)

These texts contain already all those constitutive elements of the notion of subsidiarity that gave rise to so many different interpretations in the subsequent decades.

1. According to most of the current interpretations, the higher authority *may* intervene in the affairs of lower organisations *but only* to the extent to which the lower authority or the individual ‘has shown or proved its incapacity’ (COUNCIL OF EUROPE, 1994, p. 10) or ‘is not able to fulfil a task on its own’ (STAUFFER, 1999). Here, subsidiary is interpreted in the sense of ‘secondary’ or ‘of lesser importance’. All interventions must be auxiliary in scope and scale. We cannot be convinced, however, that allowing the higher authority to intervene *at all* corresponds to the original intention of the papal encyclicals. These stress, ‘it is *gravely wrong* to take from...’ and ‘a community of higher order *should not interfere...*’ (emphasis added), which could equally suggest that the primary rule for the state is *not to intervene*. The semantic difference between the assertion ‘the higher authority may intervene if...’ and ‘the higher authority may not intervene unless...’ cannot be overseen. The wording of the encyclicals is perfectly neutral, and one can only wonder whether or not the biased interpretation proposed by the Council of Europe and picked up by various authors might be an instrument serving to legitimate the intervention of the higher tier in today’s practice.
2. The term *subsidiary* evokes also the idea of aid or rescue (‘subsidium’ = ‘help’) and has the connotation of intervention. According to Jacques DELORS (1991, p. 9), ‘subsidiarity is not simply a limit to intervention by a higher authority vis-a-vis a person or a community in position to act itself, it is also an obligation for this authority to act vis-a-vis this person or this group to see that it is given the means to achieve its ends.’ The COUNCIL OF EUROPE (1994, p. 10) uses a less precise language: ‘Here it is a question of assessing, not if the authority has the right to intervene, but if it has the duty to do so.’ This interpretation is confusing because it ignores the difference between two types of intervention that the encyclicals (and also Delors)

clearly distinguish; namely, between ‘destroy’ / ‘absorb’ / ‘interfere’ on the one hand, and ‘support’ / ‘(furnish) help’ on the other. The encouraging type of intervention, which is indeed the *duty* of the higher authority, must be clearly distinguished from interference that is not a question of duty but one of *right*.

3. All members of society have to acknowledge the common good. Here, subsidiarity is more than a presumption of competence in favour of the lower level. ‘Society is based on mutual assistance and every part has to take responsibility for the common good. In this sense, not individual freedom but societal bonding is to be maximised [...]’ (STAUFFER, 1999). Transposed to the level of communities, this message suggests that subsidiarity is not an argument in favour of a minimal state and a corresponding maximum autonomy for lower-level communities. Rather, it is an argument in favour of a well-functioning society in which the level of local autonomy is optimised ‘with a view to the common good’, whatever this common good may mean (see below). Unfortunately, this important element of the original concept is rarely mentioned in the discussions on subsidiarity.

While the encyclical letters clearly indicate the general trend to be followed, they also leave two questions unanswered.

What kind of incapacity calls for which type of intervention?

First of all, the encyclicals do not draw a clear dividing line between those situations (or types of incapacity) that call for *support* by the higher organisation and those that necessitate the *withdrawal* of a competence. In reality, virtually all kinds of incapacity can be addressed in one way or another without necessarily requiring a re-assignment of the function to a higher level. Managerial and administrative capacity problems can be corrected with an increase in the jurisdiction size (via co-operation or amalgamation of the authorities concerned) or through specific measures for capacity building. Reforming the territorial structure may also be a remedy for financial incapacity, although the usual short- and medium-term solution to this latter problem is a system of block grants (possibly in the framework of an equalisation scheme) or the re-assignment of revenue sources among government tiers. For DAFFLON (2006, p. 290), for example, financial incapacity can never be the reason for the re-centralisation of a competence: the only argument that justifies a transfer to higher levels is when the inherent (technological) dimension of the task exceeds the natural capacity of a small government unit.

As a matter of example, expecting a village to operate a highly specialised clinic with advanced technology is not realistic.

Who has the right to declare incapacity? As has been mentioned above, the original texts released by Pius XI and John Paul II do not elucidate the question as to whose verdict should matter in this regard. One could very well assume that it is up to the lower authority to make a sign when it is no longer capable of exercising its responsibility and no other person or authority has any legitimacy to decide in this matter, even though this approach might be criticised for being too federalist and restrictive.⁵² On the other hand, the COUNCIL OF EUROPE (1994, p. 16) proposes that ‘if the intervention of the higher authority is necessary, the lower authority must be consulted “in so far as possible, in due time and in an appropriate way”’, in line with art. 4 para. 6 of the European Charter of Local Self-Government. This suggests that the verdict about the incapacity may also come from the higher authority, though no intervention is admitted without prior consultation of the lower authority concerned.

These questions are important because they remind of the double interpretation of intervention, once as a *duty* (to furnish help) and then as a *right* (to transfer the competence to a higher level). In the spirit of the encyclicals, we could attempt to conclude that the withdrawal of a competence from the lower authority is legitimate if and only if the following three conditions are met simultaneously:

- Within the limits of its competence and capacity, the higher authority has offered all reasonable assistance to the lower authority in order to address the (managerial, administrative, financial, etc.) incapacity of the latter;
- The lower authority has already exploited every opportunity within its competence in order to regain capacity or it is unwilling to search for an autonomous solution;
- Either the demand for a re-assignment of the competence comes from the lower authority or, if it comes from the higher authority, it is consulted with the lower organisation before any action is undertaken.

⁵²Swiss scholars tend to understand subsidiarity in this restrictive sense, but indeed few (if any) other nations seem to share this interpretation. It is true that the ‘federalist approach’ is inspired by the particular (bottom-up) institutional system of Switzerland rather than by any principle of political theory. In Switzerland, no public function can ever be transferred from a municipality to the canton or the federal state without a vote in which the constituency of the lower authority give their consent to the proposed change.

This threefold condition may give the impression of being exhaustive. Yet, when applied in practice it gives rise to further questions. What does 'reasonable assistance' mean? Where are the capacity limits of the higher authority? The central government may refuse to provide grant-in-aid to a local authority and prefer withdrawing the competence, arguing that a capacity enhancement is impossible due to general budget restrictions. Is this an acceptable reaction or would we rather expect the central government to revise its budget or to re-assign functions and resources among the government tiers? Here, the vision of the 'common good' may be of some help, but it is not likely that all stakeholders have the same opinion about what is the best for society (more autonomy or more centralism). And what sort of effort can we realistically expect from the lower authority? Further, what exactly does 'consultation' mean? Does it need to result in a commonly agreed solution or should one of the authorities have the final word?

3.6.3 Subsidiarity in Europe Subsidiarity as a legal and political concept appeared in the European Communities in 1975 and it was introduced in the Draft Treaty Establishing the European Union in 1984. In order to avoid that the European project give birth to a centralising super-state, the so-called Spinelli Draft proposed the following:

The Union shall only act to carry out those tasks which may be undertaken more effectively in common than by the Member States acting separately, in particular those whose execution requires action by the Union because their dimension or effects extend beyond national frontiers. (Draft Treaty Establishing the European Union, art. 12 para. 2)

Although the Draft has never been passed and has thus no legal validity, the way this paragraph is formulated may leave the reader puzzled about what precisely was meant here by the term 'effectively' (the supra-national dimension or effect of the task appears to be only one particular factor) and who should decide in this matter. The return of the same principle in the Treaty of Maastricht of 1992 (the first document in which subsidiarity as a general principle was mentioned for the first time officially and explicitly) only adds to the confusion:

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go

beyond what is necessary to achieve the objectives of this Treaty. (Treaty establishing the European Community, as amended by the Treaty of Maastricht; art. 3b)

‘Effectively’ (undertaken tasks) are replaced here with ‘sufficiently’ (achieved objectives) without any clarification about the content of this criterion. Besides, the Treaty of Maastricht is already more restrictive concerning the range of competences suitable for decentralisation: the ‘exclusive competences’ of the Community are excluded from the outset. This approach clearly departs from the original sense of subsidiarity as interpreted in the Catholic social teaching.

It would be unjust to ignore the attempt that GRETSCHMANN (1991, p. 50) made to elucidate the meaning of effectiveness in the context of the Draft Treaty of 1984. According to his view, the criteria offered by the economic theory of federalism for the determination of the optimal size of jurisdictions, notably economies of scale and spillover effects ‘can be interpreted as means to specify the analytical black space in the definition of subsidiarity, i.e. which level of authority is able to perform the task *adequately*.’ Since both concepts are closely related to economic efficiency, ‘adequate’ or ‘effective’ performance for Gretschemann is one that is *economically efficient*. Even though his view could be criticised for being too narrow (other criteria such as proximity, control, equal access, room for experimentation, etc. could also substitute for ‘adequate’), it goes nevertheless a step further than the encyclicals because it combines capacity with economic efficiency. It is at the same time more restrictive than the papal letters: the lower authority must not only be capable of executing the task but also be capable of executing it in an economically efficient way.

In 1992, the European Commission developed the notion of efficiency into a ‘test of comparative efficiency’ that takes into account, beside the traditional economic efficiency arguments, criteria such as the cost of failure to act, the need to maintain a reasonably coherent policy, the limits of individual national action, and need to observe the rules of competition.

While the European Communities and the European Union employ subsidiarity as a guiding principle for the relations between the supranational European organisation and the member states, the definition proposed by the Council of Europe in 1985 is specifically adapted to the relations between national and sub-national governments *within* the ratifying states. The European Charter of Local Self-Government introduces four criteria that help decide to which level of authority a competence should be assigned; these are the extent and the nature of the task (objective criteria, according to COUNCIL OF EUROPE, 1994, p. 14), as well as efficiency and economy (subjective criteria).

Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy. (European Charter of Local Self-Government, art. 4 para. 3)

The Explanatory Report attached to the Charter suggests that not only the size and nature of the task but also the size and nature of the executing local authority is relevant. The principle of subsidiarity ‘does not imply [...] a requirement systematically to decentralise functions to such local authorities which, because of their nature and size, can only accomplish limited tasks’ (COUNCIL OF EUROPE, 1985b, p. 7). On the other hand, the Report says: ‘[...] unless the size or nature of a task is such that it requires to be treated *within a larger territorial area* [...]’ (emphasis added). The reference to a larger territorial area instead of a higher authority suggests that, before transferring a task to a higher authority, increasing the size of local authorities through association or amalgamation may be a possible solution DAFFLON (2006, p. 291). In fact, if we adhere to one of the earliest interpretations of ‘subsidiary’ as a duty to help, then such a solution is not only possible but also preferable to the re-assignment of the task to a higher level.

The first major review of the definition and limits of the principle of subsidiarity in light of the practices of member states took place in the mid 1990s. A study prepared for the Steering Committee on Local and Regional Democracy revealed that the rather vague term ‘generally’ in art. 4 para. 3 of the Charter refers to the principle of subsidiarity as ‘a standard of general scope’ (COUNCIL OF EUROPE, 1994, p. 13), while ‘in preference’ marks a political choice. It also took in a relatively prudent position on the terms ‘economy’ and ‘efficiency’ (without actually explaining the difference between them) to suggest that decentralised management and closeness to citizens are not forcibly efficient. The questions as to what is efficient and who has the right to determine if something is (in)efficient were not further considered. With regard to the ‘nature’ of the task, DAFFLON (2006, p. 291) noted later that, in whatever sense ‘nature’ is understood, it cannot be limited to economic parameters only, since the latter are the ones to which the nature of the task shall be opposed.

An important development in the understanding of the principle of subsidiarity is the attempt of the study to establish a link between the principle itself and art. 9 concerning the financial resources of local authorities. The authors emphasise that ‘state intervention is necessary but to enable each authority to acquire the means to exercise its own will’ (COUNCIL OF EUROPE, 1994, p. 15). Hence, in case of need, the higher authority should offer grants and other financial equalisation measures

without diminishing the discretion lower authorities may exercise within their own jurisdiction. It should also consult the lower authority, 'in an appropriate manner, on the way in which redistributed resources are to be allocated to them' (European Charter of Local Self-Government, art. 9 para. 6).

The study also concludes that the application of the principle of subsidiarity should take into account the existence of other principles that govern the organisation and functioning of the state, such as:

- unity of action (avoiding the duplication of effort);
- efficiency in the widest sense;
- unity of application (reconciling equality with subsidiarity);
- solidarity (balancing out resources among different authorities).

A year later, the Committee of Ministers of the member states transformed these insights into a set of recommendations (COUNCIL OF EUROPE, 1995). This document marks a return to the idea of a 'common good' insofar as it stipulates that '[...] the principle of subsidiarity should be implemented in conjunction with other organising and operating principles of the state, such as the principles of coherence and unity of application of public policies for the benefit of all citizens, of co-ordination and of territorial solidarity.' (COUNCIL OF EUROPE, 1995, p. 1)

In this spirit, it recognises that not all local authorities of the same level are necessarily capable of meeting the same responsibilities and hence, member states should adopt a pragmatic and flexible approach. It reaffirms the importance of financial equalisation policies in favour of the financially weaker local authorities and encourages the central governments to implement principles of expenditure assignment that are designed to match powers with the characteristics (resources, size, geographical location, etc.) of the lower authorities.

Owing to the countless ambiguities around the core idea of subsidiarity and its components, the principle has remained only a recommendation, a rule without normative character (GRETSCHMANN, 1991), or 'a mode of argumentation' (STAUFER, 1999), a trend. 'Rather than defining a norm, the principle of subsidiarity indicates a trend. It leaves open the concrete conditions of its application and these can therefore vary according to the circumstances of time and place' (COUNCIL OF EUROPE, 1994, p. 10). GRETSCHMANN (1991, p. 49) points to another advantage of the diverging practical interpretations of subsidiarity: 'consensus on a programme of institutional reform can be reached more easily if the key concept is not too cutting and precise.' On the other hand, he criticises the principle of subsidiarity

134 for starting from the assumption of exclusive powers to be assigned to different levels whereas the political reality is marked by interdependencies, complexities and overlapping responsibilities.

In spite of its apparent weaknesses, the principle of subsidiarity has served as a standard in the decentralisation process of East European transition economies and it continues to feed the debate about the renewal of existing decentralised and federal systems.

3.6.4 Subsidiarity and local (financial) autonomy The above investigations on the principle of subsidiarity are relevant to the study of local (financial) autonomy, but the relationship is not entirely straightforward. One thing seems to be sure: subsidiarity is not synonymous to local autonomy.

It is true that the underlying socio-philosophical idea of subsidiarity is autonomy (for GRETSCHMANN, 'sovereignty'; 1991, p. 47): the autonomy of an individual, a community, an organisation, or an authority. The spirit of both encyclical letters suggests that these smallest units of society should be allowed to preserve their autonomy as long as they do not feel constrained by their incapacity (in whatever way this is defined) to call for an intervention by higher organisations.

If an intervention reveals to be necessary, it should be of a kind that encourages and strengthens local autonomy instead of destroying it, and that 'enable[s] each authority to acquire the means to exercise its own will' (COUNCIL OF EUROPE, 1994, p. 15). Here, the principle of subsidiarity refers indirectly to the double definition of local autonomy, first as a *right* and then as an *ability* ('capacité effective'), as presented in Section 3.1.2.

The principle of subsidiarity finds its limits in the respect of the 'common good': it is not a presumption of competence in favour of the lower organisations. Instead of being maximised, the autonomy of the lower level should be *optimised* with a view to the global interest of society. The notion of 'common good' entails a multitude of criteria beside local autonomy, such as economic efficiency (minimising spillovers, maximising economies of scale), nature and size of the task, nature and size of the executing authority, costs of non-intervention, coherence, unity of application, or solidarity. What actually count are the relative weights of these criteria in the value system of the society, which are then (in an ideal case) reflected in the political programmes at all levels of government.

Finally, the question as to who is allowed to determine what exactly is meant by 'efficient' ('effective', 'sufficient', 'adequate', 'capable', etc.) is crucial for the autonomy. Only those local authorities that have the exclusive right to declare

their incapacity and those that are consulted upon their incapacity (inefficiency, etc.) and may co-operate with the higher government in the search for an optimal solution can be sure that their autonomy is respected. On the contrary, if the centralisation of competences results from a unilateral decision of the higher authority, then local autonomy is violated.

For the local application of the universal principle of subsidiarity, two elements of the discussion above may provide a fruitful basis:

1. the conditions of legitimate withdrawal of a competence from the lower authority (Section 3.6.2);
2. the meaning of key terms such as ‘reasonable assistance’, ‘consultation’, ‘incapacity’, ‘efficiency’, etc.

If both the central government and the subnational units accept the validity of the principle of subsidiarity 1, then they are implicitly ready to elaborate a consensus or a compromise about the key terms 2. The results of their negotiations would then place the principle of subsidiarity into the relevant national context, whereas the conditions and key terms under 1 and 2 remain universal.

PART II

**Local Financial Autonomy in Practice:
The Case of Hungary**

Legal and Institutional Framework

Chapter 2 suggested that no study of the practice of multi-level finance could do without a profound understanding of the underlying constitution and the network of legal and political institutions. We simply cannot start from the premise that fiscal decentralisation in any country would pursue the sole objective of economic efficiency as the early textbook theories suggested. Any reform of the intergovernmental fiscal relations must build upon the existing institutions (tradition, norms and legislation) even if the reform will eventually modify these institutions.

Section 4.1 will familiarise the reader with the constitutional and legal foundations of the multi-level system of elected governments established in Hungary in the late 1980s as well as the major motives behind the reform. Section 4.2 shows the measures with which the national legislature attempted to reconcile equality and asymmetry of subnational governments in line with the recommendations of the European Charter of Local Self-Government, with the aim to make the system politically acceptable and workable at the same time. The importance of the deconcentrated public sector and thus of the policy decisions that are outside the scope of subnational autonomy is discussed in Section 4.3. Finally, Section 4.4 shows how citizen participation at the local and the national level affects the financial autonomy of decentralised governments.

4.1 Constitutional and legal foundations of the decentralised public sector

The wave of fundamental institutional reforms starting at the end of the 1980s was marked by a strong desire to break with the fully centralised government system that characterised the country under the totalitarian regime. Already during that era, the government system consisted of three to four layers, the central state, counties, districts (from 1950 to 1983) and municipalities, but the dominant power resided with the ruling socialist labour party and its various organs. The steering councils ('soviets') of the intermediate levels, the 19 counties and the 83 to 140 districts, were merely deconcentrated agencies of the central state.¹ The Council of Ministers (the executive organ of the ruling party) appointed the members of the county councils and empowered them to exert a tight control over the 1,523 municipal councils that had no separate legal identity. The authorities of the three subcentral tiers had little own-source revenues (for the limited array of 'independent' resources such as tourist fees, stamp duties or licence fees, the centre set the rates) and only a few independent expenditure functions (BIRD et al., 1995c, p. 70). Deprived of their political and financial autonomy, they obviously could not be held accountable for their actions, thus they faced a soft budget constraint. Public goods and services were provided by state-owned companies that had little interest in matching the diverse preferences of individual local communities. Both public service provision and administration were characterised by low levels of efficiency and a permanent backwardness in the application of modern methods and techniques.

The first step in the reform of the government system was the creation of a new legal and institutional framework consisting of democratically elected and accountable subnational governments (SNGs).² With the legal and institutional reform, the Parliament explicitly sought

- to lend democratic legitimacy to all levels of administration;

¹Both counties and districts existed already in the Middle Ages. The district authorities acted as executive agents of the self-governing counties in an early system of territorial deconcentration. Coming into power at the end of the 1940s, the Communists reduced the number of districts from 150 to 140. Further consolidations made this number shrink to 83 by the end of the district system in 1983. By contrast, the number of counties has remained stable since 1950; however, they lost their democratically elected institutions.

²Throughout this study, the term 'subnational government' (SNG) refers to the freely elected, self-governing authorities of municipalities and counties; the self-governing bodies of national and ethnic minorities are excluded.

- to create safeguards against political and financial re-centralisation;
- to provide equal rights to all self-governing units;
- to accommodate the interests of selected communities such as the capital and its districts, large towns, and national and ethnic minorities (LÁSZLÓ, 1992; CSEFKÓ, 2000).

These objectives spurred the national legislature to redesign the entire government system through a global revision of the national Constitution and the elaboration of specific laws. During the revision of the Constitution (Act XX of 1949 on the Constitution of the People’s Republic of Hungary) in 1989, the legislators added an additional chapter to lay down the foundations of the system of democratically elected SNGs. The second major legislative measure in this direction was the adoption of the Act LXV of 1990 on Local Governments (ALG). Boxes 4.1 and 4.2 cite some of the most fundamental provisions of these laws.³

Box 4.1: Excerpts from the revised National Constitution [Source: ICL (2003)]

Act XX of 1949 on the Constitution of the Republic of Hungary
(including amendments before 31.12.2003)

[...]

Chapter IX
Local Governments

Article 41 [Administrative units]

- (1) The territory of the Republic of Hungary is divided into the following administrative units: the capital, the counties, the cities and communities.
- (2) The capital is divided into districts. Districts may be formed in cities as well.

Article 42 [Right to local government]

Eligible voters of the communities, cities, the capital and its districts, and the counties, have the right to local government. Local government refers to the independent and democratic management of local affairs and the exercise of local public authority in the interests of the local population.

³In the rest of the study, we will deliberately deviate from the terminology applied in the unofficial translation of the Constitution (ICL, 2003), replacing the term ‘city’ with ‘town’ (which sounds more plausible, given the relatively modest size of the average urban settlement in Hungary), and the term ‘community’ with ‘village’.

Article 43 [Fundamental rights of local governments]

- (1) The fundamental rights of all local governments (see Article 44A) are equal. The duties of local governments may differ.
- (2) The rights and duties of local governments shall be determined by law. The lawful exercise of the powers of local government is afforded the legal protection of the courts and any local government may appeal to the Constitutional Court for the protection of its rights.

Article 44 [Exercise of the right to local government]

- (1) Eligible voters exercise the right to local government through the representative body that they elect and by way of local referendum.
- (2) With the exception of mid-term elections, the mayor and the members of local representative bodies shall be elected in the month of October in the fourth year following the previous general elections.
- (3) The mandate of the representative body shall expire on the day of the general local government elections. If no elections are held due to the lack of nominees, the mandate of the representative body shall extend to the day of the mid-term elections. The mandate of the mayor shall expire upon the election of the new mayor.
- (4) A representative body may declare its dissolution prior to the expiration of its mandate and in accordance with the conditions stipulated in the law on local governments. Upon dissolution of the body [Article 19, Paragraph (3), Point (l)] the mandate of the Mayor also ends.

Article 44A [Representative body]

- (1) The local representative body –
 - a) shall independently regulate and manage the affairs of local government and its decisions may only be reviewed upon their legality;
 - b) shall exercise the rights of ownership in the assets of local government, may independently manage local government revenues, and may undertake business activities at its own liability;
 - c) shall be entitled to its own revenues for attending to the duties of local government as prescribed by law, and shall furthermore be entitled to state support commensurate to the scope of such duties;
 - d) shall determine the types and rates of local taxes in accordance with the framework established by law;

- e) shall independently establish its own organisation and rules of procedure in accordance with the framework established by law;
 - f) may develop symbols and emblems of government, and establish local honours and titles;
 - g) may present proposals to the authorities responsible for decisions that affect the local population;
 - h) may freely merge with other local representative bodies and create associations of local government for the representation of their interests; may co-operate with the local governments of other countries and may be a member of international associations of local governments.
- (2) Local representative bodies may issue decrees, which may not conflict with legal statutes of a superior order.

Article 44B [Mayor]

- (1) The Mayor is the chairman of the local representative body. The representative body may elect committees and create offices.
- (2) In exceptional cases the Mayor may attend to state administrative duties and authorities in addition to his responsibilities of local government, in accordance with the law or a government decree authorized by law.
- (3) State administrative duties and authority may be assigned to the Clerk of local representative bodies and in exceptional cases to the Director of the Office of Local Government.

Article 44C [Law on local governments]

A majority of two-thirds of the votes of the Members of Parliament present is required to pass the law on local governments. The fundamental rights of local governments may be restricted by a law which also requires a two-thirds majority.

The explicit reference to the European Charter of Local Self-Government (hereinafter: the Charter) in the preamble of the ALG attests the importance that the Hungarian Parliament attaches to the recommendations issued by the Council of Europe. As has already been quoted in Chapter 3, the Charter defines local self-government as ‘the right and ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population’ (COUNCIL OF EUROPE, 1985a, art. 3 para. 1). Both art. 42 of the Constitution and the preamble and art. 1 para. 1 of the ALG scrupulously respect this definition. Regardless of their size

Act LXV of 1990 on Local Governments
(including amendments before 31.12.2007)

Preamble

Following the progressive local government traditions of our country as well as the basic requirements of the European Charter on Local Self-Government, the National Assembly recognises and protects the rights of the local communities to self-government.

Local self-government makes it possible for the local community of electors to manage, directly and/or through their elected local government, the public affairs of local interest in an independent and democratic way.

Supporting the self-organising autonomy of local communities, the National Assembly assists in creating the conditions that are necessary for self-government and promotes the democratic decentralisation of public authority.

In order to realise these goals, the National Assembly enacts the following Act:

Chapter I
General Rules of Local Self-Government
Local government rights

Article 1

- (1) The local government of the village, the town, the capital city and its districts, and the county (hereinafter: local government), acts independently in those public affairs of local interest that belong to the sphere of its tasks and jurisdictional competence (hereinafter: local public affair).
- (2) Local public affairs are related to providing public services to the local constituency and exercising public authority in an autonomous way, as well as to ensuring the organisational, personal and material conditions of both activities within the local jurisdiction.
- (3) Within the limits of the law, the local government may regulate autonomously and, in individual cases, manage freely, all local public affairs coming within its sphere of tasks and jurisdictional competence. The Constitutional Court or the respective territorial court can overrule only those decisions that violate the law.
- (4) Through decision by the elected local body of representatives or by local referendum, the local government may voluntarily undertake the independent management of any local public affair that the law does not refer to the jurisdiction of another organ. In the sphere of voluntary local public affairs, the local government may do anything

that does not infringe the law. The management of voluntary local public affairs must not endanger the execution of mandatory tasks and jurisdictional competences imposed by law.

- (5) The law may also impose mandatory tasks and jurisdictional competences on the local government. Simultaneously with the definition of mandatory tasks and competences, the National Assembly shall ensure the material conditions of their execution; in addition, it shall make a decision on the size and type of contribution from the public budget.
- (6) Within the limits of the law, the local government –
 - a) may autonomously define its organisational and operational rules and create local symbols, distinctions and awards;
 - b) has autonomous control over its property, manages its revenues independently, and ensures the execution of voluntary and mandatory tasks by means of its unified budget. It may pursue any entrepreneurial activity at its own risk. Municipal local governments that come into difficulties through no fault of their own are entitled to additional support from the state;
 - c) may freely create or join local government associations [for joint service provision] as well as territorial and national interest groups for the representation and protection of its interests; within its sphere of tasks and jurisdictional competences, it may co-operate with local governments abroad and join international organisations of local governments.

Article 2

- (1) The local government implements the principle of people's sovereignty; in the sphere of local public affairs, it expresses and accomplishes the local public will in a democratic and transparent way.
- (2) Local government decisions may be taken by the elected local body of representatives (or, under its authorisation, its committee, the body of representatives of its sub-government, the body of representatives of the local minority government, the local government association or the mayor), as well as through local referenda. Exceptionally, the law may assign local government tasks and jurisdictional competences to the mayor, the lord mayor, or the chairman of the general assembly of the county.
- (3) The local government may express its opinion and launch initiatives in matters that are outside its sphere of tasks and jurisdictional competences but concern the local community. The deciding authority is obliged to provide a substantive response to the local government within the deadline set by law.

Article 3

The Constitutional Court and the respective territorial court protect the rights of local government and the lawful exercise of its jurisdictional competences.

Article 4

The rights of self-government laid down in Articles 1 to 3 are equal for each local government.

Article 5

The rights of local government are granted to the community of residents with a local voting right (hereinafter: voters). The voters exercise their collective rights of self-government via their elected representatives and their participation at local referenda.

and scope, all subnational administrative units have the right of self-government and are uniformly called ‘local governments’. This terminological particularity is meaningful for the legal status of subnational units that will be further elaborated in Section 4.2. In addition to the territorial administrative units, art. 68 of the Constitution also recognises the national and ethnic minorities as parts of the state and provides them the right of self-government at both national and subnational levels.

Despite their general and accordingly imprecise wording, the provisions of the Constitution and the ALG contain already a mass of information about the financial autonomy of subnational authorities.⁴

With regard to expenditure autonomy, both laws stipulate the freedom of elected SNGs to manage local public affairs independently and their freedom from the supervising power of higher-level authorities. They allow SNGs to accumulate and manage property and to undertake entrepreneurial activities at their own risk. In addition, the ALG grants subnational authorities the power of general competence, i.e. the right to undertake, in the local public interest, any activity that is not specifically forbidden or delegated to other authorities. The law may also impose mandatory responsibilities on the SNGs. In the order of performing public service activities, mandatory responsibilities must always take priority over the voluntarily assumed functions.

Revenue autonomy finds expression in the right of SNGs to ensure the material conditions of exercising their powers and to manage their revenues independently. Concerning budgetary autonomy, the Constitution and Chapter 1 of the ALG

⁴See art. 44A of the Act XX of 1949 on the Constitution of the Republic of Hungary, and art. 1 of the ALG.

stipulate merely the right of SNGs to central government funding in proportion with the volume of delegated responsibilities. The following chapters of the ALG contain further provisions on all three aspects of subnational financial autonomy. These will be discussed in Chapters 5 to 7 of the present study.

From the early 1990s, the Parliament adopted and amended a number of laws regulating particular issues of local self-government. The most important ones are the following:

- Act LXIV of 1990 on the Election of Local Government Representatives and Mayors;
- Act C of 1990 on Local Taxes;
- Act XX of 1991 on the Tasks and Competences of Local Governments and their Bodies, the Commissioners of the Republic and Selected Deconcentrated Authorities;
- Act XXXIII of 1991 on the Transfer of State Property to Local Governments;
- Act XXXVIII of 1992 on Public Finance;
- Act LXXVII of 1993 on the Rights of National and Ethnic Minorities.

The Constitution, the ALG and the complementary laws provide a relatively solid basis for decentralisation inasmuch as they formally suggest the political, administrative and financial independence of elected SNGs. Several foreign observers have praised Hungary for its particularly modern and detailed legislation on decentralisation compared to some other countries in Central and Eastern Europe (BIRD et al., 1995b, p. 10). Criticism has surged, however, with regard to the lack of clarity in expenditure assignment and the vague definition of the role of the counties. Partly due to these deficiencies and partly because much of the subnational government finance is regulated via laws whose amendment does not require a qualified majority, the financial autonomy of SNGs is not entirely guaranteed in practice.

In order to minimise the risk of a full re-centralisation of state powers, the legislature provided for a series of specific arrangements. These include the attribution of basic constitutional rights to SNGs such as the democratic election of representatives, the independent management of local public affairs, the ownership rights over local assets, or the reduction of the external control of SNG decisions to the sole aspect of legal compatibility. Further guarantees against re-centralisation include the legal protection of the self-government rights by the courts as well as the constitutional provision that turns the ALG into an organic law.

4.2.1 Territorial administrative organisation The enumeration of the types of administrative units in the revised national Constitution is not new: already the original version (dating from 1949) divided the national territory into counties, districts, towns and villages.⁵ The Council of Ministers had the exclusive right to revise the political boundaries of the jurisdictions. During the global revision of the Constitution in 1989, this rule was abolished so that it became easier for subnational entities to split up and create their own local governments. As a result, the number of municipalities soared from 1,523 in 1980 to 3,093 in 1990, to reach 3,151 by the end of 2006 (data from the Ministry of Finance). Table 4.1 illustrates the resulting territorial fragmentation of the country.

According to the figures, above 90 per cent of all municipalities counted less than 5,000 inhabitants at the end of 2003. At the same time, the data suggest a relative concentration of the population in towns and large villages: 58.8 per cent of the total population lives in municipalities with more than 10,000 inhabitants. Budapest alone counts more than 1.7 million residents that account for 16.9 per cent of the national population. The average size of municipalities is 3,216, which is still higher than the averages found in the Czech Republic Slovakia, France, Greece, or Switzerland, but lower than that of most OECD countries in Europe.

A large-scale territorial reform has been on the agenda since the mid-1990s. To one part, it has been motivated by the efficiency problems related to the fragmented territorial structure and by the recognition that the counties are not strong enough to ensure the co-ordination and planning of public policies on a regional scale. To another part, soon after transition, Hungary started negotiations with the European Union about the future membership. Although the Community legislation does not interfere with the territorial organisation of the member states, it became clear very soon that adapting the Hungarian territorial organisation to the Nomenclature of Territorial Units for Statistics (NUTS) is of key importance for a successful participation in the development grant programmes of the European Union. The principle of resource concentration declared by the European Commission called for the creation of large benefit areas that allow the co-ordination and realisation of large-scale projects via well-developed institutions that have sufficient skills in project management. The counties could not fulfil these conditions (TÓTH, 2004).

⁵Art. 29 para. 1 of the Act XX of 1949 (prior to the amendment of 1989). This did not explicitly mention the capital city and its districts but allowed the establishment of sub-units in major towns.

Table 4.1: **The municipal structure of Hungary, as of 31.12.2003**
[Source: Balázs (2005)]

Number of inhabitants	Number of municipalities	Share within total nb of municipalities (%)	Share of national population (%)
less than 500	1,014	32.2	2.7
500–999	694	22.1	5.0
1,000–1,999	652	20.7	9.2
2,000–4,999	505	16.1	14.9
5,000–9,999	138	4.4	9.4
10,000–19,999	79	2.5	10.8
20,000–49,999	42	1.3	11.9
50,000–99,999	12	0.4	7.5
over 100,000	9	0.3	28.6
Total	3,145	100.0	100.0

From 1996, the Parliament introduced thus two further layers into the decentralised government system. With the Act XXI of 1996 on Regional Development and Land Use Planning, it organised the nineteen counties and the capital city into seven so-called statistical planning regions of a nearly equal size, without abolishing the counties, however. Three years later, the Parliament ordered the establishment of seven Regional Development Councils.⁶

By adopting the Act CVII of 2004 on the Multi-purpose Micro-regional Associations of Municipal Governments, the Parliament introduced a new tier of administration consisting of 168 micro-regions situated (not hierarchically, but with respect to their functions) between the municipalities and the counties.⁷ Like the network of the regions, that of micro-regions was designed in a way to cover the entire territory of the country without any overlapping. The goal was to create a legal framework for increased co-operation among the municipalities in order to promote efficiency in the provision of public goods and services, spatial planning, and the deconcentrated execution of uniform public administration pro-

⁶Art. 6 of the Act XCII of 1999 on the Amendment of the Act XXI of 1996.

⁷The predecessors of the 168 micro-regions were those 138 (from 1998: 150) statistical districts that the Hungarian Central Statistical Office had created artificially (for data collection purposes) in 1994.

cedures. In a bid to ensure that the framework is filled with real content, the central government provides financial incentives to the establishment and operation of multi-purpose associations.

Up to the end of the period under review (1990–2006), every political initiative aimed at transforming the regions and/or the micro-regions into democratically elected territorial governments has failed.⁸ In this sense, none of these entities is self-governing, even if they enjoy a relatively high level of autonomy in the management of their daily affairs. Both the Regional Development Councils and the micro-regional management boards are collegial bodies with members delegated by the governments of the participating jurisdictions. Neither the municipalities nor the counties are free to choose their partners: the only authority that is allowed to define and modify the political boundaries (and hence the composition) of regions and micro-regions is the Parliament. The law also determines (by enumeration) the range of tasks and responsibilities that regions and micro-regions may assume and defines their financial resources. For regions, these consist of central government grants only, whereas micro-regions are primarily financed by the participating municipalities and co-financed by the centre via fiscal incentives.

For the government system as a whole, the combination of the existing constitutional provisions and the ongoing reforms gives a relatively complex organisational structure. Table 4.2 shows the relative position of the three self-governing levels (shaded rows) and two administrative levels (white rows) within the NUTS system of the European Union.

The reader might be surprised by the sudden comeback of the term ‘level’ in the discussion: the new Constitution explicitly avoids this and any other term that could hint at some kind of a hierarchy between the territorial administrative units. Counties and municipalities are situated at the same (local) level of government but their status is different. In Figure 4.1, we attempt to illustrate the government system under these conditions. The shapes filled in grey represent the existing structure of democratically elected authorities: this consists of the central government, the local governments, as well as the minority self-governments at both levels. The rest of the shapes contain other territorial unit categories constituted and governed upon delegation or another basis. The micro-regions and the regions are results of the latest territorial reforms, whereas the so-called ‘natural’ regions indicate

⁸The latest and most serious proposal to introduce self-governing regions in the Constitution was rejected by the Parliament in July 2006. The bill did not receive the two-thirds majority that would have been necessary for an amendment of the Constitution: only 195 members of Parliament were in favour of the change instead of the minimally required 257, while 148 voted against it and one MP abstained.

Table 4.2: **Administrative units of the Republic of Hungary, as of 31.12.2006**
 [Source: European Communities (2003), European Commission and Eurostat (2004), Dobos and Szélényi (2004, p. 939), Hungarian Office for Territorial and Regional Development, Hungarian Central Statistical Office]

European Union		Hungary		
NUTS* category	NUTS population limits	Effective population per unit	Type of territorial unit	Type of government
(former NUTS-1)		> 10.1 million	1 nation	democratically elected central government (4-year term) + 13 democratically elected national minority self-governments (4-year term)
NUTS-1	3 – 7 million	–	–	–
NUTS-2	800,000 – 3 million	990,000 – 2.8 million	7 statistical planning regions	collegial government
NUTS-3	150,000 – 800,000	220,000 – 1.1 million	19 counties 1 capital city with 23 districts	democratically elected government (4-year term) + 57 democratically elected territorial minority self-governments (4-year term)
LAU-1** (former NUTS-4)	< 150,000	20,000 – 200,000	168 micro-regions	collegial government composed of the members of the participating municipal councils
LAU-2** (former NUTS-5)	< 150,000	20 – 200,000	3,151 municipalities, of which: – 23 towns with county rights (excl. Budapest) – 265 towns without county rights – 2,863 villages	democratically elected municipal governments (4-year term) + 1849 democratically elected local minority self-governments (4-year term)

* NUTS = Nomenclature of Territorial Units for Statistics; ** LAU = Local Administrative Units.

152 a territorial organisation that is adapted to the needs of specific public policy areas (e.g. water management organisations follow the natural division of the country into catchment basins). The following sections will explain the elements of Figure 4.1 in more detail.

4.2.2 Categories of subnational governments Already in its initial form of 1990, the ALG contained distinct chapters on the municipal governments (including rural communities, towns, the capital and its districts in general, Chapter II), the towns with county rights (Chapter VI), the capital city (Chapter VII), and the counties (Chapter VIII). In the subsequent years, the Parliament adopted further legislative acts in order to better accommodate the specific interests of Budapest and its districts, as well as those of the national and ethnic minorities.⁹ These legislative acts were integrated (with slight modifications) in a new version of the ALG in 1994, which resulted in a considerable increase in the volume of Chapter VII on the capital city and its districts and the introduction of a new chapter on local minority governments (Chapter X/A).

The following paragraphs provide a brief overview of the various categories of self-governing units and, at the same time, an insight into the inequality and asymmetry that are inherent to the multi-unit government system of Hungary.

Counties

These historically grown territorial entities (*megye*) enjoyed vast self-governing rights during various periods in the last few centuries. During the socialist regime, they were granted special powers to supervise the municipalities in their jurisdiction. In order to break with the past and allow free rein to the newly elected municipal governments, the new Constitution and the following laws on decentralisation deliberately weakened the powers of the 19 counties and their position in the multi-level government system. With limited freedom to compile and manage their expenditure portfolio and practically zero financial autonomy, they constitute today the least powerful segment of the intergovernmental system. The deterioration of their position resembles a vicious circle: the less they are powerful, the more vehement the efforts in certain political circles (in the executive as well as in the legislative) to replace them with seven self-governing regions.

The capital city and its twenty-three districts

With a population of more than 1.7 million, Budapest is the largest urban municipality in Hungary. Although it is also the seat of Pest County, the law does not

⁹Act XXIV of 1991 on the Local Government of the Capital City and its Districts; Act LXXVII of 1993 on the Rights of National and Ethnic Minorities.

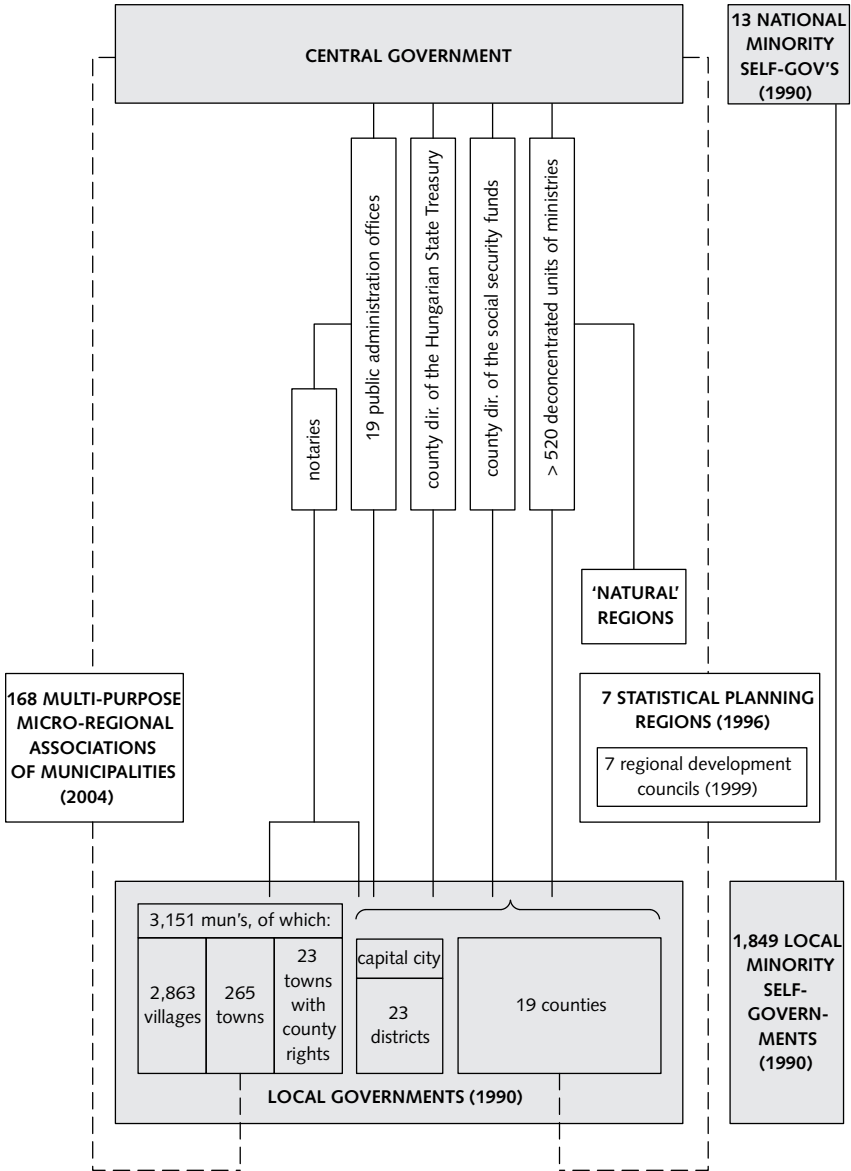


Figure 4.1: The multi-level government system in Hungary, as of 31.12.2006 [Source: the author, based upon data from the Hungarian Central Statistical Office and the National Election Office]

154 treat it as a town with county right but grants it a unique status. The capital city is also one of the 168 micro-regions and one of the seven statistical planning regions (forming one entity with Pest County). The legislation on the capital city and its districts occupies a distinct chapter in the ALG, and sector-specific laws that assign new competences or resources to the subnational public sector invariably address them separately from other types of administrative units.

Budapest has a double-tier administration consisting of the city and twenty-three districts. The residents elect their mayor and council members at both tiers directly. Although the Constitution explicitly allows other large towns to divide their territory into self-governing districts, none of them has made use of this right so far.

Political and fiscal relations between the city and its districts have always had substantial influence on the performance of the public and private sector of the Budapest agglomeration that is still the strongest driving force of the Hungarian economy (EBEL and SIMON, 1996) and the greatest net contributor in the system of fiscal equalisation.

Already under the socialist regime, Budapest played a primordial role in the economic development of the country and participated directly in the economic planning process driven by the central authorities (EBEL et al., 1999). Its growing population, robust economy and well-developed infrastructure allowed Budapest to keep its leading position after transition. Since 2001, the rate of growth of the Gross Domestic Product (GDP) of Budapest (4.1 per cent in real values) has systematically exceeded the pace of development of the national economy. Today, the capital alone produces one-third of the GDP. Together with the agglomeration, its contribution is nearly 50 per cent. About 28 per cent of all enterprises and 54 per cent of the foreign enterprises are seated in the capital city.¹⁰ It is by far the most important centre of the economic, political and cultural life and offers the most buoyant market for the third sector of the economy (especially banking and insurance, real estates and tourism). Its primordial position allows Budapest to defend its particular interests and to hold a strong position in Parliament. Nevertheless, this is not the main reason why the capital received specific legislation in the ALG and the Act CXIV of 2003 on the Revenue Sharing between the Capital City and the Districts. Rather, the goal of the legislative was to clarify the procedures of decision-making and the sharing of expenditures and revenues between the capital and its districts, all of which are independent local government units without any hierarchical relationship between them. From a federalist perspective,

¹⁰Data from the municipal council of Budapest, April 2005.

it appears perhaps unusual that such internal affairs are regulated in the national law rather than in the local legislation. For lack of other experience, however, it is not easy to judge whether internal rules elaborated in a bilateral negotiation would perform better in resolving the political conflicts that characterise the daily relationship between the capital city and the districts (EBEL and SIMON, 1996).

Towns with county rights

According to the law, all county seats enjoy the same rights as counties do. The Parliament may grant the same status to any town that has a population of above 50,000, upon the explicit demand of the latter.¹¹ Despite being the seat of Pest County and a regular member of the Association of Towns with County Rights (MJVSZ), neither the legislation nor the practice regards Budapest as a part of this category but as a distinct administrative unit with a unique status. Excluding Budapest, eighteen county seats and five other towns enjoyed county rights at the end of 2006.

While the law speaks about ‘county rights’, in fact these are county competences and duties. In addition to their own functions, towns with county rights are free to assume any of those public expenditure functions that are normally assigned to counties, such as land use regulation or the maintenance of secondary schools, museums and hospitals.¹² The underlying idea is to assign larger municipalities the role of regional centres in public service provision. If the town and the county agree upon sharing a specific function, they are obliged to set up a joint committee for planning and co-ordination. Because of their considerable economic, political and weight (compared to other municipalities and the counties), the towns with county rights regard themselves as powerful players between the counties and the central government.

The separate treatment of 23 towns among a total number of 288 is thus a clear sign of asymmetry that affects primarily the assignment of responsibilities. However, the ‘privilege’ offered by Chapter VI of the ALG is mitigated by the rest of the legislation. Notably, the ALG does not forbid municipalities *without* a county status to assume county competences. Chapter VIII on County Governments explicitly allows any municipality to take over the management of a public institution from the county, provided that the majority of the users or beneficiaries reside in the municipality.¹³ Since it is not reciprocal—the county may not initiate any takeover of competences and is thus a passive partner of the municipality—, this

¹¹Art. 61 para. 1 ALG.

¹²Chapter VI of the ALG.

¹³Art. 69 para. 2 ALG.

156 privilege brings another type of asymmetry into the intergovernmental relations. Moreover, it derogates the fundamental right of county governments to assume any local function that has not been assigned by law to another authority. The problem of the implicit dominance of municipalities over the counties will be further analysed in Section 5.1.

Other towns

The term ‘town’ (*város*) in the Constitution¹⁴ designates those urban or semi-urban settlements that, irrespective of their size, assume the role of a regional centre providing a range of public services to the surrounding jurisdictions. Under specific conditions laid down in the law, any village may apply for a town status. Although the equal footing principle of the Constitution excludes any hierarchical distinction between urban and rural settlements, the town status has an important prestige value largely because of the century-long tradition of urban-rural divide in Hungary. The town status does not necessarily imply higher amounts of transfers from the central budget compared to what other municipalities receive, especially if the town is a net contributor to the fiscal equalisation policy. Yet, it makes the municipality more attractive in the eyes of potential investors. Due to these apparent advantages and the dilution of the conditions of acquiring the town status, the 1980s and 1990s saw an explosion in the number of towns: while it grew by merely 43 between 1950 and 1980, another 140 municipalities received the town label in the following two decades. Today there are 288 towns in Hungary (including 23 towns with county rights; excluding the capital city), but most of them still have a semi-rural character with relatively poor infrastructure and few public service facilities with a micro-regional function.

Villages

The 2,793 villages of Hungary are rural communities with a relatively low level of infrastructure and public services. Following a historic tradition, it is common to distinguish between the 2,708 small and the 155 large rural communities (*község* and *nagyközség*, respectively) upon whether they reach the limit of 5,000 inhabitants or not. However, this distinction becomes hardly ever relevant for the assignment of new functions or resources.

¹⁴The translation by ICL (2003) features the term ‘city’ instead of ‘town’, but considering the small average size of these entities (none of them has more than 200,000 inhabitants and 40 per cent have less than 10,000), ‘town’ seems to be a more appropriate term (see also Footnote 3 earlier in this chapter).

Minority self-governments (MSGs)

Contrary to the legal practice of most other countries of the world, the revised Constitution provides the right of self-government to national and ethnic minorities as well. Thirteen legally acknowledged ethnic and national minorities are represented today by democratically elected bodies at the central and municipal levels. Since 2006,¹⁵ minorities have also been allowed to elect their representatives in the counties. In 2006, the citizens elected 2,045 minority governments in the municipalities (in 1,435 out of 3,151 jurisdictions), 46 in the counties, 11 in the capital city, and 13 at the national level.¹⁶ The Act LXXVII of 1993 on the Rights of National and Ethnic Minorities, the Act LXIV of 1990 on the Election of Local Representatives and Mayors, and the ALG (following an amendment in 1994), define the rules of establishing and operating MSGs. Every MSG is an independent legal person and has identical rights and duties.

Although the institution of MSG was conceived to become the vehicle of personal federalism in Hungary, the system has not fully met the expectations so far.¹⁷ MSGs are highly dependent on local governments in terms of both political power and financial resources. For most of the local policy issues, MSGs work closely together with the local executive council of the municipality, but the intensity of co-operation usually depends on the lobbying power of the minority representatives and on the extent to which the majority representatives are willing to co-operate. Generally, the level of minority participation in local policy-making is relatively low, and minority representatives have to compete hard in order to receive a fair share from the local budget. For the rest of their funding, they are dependent on central government grants.¹⁸

¹⁵Act CXIV 2005 concerning the Amendment of the Law on the Election of Minority Self-Government Representatives and Other Laws on National and Ethnic Minorities.

¹⁶Data from the National Election Office.

¹⁷A. N. Messarra was the first scholar to apply the term 'personal federalism' ('*fédéralisme intégré*') in a case study on Lebanon in 1987. Personal federalism is a federal or decentralised state structure under which decision-making power rests with the cultural entities or their representatives, irrespective of their geographical location. By contrast, 'territorial federalism' is usually chosen when minorities are settled down in a definable geographical area (FLEINER and BASTA FLEINER, 2000, p. 12 f.).

¹⁸For a careful treatment of the problems related to minority self-governments in Hungary, see CSEFKÓ and PÁLNÉ KOVÁCS (1999), SZALAI (2000), KALTENBACH (2001), EILER and KOVÁCS (2002), and KÁLLAI (2005).

4.2.3 Equal rights—different duties

Language is never innocent: it reflects political and ideological values or worldviews. Hence, when the Constitution and the ALG stipulate that territorial administrative units, irrespective of their size or status, have the right to ‘local self-government’ (*helyi önkormányzás*) and hence the villages, the towns, the capital city and its districts, and the counties, are uniformly called ‘local governments’ (*helyi önkormányzat*), they give an unmistakable sign of equality among subnational governments.

The lack of a clear terminological distinction between counties and municipalities as two distinct *levels* of government is thus neither a result of the simplicity of the Hungarian language nor a sign of poor rhetoric skills on the side of the legislators, but it is a deliberate choice. This choice is based on the collective perception of recent history and reflects the collective ambition of a people to break with their past. Terms such as ‘level’ or ‘tier’ would only evoke the notion of hierarchy. Instead of levels or tiers, the territory of Hungary is therefore divided into ‘administrative units’. Following the legislators’ intention, a flat government structure should lead to a more balanced relationship among the different types of administrative units. Central authorities should not be allowed to exert any influence upon counties and municipalities, and the latter two types of jurisdictions should be on equal footing with regard to each other.

A major amendment of the ALG in 1994 introduced the distinction between ‘municipal government’ (*települési önkormányzat*) and ‘territorial government’ (*területi önkormányzat*) but continued to use ‘local government’ (*helyi önkormányzat*) as a collective term to address both forms. The correction affected purely the terminology but not the constitutional equality of subnational governments. Non-legal texts such as policy reports or academic studies nevertheless recognise the existence of two distinct levels (counties and municipalities) in the subnational public sector.

The same ideological considerations gave rise to one of the most pivotal principles of the Hungarian intergovernmental system. Art. 43 para. 1 of the Constitution stipulates that the fundamental rights of local governments (i.e. SNGs) are equal; differences may only exist in terms of duties.¹⁹ The subsequent chapters of the ALG and the sector-specific laws define further (not fundamental) rights and duties. It must be noted here that both the Constitution and the ALG address the rights and duties to the different ‘administrative units’ and not to local (or municipal / territorial) governments in general. This is an important detail as it suggests the intention of the legislative to differentiate among the types, rather

¹⁹Similar legal provisions apply in Denmark and France as well.

than tiers, of administrative units, in the moment of assigning a new mandatory responsibility. Although there is a great deal of overlapping between the unit-based and level-based territorial division of the country, not every type of administrative unit constitutes a distinct level of government and, conversely, some types of administrative units belong simultaneously to two different levels.

Even if hierarchy is unknown to the Hungarian multi-level government system, some differences do exist among the various types of subnational jurisdictions, primarily in terms of autonomy. This manifests itself not only in the constitutional principle of equal fundamental rights and different duties. The law also stipulates that the administrative units (villages, towns, the capital and its districts, and counties) act independently ‘in those public affairs of local interest that belong to the sphere of its tasks and jurisdictional competence’.²⁰ *What* actually constitutes a local public affair (i.e. the rights and duties of local government) is ‘determined by law’.²¹ Local governments may exercise their various fundamental rights ‘within the limits of the law’.²² The best synthesis of the equal but limited autonomy is given in art. 1 para. 3 of the ALG: ‘Within the limits of the law, the local government may regulate autonomously and, in individual cases, manage freely, all local public affairs coming within its sphere of tasks and jurisdictional competence.’

These investigations show the principles of autonomy and equality in a different light. Local governments are certainly autonomous and equal in the sense that one unit cannot review the decision of another unit (there is no hierarchy among them). By contrast, with regard to the rights and duties, they are neither autonomous nor equal. They are autonomous, and their autonomy is equal, only in the management of those local public affairs that the law delegates to them or allows them to assume voluntarily. Since the range of local public affairs varies across the types of administrative units, local governments are in practice everything but equal. In other words, each local government is entirely free to do what the law actually allows it to do, and in this freedom, they are perfectly equal.

This latter paraphrase might sound provocative but in fact, it should not surprise at all. Given the multiple interdependences among government units that are inherent in every decentralised system, it would be an illusion to expect every subnational government unit to enjoy unfettered autonomy in all possible spheres of activity. Autonomy and equality can and must be constrained if they are to be reconciled with other objectives that the society considers equally important.

An important implication of the principle of ‘autonomy and equality within

²⁰ Art. 1 para. 1 ALG; similar wording in art. 42 of the Constitution.

²¹ Art. 43 para. 2 of the Constitution.

²² Art. 44/A para. 1 of the Constitution, art. 1 para. 3 and 6 ALG.

160 the limits of the law' is that local governments are free to do anything that is not explicitly prohibited by law. Beyond the range of tasks and competences specified in the law, they are completely sovereign and equal.

The conclusion of all these arguments is that the principles of equality and autonomy should not be overemphasised in the discussion of intergovernmental relations in Hungary. Insisting on the constitutional guarantee of perfect equality and sovereignty for all subnational units is neither credible, nor is it necessary for the success of decentralisation. Formal limits on autonomy, as well as a certain degree of inequality and even asymmetry, are acceptable and even desirable.²³ While the limitation of autonomy and equality of SNGs is mainly justified with the pursuit of competing objectives such as equity or efficiency, asymmetry draws its legitimacy from the will of the legislator to accommodate specific interests of selected constituent units.

To sum up, the complementary legislation on specific types of administrative units partially compensates for the levelling effect of the constitutional provision of equal rights. Some degree of inequality and asymmetry among government units is certainly justified from the perspective of equity, efficiency and other objectives. Insisting on the equal rights principle is anyway deceptive: when it comes to the implementation in practice, it turns out that all local governments are equal but some are 'more equal than others', just as in Orwell's famous utopian vision.

Furthermore, the equal rights principle is treacherous because it misleads us about the fact that even if the rights of all subnational governments are equal, their chances are not. A great number of jurisdictions cannot fully exploit their fundamental rights because of shortages in financial, technical or human resources, lack of valuable assets or local investors. To what extent the fundamental rights are constitutive for effective local autonomy depends on exogenous factors that are largely identical with those mentioned in Chapter 3 on local autonomy. Both the institutional and legal framework (of which the equal rights principle is only one element) and socio-economic, demographic, etc. variables are decisive in this respect. The problem that we could call 'equal rights—different chances' also raises the question about the responsibility of the central government and the legislative in the creation of truly equal conditions for the operation of all types of government units LÁSZLÓ (1992, p. 403).

²³In the context of federalism and decentralisation, inequality is not equivalent to asymmetry. Inequality means a different treatment of different types (or levels) of constituent units, while asymmetry implies a different treatment of constituent units that belong to the same category (or are situated at the same level of government).

Despite the general trend of devolving powers and competences to the democratically elected subnational authorities, the central government continues to play a key role in public service provision and administration by means of its deconcentrated branches in the subnational units.

Deconcentrated authorities existed already during the socialist era and even before. Their survival in the post-transition period has much to do with the asymmetry of the newly designed intergovernmental system. As has been noted before, the decentralisation in 1990 brought about a fundamental change in the status quo between municipalities and counties: the municipalities became the dominant players of the decentralised government system in both political and economic terms. Between the territorially fragmented municipal structure and the artificially weakened counties, a substantial amount of tasks with a regional scope was left derelict. The central public administration filled this vacuum with a plethora of deconcentrated agencies and authorities. The result is a dual system of decentralised public administration, consisting of democratically elected governments from the bottom up, and deconcentrated agencies with appointed head officers from the top down (SZIGETI, 2004b, p. 166, GYERGYÁK, 2004, p. 91). Since the Constitution has never envisaged such an arrangement, there is currently no strong rule in place that could limit the expansion of central government authorities at the subnational level. From 1996, a series of administrative reforms led to the restructuring and integration of several territorial office categories, reducing their number from 35 to some 20 within two years. These measures made the system more rational but did not essentially change the extent or the content of the influence of central government on the local tier. Since 1998, the number of territorial offices has been again on a rise. Currently, four major types of deconcentrated authorities are operating in Hungary (see Figure 4.1).

Public administration offices (PAOs)

The public administration offices operating in each of the nineteen counties and the capital city are successors of the Commissioners of the Republic introduced by the ALG in 1990. Based on the amendment of the ALG in 1994 and complementary legislation,²⁴ they control the lawfulness of local government decisions and coordinate the activities of local governments and deconcentrated authorities.

²⁴Act LXIII of 1994 concerning the Amendment of the Act LXV of 1990 on Local Governments, art. 49–54; Government Decree no. 191/1996 (17 December) on the Public Administration Offices of the Capital City and the Counties.

162 They also provide professional assistance to local governments (training, IT, etc.) and execute further administrative tasks within their competence. The head of the Prime Minister's Office and the Minister of the Interior together appoint and supervise the general director of each PAO.

Deconcentrated units of ministries and other public authorities (DUMs)

DUMs cover a large number of public policy areas such as land registration, police, public health, employment, tax administration, consumer protection, or statistics, with various competences ranging from the execution of administrative procedures to the monitoring and control of the implementation of national norms and directives. In the early 1990s, the jurisdiction of competence of DUMs followed the political boundaries of the counties, except for those (specialised on water management, the maintenance of national parks, etc.) whose scope of activity required an adaptation to natural boundaries. In recent years, several ministries and other public authorities have reorganised their territorial offices in greater 'regional' units, without actually agreeing on a common definition of 'regional'. Since they enjoy full sovereignty in the management of their sub-units, the spontaneous wave of restructuring resulted in a wide variety of institutional designs. In 2006, more than 520 DUMs were operating in the country.

County directorates of the social security funds

The two major social security funds operate their territorial offices in the nineteen counties and the capital city. The directorates of the National Health Insurance Fund manage the relationship with local public, non-profit and private providers of health services. The offices of the National Pension Fund are responsible, among others, for the maintenance of the databases related to wages and length of service and the calculation of retirement pensions.

County directorates of the Hungarian State Treasury

Established by the Act XXXVIII of 1992 on Public Finance, the branch offices of the Hungarian State Treasury in the counties and the capital city are directly subordinated to the head office and constitute an operational link between the central and local tiers of government in terms of budgeting and account management. Their major tasks include the management of the government financial information system and the controlling of the use of intergovernmental fiscal transfers.

Wherever the nature of the public service requires proximity to the beneficiaries (as is the case e.g. with employment offices, public health or land registry), deconcentrated authorities have additional agencies at the micro-regional (LAU-1)

level, each of which serves about 15 to 20 municipalities. Centrally harmonised administrative procedures with a similar scope such as guardianship services or the issue of building permits are delegated to the notaries. A notary may be in charge of one or more municipal governments. Together with the mayor, he or she controls the hierarchy of norms, countersigns all municipal decisions and informs the PAO in case of an illegal resolution. In comparison with other European countries, the scope of competence of notaries in Hungary is almost unparalleled BALÁZS (2004, p. 194). In practice, however, many of them find it difficult to take independent decisions, as they are recruited and paid by the municipal council.

In most of the counties, the contacts among deconcentrated authorities as well as between these and the elected local government councils are characterised by partnership and mutual understanding. Nevertheless, the current system of deconcentrated public administration is admittedly chaotic. County-based territorial offices are run parallel with ad-hoc regional authorities of various territorial scope. The efforts to reduce the number of authorities are doomed to failure, as the sector ministries prefer setting up their own territorial organisations rather than ceding some of their competences to the PAOs. Although a new regulation following the reform in 1996 prohibited the establishment of new branch offices outside the network of PAOs, the period between 1998 and 2004 saw the rise of ten new categories of deconcentrated authorities BALÁZS (2004, p. 195). The circumvention of PAOs is also visible in the fact that even the central government refrains from delegating new co-ordination competences to these institutions, although the need for co-ordination is the principal *raison d'être* of PAOs, at least according to the law. While there is scope for further harmonisation and simplification of the territorial organisation of deconcentrated authorities (FINTA, 2002; BALÁZS, 2004; SZIGETI, 2004a), little work has been done in this direction except for the regionalisation of the PAOs, as there is no consensus in the central government about how to proceed.

4.4 Citizen participation

The growing transparency of national and local policymaking and the direct involvement of local citizens in the decision-making procedure are among the greatest achievements of the post-socialist transition. Under the socialist regime, soviet-type councils executed mandates from above without ever consulting their local constituency. Not only the involvement of citizens into the decision-making, but also their information on local policy matters, were considered as a threat to the

164 realisation of the rationally designed plans of the omniscient state authorities (Soós and KÁLMÁN, 2002, p. 44). Breaking with this practice was one of the first priorities of the intergovernmental reform. As a reflection of this, in 1990 the entire local government system was founded on the concept of 'self-government'.

Recent empirical analyses on the quality of local democracy in Hungary distinguish several categories of citizen involvement at the local level. Local entrepreneurs, firms, business associations, civil associations, foundations, trade unions, churches, local branches of political parties, print and electronic media, and citizens may all have some influence on the decision-making (POP, 2005). Concerning the subject matter, Soós and KÁLMÁN (2002) distinguish between budgeting (publication and open discussion of the budget prior to council vote) on one hand and other policy issues on the other. As for the tools of participation, referendum and initiative (petition) constitute only a minor part. Other instruments include public hearings and forums, direct meetings between local officials and citizens, proposals or requests by civil organisations, participation at public demonstrations, and appeals to local government decisions in a court of law or another higher administrative authority (POP, 2005).

Four of these instruments, namely referendum, initiative, general assembly and public hearing, have their legal foundation in art. 45 to 51 of the ALG. However, the legally admitted scope of direct citizen participation is relatively narrow. Consequently, direct participation in Hungary (alike in the majority of European countries) plays only a subsidiary role within democratic decision-making (NAGY and TAMÁS, 2004).

The following themes are subject to obligatory referendum in municipalities and (where applicable) counties:

1. the amalgamation with, and separation from, another jurisdiction;
2. the foundation of a new jurisdiction;
3. the establishment of a joint council as part of the cooperation with another SNG;
4. the transfer and exchange of populated territories to another jurisdiction;
5. other matters determined in the legislation of the municipality or county.

Other issues are subject to optional referendum that can be held either in the forefront of a planned decision of the local (or county) council, or as a reaction to a decision that has been already taken. The only exceptions are issues concerning the

budget of the SNG, the types and parameters of local taxes, as well as organisational and personal issues residing in the local (county) council's sphere of competence: citizens are not allowed to vote on any of these subjects.²⁵ The referendum may be initiated by the local council upon request of the committee or at least one-fourth of the council members, by a local civil organisation, or by 10 to 25 per cent of local voters (with the threshold being set in a local government decree). In villages with less than 500 inhabitants, the local council may decide to replace the referendum by a vote in the general assembly.

The referendum (the vote in the general assembly) is valid if the turnout rate reaches 50 per cent plus one. If at least 50 per cent of the votes plus one are identical, then the result of the referendum (vote in the general assembly) is binding for the local council. If the referendum (vote in the general assembly) is invalid or brings no result, the council is free to decide on the issue without any further consultation of the electorate.²⁶

The right to local initiative in both counties and municipalities allows the voters to put forward any policy issue or proposal to the municipal (county) council, although proposals concerning financial, organisational and personal issues have no chance to become validated by the local council because they are excluded from the legal scope of the referendum. Here again, the required number of signatures (5 to 10 per cent of the voters) is laid down in the relevant local government decree. If the initiative meets the formal requirements, the council is obliged to discuss the issue in meeting and take a stance on it.

Finally, municipal and county councils have to organise at least one public hearing every year. At such meetings, local citizens may directly address their questions and proposals to the elected members of the council. The latter are obliged to answer all inquiries and motions and to decide whether to put them on the policy agenda or not.

As the first empirical studies on the use of direct democracy instruments point out, the initial disinterest of citizens in local politics began to disappear at the end of 1990s, although there is scope for further improvement. In their analysis of the 57 local referenda held between 1999 and 2001 in Hungary, NAGY and TAMÁS (2004) show that territorial reorganisation, new industrial investments,

²⁵Art. 46 para. 4 ALG. A similar prohibition exists for the national referenda: budget laws, national taxes and stamp duties as well as national conditions for local taxes cannot be submitted to referendum (art. 6 of the Act XVII of 1989 on Referendum and Popular Initiative).

²⁶The second threshold is twice as high as the one that applies to national referenda. The latter was lowered in the forefront of the national referendum about Hungary's accession to the North-Atlantic Treaty Organisation (Article 3 of the Act LIX of 1997 about the Amendment of the Constitution of the Republic of Hungary).

166 environmental projects (landfills, waste incinerators, etc.) and public services (maintenance of schools and health care institutions) are the predominant issues. Most of the referenda are reactive in the sense that they are oriented at ruling out possible negative effects of local council decisions instead of acquiring new benefits. Participation rates vary widely, with the issues of intermunicipal amalgamation, separation and cooperation having the most important mobilising effect. However, the double threshold of 50 per cent plus one results in a relatively high rate of failure: in the period under review, 21 out of 57 referenda were invalid and many of the rest did not bring about any clear and binding result. While little can be said about the frequency of general assemblies and popular initiatives for lack of relevant statistics, it is proven that public hearing is a rather formal element of direct democracy. In a sample of 646, nearly two-thirds of all municipalities provided only one forum a year, thus barely complying with the required minimum (LGS, 2001; Soós and KÁLMÁN, 2002). The local budget is seldom open to public discussion, with only one-third of the surveyed municipalities involving their constituency in this issue prior to the final vote in the council. As for the involvement of other participants in local issues (including the budget), less than half of the 646 municipalities declared to have involved civil organisations in the decision-making process in 2000, while the local media are more frequently consulted, with more than 90 per cent of the local governments having occasional or regular contact with them. As for the political participation of citizens, the most frequent forms are addressing proposals or requests to the members of the local council (in 37 per cent of the surveyed municipalities) and direct meetings between local officials and (groups of) citizens (24 per cent) (LGS, 2001).

According to all empirical studies, the intensity of citizen participation in Hungary correlates positively with the density of civil organisations and the municipality's socio-economic development. The relationship between the municipality size (in terms of population) and effective citizen participation, however, is more ambiguous.²⁷ The low number of existing empirical analyses does not allow us to draw any clear conclusion, particularly as it is difficult to say to what extent the variables used by the different authors are comparable. NAGY and TAMÁS (2004) examine the different types of municipalities (that are largely correlated with size) and the *number of referenda* held in each of these, and find a negative relationship between the two variables. The studies based on the Local Government Survey (LGS, 2001), however, look at the relationship between municipality size and *citizens' effectiveness* in influencing local policies (which is measured with a

²⁷The worldwide theoretical literature of the subject shows similarly great ambiguities, see POP (2005).

composite indicator integrating subjective evaluations on the influence of different stakeholders) and suggest a moderately to strong positive relationship (Soós and KÁLMÁN, 2002; POP, 2005). The argument of DAHL and TUFTE (1973), according to which larger municipalities experience a certain alienation of citizens from policymakers but have a better institutional capacity to facilitate participation, is confirmed by POP (2005) for three CEE countries including Hungary.

Looking only at the 'demand and supply sides' of direct democracy in Hungary, we can conclude that at least two elements in the current institutional system constrain effective citizen participation. First, the double threshold of 50 per cent plus one for local referenda (one for the turnout rate and one for the result of the vote) is unduly strict compared to the corresponding regulation for the national level. Citizens' activism in this domain could possibly increase if the threshold was lowered, although it is true that those issues that citizens generally consider important are able to attract even 80 to 90 per cent of the voters (NAGY and TAMÁS, 2004, p. 218). Second, the exclusion of local budget and taxation issues from the scope of local referenda makes participation in local politics far less interesting than it could be. Between two elections, taxpayers can hardly influence how their money is used. Moreover, it deprives the decentralised fiscal system of its potential advantage of making elected representatives more accountable for their decisions. Surprisingly, in the Hungarian literature on local referenda, this is discussed neither as an actual problem nor as a potential one.

However, it would be premature to conclude that, by lowering the minimum threshold or introducing more meaningful issues in local referenda, one could automatically increase citizens' effectiveness in influencing local policies. The quality of local democracy depends not only on the choice and character of available instruments and the extent to which citizens make use of them. Any measure targeted at these variables will remain fruitless if it is not matched with sufficient flexibility of the existing system of intergovernmental fiscal relations. In other words, the incentive structure of democratic participation necessarily includes the system's capacity to respond to citizens' requests and provide incentives for participation. POP (2005, p. 177) measures this capacity (more precisely, the lack of capacity) by 'expenditure rigidity' that is, in his understanding, 'the percentage of own revenues in the total budget of the municipalities as reported by the local officials'. While defining expenditure rigidity as a percentage of own revenues is not entirely straightforward, the underlying idea is clear. The larger the proportion of mandatory functions and/or transfers and grants in the local budget, the weaker the potential influence of citizens on local policymaking. This definition is still unduly generous because it leaves open the question about the local government's

168 freedom to adjust tax rates and bases and to use the transferred revenues according to the preferences of the local constituency. As we saw in Section 3.4.3, under certain circumstances, grants can provide a higher degree of autonomy to local governments than own-source revenues do.

Pop's investigations revealed that the degree of expenditure and revenue rigidity in Hungary is relatively high and thus the effectiveness of citizens in influencing local matters is low. Concerning expenditures, dozens of mandated functions limit the autonomy of municipalities. In the hope of acquiring additional funds and thus a larger room for manoeuvre in finances, hundreds of local governments assume a number of optional functions, thus fully exploiting (or even going beyond) their financial capacity. Local revenue autonomy is limited, too, as central government transfers constitute half to two-thirds of the local budget, even though their share decreased from two-thirds to one half between 1990 and 2006 and a growing part of them is unconditional. Concerning the capacity to raise own-source revenues, there are significant disparities across regions, depending on their degree of economic development. Owing to several factors that will be explained in Section 6.2, local tax levels in Hungary are generally low and make thus the revenue system rather rigid. However, rigidity increases with decreasing jurisdiction size, as small municipalities are more likely to be dependent on central government transfers than large ones. Both participation rates and citizens' effectiveness in influencing local affairs tend to be higher in large municipalities than in smaller ones.

Pop's message is that citizen participation is crucial for local self-government, but at the same time, the extent of self-government itself determines the incentives for participation. Based upon our earlier investigations, we can add here another remark on the relationship between citizen participation and local autonomy. Rigidity is the opposite of flexibility and thus it is inherently connected to the notion of autonomy. The more stringent are the exogenous restrictions on revenue and expenditure autonomy, the higher the degree of rigidity. The capacity of the system to respond to citizens' initiatives depends thus also on the constraints imposed on local financial autonomy. As we saw in Section 3.4.1, citizens could theoretically have some influence at least on the nature and strength of *legal* constraints, notably through their participation in higher-level legislative procedures. Yet, since the preference of the regional or national constituency on a given issue does not forcibly coincide with that of the voters of an individual municipality, democratic participation at higher levels does not automatically soften the legal constraints on local autonomy.²⁸ Anyway, even if the preferences of the two groups

²⁸This is also true for the democratic participation at the local level; e.g. the majority of the local

were identical, the Hungarian law prohibits the direct participation of citizens in budgetary and financial decisions at both the central and the local level of government. In this situation, there are two ways left to soften the centrally imposed legal constraints on local revenue and expenditure autonomy. First, counties and regions can play the role of coordinator and disseminator of local government interests. At present, neither the counties nor the statistical planning regions are powerful enough to assume this role. Second, local governments can organise themselves in a lobby group in order to defend their interests in the legislative procedures. In 2006, however, seven associations operated simultaneously, representing different (though partly overlapping) circles of SNGs.²⁹ The intensity of co-operation among them usually depends on the importance of the issue at stake. Because of their incapacity to coordinate their interests on a regular basis, the central government has never regarded them as strong partners. Municipal and county interests most often appear in national policymaking through mayors and heads of county councils who are also members of Parliament, but whether these initiatives receive any attention in the legislative depends on the political side (government or opposition) from which they emerge.

Following its crushing defeat at the local elections of October 2006, the socialist party (MSZP) that constitutes the bigger part of the ruling government coalition recognised that it was impossible to carry through any reasonable policy programme without the consent of SNGs. For the first time since 1990, an interest conciliation board was set up in December 2006, regrouping five ministers and the presidents of the seven local government lobby organisations.

population may vote for more strictness in the management of the municipal budget. Since the resulting constraint is purely endogenous, it will be not treated in this study.

²⁹National Association of County General Assemblies (MÖOSZ), Hungarian National Association of Local Authorities (TÖOSZ), Association of Hungarian Local Governments (MÖSZ), Association of Towns with County Rights (MJVSZ), Hungarian National Association of Self-Governments of Small Towns, Hungarian Association of Villages, and National Association of Rural Communities (KÖSZ).

Expenditure Autonomy

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As has been shown in Chapter 4, the legal and institutional framework of inter-governmental finance in Hungary grants a comparably wide autonomy to SNGs and most particularly to municipalities. It also stipulates that there is no hierarchy of any kind between the municipalities and the counties, nor between the capital city and its districts. All SNGs enjoy equal rights, the most important one being the independent management of local public affairs. Yet, the law also admits of differences between SNGs in terms of their mandatory responsibilities, and of specific regulations on service delivery in the various policy areas. At the same time, the geographical, demographical and socio-economic environment in which local public sector activities unfold is not the same for all SNGs. All these factors result in considerable disparities across jurisdictions concerning the degree and quality of their expenditure autonomy.

Chapters 5 to 7 focus on the autonomy of municipalities. This subcategory of municipalities consists of the capital city and its 23 districts, the 23 towns with county rights, the 265 towns without county rights, and the 2,863 villages. The autonomy of counties and micro-regions (that usually also appear in the statistics of the local government sector) will not be analysed systematically. Wherever the term local government is applied, it refers to the municipal sector, except if otherwise indicated.

The present chapter will discuss the extent of, and some major constraints on, local expenditure autonomy in Hungary. Section 5.1 provides an introduction on the national legal framework in which local expenditure decisions can take place. Section 5.2 analyses the statutory assignment of expenditures that ultimately

172 determines much of the autonomy of local governments with regard to expenditure policy and management (steering). Inter-municipal co-operation is just as much an issue of steering as it is one of rowing. Therefore, its advantages and drawbacks in terms of local expenditure autonomy will be discussed in Section 5.3 situated in the middle of the chapter. Finally, Section 5.4 investigates local autonomy in the organisation of service delivery (rowing).

5.1 Expenditure autonomy: an overview

5.1.1 The legal framework of expenditure autonomy Throughout the socialist period, the freedom of municipal councils in spending decisions was limited. Expenditure plans were subject to prior approval by the central planning bureau that then matched the spending need with a corresponding amount of monetary transfers. From the end of the 1960s, the constraints on local spending targets and amounts were continuously eased and the proportion of locally controlled own revenues within total local revenues increased gradually. Nonetheless, the system remained strongly centralised and particularly the recurring expenditures of the municipalities were rigidly controlled from above. The influence of citizens on the choice and the quality of public goods and services was negligible.

Bringing expenditure decisions closer to the local constituency became therefore one of the major objectives of fiscal decentralisation from the early 1990s. By increasing the autonomy of local communities in the choice of their spending patterns, the legislative expected to enhance the power of citizens to control local policymaking, thereby making local policymakers more accountable for their decisions. On the other hand, the central government also wished to define a minimum range of functions that democratically elected local governments would be obliged to assume in the interest of citizens. This double endeavour became translated into a system of optional and mandatory functions that was first laid down in the ALG and further specified in the Act XX of 1991 on the Tasks and Competences of Local Governments and their Bodies, the Commissioners of the Republic and Selected Deconcentrated Authorities (ATC).¹ This latter was conceived as a transitional law in the sense that subsequent sector-specific laws (on social services, public education, waste management, etc.) would repeal each of its chapters in turn. These laws would contain a more detailed regulation on each

¹The commissioners of the Republic are the predecessors of the current county-level public administration offices. This system was in force between 1990 and 1994.

public policy area and the role of SNGs in the supply of the related public services. Consequently, between 1991 and 2005, the Parliament passed twenty sector-specific laws (some of which were amendments of previously existing laws) and several dozens of related acts treating more specific policy areas within the sectors. Today, only a few clauses of the ATC are still in force.

According to the ALG, any law can define new mandatory tasks for SNGs.² In this context, PÁLNÉ KOVÁCS (2004, p. 94) points to the unclear legal relationship between SNG tasks set forth by the ALG that requires a two-thirds majority to be approved, and the responsibilities defined by various sector-specific laws that necessitate only a simple majority. The relative simplicity of pushing a new sector-specific law (or an amendment) through Parliament explains in part how such laws and, correspondingly, SNG tasks could proliferate so greatly in the past decades.

The same paragraph of the ALG also implies that SNG tasks can have no other origin than the law. Notwithstanding this rule, several lower-level legal sources such as ministerial decrees (requiring no parliamentary approval) have introduced new SNG tasks in the form of various sector-specific minimum standards. The semantic frontier between minimum standards and new tasks is somewhat blurred, which adds to the legal uncertainty and makes SNGs defenceless against excessive intrusion into their local affairs.

In Section 3.4.2, we defined local expenditure autonomy as the right and the ability of local governments to spend their public budget on goods and services in a way to meet the demand of the local constituency. This implies decisions about *what* to provide and *how*. In OSBORNE and GAEBLER'S (1993) vision of a 'catalytic government', the question of *what* to provide (expenditure policy design) is the essence of the steering function of the government, while the question of *how* (service delivery) determines the rowing function. As we saw in Section 3.4.2, the exercise of both functions underlies a number of constraints. In the following, we are going to estimate the extent and the nature of municipal expenditure autonomy in Hungary with respect to these constraints.

²Art. 1 para. 5 ALG.

Table 5.1: Municipal expenditures 1995–2006 at constant prices (base year = 1995, million HUF) [Source: Ministry of Finance; GDP deflator: IMF (1998, 2007)]

#	Expenditure category	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1	Current expenditures	507,371	480,524	480,958	495,027	516,278	503,583	524,956	585,009	648,999	658,464	687,330	708,297
2	Wages and salaries	212,907	196,028	196,027	203,474	214,855	211,419	232,855	272,460	325,885	323,026	341,465	348,406
3	Social contributions	91,016	85,918	88,922	91,661	89,067	85,618	87,977	95,582	108,760	106,272	111,120	110,029
4	Other operational expenditure of which:	203,448	198,578	196,009	199,892	212,355	206,546	204,123	216,967	214,355	229,166	234,745	249,863
5	Interests paid	13,134	9,507	5,698	4,791	5,515	4,532	4,325	4,170	4,966	6,682	5,613	7,219
6	Capital expenditures of which:	123,755	110,142	140,308	156,531	137,527	150,573	170,448	196,544	162,121	164,370	200,942	238,903
7	Acquisition of land, tangible and intangible assets	67,554	57,528	80,270	90,510	77,131	86,491	103,583	116,404	93,923	95,714	106,656	126,178
8	Acquisition of shares	–	–	–	2,901	2,423	1,719	3,917	2,931	1,810	1,814	2,105	2,929
9	Capital transfers to other government entities ¹	379	527	1,470	756	726	565	441	615	432	526	642	654
10	Capital transfers to non- governmental entities ²	28,538	24,259	20,654	19,535	18,496	18,480	17,017	22,667	21,818	21,305	31,988	40,213
11	Current grants and subsidies	65,650	64,075	62,619	74,399	72,272	67,219	76,768	78,875	71,994	79,058	87,692	85,827
12	Current grants to other government entities ¹	703	1,073	1,100	637	655	609	676	722	583	916	448	522
13	Current grants and subsidies to non-governmental entities ²	14,807	17,324	18,009	18,228	18,920	19,524	29,460	31,753	26,525	31,646	35,336	42,565
14	Social benefits in kind	48,781	44,480	42,431	54,449	51,382	45,717	45,249	45,001	43,099	44,760	50,166	41,036

15	Social benefits in cash	1,359	1,199	1,080	1,085	1,315	1,369	1,384	1,399	1,787	1,736	1,741	1,703
16	Loan disbursement	-	-	1,095	1,572	4,491	4,905	5,687	5,240	4,898	4,241	4,287	5,001
17	Total GFS expenditures	696,776	654,741	684,980	727,530	730,567	726,280	777,859	865,668	888,013	906,132	980,251	1,038,028
18	Loan repayment	17,711	16,997	12,835	14,039	7,128	6,627	8,182	9,179	18,418	8,568	10,340	11,505
19	Purchase of long-term securities	5,889	9,679	21,518	10,775	13,346	16,803	11,930	2,092	1,249	1,174	3,594	1,618
20	Net purchase of short-term securities	11,514	11,683	23,566	-	7,970	2,540	0	0	0	9,318	0	0
21	Total expenditures	731,890	693,100	742,899	752,343	759,011	752,249	797,971	876,939	907,680	925,193	994,184	1,051,151
22	GDP deflator	1,000	1,209	1,433	1,613	1,750	1,960	2,121	2,297	2,450	2,548	2,605	2,662

¹ Other government entities include own service facilities and other SNG units.

² Non-governmental entities include private or nonprofit organisations and churches.

5.1.2 The dynamics of local expenditures

Table 5.1 shows the development of municipal expenditures between 1995 and 2006 at constant prices (base year: 1995).³ While aggregate data for the entire subnational government sector are available from 1990, specific data on the various SNG categories (notably with a separation between municipalities and counties) could not be retrieved for the first five years.

Total GFS expenditures in real terms (calculated according to the methodology of the Government Finance Statistics 2001 of the International Monetary Fund) had to recover from the dampening impact of the Bokros austerity package of 1995 before they could take off again. After a first increase in 1998 (election year) they grew steadily from the early 2000s.

Centrally dictated salary increases of public employees led to an explosion of the wage bill in 2002 and 2003; payroll taxes followed suit. Apart from these items, operational expenditures remained relatively stable (or grew only slightly) over the period. By contrast, capital expenditures are less determined by sector-specific norms and thus more sensitive to political cycles SZALAI (2005, p. 14), which explains the peaks registered in the election years 1998, 2002, and 2006.

Figure 5.1 indicates no significant dynamics in the structure of local expenditures. Wages, salaries, and social contributions add up to 45 per cent of total expenditures. Together with other running costs of public service facilities, VAT and interest payments, they account for approximately three-fourth of the budget. Around 20 per cent of the expenditures is related to capital development, including own investments and grants to various organisations involved in the development of public infrastructure. Subsidies and grants to cover the running costs of external public service providers add up to nearly 10 per cent of the local budget.

5.2 The statutory assignment of responsibilities

5.2.1 Mandatory and optional functions: an overview

According to a proposition in Section 3.4.2, the major determinant factor of local expenditure autonomy from the steering side is the way the various public expenditure responsibilities are

shared among the government tiers.

³In the category of 'municipalities', we took into consideration the following administrative units: the capital city and its 23 districts, the 23 towns with county rights, the 265 towns (without county rights), and the 2,863 villages; thus 3,175 units in total. Counties and micro-regions were left out of consideration.

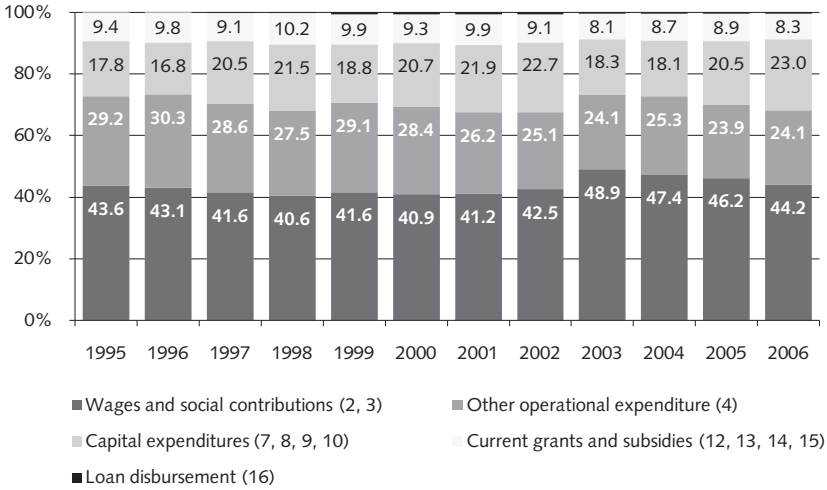


Figure 5.1: **The expenditure structure of municipalities 1995–2006**
 [Source: the author, based on Table 5.1]

A quick glance over Table 5.2 suggests that the range of subnational responsibilities (taking mandatory and optional functions together) is largely comparable to that in other decentralised unitary countries in Europe.⁴ Two distinctive features of the Hungarian system, however, are the dominant role of municipalities in public service provision (compared to that of the counties) and the relatively high proportion of mandatory functions within the overall volume of functions. This fits more into the Nordic than into the Southern model of expenditure assignment. With regard to the excessively fragmented territorial structure, however, Hungary is closer to the Southern model (BATLEY and STOKER, 1991; KOPÁNYI et al., 2004, p. 20).

As has been pointed out in Chapter 4, the constitutional provision on equal rights and different duties and the subsequent regulations in the ALG, the ATC and

⁴In order to ensure international comparability and to avoid describing each function in detail, we chose to apply the GFS (Government Finance Statistics) Functional Classification of Outlays elaborated by the International Monetary Fund (IMF, 2001, Appendix 4). This job implied the thorough review of all sector-specific laws existing on 1 January 2006 to see which of them contains a rule on SNG involvement. In a second step, we had to identify the nature of the SNG involvement. Because of the multitude of sector-specific laws and their various amendments, this job took several days.

70455	Pipeline and other transport	M	M	O	O	O	O	O	O											Act C of 2003, art. 4–13; Act CI of 2003 art. 42–46
7046	Communication	M	M																	
7047	Other industries	M	M	M*	M*	O*	O*	O*	O*	O*										* promotion and development ALG art. 70[1], art. 63/A; ATC art. 66 of tourism
7048	R&D Economic affairs	M	M																	
7049	Economic affairs n.e.c.	M	M	M	M															
705	ENVIRONMENTAL PROTECTION																			
7051	Waste management	M	M	M	M	M	M	M	M											ALG art. 63/A; Act XLIII of 2000 art. 21–24, 34–35
7052	Waste water management	M*	M**	M**	M**	M**	M**	M**	M**	M**										ALG art. 8[1]; ATC art. 86–87; Act LVII of 1995 art. 4 * if the scope of the service exceeds the limits of the capital districts; ** if waste-water emission > 2.000 inhabitant equivalents
7053	Pollution abatement	M	M	M	M	M	M	M	M	M										ALG art. 8[1]; ATC art. 84–85 >> Act LIII of 1995 art. 37–48
7054	Protection of biodiversity and landscape	M	M	M	M	M	M	M	M	M										ALG art. 8[1], art. 63/A, art. 70[1]; ATC art. 80, 85; Act LIII of 1996 art. 53–67; Act LXXVIII of 1997 art. 6
7055	R&D Environmental protection	M	M																	
7056	Environmental protection n.e.c.	M	M																	Act LVII of 1995 art. 2–3; GD 72/1996
706	HOUSING AND COMMUNITY AMENITIES																			
7061	Housing development	M	M	O	O	O	O	O	O											ALG art. 8[1]
7062	Community development	M	M	M	M	M	M	M	M											ALG art. 8[1], art. 63/A, art. 70[1]; Act LXXVIII of 1997 art. 6[1]
7063	Water supply	M*	M	M	M	M	M	M	M											ALG art. 8[4], art. 63/A; ATC art. 86–87; Act LVII of 1995 art. 4 * if the scope of the service exceeds the limits of the capital districts

Legend: n.e.c. = not elsewhere classified; M = mandatory; O = optional; S = subsidiary (if the responsible SNG is not ready to assume the function).
 Legislation: see at the end of the table. [] indicates the paragraph number.

Table 5.2: (cont.)

GFS code / Expenditure category	Central govt	Dec. agcies	Counties	Capital city	Capltl distrcts	Towns with cnty rights	Other twns	Villages	Remarks	Legislation
7064 Street lighting		M	M*	M*	M	M	M	M	* If the scope of the service exceeds the limits of the capital districts	ALG art. 8(4), art. 63/A; ATC art. 65(3)
7065 R&D Housing and community amenities	M									
7066 Housing and community amenities n.e.c.	M	M	M	M*	M*	M*	M*	M*	* mandatory; cemeteries; maintenance and cleaning of streets, parks etc.	ALG art. 8(1), 4), art. 63/A; ATC art. 18, 21, art. 129(3); Act CLIV of 1997 art. 153(1)
707 HEALTH										
7071 Medical products, appliances and equipment	M	M								
7072 Outpatient services				M	M	M	M	M		
70721 General medical services				M	M	M	M	M		ALG art. 8(4), art. 63(1); ATC art. 129(1) >> Act CLIV of 1997 art. 152(1)
70722 Specialized medical services			M*	M*	M*	M*	M*	M*	* mandatory only if there are facilities in the jurisdiction	ALG art. 8(1), art. 63/A, art. 70(1); Act CLIV of 1997 art. 152(3)
70723 Dental services			M	M	M	M	M	M		ALG art. 8(4), art. 63(1); ATC art. 129(1) >> Act CLIV of 1997 art. 152(1)
70724 Paramedical services										
7073 Hospital services			M*	M*	M*	M*	M*	M*	* mandatory only if there are facilities in the jurisdiction	ALG art. 8(1), art. 63/A, art. 70(1); Act CLIV of 1997 art. 152(3)
7074 Public health services	M	M								
7075 R&D Health	M	M								
7076 Health n.e.c.	M	M	M	M						Act CLIV of 1997 art. 141–151
708 RECREATION, CULTURE, AND RELIGION										
7081 Recreational and sporting services	M	M	M	M	M	M	M	M		ALG art. 70(1); ATC art. 110–111, 121; Act I of 2004 art. 49–51, 55

7082 Cultural services										
Libraries	M	M	M	M	M	M	M	M	ALG art. 8[1], art. 70[1]; ATC art. 108[1]; Act CXL of 1997 art. 64-67	
Sports facilities and programmes	M	M	M	M	M	M	M	M	ALG art. 70[1]; ATC art. 110-111, 121; Act I of 2004 art. 49-51, 55	
Local community centres	M	M	M	M	M	M	M	M	ALG Art. 8[1], art. 63/A; ATC art. 107; Act CXL of 1997 art. 76-81	
Museums	M	M*	M*	O	O	O	O	O	* mandatory: a museum or an archive	
Archives	M	M*	M*	O	O	O	O	O	* mandatory: a museum or an archive	
Theatres		O	O	O	O	O	O	O	108[2-3]; Act CXL of 1997	
7083 Broadcasting and publishing services										
	M								Act I of 1996	
7084 Religious and other community services										
7085 R&D Recreation, culture and religion										
	M									
7086 Recreation, culture and religion n.e.c.										
	M	M							Act CXL of 1997	
709 EDUCATION										
7091 Pre-primary and primary education										
70911 Pre-primary education (ISCED 0)				M	M	M	M	M	ALG art. 8[4], art. 63[1]; ATC art. 96; Act LXXIX of 1993 art. 86[1]	
70912 Primary education (ISCED 1)				M	M	M	M	M	ALG art. 8[4], art. 63[1]; ATC art. 96; Act LXXIX of 1993 art. 86[1]	
(Pre-)primary education for handicapped children		M	S	M	O	O	O	O	Not classified in ISCED-97	
(Pre-)primary education for ethnic / national minorities				M	M	M	M	M	Not classified in ISCED-97	
									ALG art. 8[4]; ATC art. 96-97; Act LXXIX of 1993 art. 86[1]	

Legend: n.e.c. = not elsewhere classified; M = mandatory; O = optional; S = subsidiary (if the responsible SNG is not ready to assume the function).
 Legislation: see at the end of the table. [] indicates the paragraph number.

Table 5.2: (cont.)

GFS code / Expenditure category	Central govt	Dec. agcies	Counties	Capital city	Capitl distrcts	Towns with cnty rghts	Other twns	Villages	Remarks	Legislation
Primary education for adults (ISCED 1B Type 2)	S	S	M	O	O	O	O	O		ATC art. 97; Act LXXIX of 1993 art. 86[3-4]
7092 Secondary education (general / vocational)										
70921 Lower-secondary education (ISCED 2)			M	M	M	M	M	M		ALG art. 8[4], art. 63[1]; ATC art. 96; Act LXXIX of 1993 art. 86[1]
Elementary art schools (ISCED 2B Type 2)	S	S	M	O	O	O	O	O		ALG art. 8[1]; ATC art. 97; Act LXXIX of 1993 art. 86[3-4]
Lower-secondary education for handicapped children	M	S	M	O	O	O	O	O	Not classified in ISCED-97	ALG art. 8[1]; Act LXXIX of 1993 art. 87[1]
Lower-secondary education for ethnic or national minorities			M	M	M	M	M	M	Not classified in ISCED-97	ALG art. 8[4]; ATC art. 96-97; Act LXXIX of 1993 art. 86[1]
Lower-secondary education for adults (ISCED 2B Type 2)	S	S	M	O	O	O	O	O		ATC art. 97; Act LXXIX of 1993 art. 86[3-4]
70922 Upper-secondary education (ISCED 3)										
Upper-secondary education for handicapped children	M	S	M	O	O	O	O	O	Not classified in ISCED-97	ALG art. 63/A, art. 70[1]; ATC art. 97; Act LXXIX of 1993 art. 86[3]
Upper-secondary education for ethnic / nat. minorities	S	S	O	O	O	O	O	O	Not classified in ISCED-97	ALG art. 8[4]; ATC art. 96-97; Act LXXIX of 1993 art. 86[3, 5]
Upper-secondary education for adults (ISCED 3B Type 2)	S	M	O	O	O	O	O	O		ATC art. 97; Act LXXIX of 1993 art. 86[3]

7093	Post-secondary non-tertiary education									Supplementary programmes of 1–2 years offered by vocational schools	Act LXXVI of 1993	
7094	Tertiary education										Act LXXX of 1993	
7095	Education not definable by level											
7096	Subsidiary services to education											
	Lodging		S	S	O	S	O	O	O	S: mandatory for county, capital and towns with county rights if there is no such facility in or around their jurisdiction	ALG art. 63/A, art. 70(1); Act LXXIX of 1993 art. 86(3)	
	Speech therapy, vocational consultancy		S	S	M	O	O	O	O		ATC art. 98(1); Act LXXIX of 1993 art. 86(3–4)	
7097	R&D Education	M	M									
7098	Education n.e.c.	M	M	M								
710	SOCIAL PROTECTION											
7101	Sickness and disability											
	71011 Sickness	M	M								Act LXXXIII of 1997	
	71012 Disability											
	Disability pensions	M	M								Act LXXXI of 1997	
	Homes for disabled persons	M	M	O	O	O	O	O	O		ALG art. 8(1), art. 63/A, art. 70(1); ATC art. 130; Act III of 1993 art. 86, 88	
	Home care (daytime nursing services)	S	M	M*	M*	M*	M*	M*	M*	* mandatory if population > 10,000	ALG art. 8(4); ATC art. 129(2); Act III of 1993 art. 86(1, 4), art. 88(1)	
	Meal service for homebound and disabled persons	S	M	M	M	M	M	M	M		ALG art. 8(4), art. 63(1); ATC art. 129(2); Act III of 1993 art. 86(1, 4), art. 88(1)	
7102	Old age											
	Old age pensions	M	M								Act LXXX of 1997, Act LXXXI of 1997	
	Nursing homes, rehabilitation centres	M	M	O	O	O	O	O	O		ALG art. 8(1), art. 63/A, art. 70(1); ATC art. 130; Act XXXI of 1997 art. 95(1); Act III of 1993 art. 86, 88	

Legend: n.e.c. = not elsewhere classified; M = mandatory; O = optional; S = subsidiary (if the responsible SNG is not ready to assume the function).
 Legislation: see at the end of the table. [] indicates the paragraph number.

Table 5.2: (cont.)

GFS code / Expenditure category	Central govt	Dec. agcies	Counties	Capital city	Capltl distrcts	Towns with cnty rights	Other twns	Villages	Remarks	Legislation
Home care (daytime nursing services)		S			M	M*	M*	M*	* mandatory if population > 10,000	ALG art. 8[4]; ATC art. 129[2]; Act III of 1993 art. 86[1–2, 4], art. 88[1]
Meal service for homebound persons					M	M	M	M		ALG art. 8[4], art. 63[1]; ATC art. 129[2]; Act III of 1993 art. 86[1]
Temporary shelter and board for the elderly		S			M	M*	M*	M*	* mandatory if population > 10,000	ALG art. 8[4], art. 63[1]; ATC art. 129[2]; Act III of 1993 art. 86[2, 4], art. 88[1]
7103 Survivors										
Survivors' benefits	M	M								Act LXXXIV of 1992, Act LXXXI of 1997
7104 Family and children										
Cash benefits to family and children	M	M			M*	M*	M*	M*	* mandatory, regular social aid for families, indemnity for home nursing, special child protection allowances	Act III of 1993 art. 25; Act LXXXIII of 1997 art. 40–42/C; Act LXXXIV of 1998
Assistance to families	S				M	M*	M*	M*	* mandatory if population > 2,000	ALG art. 8[4]; ATC art. 129[2]; Act III of 1993 art. 86[2, 4], art. 88[1]
Day care for children < 3 years					M*	M*	M*	M*	* mandatory if population > 10,000	ALG art. 8[4]; Act XXXI of 1997 art. 94[3]
Temporary shelter and board for children	S	S			M*	M*	M*	M*	* mandatory if population > 20,000	ALG art. 8[1], art. 63/A, art. 70[1]; ATC art. 130; Act XXXI of 1997 art. 94[3], art. 95[1]
Temporary shelter and board for families	S	S			M*	M*	M*	M*	* mandatory if population > 30,000	ALG art. 8[1], art. 63/A, art. 70[1]; ATC art. 130; Act XXXI of 1997 art. 94[3], art. 95[1]
Child protection services	M				M*	M	M*	M*	* mandatory if population > 40,000	ALG art. 8[1], art. 63/A, art. 70[1]; ATC art. 130; Act XXXI of 1997 art. 94[3–4], art. 95[1]
Nursing homes for children < 3 years, with shelter and boarding	M	M								ALG art. 8[1], art. 63/A, art. 70[1]; ATC art. 134; Act XXXI of 1997 art. 95[1]
Orphanages, foster families	M	M								ALG art. 63/A, art. 70[1]; ATC art. 130; Act XXXI of 1997 art. 95[1]

Table 5.2: (cont.)

Legal references:

Statutory Act XI of 1979 on the Execution of Punishments and Measures
 Act I of 1988 on Road Transport
 Act LXV of 1990 on Local Governments (ALG)
 Act IV of 1991 on Job Assistance and Unemployment Benefits
 Act XX of 1991 on the Tasks and Competences of Local Governments and their Bodies, the Commissioners of the Republic and Selected Deconcentrated Authorities (ATC)
 Act LXXXIV of 1992 on the Funding of the Social Security System
 Act III of 1993 on Social Administration and Social Services
 Act XLVIII of 1993 on Mining
 Act LXXXI of 1993 on Vocational Training
 Act LXXXIX of 1993 on Public Education
 Act LXXX of 1993 on Higher Education
 Act XCV of 1993 on the Railways (replaced by the Act CLXXXIII of 2005)
 Act XXXIV of 1994 on the Police
 Act LIII of 1995 on the General Rules of Environmental Protection
 Act LVII of 1995 on Water Management
 Act I of 1996 on Radio and Television Broadcasting
 Act XXI of 1996 on Regional Development and Planning
 Act XXXI of 1996 on Fire Protection
 Act XXXVII of 1996 on Civil Protection
 Act LIII of 1996 on Nature Conservation
 Act XXXI of 1997 on the Protection of Children and Guardianship Administration
 Act LXXXVIII of 1997 on the Formation and Protection of the Built Environment
 Act LXXX of 1997 on Eligibility for Social Security
 Act LXXXI of 1997 on Social Security Pensions
 Act LXXXIII of 1997 on Mandatory Health Insurance
 Act CXL of 1997 on Museums, Public Libraries and General Education
 Act CLIV of 1997 on Health Care
 Act LXXXIV of 1998 on Family Support
 Act CX of 2001 on Electric Energy
 Act XLII of 2003 on Natural Gas Supply
 Act CI of 2003 on the Post
 Act I of 2004 on Sport
 Act CV of 2004 on National Defence
 Act XVIII of 2005 on District Heat Supply
 Act CLXXXIII of 2005 on Rail Transport
 GD (Government Decree) 72/1996 (22 May) on the Administrative Competences in Water Management
 GD (Government Decree) 17/2002 (9 August) on the Competences of the Ministry of Economy and Transport

the various sector-specific laws resulted in a vast and complex system of subnational competences. Since the ALG stipulates that the legislative can assign local affairs to a higher government tier only exceptionally, there is a potential in the system to become even more complex.⁵

The direct application of the principle of subsidiarity obviously strengthened the sense of liberty of local governments with regard to the management of their affairs. Nothing could illustrate this better than the Hungarian term *hatáskör* that can be translated as competence, authority, power, or function. For a central concept, it is somewhat dangerous because it blurs the distinction between rights and duties; indeed, it appears invariably in the very different contexts of deconcentration, delegation and devolution.⁶ As DAVEY et al. (2000, p. 8) observe, local governments in Hungary are inclined to regard their *hatáskör* as an instrument for exercising power and property rights. This interpretation is obviously hard to reconcile with the notions of serving, or being accountable to, the local community. The insistence on local competences has a particular implication on both steering and rowing: it incites local government councils, even those with poor capacity, to assume new responsibilities and keep existing ones, and to rely on their own facilities for service delivery rather than considering the option of contracting another provider.

Table 5.3 gives an idea about the volume and shares of current expenditure by function in the various categories of municipalities. Although the data are relatively old, they reflect the actual proportions more or less appropriately.⁷ The management of real estate and community amenities account for the largest part of total current expenditures, followed (not surprisingly) by education and health care. Education expenditures occupy a remarkably high share in the budgets of towns and villages, which is a direct consequence of the assignment of functions but may just as well signalise low efficiency in service delivery due to territorially fragmented school structures.

⁵ALG, art. 6 para. 2.

⁶A recent report mandated by the Council of Europe provides an interesting overview about the semantic differences of the term 'competence' in Europe (MARCOU, 2005, p. 5 ff.).

⁷Regrettably, the structure of the data provided by the Ministry of the Interior does not allow us to apply the same GFS classification as in Table 5.2.

5.2.2 The predominant role of mandatory functions

In Figure 3.3 (Section 3.4.2), we distinguished mandatory and optional local government functions as well as an intermediate category that we called demand-driven mandatory functions. The latter category is inexistent in Hungary: to our knowledge, there is no law that would oblige local governments to provide a certain public service on condition that a pre-defined proportion of the population in their jurisdiction express a demand for it.

Municipalities in Hungary acquire most of their mandatory functions through deconcentration and delegation, but a clear distinction between these two forms in practice is virtually impossible. Recalling Section 3.1.2, one major difference is that in the case of deconcentration, the higher-level authority retains full financial responsibility for the given task, whereas with delegation, top-down funding may be either full or partial. In Hungary, however, it is impossible to say whether, and if yes, to what extent, central government funding contributes to the costs of providing a given local public service. This is due to the principle of the unified budget that allows SNGs to use any revenue item, with the exception of earmarked grants, for covering the costs of any expenditure item (see Section 6.1.2). Yet, full coverage of local service costs is rare, and it results most often from a fortunate coincidence of circumstances rather than from an explicit policy of the centre.

The central government in Hungary transfers not only financial but also political responsibility for the delegated services. Local governments become accountable to both the central government and the citizens. If citizens are dissatisfied with the public service provided by the local government, they will complain, not to the central government or the Parliament, but to their elected local officials. Similarly, the risk of losing elections because of having performed poorly in the management of local affairs threatens primarily local politicians and not the members of Parliament. The responsibility of the centre is at best limited to the provision of adequate revenue powers that allow the local tier to execute their mandatory functions.

Another theoretical difference between deconcentration and delegation is in the liberty of action that the service-providing entity enjoys. Table 5.2 does not tell in which functions local governments act as simple territorial agents of the central government (deconcentration) and in which functions they have a certain room for manoeuvre (delegation). This piece of information would require an in-depth analysis of several dozens of sector-specific laws, and chances are good that we find a coexistence of both forms within one law. One of the few categories of local public services that are explicitly deconcentrated, and not delegated, is the management of administrative procedures. Here, equity considerations call for an identical treatment of citizens whose preferences are homogeneous with regard to

Table 5.3: **Current expenditures of municipalities by function, 2002**
[Source: the author, based on Ministry of the Interior (2003)]

Function	Capital city ⁴	Towns	Villages	Total
<i>In million HUF (at current prices)</i>				
Agriculture, hunting and forestry	3,259	6,288	2,052	11,599
Construction, maintenance and renovation of buildings ¹	648	1,128	1,145	2,921
Transport and telecommunication	5,779	6,294	2,113	14,186
Real estate management, community amenities ²	220,392	233,171	131,223	584,786
Other economic affairs ³	13,545	46,567	20,712	80,823
Education	79,246	204,664	105,459	389,369
Health care	69,930	113,853	24,019	207,802
Social protection	30,456	47,102	14,215	91,773
Sewage and waste management, cleaning of public spaces	5,498	11,909	10,237	27,644
Recreation, culture and sports	16,176	29,824	7,898	53,899
Total	444,929	700,799	319,072	1,464,800
<i>As a share of total current expenditures (%)</i>				
Agriculture, hunting and forestry	0.7	0.9	0.6	0.8
Construction, maintenance and renovation of buildings ¹	0.1	0.2	0.4	0.2
Transport and telecommunication	1.3	0.9	0.7	1.0
Real estate management, community amenities ²	49.5	33.3	41.1	39.9
Other economic affairs ³	3.0	6.6	6.5	5.5
Education	17.8	29.2	33.1	26.6
Health care	15.7	16.2	7.5	14.2
Social protection	6.8	6.7	4.5	6.3
Sewage and waste management, cleaning of public spaces	1.2	1.7	3.2	1.9
Recreation, culture and sports	3.6	4.3	2.5	3.7
Total	100.0	100.0	100.0	100.0

¹ Houses, gas pipelines, public roads, etc.

² General administration, water supply, public lighting, cemeteries, etc.

³ Publishing, provision of student accommodation, etc.

⁴ Including capital districts

190 the related service. An identical treatment necessitates control and coordination of local operations by the central authorities.

Finally, one could also argue that the provision of local public goods to which every citizen has a basic right according to the Constitution (e.g. primary education, basic health care and social care) calls for deconcentration. By contrast, the provision of other public goods that represent national priorities but no fundamental citizen rights and are provided by 'a dominant cluster of local governments', as PÁLNÉ KOVÁCS (2004) proposes (e.g. secondary education, specialised health care), should rather be delegated and encouraged (or compensated) with specific grants. In Hungary, however, most sector-specific laws start with a normative statement about the right of access of citizens in general, or the relevant target group in particular (e.g. pupils, the disabled, the insured), to the products and services related to the given policy area, and employ this statement as an argument for legitimating the mandatory character of the assignment. It seems thus as if all these functions were deconcentrated.

The logic pursued by the Hungarian legislator is in certain aspects similar to the one behind the so-called merit goods (or 'merit wants', a term coined by MUSGRAVE, 1959, p. 13 ff.) such as education or basic health care. There, consumers underestimate the benefits they can potentially derive from, but also the positive externalities that they produce by consuming, those goods and services (e.g. primary education or certain vaccines). Under normal market conditions, this situation would lead to suboptimal provision and consumption levels. In order to adjust these levels to the social optimum, the state intervenes.

In the Hungarian case, the legislator appears to find that some local governments could possibly undervalue the importance of certain public goods and services. By providing less than the 'social optimum' defined in the law, they could violate certain fundamental citizen rights. The state intervenes, not by providing these goods and services on its own, but by delegating their provision to the municipal tier and by defining certain standards with respect to quality and quantity. Local governments are allowed to provide more, but not less, than this compulsory minimum. If we consider the etymology of the term 'merit goods', we may indeed think of goods that (are considered so important that) every member of the society should have access to them ('to merit', 'to deserve'); here, the reference to fundamental citizen (or consumer) rights comes very close to Musgrave's interpretation of the term.

Delegation as a rule is not surprising in the domains of public order and safety, primary education, basic health care, or waste management. Access to these services helps citizens exercise their fundamental and universal right to a safe and

supportive living environment irrespective of the jurisdiction in which they live. However, the range of merit goods in the Hungarian law is substantially wider than that and includes libraries and sports facilities, cultural programmes, the protection of children and youth, or the daily meal service for homebound people. In other countries, many of these goods and services feature in the category of devolved functions; local governments are free to decide whether to provide them or not. In Hungary, they are simply mandatory. We do not know whether this practice has to do anything with a possible ambition of the central government to preserve the social, educational and other achievements of four decades of socialism. The mandates concerning children and youth policy or the services to the homebound may just as well derive from the objective of protecting minority interests. In any case, the elimination of the local supply-demand mechanism in such a wide range of public services involves costs: it reduces the expenditure autonomy of local governments and imposes a burden on the centre to ensure equal access by providing targeted assistance to the less wealthy jurisdictions.

5.2.3 Mandatory functions and the insistence on self-sufficiency The ongoing discussion about the pressure on local governments and the claims of these latter about their lack of capacity and the related difficulty to meet mandatory responsibilities reveal that there is still considerable confusion among local policymakers about the difference between steering and rowing.

In the view of academics and practitioners dealing with fiscal decentralisation in Hungary, one of the most important weaknesses of the current scheme of responsibility assignment is the lack of respect for disparities in the size of municipalities and their level of economic development. Several authors identified this as a serious problem (OECD, 2001, p. 39; FEKETE et al., 2002; HERMANN et al., 2004; KUSZTOSNÉ NYITRAI, 2004, p. 75). They argue that the constitutional provision that provides the possibility to assign different competences to different categories of self-governing administrative units (see Section 4.2) also implies a potential for a differentiation among municipalities according to their size or status. Yet, the Parliament has hardly ever made use of this provision so far. Social care (with the exception of the daily meal service for the homebound) and the maintenance of sewage systems are two of the rare examples where the scope of responsibility depends on the size of the municipality. For the overwhelming majority of mandated functions, local governments are treated homogeneously, or differentiation is made along other, less plausible criteria.

Experts tend to overemphasise the problem particularly against the background

192 of a fragmented territorial structure that allows neither the realisation of scale economies nor the development of sufficient technical and administrative capacities within the municipality. However, this line of reasoning neglects the possibility of joint service provision. In fact, the problem is not the lack of differentiation in the assignment of *responsibilities* (steering). In most of the federal and decentralised systems (except for a few such as Spain and France), the national constitution treats all units of the same government tier as equals, regardless of size or any other characteristics, for the assignment of revenue and expenditure competences. The fact that the Hungarian Constitution distinguishes several categories of administrative units at the same (municipal) level makes therefore possible but not necessary for the legislative to pursue a differentiated assignment of responsibilities.⁸

In this context, the conceptual difference between the responsibility for, and the delivery of, public services (steering vs rowing) becomes particularly relevant. What the Hungarian legislative presumably meant by the term ‘responsibility’ is an obligation to organise, or provide access to, the service, which corresponds to steering. Whether the local government meets this obligation by using its own production capacities, by purchasing the service from outside, or by delivering it in co-operation with other municipalities (all these are various modes of rowing), is normally left to the discretion of the local executive and/or the voters. If a local government has not enough administrative, personal or technical capacity to deliver the service independently, it may (and should, logically) search for a partnership in order to fulfil its duties imposed by the law. Such a choice is not going to reduce its expenditure autonomy by any means. The opposite is true: local autonomy would be hurt if the legislative decided to centralise the competence or to delegate it to a higher level of government.

It is true, however, that the wording of the law is ambiguous. The terms *biztosít* (‘ensure’) and *nyújt* (‘provide’) occurring in combination with the name of an institution that can be interpreted in both physical and abstract sense (e.g. day care), give little information about the necessary degree of local government involvement in service delivery. Two other factors contribute to the confusion about the meaning of responsibility. First, there is a sense of ‘local pride’ among local policymakers that converts the notion of duty into the notion of right (see the

⁸A number of Hungarian policymakers have already recognised this problem but their voices went unheard. During the parliamentary debate of the Act CXXXV of 1997 on Municipal Associations and Inter-municipal Co-operation, a centre-right politician said that the problem was not the number of local government *entities* but the number of local government *offices* that execute virtually the same range of functions (Archives of the Hungarian Parliament, debate of 28.10.1997, contribution no. 3160066).

discussion of the term ‘competence’, *hatáskör*, in Section 5.2.1); the result is a bias in favour of autonomous solutions and self-sufficiency in every aspect of local public administration. Second, this sense of ‘local pride’ has been matched, at least until the end of the 1990s, with an intergovernmental legal and financial system that provided stronger incentives for the separation and self-sustaining development of municipalities than for interjurisdictional co-operation and the rationalisation of service delivery.

Following these arguments, it can be argued that local expenditure autonomy is reduced, not by the lack of differentiation in the assignment of responsibilities and the subsequent ‘overloading’ of small jurisdictions, but by the poor flexibility of several municipalities to adapt the service delivery function to the statutory assignment of expenditures. This incapacity imposes an endogenous constraint on expenditure autonomy. At the same time, the responsibility of the legislative for creating the necessary conditions for a smooth adjustment is not to be overlooked. In the following section, we temporarily digress from the topic of local expenditure autonomy to discuss what we consider a major flaw in the current assignment scheme. Namely, wherever the legislative allows for some kind of a differentiation in the assignment, the applied criteria are manifold and have little economic foundation.

5.2.4 Differentiated assignment and the logic behind it

When combing through the sector-specific laws to find instances of differentiation in the assignment of responsibilities to municipalities, one can observe that differentiation is primarily made along two dimensions. The first one may be called the object of responsibility. Some laws oblige a selected category (or categories) of local governments to provide access to a particular service (i.e., to steer). Others oblige them not only to provide access but also to maintain and operate the facilities related to the given service (i.e., to row). The second dimension is what we call the subject of responsibility: this is the category (or categories) of municipalities to which the obligation of steering and/or rowing applies. This distinction allows us to place the existing assignment patterns into a two-dimensional matrix (Figure 5.2).

While the most typical assignment pattern is A (no differentiation), the law contains also several examples of the patterns B to H. Since differentiated assignment is more an exception than the rule, the variety of the differentiation criteria is not worrying. Nevertheless, it raises questions about the logic of differentiation and its impact on intergovernmental relations.

Concerning the differentiation in the object of responsibility, the obligation to

	Every municipality	Selected categories	Only if population exceeds threshold	Only those with facilities	Other criteria
Obligated to provide access to the service (steer)	A	B	C	D	E
Obligated to maintain and operate own facilities related to the service (steer and row)	–	F	G	H	–

Examples

- A All municipalities are obliged to provide access to:
- drinking water provision (Act LXV of 1990, art. 8 para. 4)
 - day care, kindergarten and primary education (Act LXXIX of 1993, art. 86 para. 1)
 - basic health care and primary school health services (Act CLIV of 1997, art. 152 para. 1)
 - home nursing, meals for the disabled (Act III of 1993, art. 86 para. 1)
 - library services, cultural programmes and sports (Act CXL of 1997, art. 64 and 76–77; Act I of 2004, art. 55)
 - maintenance of local public roads and public cemeteries (Act LXV of 1990, art. 8 para. 4), etc.
- B Towns with county rights are obliged to provide basic social services, temporary accommodation of all sorts, nursing homes for the elderly, and assume two other items from the list of mandatory tasks of the counties, according to local preferences (Act III of 1993, art. 90 para. 2).
- C Municipalities are obliged to provide basic social services according to the following criteria (Act III of 1993, art. 86 para. 2):
- (a) if pop. > 2,000: assistance to families
 - (b) if pop. > 3,000: (a) + social day care facility for the elderly
 - (c) if pop. > 10,000: (a) + (b) + home nursing in medical alert system, social day care facility open to all, (until 31.12.2008) support services and community centres for addicts and psychiatric individuals
 - (d) if pop. > 30,000: (a) + (b) + (c) + temporary accommodation of all sorts
 - (e) if pop. > 50,000: (a) + (b) + (c) + (d) + street workers
- D Municipalities are obliged to maintain and operate the hospitals and specialised outpatient care facilities in their ownership or usage (Act CLIV of 1997, art. 152 para. 3). Municipalities having no such facilities in their jurisdiction are not obliged to provide access to the related service.
- E Municipalities belonging to so-called 'sewage agglomerations' characterised by a wastewater emission of higher than 2'000 population equivalents are obliged to organise the collection and secondary treatment of wastewater and construct the necessary infrastructure in collaboration with the rest of the agglomeration (Act LVII of 1995, art. 4 para. 2).
- F Towns with county rights and other towns are obliged to establish and maintain own cultural facilities (Act CXL of 1997, art. 76). Towns with county rights are obliged to maintain a child welfare centre, regardless of population size (Act XXXI of 1997, art. 94 para. 4).
- G Municipalities are obliged to maintain various facilities for children and youth protection according to the following criteria (Act XXXI of 1997, art. 94 para. 3):
- (a) if pop. > 10,000: day care (for children of 0–3 years)
 - (b) if pop. > 20,000: (a) + temporary accommodation for children
 - (c) if pop. > 30,000: (a) + (b) + temporary accommodation for families
 - (d) if pop. > 40,000: (a) + (b) + (c) + child welfare centre
- H Fire fighting and rescue services belong to the mandatory responsibilities of those local governments that are operating a public or voluntary fire brigade (Act XXXI of 1996, art. 2 para. 2). Municipalities are obliged to maintain and operate the sports facilities in their ownership (Act I of 2004, art. 55 para. 1). Municipalities having no such facilities are not obliged to establish any; nonetheless they are obliged to provide access to the related services through outsourcing, inter-municipal co-operation etc.

Figure 5.2: Assignment criteria for the mandatory tasks of municipalities, as of 31.12.2006 [Source: the author]

maintain and/or operate service-related facilities is objectionable insofar as one of the declared goals of the central government is to grant local governments the greatest possible freedom with regard to the parameters of service delivery. Rowing autonomy is indeed provided for the great majority of public services and there appears to be no economic or other argument in support of maintaining these few exceptional arrangements.

As for the differentiation in the subject of responsibility, the underlying motive is clearly to impose a proportionally heavier burden on municipalities with greater fiscal capacity. Large towns, especially those owning and running several service facilities, tend to be financially strong. However, it is hard to find an argument for the conditionality of specialised health care provision upon the availability of related facilities in the jurisdiction (pattern D). The approach suggests that municipalities owning such facilities are in some way better suited to provide the related services than those that would first need to establish the necessary infrastructure.⁹ Similarly, it is not clear either why population size is a relevant criterion for the differentiation in the assignment of social service responsibilities (patterns C and G); in fact, as we will see below, particularly in the domain of social care, this approach is highly counterproductive.

Beyond the fact that its logical foundation is at least arguable, the assignment rule for *specialised health services* also represents an important hindrance to local autonomy as well as to local economic development. Box 5.1 provides some background information about the functioning of the multi-level health sector.¹⁰

Box 5.1: Health care: assignment rules and financing

The Act XXXIII of 1991 on the Transfer of State Property to Local Authorities transferred the ownership right related to former state property to those SNGs that were actually providing the related public service. In practice, this meant that SNGs inherited all facilities that were situated in their jurisdictions. In consequence, municipalities hold now the majority of primary health care, outpatient and basic inpatient care facilities, while the central government (ministries and universities) and the counties provide more specialised out- and inpatient care in large hospitals. Art. 152 para. 3 of the Act CLIV of 1997

⁹The Act CXXXII of 2006 on the Development of the Health Care System that entered into force on 01.01.2007 restricts the scope of this rule to the owners of those few hospitals that have been selected to participate in the network of key facilities funded by the National Health Insurance Fund (NHIF). The smallest local governments are not among these. Nevertheless, since our period of analysis is 1990–2006 and the reason behind the current reform is not the poor logical link between the availability and the successful operation of facilities, we discuss here the original assignment rule.

¹⁰For an overview of the health sector, see e.g. OROSZ and BURNS (2000) and FÜZESI et al. (2005).

on Health Care obliges decentralised authorities at both municipal and county levels to guarantee the continuous operation of the outpatient and inpatient health care facilities in their ownership or usage.

According to the Act LXVIII of 1996 on the Territorial Supply of Health Services and Regional Capacity Norms and the Act XXXIV of 2001 on the Territorial Supply of Specialised Health Services and the Amendment of Various Laws related to Health Care, the territorial competence of a facility (the area from which it is obliged to receive patients) is defined in a so-called capacity agreement between the managers and the owners of the facility and the National Health Insurance Fund (NHIF).

Since April 1998, the reimbursement of operational expenditures has followed the so-called fee-for-service system in which, the overall budget being closed-ended, the value of a service unit (or 'performance point') depends on the aggregate number of service units provided throughout the country in a given period. It is up to the management to ensure that they stay within the limits of their budget and continue to satisfy the demand for health services within their territorial competence. In July 2006, the central government decided to freeze the maximum amount of annual cost reimbursement from the NHIF at a level of 95 per cent of the actual outlays of the penultimate year (Government Decree 132/2006 concerning the Amendment of Government Decree 43/1999 on the Detailed Rules of Financing Health Services from the Health Insurance Fund).

Beneficiary jurisdictions are not obliged to offer any contribution to the outlays incurred by the provider jurisdiction, but hospitals are allowed to refuse patients coming from outside their territory (as laid down in the capacity agreement) or, alternatively, to apply price discrimination to patients according to where they live. A recent study of the National Health Insurance Fund (Danó, 2006) shows that one-fifth of the patients choose a hospital outside the competence area to which they officially belong. The hospitals in Pest County (not including those of Budapest) treat altogether only 43 per cent of the citizens belonging to their competence area (57 per cent migrate elsewhere); while in Heves County this rate is 70 per cent. While migration towards Budapest may be explained with the better infrastructure, the reasons for other cross-country migration flows are unclear and the trend contradicts the experience of other countries. However, new admission rules recently adopted in a few hospitals suggest that the announced budgetary restrictions may effectively reduce patient migration.

In order to compensate provider jurisdictions for the benefit spillover they produce, the central government offers them a grant supplement which, however, is not adjusted to the marginal costs of treating external beneficiaries. Moreover, while current expenses are reimbursed on a regular basis, grants for capital investments are provided case by case.

As KERESZTY (2000, p. 61) observes, the exclusive assignment of health care functions to jurisdictions running health care facilities imposes on selected SNGs (municipalities and counties) a responsibility that goes beyond the scope of their local affairs. Namely, it obliges them to continue providing outpatient and hospital

services to the inhabitants of the surrounding (or constituting) municipalities even if these latter have never empowered (contracted) the provider. Simultaneously, the rule reduces the chances that the surrounding (or constituting) municipalities will search another way of organising service delivery (special service district, contract with private providers, etc.) Therefore, the current assignment rule imposes a direct and an indirect legal constraint on the expenditure autonomy of the provider and beneficiary jurisdictions, respectively.

Particularly small municipalities with low financial capacity consider this inconvenience largely compensated by the fact that no legal rule obliges them to pay the full price of using the facilities in the provider jurisdiction. Simultaneously, the facility owner (and thus the provider jurisdiction) is probably not interested in demanding a cost contribution, if serving patients from the beneficiary jurisdictions permits a better exploitation of the capacities and the realisation of economies of scale. In this case, the increment in the received reimbursement (NHIF fees and grant supplement from the central government) is likely to exceed the marginal costs of enhanced service provision. However, this phenomenon does not diminish what we will call the problem of asymmetric responsibility: the risk of a deficit in the health care budget and the burden of correcting this deficit are distributed unevenly among SNGs. Those running one or more health care facilities are supposed to bear the financial consequences of (i) possible decreases in the value of the NHIF performance point, (ii) sudden cuts in the cost reimbursement rates (like the one introduced in July 2006, see Box 5.1), and (iii) the limited availability of grant supplements and financial aid for investment.

Bound by the capacity agreements that define the groups of population to be served, providers cannot adjust the expenditure side of their budget to decreases in the reimbursement level, except if they find a potential for improving cost efficiency. On the revenue side, the situation varies from one government tier to another. For municipalities, the pressure on those taxpayers who reside in a provider jurisdiction will thus rise, while those living in beneficiary jurisdictions will at worst experience some deterioration in overall service quality, but no direct budgetary consequences. In contrast to municipalities, counties have even less room for manoeuvre because the law does not grant them any taxing power. Counties hold 18.7 per cent of all hospitals and 34.7 per cent of all hospital beds in the country (NHIF, 2006), representing the highest and most cost-intensive level of specialised health care and serving vast territories.

The migration of patients towards jurisdictions with highly specialised (or just better equipped) hospitals imposes a great pressure on Budapest and other cities as

198 well. The only way they can fend off the ‘invasion’ of patients coming from outside their territory is by setting higher fees or refusing admission.

Because of the lack of interest on the beneficiary side and sometimes even on the provider side (depending on the relationship between the marginal costs and benefits of service extension), interjurisdictional compensation schemes are not likely to arise spontaneously. If municipalities with specialised health care facilities were not obliged to continue operations, they would probably provide a lower service level than what is optimal from the point of view of the society, as Courchene and his fellow authors suggest: ‘Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient underprovision of services, with taxpayers unwilling to pay for services provided to others. An example is a tertiary public hospital providing regional services that is financed solely by a single municipality (COURCHENE et al., 2000, p. 19).’

Against this background, the supplement grant provided by the central government is a meaningful measure to compensate (at least partially) for the benefit spillover produced by the provider jurisdiction. Nevertheless, it perpetuates the unsatisfactory status quo insofar as it boosts the budgets of provider jurisdictions and possibly holds them back from demanding a higher fee from external patients. Furthermore, spillover effects normally decrease as distance grows so that they benefit the neighbouring jurisdictions only. This calls for horizontal transfers between the provider jurisdiction and the beneficiaries. There is no apparent reason why the centre should intervene with a vertical transfer financed by taxpayers throughout the entire society (DAFFLON and MISCHLER, 2008, p. 220).

To sum up, provider municipalities are forced to charge local taxpayers (and counties are forced to cut other expenditures) in order to offer a regional service with a sizeable infrastructure that perhaps does not even satisfy the needs of beneficiaries in the end. Even if the initial territorial distribution of hospitals and specialised outpatient facilities took account of the size and shape of the related benefit areas (suppose that the central planning in the 1950s was correct), shifts are possible over time, so that today the inheritors of state assets find themselves in a trap. From the point of view of both allocative efficiency and equity, the situation is suboptimal.

Interestingly, and much to the relief of several provider jurisdictions, the rule on the mandatory maintenance and operation of existing facilities is not as stringent as the law might suggest. Namely, provider municipalities can escape from the trap by transferring their facility to the county (see Section 5.2.5) that is obliged

to take it according to the ALG.¹¹ The decrease in the NHIF cost reimbursement levels is likely to prompt some of the municipalities to transfer their loss-making hospitals (or at least the management function) to the county governments, which will further deteriorate the financial situation of the latter. Another exit option has emerged with the health care reform package of 2006 that releases facility owner SNGs under certain conditions from their duty to maintain existing service levels (see Section 5.4.2).¹² From the allocation perspective, however, it would perhaps be more reasonable to amend the Act CLIV of 1997 on Health Care in a way to make SNGs accountable for the health of their citizens rather than for the maintenance and operation of facilities, as has already been suggested by KERESZTY (2000, p. 61).

The assignment of *welfare and social services* (Box 5.2) is marked by a similar asymmetry. SNGs running a facility are not allowed refuse non-residents coming from a jurisdiction without such facility, if the latter made use of the service before the Act III of 1993 on Social Administration and Social Services entered into force. The underlying principle is that vested rights (here: the access to social services) should not be affected by legislation modifying the previous status quo. This would be a reasonable argument if the rights were vested in the beneficiaries as individuals. In this case, ideally, the central government would assume the duty to pay the costs of social care for those individuals who are concerned by the change of legal rules. The duty of the central government would then expire with the decease of the last beneficiary concerned. However, in the actual system, the rights are vested in jurisdictions instead of individuals. Hence, the law perpetuates the existing status quo by obliging provider jurisdictions to continue offering social services to new generations of beneficiaries as long as similar infrastructure remains unavailable in their home jurisdiction. This arrangement is asymmetrical, as it requires only those SNGs that inherited former state property, or created new infrastructure before the adoption of the law, to carry the burden of previous legal regulations.

Another problem with the assignment of welfare and social services is in the assignment criterion itself. Recent studies on social policy in the seven development regions of Hungary (NIFSP, 2005) revealed that the delegation of responsibilities based on population size is too rigid and the resulting territorial distribution of social service facilities hardly corresponds to citizens' needs. Given the fact that municipalities with less than 2,000 inhabitants are obliged to provide only home nursing and meal service for disabled persons, access to care in the excessively fragmented rural areas is scarce, although the needs are acute. In the Central

¹¹ Art. 70 para. 1/b ALG.

¹² Act CXXXII of 2006 on the Development of the Health Care System.

200 Transdanubian region, for instance, 73 per cent of the municipalities have less than 2,000 inhabitants and many of them provide not even the legally defined minimum level of social services; yet, for lack of systematic control by higher authorities, their in compliance remains mostly hidden. The entire scale of services is available only in those six towns that fall into the highest population category (larger than 30,000). The observed mismatch between delegated expenditures and actual needs has also been confirmed by the State Audit Office (SAO, 2007b). This latter survey involving 333 municipalities also points to the growing horizontal disparities in the access to basic social services.

Alike in the domain of health care, beneficiary jurisdictions contribute little, if anything, to the social expenditures incurred by the provider jurisdiction. Whether the provider jurisdiction requires external beneficiaries to pay a higher fee for the services depends on its potential to realise economies of scale by accepting those beneficiaries.

Villages in rural areas increasingly recognise the need for inter-municipal co-operation that enables them to offer at least a basic level of social services to their constituency. The number of single- and multi-purpose districts for social services (with formal cost sharing agreements) is on the rise. Yet, there are still some traces of resistance against this form of service provision. According to TAUSZ (2000, p. 93), several villages are afraid of losing control over their social policies once they engage in an association with a dominant core municipality. This concern is justified insofar as most of these villages lack the professional capacity that is necessary for gaining an overview of the complex service agreements. At the same time, the terms of service provision and financial compensation emerge from a negotiation process in which all members of the associations can assert their interests. A cross-regional study revealed a phenomenon more worrying than the loss of influence of individual SNGs: the quality of the services provided in the framework of an inter-municipal association tends to deteriorate as the number of participating SNGs (and beneficiaries) increases. The dysfunctional character of large associations has been observed in the northern and western regions of the country (NIFSP, 2005).

As it is particularly difficult to convince the smallest and most remote villages about the advantages of co-operation, residents of many of these jurisdictions are still totally excluded from the benefits of basic social care, despite of their enhanced need for assistance.

The scarcity of primary social services (such as family assistance) in rural areas drives villagers towards the more costly secondary level of social services, especially to institutions that provide shelter or inpatient clinical care KERESZTY (2000, p. 57).

Box 5.2: Welfare and social services: assignment rules and financing

In contrast to health care, the responsibility of providing welfare and social services depends not on the availability of the related infrastructure but on population size (see Figure 5.2). As a general rule (art. 89 of the Act III of 1993 on Social Administration and Social Services), SNGs are not obliged to provide social services beyond the geographical boundaries of their jurisdiction, except if a valid service contract or inter-municipal agreement provides otherwise. However, SNGs running a social service facility are not allowed to refuse non-residents coming from a jurisdiction without such facility, if the latter had been using the facility before the law entered into force. This rule applies even if the beneficiary jurisdiction does not contribute to the costs of service provision (art. 90 para. 3 of the Act III of 1993 on Social Administration and Social Services; art. 94 para. 7 of the Act XXXI of 1997 on the Protection of Children and Guardianship Administration).

Capacity-based (so-called normative) grants cover a part of the social service outlays of SNGs, although there is no obligation to use these funds for social policy purposes. In fact, several SNGs divert them towards other spending purposes, even if there is a visible need for improvement in the level of social services. Therefore, while statistics are explicit about the amount of grants provided to SNGs for social policy purposes, it is impossible to calculate how much SNGs effectively spend on this domain. The amount of these capacity-based grants is subject of political bargaining and varies thus from one year to another, while its value has been decreasing in real terms since the beginning of the 1990s (Krémer et al., 2002, p. 108). Further resources in the service of social policy include the personal income tax share, various investment grants as well as local taxes.

Benefit spillovers produced by large municipalities are compensated from the central budget only insofar as they are reflected in the difference in capacities (e.g. the number of beds in a shelter for the homeless). No legal rule exists that would oblige beneficiary jurisdictions to contribute to the costs incurred by the provider jurisdiction. Cost sharing agreements arise therefore almost exclusively in the framework of inter-municipal co-operation where they constitute a compulsory element of the service contract.

202 This leads in these facilities to an overutilisation of existing capacities and long waiting lists, causing administrative and financial bottlenecks on the provider's side.

In summary, the current assignment of social service responsibilities might take some account of the financial capacity of jurisdictions inasmuch as we can assume a positive relationship between this measure and population size. Arguments like economic rationality or proportionality may then very well justify this assignment rule. However, the outcome is not flawless from the perspective of interpersonal equity. It is not clear why the smallest villages, registering the highest demand for most categories of social assistance, should be exempted from the obligation to provide access to (i.e., steer) the related services.

The diversity and incoherence of the assignment criteria may also be observed with regard to the competences of the capital city and the counties. Essentially, we can distinguish three patterns:

1. The county government (the capital city) must provide for those services that do not belong to the mandatory responsibilities of municipalities (capital districts), unless these latter are ready to assume them on a voluntary basis. Examples: secondary and vocational education, student hostels, adult education, elementary art schools, speech therapy for children; foster homes, nursing homes, rehabilitation centres, social day care facilities, and temporary accommodations of all sorts.
2. The county government (the capital city, the capital district) is obliged to maintain and operate the facilities in its ownership (and usage) and provide the related public services. Examples: hospitals and specialised outpatient facilities, sports facilities and fire stations. In practice, such facilities are available in every county and every capital district, which makes a differentiation similar to the one between patterns D and H (see Figure 5.2) useless.
3. The capital city (the capital district) is obliged to provide the service unless an agreement between the capital city and the capital districts provides otherwise. According to this rule, the capital city is responsible for providing night shelter and temporary accommodation for the homeless, while capital districts must run elementary art schools, primary schools for adults, speech therapy for children, pedagogical assistance to kindergartens and primary schools, and temporary nursing of children.

The regulation on the provision of hospitals and specialised outpatient care by the capital city and the counties is more complicated than what would seem to be reasonable from an economic point of view. According to the Act CLIV of 1997 on Health Care, SNGs in both categories are obliged to maintain and operate the facilities situated in their jurisdictions. The complementary rule laid down in the ALG in 1990 and in its major amendment of 1994, however, is not the same for the two categories. For the capital city, hospital and specialised outpatient care is part of the mandatory public services with a spillover character (services benefiting two or more capital districts, the entire capital city or the agglomeration).¹³ By contrast, counties are not obliged to assume this competence unless the lower-level government (municipality) has refused it.¹⁴ The competence in this case will be transferred from the municipality to the county, with important consequences for both authorities. This particular manifestation of the subsidiary role of counties will be the subject of the following section with which we return already to our original subject, namely, subnational expenditure autonomy.

5.2.5 Competence transfer between municipalities and counties

Beside the improvement in local accountability and the equal access to basic public services, the legislative in the early 1990s also sought to ensure that the supply of local public goods and services are tailored to the needs of the local population to the greatest possible extent. For this reason, the ALG grants the power of general competence to all SNGs (they are allowed to assume any competence that has not been assigned to another level of government)¹⁵ as well as a number of asymmetric rights to the municipalities.

First, the ALG authorises local governments to *reclaim* any competence otherwise delegated to local governments with a larger population, as well as county seats and inter-municipal associations to reclaim any competence otherwise delegated to the counties.¹⁶ Concerning this latter provision, counties are obliged to cede the function to the requesting local government for a period of at least three years if, in the preceding four years, more than fifty per cent of beneficiaries were residents of the municipality.

GAÁL (2004, p. 59) finds that this rule is in accordance with the principle of subsidiarity because ‘the county governments cannot refuse to pass the responsibility for service provision to the municipalities if the latter are willing to accept it’.

¹³Art. 63/A para. n ALG.

¹⁴Art. 70 para. 1/b ALG.

¹⁵Art. 1 para. 4 ALG

¹⁶Art. 6 para. 1b; art. 44 para. 6; art. 69 para. 2–3 ALG.

204 Although subsidiarity in a narrow sense means something else (see Section 3.6), Gaál's argumentation is in line with the broad interpretation of the principle that the Council of Europe published ten years after the elaboration of the European Charter of Local Self-Government. In this document, the Committee of Ministers recommends that the governments of the member states

- implement principles of organisation of powers designed to match powers with the characteristics (resources, size, geographical location, etc.) of the local and regional authorities;
- adopt experimental legislative and administrative measures to this effect (for example possibility for local authorities to give up certain powers and transfer them to a higher level, or, conversely, possibility for certain local authorities—in particular those of medium and large cities—to amass powers belonging to different levels of local and regional authorities; [...] (COUNCIL OF EUROPE, 1995, p. 2).

This type of competence transfer, from the county to the municipality, is most characteristic for secondary education and education-related services such as student hostels. If the extraterritorial responsibility of the service-providing municipality derives from a previous county competence, the municipality receives the amount of central government grant that would otherwise accrue to the county. It cannot, however, reclaim any additional support neither from the county nor from the central government, nor refuse the demand of beneficiaries coming from outside its jurisdiction. This clause of the ALG¹⁷ implies that monetary transfer flows are always vertical and that the beneficiary jurisdictions do not need to pay for the services offered by the providing jurisdiction. A formal agreement between the provider and the beneficiaries is not necessary either.

Second, the law also allows municipalities to *shift* to the county any mandatory function they are unable to meet for whatever reason. If, according to the ALG or the relevant sector-specific law, the county has a subsidiary (complementary) responsibility for the function in question, then it is obliged to take over the function. The central government grant is then transferred to the county instead of the municipality. Examples of this type of competence transfer, from the municipality to the county, include the maintenance and operation of hospitals, specialised outpatient health care facilities, secondary schools, vocational schools and student hostels, as well as public order and safety.¹⁸

¹⁷Art. 69 para. 6 ALG.

¹⁸Art. 70 para. 1a–1b ALG

Figure 5.3 shows the variety of possible attitudes of municipalities towards their mandatory and optional expenditure functions as well as the impact of these attitudes on the counties.

In the domains of mandatory responsibilities, the municipality will normally make an effort to comply with the law but might not succeed for a variety of reasons (scarceness of resources, ill-designed budget, a sudden rise in demand, etc.). As for the optional responsibilities, the municipality is free to decide whether to assume or to ignore these. Thus, with regard to both mandatory and optional responsibilities, there are two possible outcomes: providing or not providing the service.

Theoretical thinking would suggest that either the law or fiscal disincentives, or at least the local electorate, would sanction those local executives that neglect their mandatory functions. The latter type of sanction should also be effective with regard to optional functions, i.e. when the local executive decides not to provide a service for which, however, there is an apparent local demand. In practice, however, these sanctions are mostly ineffective.

Legal sanctions are virtually inexistent, since the enforcement of sector-specific quality standards (if there is any) is usually weak, the implementation of the regulations on local government tasks is not monitored, and counties or central authorities control the output only sporadically (HALÁSZ, 2000; TAUSZ, 2000; PÁLNÉ KOVÁCS, 2004).¹⁹

Fiscal sanctions exist but follow with a year's delay. The majority of operational grants are unconditional, and although they are allocated upon the basis of sector-specific measures of capacity or need, nothing hinders local governments from using the amount for a completely different purpose. Thus, grants received in proportion to the number of beneficiaries in the homes for the elderly can very well serve the purpose of financing teachers' salaries in primary schools. Given the fact that legal sanctions for the non-compliance with mandatory responsibilities are weak, such intra-budget reallocations bear practically no risk. The sanction comes only in the following fiscal year: the norms-based grant is then shortened proportionally to the decline in the activities of day care centres. If own-source revenue is scarce and public services are predominantly financed out of central government grants, the absence or weakness of sanctions makes that local governments systematically ignore policy areas that they consider irrelevant for the local economic development, or where citizens' interests are not sufficiently

¹⁹In the domain of public education, an important step towards regular quality control was the foundation of the National Public Education Evaluation and Examination Centre (OKÉV), a central government authority, in September 1999.

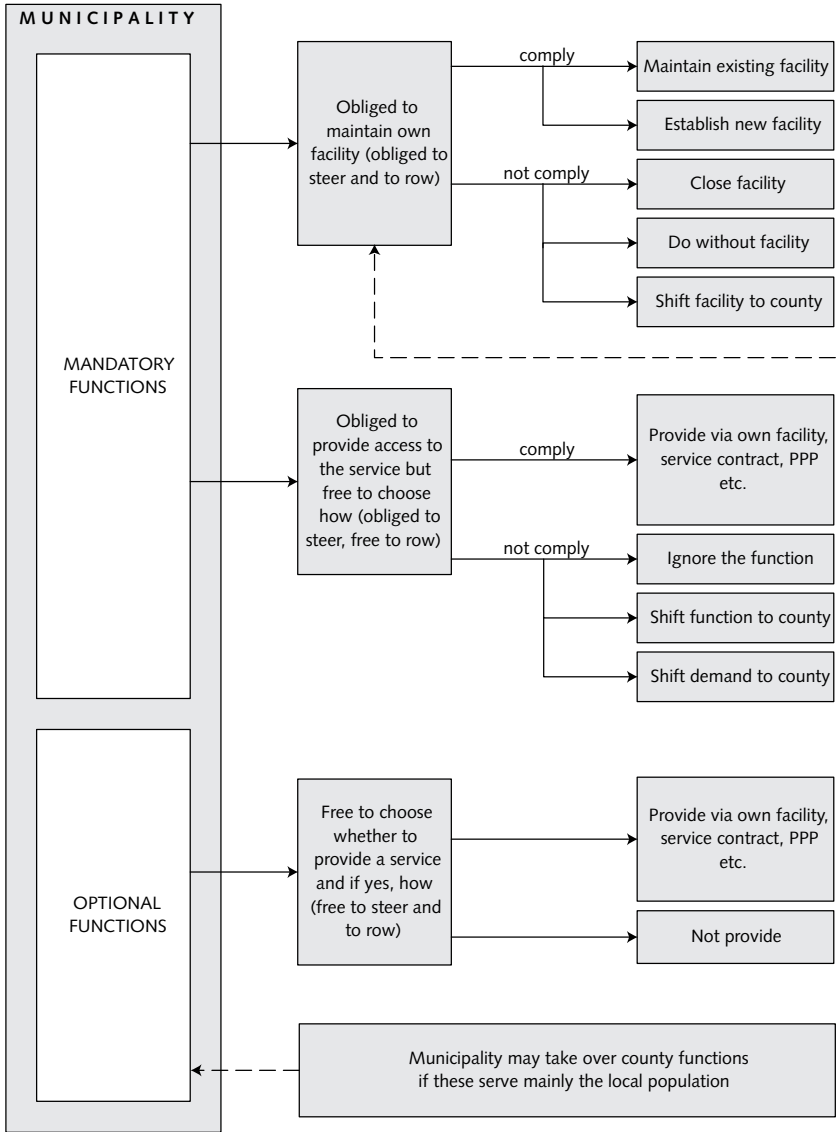
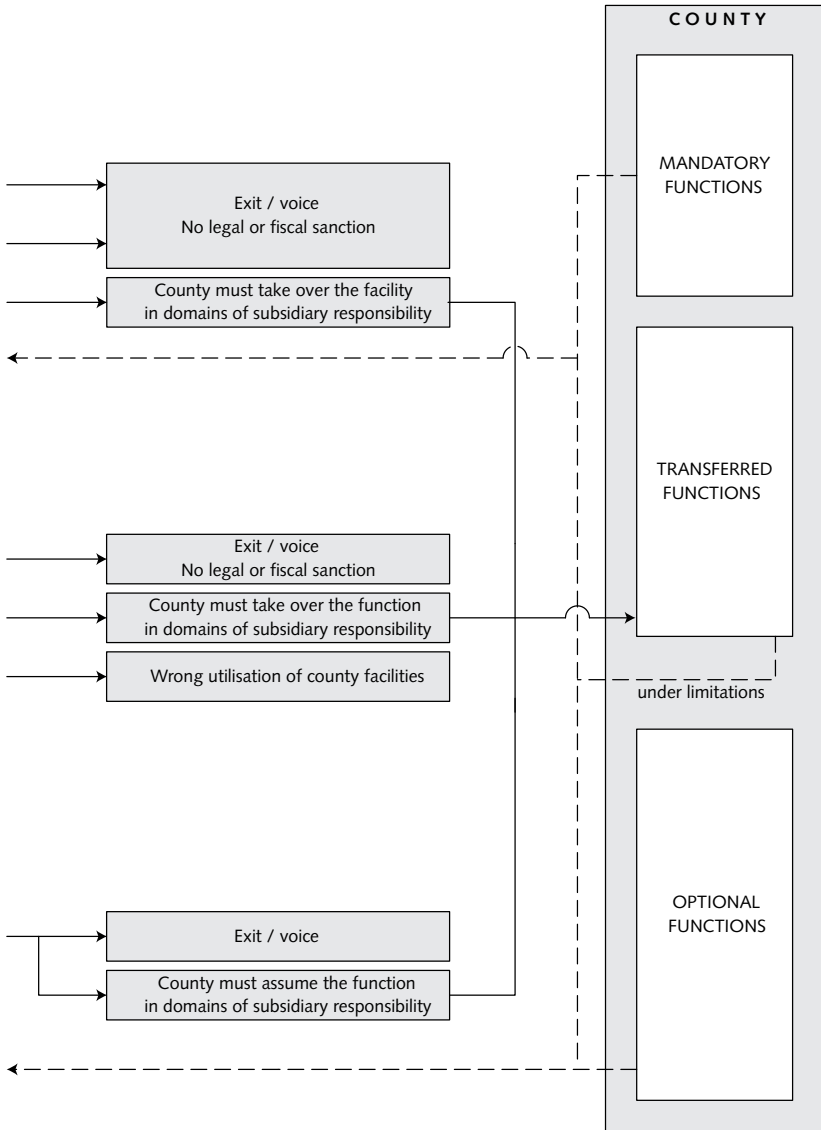


Figure 5.3: Mechanisms of competence transfer [Source: the author]



208 well-organised. Therefore, the latest amendments of the Act III of 1993 on Social Administration and Social Services²⁰ oblige local governments to contract out the service or to create municipal associations if they are unable to deliver the service on their own, and to cede the corresponding part of their grant revenue to the organisation that actually delivers the service.

As for the sanctioning by voters, in Figure 5.3 we borrowed the terms 'exit' and 'voice' from HIRSCHMAN's (1970) political model. These indicate that voters might not re-elect the mayor ('voice') or even quit the jurisdiction ('exit', fiscally induced migration) if they are unsatisfied with the net benefit resulting as the difference between the actual level of public services and the local tax bill. 'Voice' is usually an effective way of sanctioning local policymakers, yet statistics show that at every local government election in Hungary, at least two thirds of the mayors are re-elected (although their share is decreasing: 1994: 74%, 1998: 72%, 2002: 66%). According to the results of a recent investigation about this phenomenon (BOCZ, 2004), small municipalities tend to re-elect their mayors because the number of potential candidates in their jurisdiction is limited (see 'tacit elections' in Section 3.3.5), while in large municipalities re-election is more motivated by the local customs and the personal qualities of the mayor. Remarkably, the income situation of the local constituency and the level of economic development do not seem to influence the election results. The weak impact of the local economic situation is also true for the 'exit' option. In comparison to Western Europe and the United States, Hungary has been recording relatively low rates of taxpayer mobility due to the traditional rootedness of people, the underdeveloped state of the real estate market (especially the rent market) and the comparably high costs of relocation. Depending on the nature of their business activity, enterprises can relocate more easily, yet there have been few examples of such moves so far.²¹

The weakness of sanctions makes the ignorance of mandatory expenditures (i.e. non-compliance) a valid option. Despite this fact, most local governments choose to stay within the bounds of law and simply shake off the responsibility for the function. This is represented by the continuous arrows in Figure 5.3. In principle, one could argue that shaking off the responsibility is also a valid decision in the framework of steering and, from the point of satisfying citizens' needs, it is undoubtedly better than simple ignorance. The figure demonstrates that

²⁰ See art. 54 of the Act LXXIX of 2001, and art. 35 of the Act IV of 2003.

²¹ According to a recent study (DÖVÉNYI, 2007), the volume of internal migration sunk drastically in the early 1990s and recovered only around 2000. Due to a brain drain towards Western Hungary, the eastern and southern regions of the country face the challenge of an ageing population and growing social problems.

when a municipal government declares itself to be unable to meet its mandated responsibility (be it steering or rowing) or is passive with regard to voluntary expenditure functions, then the county is obliged to stand in, provided that it has subsidiary responsibility for the given function. Depending on the nature of the mandate, the county then has to take over the maintenance and operation of the service facility, the overall responsibility for the service, or both. If the county has no subsidiary responsibility, then it is free to accept or refuse the demand of the municipality. Any service provision by the county is then regulated through either a service contract (which obliges the municipality to pay for the service) or a reorientation of the corresponding share of central government grants from the beneficiary jurisdiction (municipality) towards the provider jurisdiction (county).

Another repercussion of municipal choices on the counties is the potential over-utilisation and/or wrong utilisation of existing county facilities. This occurs when the existing local demand is not satisfied by the municipality but is rolled over to the county. Particularly in the domain of social services, the existing primary facilities and services at the municipal level (social day care, daily nursing for old people, etc.) are often not sufficient in number, or not sufficiently developed, to fulfil their gatekeeper function. Consequently, national and county-owned facilities that provide accommodation are overcrowded with beneficiaries who could otherwise be treated in simple day care facilities. This not only forces beneficiaries to quit their community of origin in order to use the service but, more importantly, it increases the costs of service provision and the risk of vertical fiscal imbalance in the counties (NIFSP, 2005).

The staggered arrows in Figure 5.3 indicate competence transfers in the opposite direction. Municipalities can pick from all three groups of county competences (mandatory, transferred and optional functions) with little or no limitation. They also may choose to take over the responsibility for the maintenance and operation of certain infrastructures (school or hospital buildings, etc.) without assuming the responsibility for the related services. In either case, however, the responsibility of the municipality for the function and/or the asset expires as soon as it returns them to the county. The county government lacks this kind of flexibility in compiling its range of competences as well as the freedom to raise taxes in order to cover the marginal costs of service provision resulting from the competence transfer. On the other hand, every time a town decides to take over a function or asset, the budget of the county is somewhat relaxed.²²

²²In its recent takeover bid for the Szent György County Hospital in August 2006, one of the motives of the county seat Székesfehérvár was to ease the fiscal tension that Veszprém county had been experiencing (HVG ONLINE, 2006).

210 Figure 5.3 reveals two basic properties of the scheme of expenditure assignment in Hungary:

1. **Circularity:** municipalities may shift certain competences to, and take over other competences from, the county.
2. **Asymmetry:** only municipalities are entitled to initiate a competence transfer, whereas counties must adapt themselves flexibly to municipal decisions (at least in the domains of subsidiary responsibility).

Although both types of competence transfer (i.e. to and from the counties) are subject to specific legal conditions and always followed by a redirection of inter-governmental grants towards the jurisdiction that ultimately assumes the function, the resulting situation is worrying for several reasons KUSZTOSNÉ NYITRAI (2004, p. 77):

1. In the years following the adoption of the law, county seats, other large and/or rich towns and well-performing municipal associations have rapidly seized upon the most attractive public service functions initially assigned to the counties.
2. In policy areas where counties have a subsidiary responsibility, municipalities coping with vertical fiscal imbalances successfully abandoned some of their costly and capital-intensive functions (often loaded with depleted assets) by passing them to the counties. However, counties are not necessarily better-off or better equipped to ensure an acceptable service level.
3. The transfer of a competence is seldom accompanied by the transfer of the ownership rights of the related assets.

Ad 1 and 2

The real financial and institutional impact of competence transfers is difficult to estimate because the annual stock figures on the volume of property of municipalities and counties (the only statistics currently available) do not allow any conclusion on the transactions taking place between counties and municipalities. In the two most important subnational policy areas, education and health care, up to 85 per cent of the facilities are in the hands of SNGs (MINISTRY OF EDUCATION, 2005; BORBÁS et al., 2005). Recent press reports on selected cases and partial analyses (e.g. BALÁZS, 2003) suggest that in the domain of primary and secondary education, municipalities rarely cede the function to the county, as they recognise that

schools play a primordial role in local economic development insofar as they attract businesses and help keep local population in place. By contrast, in policy areas considered less crucial for local economic development (e.g. social policy, health care, and environment), the more an activity is loss-making and the related assets depleted, the more municipalities are inclined to shift it to the counties, retaining only the less costly functions for themselves. In other words, the legal obligation of SNGs authorities to maintain and operate facilities located in their jurisdictions applies rigorously to counties but not to municipalities. The notion of ‘inability to provide’ that gives the municipality the green light for the upward shifting, is not defined in the law, which creates uncertainty for the budgeting in the counties.²³

The amendment of the ALG in 1994 imposed some more stringent conditions, prohibiting local governments from shifting competences back and forth every year. While this measure has improved the predictability of competence transfers and brought thus some stability into the expenditure system, the dependence of counties on the behaviour of municipalities remains a major problem. The entire mechanism of competence shifting is driven and controlled exclusively by the municipalities. Counties have scarcely any chance to fend off such actions; in most of the cases, they adapt themselves to the new situation and suffer from the consequences. It must be noted, however, that sixteen years after transition, local authorities still consider self-governance and autonomy as a privilege and thus do not cede any competence unless it is absolutely necessary.

Ad 3

A classical example of the separation of ownership rights from management competences is the network of student hostels. For municipalities, this is an optional expenditure function, but if they are not ready to assume it despite an apparent demand for student accommodation among the population, then the county must stand in (subsidiary responsibility). Municipalities hold around 41 per cent of the facilities while 34 per cent are in county property. Churches, non-governmental organisations and the private sector own the rest (MINISTRY OF EDUCATION, 2005, p. 42). Since, by their nature, student hostels primarily benefit the residents of other jurisdictions, municipalities have little interest in maintaining and operating them HALÁSZ (2000, p. 39); on the other hand, ceding them to the county could potentially hurt the attractiveness of the jurisdiction. Counties have a subsidiary responsibility for the service because of the related spillover effect, yet they cannot effectively intervene in the management of those 41 per cent of the facilities that

²³The notion of ‘inability to provide’ and its possible interpretations were already discussed in Section 3.6.2.

212 are in municipal hands. One possible way to remedy this situation is by transferring the property rights to the counties. Alternatively, a cost contribution scheme imposed on the beneficiary jurisdictions (or on the beneficiaries directly) could make municipalities more interested in maintaining and operating facilities that produce spillover benefits. Interjurisdictional cost-sharing is still in its infancy in Hungary, as we will see in Section 5.3.

5.3 The costs and benefits of inter-municipal co-operation

For most of the functions delegated or devolved to the subnational tiers, the ALG²⁴ and the various sector specific laws allow local governments to choose their preferred mode of service delivery. The latter can thus decide whether to meet their responsibilities

1. individually or in co-operation with other local government units;
2. through internal or external providers (non-governmental organisation, church, private enterprise);
3. if through internal providers: whether through the municipal administration or an own enterprise.

All these modes of service delivery imply a certain number of challenges for subnational expenditure autonomy. In the following, we limit the discussion to 1, whereas Section 5.4 will deal with 2 and 3 together.

While all local governments offer a certain range of public policies, many of them delegate the steering function to other local governments, retaining only the ultimate responsibility for the task. The capital city as well as most towns and large villages in rural areas play the role of (micro-)regional centres and produce a large range of local public services not only for their own constituency but also for residents of neighbouring jurisdictions.

As we saw in Section 5.2.4, a part of this activity (e.g. in the domains of specialised health care and social services) is induced by sector-specific laws that oblige the larger jurisdictions to execute the task for the smaller ones in their neighbourhood. In these instances, the law normally defines the territorial scope of responsibility of the provider jurisdiction as well as the cost sharing mechanism, or at least it obliges the involved parties to elaborate a formal agreement. Sector-specific laws

²⁴Art. 8 para. 2 ALG.

show vast differences in their degree of precision with regard to the definition of the terms and conditions of co-operation. 213

The present section deals, not with this model, but with the spontaneous and voluntary co-operation between municipalities. The choice to co-operate or not to co-operate is an endogenous one: it results from the autonomy of the local government units. Hence, many of the constraints on local autonomy that result from this choice are also endogenous. Nevertheless, the national legal and institutional framework of inter-municipal co-operation with its various incentives, restrictions and loopholes also affects the autonomy of local governments and their attitude towards co-operation. Notably, the legal provisions about cost sharing and available grants are likely to influence the attractiveness of co-operation.

A balanced relationship between provider and beneficiary jurisdictions calls for clarity with regard to the terms of service provision and the corresponding monetary compensation. If the beneficiary jurisdictions take the initiative and explicitly ask the provider jurisdiction to produce a given service for them, then the terms and conditions of co-operation will emerge from negotiations between the parties. Such explicit contracts contain clear performance indicators (targets) and provisions about the cost sharing between provider and beneficiary jurisdictions. Implicit (or tacit) agreements lack these parameters. Here, the jurisdiction providing a specific public service (e.g. primary education) decides voluntarily to extend the benefit area to cover the neighbouring jurisdictions as well, but it does not necessarily ask (or expect) the latter to contribute to the costs. In exchange, if the beneficiary jurisdictions do not pay their fair share, they can hardly influence the parameters of service delivery and the quality and quantity of the output.

Such implicit agreements in Hungary are observed mainly in the domains of *pre-primary, primary and secondary education*. About two thirds of the municipalities maintain some kind of facility on their own, while the rest make use of the services of a nearby local government HALÁSZ (2000, p. 37). The law itself does not oblige kindergartens and schools to accept pupils from other jurisdictions; however, once the municipal council has defined the geographical boundaries of the kindergarten or school districts, no pupil living within the district can be refused.²⁵ Depending on their capacity, the institutions can accept pupils coming from outside the district as well.

In order to ensure the financial basis of service provision, the central government withdraws the respective amount of basic norm-based grant from the beneficiary municipality (whether it is inside or outside the school district) and transfers it to

²⁵Art. 65 para. 2, art. 66 para. 2, art. 90 para. 1 of the Act LXXIX of 1993 on Public Education.

214 the provider municipality. In addition, the centre offers another type of unconditional norm-based grant to the provider municipality, the so-called *commuter grant*, in order to take account of the commuters who come over from other jurisdictions and generate additional costs in the provider jurisdiction.

At the same time, however, intergovernmental fiscal arrangements are such that even the smallest municipalities are encouraged to maintain and manage their own primary school. There are two types of incentives in this category. The fact that the quality and quantity of educational services are not systematically controlled and sanctions against poor performance are virtually inexistent (see Section 5.2.5) acts as a passive incentive. An active incentive is the so-called *grant supplement*, an unconditional transfer offered to the smallest municipalities in the annual budget law, whose amount is based on the number of pupils in the jurisdiction and which helps tiny village schools survive regardless of their performance. The coexistence of the commuter grant for large municipalities and the grant supplement for small municipalities reflects the lack of coherence that has characterised the central government policy on village primary schools until most recently (see Box 5.3). Although small jurisdiction size and the resulting constraint on expenditure autonomy (see Section 3.4.2) could have worked as an automatic incentive for co-operation, the grant supplement softened this effect and made villages believe that 'small is beautiful'. Luckily, the new fiscal incentives available for inter-municipal co-operation are apparently more attractive than the sum of the commuter grant and the grant supplement. At least this is what the growing number of independent school districts (inter-municipal associations specialised on school maintenance or educational services) suggests.

Box 5.3: **Primary schools in villages: is small beautiful?**

The present territorial distribution of schools results from two conflictive developments. On one hand, with the Act XXXIII of 1991 on the Transfer of State Property to Local Authorities, municipalities running a public school in their jurisdiction became owners of the school regardless of where the pupils actually came from. On the other hand, the ALG granted all territorial units the right to manage local affairs independently. Eager to make use of this new competence, hundreds of municipalities that had no school on their territory before 1990 established one. The number of primary schools rose rapidly, from 3'526 in the school year 1988/89 to 3,814 in 1994/95, while the number of pupils in primary school age declined from about 1.24 million to 0.98 million (see Figure 5.4).

By the mid-1990s, vast territorial disparities emerged in terms of access to schools and the quality of education, due to the naturally unequal distribution of pupils across jurisdictions (which was directly reflected in the grant allocation) and the inequalities in

the potential of local governments to raise additional funds (Balázs and Hermann, 2002, p. 68 f.). The lack of organisational capacity and well-qualified staff for the drafting and implementation of education plans led to an unsustainable situation, particularly in rural areas. A growing number of villages started to recognise that they were unable to meet their mandatory responsibilities. The mid-1990s saw therefore the emergence of the first independent school districts. By 2001, more than 32 per cent of the municipalities (particularly villages) participated in an association for facility management and another 17 per cent were co-operating in other specific tasks related to primary education (Imre, 2004). At the same time, a number of villages felt impelled to close their primary school. By 2004/05, the number of schools declined to 3,293, which is way below the initial level of 1985/86.

The spontaneous process of concentration in primary education is progressing at a varying pace, depending on the actual policy of the central government. Since 2004, associations have been eligible for a specific norm-based grant. Halász (2000, p. 43) observes for the majority of local governments that access to this grant is the major motive for creating an association; further potential benefits from co-operation, such as quality or efficiency improvement, are rarely exploited. Although several mayors still consider primary schools as the cornerstone of local autonomy and a *sine qua non* of local economic development, municipalities with less than 2,000 inhabitants (maintaining more than a half of the 8-, 10- or 12-grade primary schools) are particularly sensitive to variations in the demographic trend and the central government grant system (Balogh and Halász, 2003, p. 105).

The policies of primary education funding pursued by the consecutive government coalitions from 1990 have been fairly controversial. While all cabinets emphasised the importance of intermunicipal co-operation in primary education, they continued assisting small villages in the maintenance of their schools (Hermann, 2004). Understandably, this has reduced the willingness of the villages to work together. Since more recently, the conflict between the objectives of operational efficiency and social justice (and hence the conflict between government and opposition) seem to be resolved in a compromise solution. In September 2005, the central government proposed that villages continue to run grades 1 to 4 on an individual basis (with additional subsidies, if necessary), but collaborate for a joint provision of auxiliary tasks such as administration or didactic services as well as for the education in the last four (or more) grades.

For any additional expenditure not covered by the basic allowance and the commuter grant together, it is up to the partner municipalities to set up a fair cost-sharing scheme. The provider jurisdiction may claim the entire cost differential from the beneficiary municipality. However, as BALÁZS (2003) observes for the domain of secondary education, very few of them ever claim any contribution, knowing about the precarious financial situation of the beneficiary jurisdiction(s) and the consequent low chance of getting ever paid.

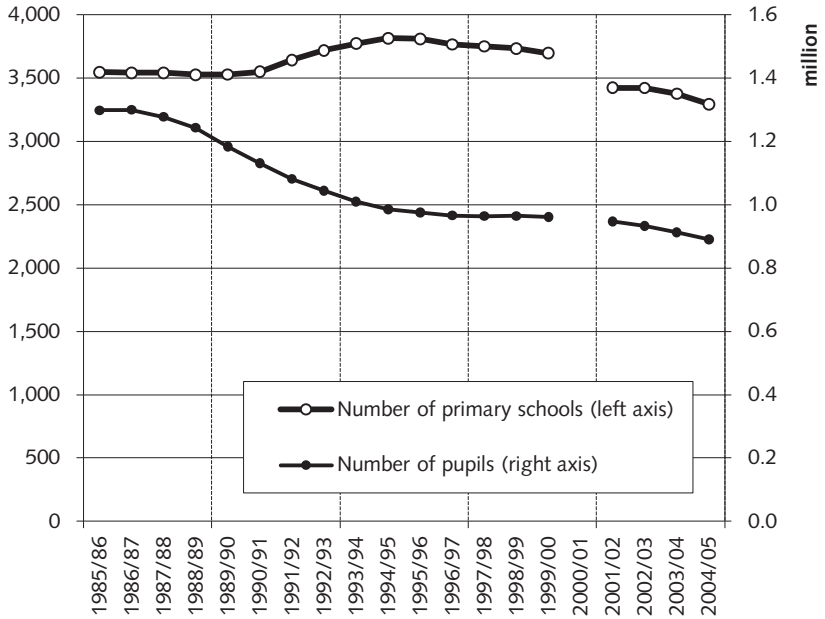
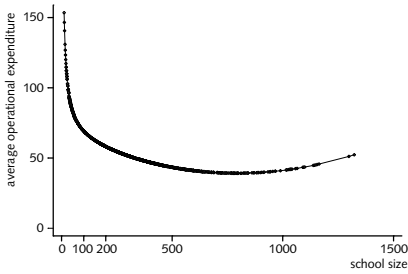


Figure 5.4: The number of primary schools and pupils between 1985 and 2005
 [Source: Halász and Lannert (1998); Ministry of Education (2005)]

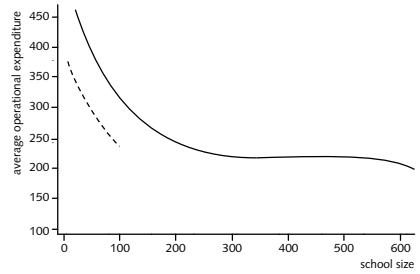
The provider jurisdiction is unlikely to be interested in requiring a contribution from the beneficiary if it expects the amount of transfers (basic norm-based grant, commuter grant, investment grant, etc.), that is, the marginal revenue resulting from the adoption of pupils from neighbouring jurisdictions, to be equal or higher than the marginal expenditure incurred through extended service provision. An earlier empirical study seems to corroborate this hypothesis. HERMANN et al. (1999) estimated the average expenditure function in local public education and found a significant negative correlation between the rate of non-resident pupils and the average operational expenditures of a municipality on secondary education. Two mechanisms are at work here. On one hand, accepting pupils from the neighbouring jurisdiction B imposes an additional financial burden on the provider jurisdiction A, since the central government grant sinks below the average (per pupil) expenditure level.²⁶ Consequently, A has a smaller per capita amount of revenues to allocate among the different public services including education (unless it can raise additional revenues through taxation, for instance). On the other hand, the commuter grant received from the central budget may exceed the marginal cost of service provision if the extension of the service area allows for a better utilisation of the existing educational capacities in A.

The potential for a municipality to realise economies of scale in its public education function and thus realise a gain from the takeover depends on the shape of the average (per pupil) cost curve and on the exact position of the municipality on the curve. The shape and the position of the average (per capita or per pupil) operational expenditure function of municipalities have been explored through various regression models and empirical tests; however, about the characteristics of the cost function, no comparable study is available. Analysing micro-data of the year 1996, HERMANN (2001, p. 16 ff.) finds that the effect of school size (in terms of number of pupils) on the average (per pupil) operational expenditure level is the strongest in villages and minor towns. The potential marginal economies deriving from a larger school size are continuously decreasing, with the expenditure per pupil curve reaching its minimum at about 800 pupils and then slightly increasing again. The estimated per pupil expenditure function for secondary education behaves somewhat differently (see Figure 5.5). A more recent study comparing the average expenditures of village schools (different sizes) and town schools has confirmed these trends for 2002 (HERMANN, 2005).

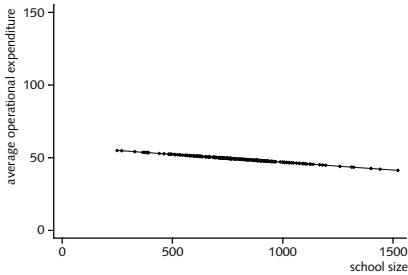
²⁶In 2001, central budget grants covered about 58 per cent of public education expenditures realised at the decentralised levels (BALOGH and HALÁSZ, 2003, p. 405).



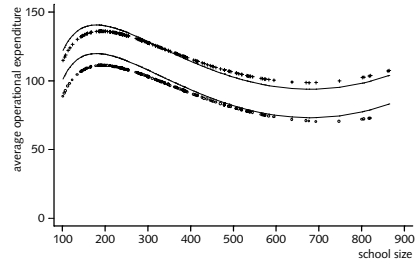
Primary schools (ISCED 1+2) in municipalities with a population below 7,000; year 1996



Primary schools (staggered curve ISCED 1, continuous curve ISCED 1+2); year 2002



Primary schools (ISCED 1+2) in municipalities with a population above 7,000; year 1996



Secondary schools (ISCED 3); year 1996

Figure 5.5: Estimated average operational expenditures as a function of school size (thousand HUF) [Source: Hermann (2001, 2005)]

However tempting it may be, it is imprudent to assume that the corresponding average cost curves would follow the same pattern. Depending on the bundle of education services offered, the revenue situation of the municipality and potentially existing X-inefficiency in service provision, the course of the cost function may be different from that of the expenditure function.²⁷ Nevertheless, we have good reason to assume that the smallest villages bear the greatest potential to realise economies of scale in primary education, while larger municipalities typically acting as providers have less opportunity for cost saving.

This brief excursion into the nature of local educational expenditure and cost functions shows that under certain circumstances, the provider municipality may be interested in taking over pupils from neighbouring jurisdictions even if it cannot realistically expect any direct compensation from the latter. The interference of the central government with horizontal financial relations among municipalities as well as the interplay between marginal and average expenditures explain why the culture of horizontal compensations in service provision is still in its infancy in Hungary. The recent case of Magyargencs and the surrounding villages (Box 5.4) illustrates that small local governments prefer relying on external funding of their services (tax revenue of the partner municipality and/or grants from the central government), to negotiating an intermunicipal service contract with a formal cost sharing scheme.

The financial impact of implicit agreements on the provider municipality depends thus on the capacity of the latter to realise economies of scale, as well as on the relationship between the marginal revenues (commuter grant from the central budget, cost contribution from the beneficiaries) received and the marginal costs incurred. If the local government is constrained to produce beyond the limits of its capacity in order to serve other jurisdictions, the marginal costs of extending the service area will be higher than the marginal revenue.²⁸ It is up to the taxpayers of the provider jurisdiction to pay the difference, unless the beneficiary jurisdictions compensate the provider spontaneously (remember that there is no legally enforceable compensation scheme). If, by contrast, the provider jurisdiction can improve capacity utilisation and reduce unit costs thanks to the inflow of new pupils, then the marginal revenue from extending the service area exceeds

²⁷ Adapting LEIBENSTEIN'S (1966) definition to the public sector, X-inefficiency is the gap between the efficient behaviour of public service providers implied by economic theory and their observed behaviour in practice.

²⁸ The marginal cost of service provision appears even if the provider jurisdiction does not enlarge its capacity; it is then manifested in overcrowded classrooms and the deteriorating quality of teaching, as the teacher-per-pupil ratio sinks.

Box 5.4: The case of Magyargencs

The village of Magyargencs in West Hungary hosts a 300-year-old elementary school. Once the largest school in the district, today it counts merely 66 pupils, due to a local economic downturn in the post-socialist transition that triggered a major decrease in the population figures (618 inhabitants in 2001). For lack of employment opportunities, the local government has difficulty keeping the young generations in place. From the early 1990s, Magyargencs has worked together with the neighbouring village to operate the primary school, but in 2005, Kemeneshőgyész decided to terminate the agreement, leaving Magyargencs alone with a facility that consumes almost half of the local government budget every year. Out of the total annual spending of HUF 40 million on primary education in Magyargencs, 25 million are covered by central government grants. Prior to 2005, the rest was shared between the co-operating municipalities, which demanded constant sacrifice from both, as little money was left for financing other public services and investments.

Caught in the crossfire of the battle about the future of the primary school, the municipal executive of Magyargencs has recently started looking for another local government that is ready to take over the 66 pupils. Its declared aim is to find a partner municipality that does not require any remuneration for the service. The municipality of Mezőlak (1,076 inhabitants) is ready to take over the Magyargencs pupils without compensation, on condition that other villages join the association as well. According to their calculation, if the number of pupils in the Mezőlak primary school rises by at least 80, then the marginal increase in norm-based grants (accruing to Mezőlak) will allow financing the enlarged primary school to 100 per cent out of grants, that is, without any contribution from either the provider or the beneficiary municipalities (Cseri, 2006).

the marginal costs. With the commuter grant provided from the central budget, however, taxpayers from the entire country pay for a service that benefits only the provider jurisdictions and the neighbouring area. In both cases, OLSON's (1969) principle of fiscal equivalence is hurt.

Beyond the fact that the groups of decision-makers, beneficiaries and taxpayers do not overlap, implicit co-operation agreements present several other problems.

1. According to HERMANN et al. (1999), production spillovers have an implicit equalising effect in that the related financial burden is normally borne by the wealthier municipalities. In our understanding, however, if the resulting redistribution of income is not part of an explicit fiscal equalisation programme, then the situation is likely to reproduce itself, and there is little hope for a long-term improvement in inter-municipal fiscal relations. Moreover, implicit equalisation as a policy instrument is unsatisfactory because it reacts only to differences in cost structures of SNGs rather than creating a solid link between financial capacity and expenditure needs.
2. If the provider jurisdiction is so much satisfied with the vertical grant that it is not interested in a contribution from the beneficiary jurisdiction, the marginal benefit realised this way serves only to finance the marginal output that is offered free of charge to the external users. If the user-pay-principle was respected instead, all (internal and external) users could benefit from the decrease in the average cost level realised through scale economies.
3. Whatever the impact of the extended service provision on their financial position, provider jurisdictions are bound to cover not only the costs of the actually produced service units but also the stand-by charges related to the given service infrastructure. At any point of time, they are expected to be ready to receive new clients from the neighbouring area. While beneficiary jurisdictions do sometimes contribute to the costs of the actually received service units, they virtually never participate in financing the stand-by charges. The same holds for the costs of the maintenance of related infrastructures. These additional cost items are visible in the oversized capacities and the related expenditures (interests and amortisation, wages and social contributions).
4. The beneficiary jurisdictions receive 'free lunch' every time they are allowed to use public services offered by a neighbouring jurisdiction without at least a partial compensation. This leads to an illusion about the real costs of

public services, which hinders the development of cost sensitivity and leads to an increased demand for the public services in question.

Compared to implicit co-operation agreements, explicit agreements represent a cleaner solution to the problem of cost sharing and improve allocative efficiency, as they force the partners to take into account the true cost of service delivery. According to the legal regulations in force, every inter-municipal association (special district) agreement must contain a compensation scheme. Due to the promotion of horizontal co-operation through numerous fiscal incentives from 1996, the number of associations in the domain of public education rose. While in 1994–95, only 22 per cent of the municipalities chose to collaborate, their share rose to 32 per cent by 2006 (HALÁSZ and LANNERT, 2006). The popularity of co-operation as a solution to the difficulty of establishing and running public schools is particularly high in rural areas with scattered population and a low potential for economies of scale. In 2006, 448 school associations were registered, involving more than 2,000 of the 3,144 local governments. These operated 7,391 facilities.²⁹ A representative survey prepared by IMRE (2004) suggests that in almost 80 per cent of all school associations, operational expenditures are shared according to the number of pupils sent by the participating municipalities. For funding investments in the service infrastructure, the formula is most often (43 per cent) based on the distribution of ownership rights. Less than one-fourth of the surveyed associations opt for a pupil-based cost-sharing scheme.

Until now, we have dealt with the financial consequences of co-operation for the provider jurisdiction and, in case of an explicit agreement, for the beneficiary jurisdiction(s). However, co-operation has further costs in terms of a weakening democratic control over the decision-making process and reduced possibility for the participating municipalities to impose their own preferences on the association. Since these challenges are not different from those observed in most other European countries, we will not go into detail on these issues.

²⁹The dynamics of inter-municipal co-operation throughout the past ten years is difficult to describe because the available statistics are not suitable for comparison. The four latest triannual reports of the National Institute for Public Education (HALÁSZ and LANNERT, 1998, 2000, 2003, 2006) differ in their approach of measuring the development of intermunicipal co-operation in education. Data for the number of school maintenance associations are available for 1996, 2003, 2004, and 2006 (though the comparison reveals a drop from 1996 to the 2000s, which does not seem to be realistic). The indicator selected for 2000–2002 is the number of multifunctional associations with an educational component. Finally, the period 1998–1999 is described with the number of local governments acting as seats of school maintenance associations. Data are unavailable for 1997 and 2005.

Similarly, the decision *not* to co-operate with neighbours may also involve some costs for a municipality in terms of local expenditure autonomy, particularly if its population is below the critical limit that would allow an efficient operation of the public service in question. Here too, primary education provides a classical example. Small rural villages in Hungary that insist on maintaining their primary school in spite of the deteriorating efficiency and quality of the education suffer from the outflow of pupils to neighbouring (larger) municipalities. Together with the fragmented territorial structure, the principle of free school choice anchored in the law has led to the segregation of pupils according to their school performance. The homogeneous classes of less talented pupils in the smallest villages present an important hindrance to local economic development and are likely to tie the hands of the municipal executive on the medium and long term.

5.4 Autonomy in the delivery of local public services

5.4.1 Sector-specific regulations on service delivery

As we saw in Section 3.4.2, minimum standards imposed by legislation to influence the organisation of service delivery and the quality and quantity of the public service output constitute

the most fundamental constraint on the rowing side of subnational autonomy.

In Hungary, a part of the minimum standards emanate from sector-specific laws that define new tasks for local governments (beyond those set out in the ALG). Another part emerges from decrees published by the central government and line ministries. A fundamental difference between laws and decrees, as mentioned in Section 5.1, is that the latter escape parliamentary scrutiny while they may substantially modify the rules of service delivery.

Sector-specific regulations are manifold. Only in the domain of primary education, there are a few hundreds of indicators defining the contents of service delivery. Since the amounts of the so-called norm-based grants (the most important pillar of local government finance) are directly linked with these indicators, local governments have obviously little interest in rationalising service delivery (PÁLNÉ KOVÁCS, 2004, p. 97 f.).

Apart from this disincentive, a detailed regulation remains more or less acceptable in those policy domains that call for deconcentration because the Constitution or another statutory law stipulates the citizens' equal rights of access to the service. Primary education is undoubtedly one of these domains, as are basic health care and social services. Here, the centre retains the ultimate responsibility (including

224 financial responsibility) for the task and edits rules in order to ensure an equal treatment of all individuals regardless of their jurisdiction of residence. However, many of these policy areas suffer from overregulation, and the rules focus more on the inputs than on the outputs of service delivery, as TAUSZ (2000, p. 96) observes for the domain of social policy. Indeed, the Decree I/2000 (7 January) of the Ministry of Social and Family Affairs describes in painstaking detail the tasks and operational requirements of social service facilities from the minimum size of a home and the number of bathrooms, through the provision of patients with clothes and bath towels, to the types of daytime activities to be organised. The great variety of facility and patient categories and their combinations turn the decree into a respectable document consisting of 115 paragraphs and 14 appendices.

Detailed regulation makes less sense (and may be perceived as less legitimate) in domains of services that are simply delegated to lower levels of government and in which the centre does not retain full responsibility in the sense of guaranteeing full coverage of the costs of service provision. Nonetheless, a bulk of these delegated tasks is currently overregulated and the rules go often beyond their original mission to enforce nationwide standards and priorities or setting the general framework of service provision (KOPÁNYI et al., 2004, p. 18). By way of example, the Act CXL of 1997 on Museums, Public Libraries and General Education contains a long list of operational requirements for public libraries (access, staff, rooms, free services, statistical data supply) further provisions on the mandatory tasks of libraries, on user fees and free services, as well as general management rules. According to KOPÁNYI et al. (2004, p. 6), overwhelming regulation may undermine effective decentralisation by breaking the link between decision-making authority and the locally available financial resources. In consequence, it tends to make SNGs more dependent on norm-based grants and less responsible for their decisions and performance.

5.4.2 The involvement of external service delivery agents Surveying state and local governments across the United States, OSBORNE and GAEBLER (1993, p. 29 ff., 332 ff.) identified no less than thirty-six alternatives to the so-called standard service delivery that occurs through either the local government administration or a public enterprise. In Hungary where experience with decentralised service provision is still modest, local governments cannot boast with such a multitude of practices. Nevertheless, the 1990s and the early 2000s witnessed momentous changes in the field.

The range of service delivery options and their relative shares in the total supply vary from one policy sector to another. A survey conducted by PÉTERI (2007)

suggests that local governments contract external service delivery agents mainly in the domains of cable television services (58 per cent of the municipalities work with external providers, mainly private entrepreneurs and enterprises), primary health care (43 per cent) and dental care (33 per cent). One-tenth of the local governments rely on non-profit organisations for the operation of primary schools, kindergartens, outpatient clinics and social accommodation facilities.

Sector-specific laws regulating the tasks of local governments generally distinguish between facility owner ('tulajdonos', 'fenntartó'), and service delivery agent ('szolgáltató', 'működtető').³⁰ The ultimate responsibility for the task rests with the facility owner who is most often a subnational government unit, another public body (ministry, national authority), a private or non-profit organisation, or a church. For any public service facility, the two functions (ownership and service delivery) may partially or fully overlap, or be distinct from each other. A local government may keep ultimate responsibility for running a home for elderly people in its own buildings and with own equipment, while a charity organisation provides for 24-hour nursing care, meals, and leisure programmes.

The volume and form of public funding available to a given facility depends upon whether the owner is an SNG unit, another public body (e.g. ministry, other national authority), a private or non-profit organisation, or a church. As the pivotal actor in this structure, the owner assumes overall responsibility for the operation of the facility, it selects an adequate service delivery agent and may decide to sell the assets.

Most sector-specific laws distinguish between public and non-public owners. Local governments, municipal enterprises and public non-profit companies acting as facility owners are automatically entitled to grants and subsidies from the central government budget. Non-public owners include churches, foundations, so-called public charities, non-governmental organisations, and private enterprises or entrepreneurs.³¹ The simultaneous engagement of public and non-public actors is also admitted and leads to various forms of mixed delivery. Service delivery

³⁰The Act XXXIII of 1991 on the Transfer of State Property to Local Governments introduced the word 'fenntartó' in the sense of a local government (actually, a soviet-type council) running or managing ('fenntart') a certain state-owned public service facility during the socialist regime. Since running a facility was not detached from the delivery of the related public services (outsourcing being virtually unknown in those times), the semantic overlapping between manager ('fenntartó') and service delivery agent ('szolgáltató', 'működtető') was not confusing. By virtue of the same piece of legislation, however, the democratically elected new local governments inherited the assets; this is how they turned from managers ('fenntartó') into actual owners ('tulajdonos'). Notwithstanding its initially narrower content, the term 'fenntartó' still prevails and is used synonymously to 'tulajdonos'.

³¹According to Art. 74/G of the Civil Code (Act IV of 1959), public charities are foundations established

226 by enterprises in mixed (public and private) ownership, the so-called 'functional privatisation' of hospitals (see below), or public-private partnerships in large infrastructure projects are examples of this category.

Non-public facility owners may not only participate in the provision of mandatory and optional local public services but also provide additional supply (in terms of quantity and quality) in response to the preferences of the local population.

Service delivery via own organisation (or in collaboration with other local governments) is still common in the domain of *primary education*, with municipal property accounting for almost 87 per cent of total assets. Table 5.4 shows that five per cent of all primary schools in Hungary are in church property, while about three per cent belong to other non-public providers. These actors are even more active at the secondary and tertiary levels of education, together holding almost one-fifth of all secondary schools and more than half of the universities and colleges. The participation of the non-public sector in public education dates back to the early 1990s and responds to three legal incentives: (i) the freedom the ALG provides SNGs to decide about the way of service delivery; (ii) the restitution of church property in 1991;³² (iii) since 1990, non-public service providers have been eligible to norm-based grants.

The emergence of church-based and non-profit educational institutions brought more diversity into public education in terms of curricula, non-school services and organisational solutions. At the same time, however, it contributed to the overall expansion of the secondary education sector from the mid-1990s and a widening gap between the number of pupils (determined by the demographic decline) and the available classroom capacities.

Some authors (e.g. SÁSKA, 2004) deplore the fact that SNGs as owners are increasingly cut off from the decision-making process concerning the objectives and contents of education provided in their institutions. The service delivery organisation (with teachers as the most influential stakeholder group) and the Ministry of Education, both characterised by the predominance of educationalists, determine jointly these parameters. With their almost insatiable demand for more and better services, parents are the third most important stakeholder group, whereas local governments are expected to pay the bill in the end. Further investigations are necessary to find out more about the determinants of local government power in the stakeholder relations and the question whether other owners such as churches or foundations are facing similar problems.

by the Parliament, the central government, or the council of a subnational or minority government, with the aim of executing a task belonging to national or subnational competence.

³²Act XXXII of 1991 on the Settlement of Properties Formerly Belonging to the Churches.

Table 5.4: Education facilities by type of owner ('fenntartó') in 2004–05 [Source: Ministry of Education (2005)]

Type of facility	Public (%)			Other (%)			Total (%)	Total number of units
	Central gov.	County	Local gov.	NGO, Individuals	Church	Other		
Kindergartens, pre-schools	1.3	3.0	86.7	4.5	3.1	1.4	100	3,405
Primary schools	1.6	5.6	84.8	2.1	5.0	0.9	100	3,293
Elementary art schools	0.6	3.7	61.6	19.1	3.1	11.9	100	810
Secondary schools	3.6	27.3	45.4	12.5	6.7	4.5	100	2,009
Student hostels	4.2	34.4	40.9	5.2	13.0	2.3	100	599
Universities and colleges	44.9	0.0	0.0	17.4	37.7	0.0	100	69
Total	2.3	10.5	72.7	6.6	5.2	2.7	100	10,185

Non-public providers (churches, social organisations, foundations, public foundations, national minority governments, public non-profit companies, private business entities and individual entrepreneurs) assume a growing role also in the domain of *social care*, with their degree of involvement varying across the different categories of services. The Act III of 1993 on Social Administration and Social Services allows SNGs to decide how they wish to meet their responsibilities. Beside delivery via own organisation or in collaboration with other local authorities, they are also allowed to contract out certain services. Notwithstanding these liberties, more than 97 per cent of the homes for the elderly were still in municipal hands in 1997. Municipalities and counties taken together owned 81.3 and 68.9 per cent of all facilities providing temporary and long-term accommodation, respectively, while much of the rest was in the property of churches, foundations and other organisations. Similar proportions are observed in terms of bed capacity. The sector-specific laws also allow contracting private organisations, but the statistics about this area are deficient (TAUSZ, 2000).

Since 2001, non-public providers of social services have been eligible for grants from the central budget, although the conditions of eligibility vary across the types

228 of providers, with churches enjoying the most favourable treatment and private enterprises receiving only limited support.³³

The recent boom of the non-profit and private markets of social services has also some negative side effects.

First, several local governments reportedly use contracting as a trick to escape from financing the entire demand for social services. For lack of a regular and exhaustive legal control over the effective service provision, a mayor can very well comply with the law by contracting another municipality and buying only two places in a temporary home for children, even if he is aware of the fact that the two places will not solve the problem (KRÉMER et al., 2002, p. 116).

Second, there are strong indices (although no reliable figures) that show an increasing presence of the private sector in those domains where there is an outlook for profit, thus for example in constructing homes for elderly people. This trend, as well as the spontaneous emergence of non-public providers in some regions and/or service categories and their absence in others, has led to massive interjurisdictional disparities in the access to, and quality of, services. More important than horizontal disparities is the apparent geographical mismatch between demand and supply. What makes the situation in the area of social policy even more acute is the incapacity of many beneficiaries to travel from their domicile to the places where social assistance is offered.

In order to remedy this situation and to improve the efficiency with which public funds are spent, the central government incorporated a new measure in its strategic reform 2006–2008 of social protection and cohesion. From January 2007, the disbursement of norm-based grants to non-public providers (except churches) for any new service or capacity unit is subject to prior approval by the Ministry of Social Affairs and Labour.³⁴ The central government has recently laid down the criteria of approval, hereby creating the so-called Managed Regional Equalisation System for social services and the protection of children. New services and capacities are generally accepted for public funding if they satisfy an existing demand, meet the legal quality requirements and are cost-efficient. A further condition is that the cost and revenue plan submitted by the provider is sound and reasonable.³⁵

³³Art. 54–55 of the Act LXXIX of 2001; art. 35 of the Act IV of 2003 on the Amendment of Selected Acts Concerning Social Affairs.

³⁴Art. 30 para. 7 and art. 103 d of the Act CLIII of 2005 on the Budget of the Republic of Hungary in Year 2006. For its decisions, the Ministry relies on the advice of a participative committee.

³⁵Government Decree no. 239/2006 (30 November) on the Managed Territorial Equalisation System of social services, child welfare and child protection in year 2007.

From a policy analysis perspective, the prior administrative control of newly offered service units is likely to slow down the pace at which regional disparities are growing. It may also ensure a better match between marginal supply and demand in the future. However, it is not likely to alleviate the existing inequalities and the problems of accessibility, as previously financed services will continue to be funded without any examination of their usefulness. Nevertheless, the ministry has already suggested that in a later stage of the reform, the same procedure could apply to all currently funded services and capacities. The goal is to ensure ‘sector neutrality’ among the providers. Such a policy could then effectively repair the territorial link between supply and demand and provide for higher allocational efficiency in the use of public resources.

Compared to public education and social care, the role of non-public providers is more important in *health care*.³⁶ At the primary level, about 80 per cent of all general practitioners (family doctors) and dentists exercise their profession as independent private providers in contract with the municipality that owns the surgery KERESZTY (2000, p. 64). The Hungarian terminology calls this ‘functional privatisation’, suggesting that only the function (the service) is transferred to private agents but not the assets. The term is somewhat unfortunate because it creates the impression that functional privatisation should be ideally followed by a ‘real’ privatisation meaning the transfer of municipal property (MIHÁLYI, 2000). According to the opponents of such a ‘purely functional’ privatisation, the only thing that goes into private hands is the right to service provision that, however, has never actually belonged to the state. Nevertheless, the classical encyclopaedia definition of privatisation includes transferring both the assets and the activities to the private sector (see e.g. NEWMAN et al., 1992, p. 206). Since primary medical care is a public sector task, the transfer of such activities to private or other agents is similar to contracting. The object of privatisation here is not the ownership but the decision-making power.

Functional privatisation is also increasingly popular at higher levels of the health care system. Particularly the more lucrative advanced diagnostic services (e.g. magnetic resonance imaging, computed tomography), dialysis stations, and laboratories have undergone such transformation. Nevertheless, service contracts in the domain of health care are loaded with conflicts between local governments (as owners and principals) and service providers (as agents). On one hand, providers have difficulty convincing the owner about the need to invest more into the surgery

³⁶For an excellent overview of the health care delivery system in Hungary, see GAÁL (2004) or FÜZESI et al. (2005).

230 infrastructure, although it must be noted that the current revenues of most local governments are definitely too short to cover such investments, while the access to alternative funding sources is difficult.³⁷ On the other hand, local governments claim that medical entrepreneurs skim off the most profitable businesses, leaving to the public sector those services that are underfinanced by the NHIF and thus involve losses KERESZTY (2000, p. 65).

The widespread practice of functional privatisation implies by no means that the only thing local governments may privatise is service delivery. Since the early transition, the law has allowed the privatisation of healthcare-related property as well. Medical surgeries, hospitals and clinics belong in most municipalities to the category of partially marketable core assets.³⁸ Private medical companies, churches, and NGOs took over several hospitals from local governments or opened new ones so that their aggregate property share in the entire sector of inpatient care is now close to one-fifth.³⁹ However, the instability of the regulatory system, the current overcapacity in inpatient facilities and the limited chance to introduce explicit service fees above the legal minimum (citizens are accustomed to make informal out-of-pocket payments) act as barriers to entering this market.⁴⁰ It is also true that the more specialised the service, the more important the ownership function

³⁷Art. 155 para. 2b of the Act CLIV of 1997 on Health Care explicitly stipulates the responsibility of the owner for the maintenance of infrastructures. However, voters appear to be too weak to enforce accountability. According to MIHÁLYI (2000), strengthening the oversight function of National Public Health and Medical Officer Service (ÁNTSZ) could remedy this problem.

³⁸According to art. 78–79 of the ALG, every local government is obliged to draft a decree in which it classifies its property into core and non-core categories. Core assets (in French: *patrimoine administratif*) are those that directly serve the execution of mandatory tasks or the exercise of public administration powers. They are either non-marketable (roads, bridges, parks, waters, dams, etc.) or partially marketable (public utilities, public buildings and institutions, monuments, protected nature areas, etc.) Non-core assets (in French: *patrimoine financier*) are always marketable and may be used in business ventures (apartments, offices, shares, etc.)

³⁹In 2006, non-governmental organisations individuals held 8.3 per cent of all hospitals and clinics, while another 8.4 per cent were in the property of churches and 3.4 per cent in the hands of private entrepreneurs (data from the NHIF). Private capital was first employed in 2004 in the Siklós Town Hospital where the enterprise Mega-Logistic Rt. got hold of 75 per cent of the assets, while the town kept 18 per cent and the rest was divided between the surrounding local governments of Harkány, Villány, and Beremend.

⁴⁰In order to enhance the citizens' cost sensitivity in health care, an amendment of the Act LXXXIII of 1997 on Mandatory Health Insurance obliged all patients in publicly financed health care facilities from 15.02.2007 to pay a unit fee of 300 HUF per visit (or per day, in clinics and hospitals). Health care providers had no influence on the level of copayment but were entitled to keep the revenues they collected. Due to a number of exemptions, about 4 million people (40 per cent of the population) did not have to pay anything. Nonetheless, at a national referendum in March 2008, 82.6 per cent of the participating voters expressed their will to cancel the copayment.

of national institutions such as ministries, state universities and national public utilities.

Understandably, the decentralisation of health care decisions and the emergence of a diversified ownership structure also triggered a competition among facilities. In terms of staff, medical equipment and buildings, private clinics and some national hospitals are better equipped than the rest. The resulting horizontal disparities in the quality of health services induce patients to migrate. Budapest has a dominant role in the provision of health care, just as in several other public service domains. The continuing strong demand for specialised hospital services in the capital city attracts private and public investments with the promise of a high return. New investments create better conditions for quality improvements in the service provision, which results in a further increase in patient demand. In terms of development potential and the quality of inpatient services, there is a deepening gap between Budapest and the rest of the country. Small towns that have difficulty attracting investors will be unable to maintain an acceptable level of health care services in the long term.

At the same time, the Hungarian health care system suffers from an oversized hospital network that is a legacy from the socialist planned economy and presents both efficiency and equity problems. The network has an extremely high proportion of acute and long-term treatment capacities, 20 to 25 per cent of which are not used even though the hospitalisation rates in Hungary are substantially higher than the European average. Despite the explosion of the aggregate number of available beds, citizens in remote rural areas suffer from a lack of capacity in both the out- and inpatient care. From 1995, the central government introduced several reforms in order to cut the excess capacity and improve the distribution of hospital beds across the country.⁴¹ Yet, since 2000, the average number of beds has remained stable at around eight per thousand inhabitants GAÁL (2004, p. 70). With the latest reform package of the central government that resulted in the adoption of the Act CXXXII of 2006 on the Development of the Health Care System, another attempt is being made to streamline the system. The jury is still out on the success of this reform in which the municipal and county governments were hardly involved and which now imposes a four-level hierarchy of facilities, an 11 per cent cut in the number of NHIF-financed hospital beds, a major restructuring between acute and chronic care capacities as well as new rules for their territorial allocation.

Aware of the precarious situation of many small hospitals and the long-term

⁴¹ Act LXVIII of 1996 on the Territorial Supply of Health Services and Regional Capacity Norms; Act XXXIV of 2001 on the Territorial Supply of Specialised Health Services and the Amendment of Various Laws Concerning Health Care.

232 effects that funding oversized capacities may have on local budgets, the legislators decided to restrict the responsibility of SNGs in the domain of ambulatory and hospital care. As mentioned in Section 5.2.4, the previous regulation required municipalities and counties to ensure the operation of all out- and inpatient facilities in their property.⁴² From 1 January 2007 when the Act CXXXII of 2006 entered into force, this obligation applies only the owners of those 39 main hospitals, 130 district hospitals and ambulatory surgeries that have been selected for funding by the NHIF.

The role of health care facility owners is a difficult one. Formally, they are responsible for the maintenance and renewal of hospital buildings and medical equipment. However, employing NHIF funds for investment purposes is strictly forbidden. A limited amount of central budget grants for capital development are available through competitive tenders. This is only a modest step forward from the pre-transition model in which investment funds used to be allocated on a residual basis (i.e. only if there was some money left) through bargaining and discretionary mechanisms KERESZTY (2000, p. 59).

Alternative service delivery options are the most common in the domain of *public utilities*, notably environmental infrastructure, water management, energy, transports, and telecommunications. Public procurement mechanisms are widespread here, although local governments have contested the applicability of the law on several occasions, arguing that expenditures that are ultimately charged to the consumers in form of user fees do not count as public expenditures (BAAR, 2004, p. 306 ff.). The reasoning is fallacious because it takes user fees as an argument for avoiding open competition among suppliers, whereas in reality, the optimum amount of user fee can be determined only if there is perfect transparency about the costs and benefits of a public service.

Concession agreements are signed for the construction and maintenance of roads and telecommunication networks. Municipal service contracts with other local governments, private or non-profit providers are widespread in the domains of waste collection and disposal, maintenance of public parks and streets, as well as sewage systems. According to BAAR (2004), the number of local government service contracts in Hungary is likely to rise in the future, due to the growing need for infrastructure investments. Additionally, the existing regulations create economic incentives for contracting out. First, private firms can employ labour far more cheaply than public entities, due to the existing minimum wage regulations for public sector employees. Second, they are free to work with independent

⁴²Art. 152 para. 3 of the Act CLIV of 1997 on Health Care.

subcontractors and are therefore more flexible in their decisions concerning the termination of the contract and the payment of social security contributions;⁴³ in addition, unlike public entities, private enterprises may get their value added tax payments refunded. These advantages for the private provider are ultimately reflected in the lower costs of service provision for the local government as principal.

The same study also reveals a number of flaws in the legal framework as well as in the practice of contracting. First, although the legal standards concerning public access are relatively strict,⁴⁴ local officials do not seem to be conscious about their duty to make public service contracts accessible at least upon request by the citizen. Other local officials claim that citizens have never asked for copies of such documents. In addition, local assemblies seldom receive sufficient information that would allow them to make informed decisions on the price setting. Second, most of the contracts are poorly designed. Local governments still tend to see contracts as a pure formality rather than as a tool that allows them to influence the production function in the interest of the local constituency. Third, long-term contracts may be attractive for the principal who seeks to secure long-term resource flows (particularly for capital investments) but fail to compel private providers to make improvements in service quality or to pass through the cost savings to consumers.

Public-private partnerships (PPP)—the more recent version for concessions—have the reputation of being the most cost-efficient technique of implementing public infrastructure investments. Projects mobilising private capital are usually subject to stricter time limits and budget constraints. Moreover, since the constructor, the bank lender and the maintenance company are all members of the same consortium, planning is done from the very beginning in a way to minimise future operating expenditures. Key to success is the ability to long-term (20 to 30 years) planning and a thoughtful preparation of the project including the analysis of the legal and macroeconomic environment and the estimation of the long-term costs and benefits related to the asset.

Although in Hungary a number of highway tracks, prisons, and sports facilities, have been or are being constructed in PPP, no law exists so far that would regulate this form of service delivery. For each project, the agreement between the partners is laid down in a central government decree. For any issue not specified by the

⁴³Because of the tough price competition for public mandates, subcontractor-entrepreneurs can hardly ever include social security contributions and liabilities into their price offer.

⁴⁴Art. 61 of the Constitution; art. 19–22 of the Act LXIII of 1992 on the Protection of Personal Data and Accessibility of Data of Public Interest; Act XC of 2005 on the Freedom of Information by Electronic Means.

234 decree, the norms of the Civil Code apply. Since this solution is generally recognised to be unsatisfactory from the point of view of risk minimisation, discussions are under way about possibly drafting a law on PPP.

Up to this date, local governments have made very little use of PPP. Since 2004, local authorities constructing sports facilities, gyms or school swimming pools in PPP have been eligible for central government grants to cover a part of the leasing fee.⁴⁵ However, several municipalities have calculated that the grant would not make the project necessarily cheaper. Another frequent reason to opt against a PPP solution is the lack of skilled professionals who would be able to draw up and strategically manage such complex projects.

5.4.3 In-house provision via own organisation or enterprise A frequent alternative to local government service contracts is service provision via own organisation or municipal enterprises. Public utilities and the services related to community amenities provide a good example. The majority of local governments continue to keep the maintenance of parks, cleaning of public spaces, and housing in their hands, while they have contracted out waste collection and disposal, district heating, sewage, and the operation of public baths. Table 5.5) provides more detail.

Municipal enterprises are more or less autonomous legal entities in partial or full local government ownership.⁴⁶ In the first half of the 1990s, municipal shareholdings rose sharply from zero to around 500 billion HUF and remained relatively stable afterwards (KOPÁNYI and HERTELENDY, 2004). Today, they play a substantial role in the national economy in terms of output (contributing 2.2 to 2.6 per cent to GDP throughout the last decade), employment and investments. However, local governments are relatively weak in exercising their ownership rights. Local property decrees are often missing or have a merely formal character. In several local governments, the economic committees that should exercise property rights are nothing more than passive watchdogs. Although public utilities must submit a proposal for rate setting every year, the municipality has often no insight into the feasibility of these proposals, so that decisions about approval or rejection are based more on political than on economic considerations. Municipal enterprises

⁴⁵Sport XXI Programme for Facility Development, launched by the Government Decree no. 1055 of 2004 (8 June).

⁴⁶In the French terminology, contracting out public services to such entities is called 'autonomisation'. For an excellent overview of the challenges related to service provision via municipal enterprises, see KOPÁNYI and HERTELENDY (2004).

Table 5.5: Share of municipalities providing communal services via own organisation or enterprise [Source: Source: Péteri (2007)]

Service category	1994	2006
Cleaning of public spaces	78.0	76.3
Maintenance of parks and green spaces	77.0	73.3
Housing and community development	79.0	62.1
Maintenance of public cemeteries	n.a.	51.6
Sewage systems and wastewater treatment	21.0	13.9
Water supply	8.0	13.8
Collection of communal refuse	28.0	11.4
Funeral services	20.0	11.1
Baths	42.0	9.7
Refuse disposal	44.0	9.7
District heating services	33.0	5.9
Local public transport	4.0	1.7
Cleaning of chimneys	3.0	1.7

236 are seldom controlled upon the realisation of their budgets, nor is there an effective price control.

Another problem with municipal companies is the lack of entrepreneurial experience. Particularly in small rural settlements that lack adequately qualified staff, business activities are risky and/or poorly designed. For the most fundamental public services, local governments tend to disregard the profitability requirement or do not expect to receive any profit from their enterprises at all. Their price policy is often influenced by the conditions of availability of central government grants. In many instances, local governments set prices just below the limit under which they become entitled to a price subsidy from the central budget, instead of considering the level of cost recovery. In general, user fees hardly ever reach the cost recovery level and fail to cover the depreciation of the assets. This behaviour signals that local governments make a wrong use of their autonomy.

Revenue Autonomy

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Chapter 3 on local financial autonomy stipulated that an important condition for the potential gains from decentralisation to be realised is that local governments receive genuine decision-making authority with regard to local affairs and the provision of local public goods and services. However, if this expenditure autonomy is to be meaningful, decentralised units also need to have sufficient financial resources at their disposal. In other words, expenditure autonomy is not conceivable without a certain degree of revenue autonomy.

Revenue autonomy implies the freedom to decide about the source and volume of resources that finance local public goods and services, about the way these are distributed among the various spending purposes, and about the way in which the fiscal burden is shared among taxpayers. However, central governments and legislatures in decentralised countries usually curtail these liberties in one way or another in order to reconcile local autonomy with other concurrent objectives such as equity or macroeconomic stability. The aim of this part of the thesis is to explore the degree of revenue autonomy of local authorities in Hungary, taking into consideration the various liberties and constraints applying to specific revenue categories.

Section 6.1 explains the transition from expenditure-oriented to revenue-oriented revenue regulation, a pivotal change in the central government's perspective of local government finance from 1990. It also provides an overview about the legal framework of revenue decentralisation and provides data about local government revenues between 1995 and 2006.

The rest of the chapter deals with the major revenue categories. Section 6.2

238 is dedicated to the achievements and challenges in local taxation. The other categories of current own-source revenues including user charges, fines, revenues from entrepreneurial activities, leasing and rental, are examined in Section 6.3. Revenues from fixed assets, intangible assets and shares (including the proceeds from privatisation) are the subject of Section 6.4.

Transferred revenues dominate the discussion in the last three sections of the chapter. Shared revenues (Section 6.5), intergovernmental grants (Section 6.6) and flow-through transfers (Section 6.7) are analysed from the perspective of local revenue autonomy.

6.1 Revenue regulation in past and present

6.1.1 The end of the expenditure-oriented revenue regulation

Between 1949 and 1990, in a system that the post-transition literature called expenditure-oriented model of revenue regulation, the yearly expenditure need declared by each municipal, district and county council was subject to formal approval by the central planning bureau of the monolithic state (KUSZTOSNÉ NYITRAI, 2004, p. 255 ff.). After deduction of the expected amount of tax collections and transferred revenues, the centre transferred the missing amount to the given jurisdiction mainly in the form of conditional grants. At the lower levels of the public administration hierarchy, money arrived not directly from the centre but through the intermediary of the county and (until 1983) district councils¹ in a cascade mechanism, which caused bargaining and arbitrary decisions to become everyday practice in intergovernmental relations. The availability of 'free' resources from the centre killed the incentive of local governments to increase own revenues or to cut inefficient spending programmes. Although various policy reforms emerged from the 1960s with the aim to enhance local revenue autonomy, the top-down allocation mechanism remained dominant and municipal councils continued to operate under the thumb of higher-level authorities, their role being limited to the justification of local expenditure needs.

The system was relatively successful in financing the basic infrastructure and elementary public services at subnational levels. However, the quantity and quality of the available goods and services were far below the West European average of that time in almost all public policy areas and particularly in those with substantial infrastructure requirements.

¹The district system was abolished in 1984.

Two other, more serious problems outstripped penury. First, despite the careful planning of local needs and costs by the central authorities, the actual revenue allocation was heavily dependent on intergovernmental bargaining and arbitrary decision-making mechanisms. Second, the system offered limited possibilities and even less incentives to local authorities to satisfy demand that went beyond the elemental needs of their constituency.

The complete revision of the national Constitution (Act XX of 1949) in 1989 and the subsequent adoption of the Act LXV of 1990 on Local Governments (ALG) brought a completely new pattern of expenditure assignment, putting an end to the era of expenditure-oriented revenue assignment that had become unsustainable for at least two reasons.

First, the ALG allowed for the first time the preferences of local constituencies to play a role in local spending choices. While a number of functions were still deconcentrated or delegated from above, the law allowed local governments to assume any responsibility in addition to those explicitly enumerated. Under these circumstances, the idea to control all revenue flows not only became illusory but would also have contradicted the very meaning of decentralisation. Hence, the central government replaced the micro-level regulation of vertical revenue flows with a transparent and solid legal framework of revenue assignment that would provide decentralised authorities ample freedom to finance their budget according to their preferences. In the expenditure-oriented model of revenue regulation, the revenue allotments to local authorities were adjusted to their calculated expenditure (needs) level. By contrast, the so-called resource-oriented model of revenue regulation takes as an independent variable the sum of revenues a local government unit can secure in a year from taxation and grants to determine the upper ceiling for local spending. Having remained intact since 1990, the principle of resource orientation continues to govern intergovernmental fiscal relations in Hungary. Section 6.1.2 will present and discuss the model in more detail.

Second, as the revised Constitution of 1989 leaves considerable room for the spontaneous development of subnational entities, the territorial structure of the country became increasingly fragmented, while the lowest (municipal) tier received, and in part voluntarily assumed, a wide range of expenditure responsibilities. Compared to the period before 1990, interjurisdictional disparities in the level of available public goods and services grew significantly. In order to ensure a minimum endowment in financial resources for every local government unit, the parliament proposed a mixed funding scheme combining local own-source revenues, shared revenues, grants and transfers. While it resembles the previous revenue assignment scheme insofar as both consist of a mixture of own revenues

and transfers, there is a substantial difference between the two systems. Before 1990, central budget contributions could fill up to hundred per cent of the vertical fiscal gap in a municipality—that is, together with the own revenues, the grants allowed to cover the totality of the expenditure needs, provided that the mayor was a talented negotiator. In the new system, the amount of so-called norms-based grants (accounting for around one-fourth of total local revenues) is based on objective capacity indicators (the so-called ‘norms’) and is thus no longer adapted to the actual expenditure need. In other words, the central government seeks to attenuate the disparities without attempting to satisfy the totality of local expenditure needs.

As the centre no longer fills the vertical fiscal gap automatically, local governments are interested in the exploration of new revenue sources and a better exploitation of the existing ones, but also in rationalising service provision in order to reduce cost levels.

Despite its undeniably progressive character, the resource-oriented model of revenue regulation has also several flaws. Some of them relate to the design of the model as a whole; we will briefly discuss these in the following section. Other deficiencies are inherent in the individual elements of the model. These will be examined in Section 6.2.

6.1.2 The design of the resource-oriented model of revenue regulation

Figure 6.1 compares the expenditure-oriented and resource-oriented models of revenue regulation, reproducing the original models presented by KUSZTOSNÉ NYITRAI (2004, p. 255 ff.).

The first remarkable feature of the resource-oriented model is that, alike the former expenditure-oriented model, it distinguishes neither between current and capital expenditures nor between mandated and optional expenditures of local governments. In the theory of public finance, there are some normative propositions (e.g. MUSGRAVE, 1963, p. 135) suggesting that for intergenerational equity reasons, capital expenditures should be financed from loans and credits instead of current tax revenues, as the benefits of capital development spread over several generations of taxpayers. Likewise, there are arguments in favour of funding most or all of the mandatory expenditures of decentralised governments via intergovernmental grants. One of them is allocative efficiency: local public services of national interest (e.g. research) tend to be underprovided if the related spillover benefits are not compensated. Another one is interregional equity: the pure reliance on local taxes for financing mandatory local expenditures is likely to result in intolerable disparities in terms of access to, and quality of, public services. A third argument

Expenditure-oriented model (1949–1989)

Step 1:	The centre approves or modifies the expenditure need declared by the local government.	E (determined by the central planning agency)
Step 2:	In a discretionary or bargaining mechanism, the centre provides the local government an entitlement in own and shared revenues and grants equivalent to the size of the expenditure need.	$G = E - (T + NT)$

Resource-oriented model (from 1990)

Step 1:	The local government calculates its expenditure need without formal approval by the centre. In addition to own revenues, it can also count on a certain amount of norms-based grants and direct transfers at the beginning of the fiscal year.	Possible outcomes: $E \leq T + NT + G$ $E > T + NT + G$
Step 2:	If $E > T + NT + G$, then the local government seeks for a solution to close the fiscal gap.	$E - (T + NT + G) = \Delta T + \Delta NT + O$

where

E total expenditure of the local government

T tax revenues of the local government including revenue sharing (from 1955)

NT non-tax revenues of the local government including user charges, administration fees, fines, rents, etc. (from 1955)

G intergovernmental grants and transfers without revenue sharing and bailout

O other local revenues including loans, revenues from financial operations, bailout, etc.

Figure 6.1: **Models of revenue regulation in Hungary before and after 1990**
[Source: the author, based on Kusztošné Nyitrai (2004, pp. 256 and 269)]

242 has to do with the idea of ‘he who pays the piper calls the tune’: if the law or a national authority imposes a minimum standard regarding the quantity or quality of a local public service, it should also provide the necessary means of financing it (BIRD, 2000).

Against these normative propositions that are shared by some (but not all) economists, the Hungarian legislature decided deliberately to disregard the classical distinctions and created the notion of a *unified budget* in which more or less any revenue item (except for the earmarked grants) can serve as funding source for any expenditure item. The underlying idea was to provide decentralised authorities a maximum of autonomy with regard to the management of their budget.

A more worrying element in the resource-oriented model is the residual category of ‘other local revenues’ (*O*). The model as described in KUSZTOSNÉ NYITRAI (2004, p. 269) explicitly mentions loans, bailout grants and revenues from transactions in financial assets as elements of this category, but every other revenue excluded from the categories *T*, *NT*, and *G*, can be presumed to be part of it implicitly (e.g. revenues from privatisation).

The problem with handling loans, bailout, revenues from financial transactions and sales of property on equal footing with taxes, user charges, rents and transfers is that the former are not structural (recurrent) revenues at the free disposal of local governments. The borrower must pay back the money to the lender (the bank or another organisation), so that loans can at best serve as a temporary source for financing capital projects or covering a one-time operational deficit and cannot (or should not) become a structural element of the revenue side of the budget. The same considerations apply to the bailout: it is (or at least should be, *per definitionem*) a non-recurrent source of funding. Considering bailout as a regular means for stabilisation gives a false signal that such ‘life buoys’ can become an integral part of the local budget throughout a longer period.

The original equation as described by KUSZTOSNÉ NYITRAI (2004) is not explicit but the specification of the model altogether leaves no doubt about the fact that revenues from the sale of local government assets could also enter the category *O* (other) and thus participate in the funding of recurrent expenditures. This is again not recommendable: privatisation yields one-off revenue and contributes to the depletion of the local capital stock. Hence, local governments cannot count upon revenues from privatisation as recurrent items in their budget.

The mixed category *O* is in itself coherent with the underlying philosophy of a unified local budget. However, some revenue sources are more adapted to financing some particular expenditure items rather than others and the nature of the various resources in terms of reliability and long-term exploitability can be very different.

Obviously, local authorities may also attain a balanced budget via cost containment or a reduction in the volume of local expenditure programmes, even if the model is not explicit about it because of its restricted focus on the revenue side of the budget. The various options of local governments in Hungary for adjusting the local budget will be subject of Chapter 7.

6.1.3 The legal basis of revenue autonomy The revised national Constitution of 1989, the Act LXV of 1990 on Local Government, the Act C of 1990 on Local Taxes and the annual national Budget Acts constitute today the legal basis of revenue assignment in Hungary.

The Constitution stipulates that local governments are free to manage their resources and are entitled to own revenues as well as to a proportionally corresponding contribution from the central budget so that they can meet their mandatory responsibilities.² The ALG refines this latter passage, appointing the national legislative to be the responsible instance for ensuring ‘adequate financial conditions’ for the provision of mandatory local public services.³ The different categories of own-source revenues, transferred revenues and grants are laid down in articles 81 to 87 of the ALG. The Act C of 1990 specifies the rules of local taxation, while the Act LXXXIX of 1992 introduces a system of earmarked and targeted grants. The legal source of norm-based grants as the most important component of subnational revenues is the annual Budget Act.

Art. 5 of the Act XXXVIII of 1992 on Public Finance confirms that the budgets of local governments (including those of the counties) and local minority governments (including those of the county-level minority governments, see Section 4.2.2) together constitute the local (*de facto* municipal and county-) level of public finance. All these entities as well as all multifunctional inter-municipal associations, the so-called micro-regions established by the Act CVII of 2004, are free to manage their budgets according to their preferences, within the legal limits imposed on budgeting procedure and fund management. The deconcentrated agencies of the Hungarian State Treasury (HST) are responsible for the management of intergovernmental revenue flows; subnational entities, on their turn, are obliged to deliver financial data to the HST.

In contrast to municipalities, micro-regions and counties have no taxing powers. Micro-regions rely on the financial contributions of the participating local governments as well as on grants from the central budget. Counties rely to two-thirds of their budget on intergovernmental grants and transfers, even if their share of

²Art. 44/A para. 1/c of the Act XX of 1949.

³Art. 1 para. 5 ALG.

Table 6.1: **Available revenue sources at the subnational levels, as of 01.05.2007)**
[Source: the author]

		municipalities	micro-regions	counties
Own revenues	Taxes	x		
	User charges, administrative fees	x		x
	Rental fees, concession fees, dividends	x		x
	Revenues from privatisation	x		x
Shared revenues	Personal income tax share	x		x
	Vehicle tax share	x		
	Tax on land leasing	x		
	Luxury tax	x		
Grants and transfers	Norm-based unconditional grants	x	x	x
	Norm-based conditional grants	x	x	x
	Conditional grants from specific budgetary funds	x		x
	Earmarked and targeted grants for capital development	x	x	x
	Infrastructure grants (allocated by the counties)	x	x	
	Transfers from other SNGs		x	
	Transfers from the National Health Insurance Fund	x		x
	Transfers from extra-budgetary funds	x		x
	Transfers from central budget authorities (ministries etc.)	x		x
	Deficit grants (<i>ōnhiki</i>)	x		
Interest rate reduction for insolvent SNGs	x		x	

the centrally collected personal income tax revenues is smaller than that attributed to municipalities and they are excluded from a part of the development grant programmes. The rest is composed of administrative fees, user charges, fines, rents and revenues from the sale of assets. Table 6.1 provides an overview of the revenue sources assigned to municipalities, municipal associations and counties. The figures make it clear that among all categories of SNG, municipalities have by far the widest choice of revenues. Given the expanding scope of responsibilities that municipalities delegate to their associations (the micro-regions), the discussion has started about the possibilities of assigning autonomous revenue sources (particularly taxing power) to this category of SNG as well (PITTI, 2003).

6.1.4 The dynamics of local revenues between 1995 and 2006

Table 6.2 provides an overview of the development of municipal revenues from 1995 to 2006 at constant prices. For the same reason as in the case of expenditures (Section 5.1.2), data on the municipal sector are not available for the years before 1990–1994.

Deflating the time series to base year 1995 makes obviously little sense in revenue categories that appear on the municipal accounts only later than that year, such as tax on land rent, luxury tax, or transfers from the European Union. Luckily, given the relatively small proportion of these revenues in the overall budget of the local government sector, the provoked distortion is not too serious. Leaving the figures at current prices instead would suggest a revenue explosion at the local level, which did definitely not take place if we take account of the inflation. Rather, as the figures suggest, the overall volume of GFS revenues (calculated according to the methodology of the Government Finance Statistics of the International Monetary Fund) displayed slightly any dynamism in the second half of the 1990s before it took an upward turn and continued to increase monotonously towards the mid 2000s.

However, an important shift took place *within* GFS revenues. Figure 6.2 highlights the changes in the revenue structure of local governments during the period under review. The most striking feature is the expansion of own-source revenues and the simultaneous decline in transferred revenues (particularly intergovernmental grants and transfers) within the overall budget until the mid-1990s, followed by a more stable period that ultimately turned out to be the typical revenue structure of local governments in Hungary. Within the broad category of transferred revenues, grants for various equalisation purposes increased by 76 per cent in nominal terms between 1994 and 1998, whereas the total volume of grants grew only half

Table 6.2: Municipal revenues 1995–2006 at constant prices (base year = 1995, million HUF)
 [Source: Ministry of Finance; GDP deflator: IMF (1998, 2007)]

#	Revenue category	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1	Current own revenues	148,184	171,236	195,358	214,042	233,499	229,289	240,313	248,990	241,498	261,685	272,074	286,447
2	of which: Local taxes	46,383	66,828	77,581	90,399	113,323	113,145	125,738	129,187	131,659	144,098	152,746	168,639
3	Administrative fees	6,768	7,759	6,375	6,530	6,816	7,653	5,608	5,761	7,640	8,599	8,896	9,503
4	Interests received	9,942	13,082	22,187	20,310	17,505	14,528	11,652	9,917	6,234	8,518	6,366	5,304
5	Shared revenues	95,416	87,521	93,461	110,690	110,355	114,805	124,546	132,987	162,322	177,827	169,260	172,215
6	Personal income tax (PIT)	92,944	81,686	87,940	105,131	102,885	107,264	116,774	125,528	149,480	159,684	150,308	152,856
7	Motor vehicle tax	2,472	5,835	5,520	5,481	6,538	6,440	6,630	6,349	12,248	18,029	18,877	19,258
8	Luxury tax												39
9	Tax on agricultural land rent				77	932	1,101	1,143	1,110	594	114	74	63
10	Revenues from property	87,756	93,960	123,144	69,583	69,336	87,109	91,280	86,633	82,957	82,364	99,369	120,293
11	Sale of land, tangible and intangible assets	43,400	34,801	34,744	29,115	33,108	37,729	36,930	35,241	37,122	34,671	39,685	41,289
12	Sale of shares	19,021	21,407	56,095	9,465	9,305	10,919	2,407	2,756	1,849	3,337	5,260	4,381
13	Sale of enterprises	4,894	15,829	3,394	2,049	2,606	6,249	2,602	1,883	1,702	847	165	98
14	Compensation payments from the central budget	6,746	8,830	8,907	11,732	10,769	16,189	16,486	25,789	25,194	22,142	26,722	46,533
15	Compensation payments from outside the central budget	13,695	13,093	20,004	17,222	13,548	16,022	32,855	20,964	17,089	18,795	20,978	19,758
16	Transfers from the European Union										2,571	6,559	8,234
17	Intergovernmental grants	280,987	242,034	217,390	223,201	227,352	196,365	218,882	245,687	272,818	272,268	301,787	291,721
18	General norm-based grants	211,064	172,296	163,436	148,652	144,046	125,873	130,955	130,571	184,871	180,659	189,112	174,465
19	Earmarked norm-based grants	2,561	6,023	8,344	11,162	15,476	29,383	31,055	30,995	39,174	40,639	43,637	31,563

20	Theatre grants	2,156	2,444	2,581	2,526	2,595	2,451	2,435	2,457	3,748	3,852	3,844	3,575
21	Deficit grants	5,445	3,687	4,340	4,060	6,573	6,535	7,013	8,249	6,924	6,815	7,730	11,455
22	Centralised appropriations	32,305	41,026	18,065	30,789	32,870	7,145	11,916	40,263	13,549	17,149	24,011	31,429
23	Addressed and targeted grants	18,161	14,356	15,593	16,913	16,867	18,745	28,016	23,528	17,723	16,804	20,665	20,602
24	Other investment grants	0	453	4,746	8,883	9,014	6,233	7,487	9,634	6,822	6,099	12,221	15,951
25	Other grants	9,296	1,750	253	0	0	0	0	0	722	564	6,588	18,982
26	Flow-through transfers	88,609	90,386	91,835	92,294	93,593	92,012	88,219	93,269	102,447	96,794	96,932	103,208
27	Transfers from the Health Insurance Fund	79,232	73,976	69,365	68,628	70,264	68,398	68,272	78,160	89,812	85,197	83,507	79,859
28	Transfers from special government funds	3,087	10,267	14,591	15,398	15,270	12,193	7,846	4,528	4,023	3,433	4,556	3,907
29	Transfers from central budget authorities (ministries etc.)	5,224	5,173	6,922	7,443	7,810	11,341	11,886	10,110	7,872	8,099	7,821	16,552
30	Supplements and reimbursements	1,066	969	957	825	249	80	215	470	740	65	1,047	2,889
31	Revenues from outside the government	6,430	7,836	6,337	6,222	5,722	5,960	9,653	5,821	7,135	4,286	5,089	5,139
32	Revenues from loan reimbursement, temporary liquid assets			2,035	4,073	3,512	3,335	4,086	5,298	4,854	4,168	4,295	4,762
33	Total GFS revenues	707,382	692,974	729,561	720,105	743,368	728,874	776,980	818,684	874,031	899,392	948,806	983,786
34	Sale of long-term securities	3,369	6,557	3,502	7,875	13,301	15,906	20,109	34,485	24,911	28,836	35,156	54,723
35	Loans	19,132	11,352	12,063	26,507	10,795	11,431	12,787	13,240	13,394	4,795	2,489	11,917
36	Net sale of short-term securities				570	0	0	6,147	10,962	228	0	6,857	1,653
37	Total revenues	729,883	710,883	745,126	755,057	767,464	756,211	816,023	877,371	912,565	933,022	993,308	1,052,079
38	GDP deflator	1,000	1,209	1,433	1,673	1,750	1,960	2,121	2,297	2,450	2,548	2,605	2,662

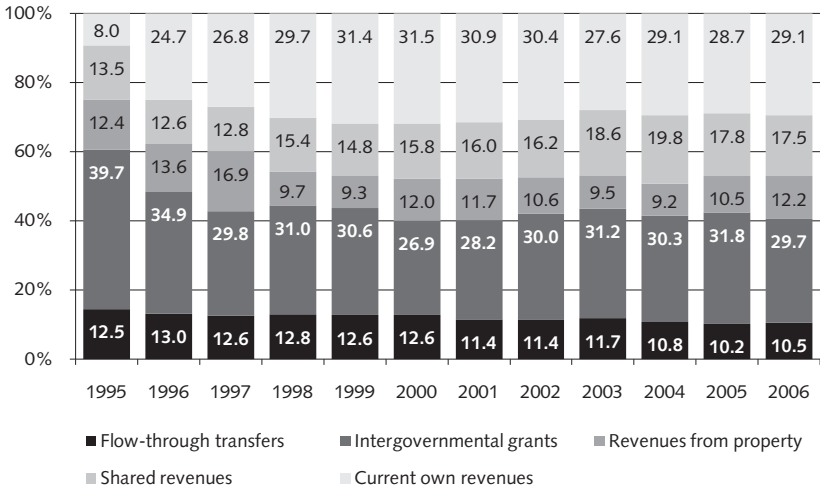


Figure 6.2: **The revenue structure of local governments 1995–2006**
 [Source: the author, based on Table 6.2]

as much (DAVEY and PÉTERI, 2004a, p. 139). Sections 6.5 to 6.7 will analyse these trends in more detail.

6.2 Local taxes

6.2.1 Overview With the entry into force of the Act C of 1990 on Local Taxes on 1 January 1991, the central government transferred a part of its taxing powers to the newly elected local governments. At the same time, in order to protect taxpayers and ensure conformity with the legislation of the European Union KUSZTOSNÉ NYITRAI (2004, p. 344), the law also imposes a number of restrictions on local tax autonomy insofar as it withdraws from the competence of municipalities the right of autonomous regulation of a number of tax parameters. Table 6.3 provides an overview of the legal framework of local taxation.

Municipalities are free to decide whether to introduce any tax in their jurisdiction and choose one or more from the tax categories laid down in the law. They may define and modify tax rates, tax base and other tax parameters within the statutory

limits. However, amendments to local tax decrees must be made in a way to avoid an increase in the fiscal burden on taxpayers in that same year.

While the property taxes on land and buildings as well as the tourism tax on holiday accommodation facilities belong to the broader category of wealth taxes, the tourism tax collected upon the basis of the duration of stay of individuals is a sort of income tax imposed on hotelkeepers and providers of other accommodation facilities. Because of the regular practice of these enterprises shifting the tax forward to their clients, this latter type of tax is also considered as a consumption tax.

The communal tax on businesses is a tax on employment (not a payroll tax, as it does not relate to earned income), while the one imposed on private individuals is a somewhere on the verge between a wealth tax and a poll tax: here, a lump-sum tax is applied on individual property. Finally, the local business tax is a classical multi-stage turnover tax.

Subject to certain constraints, the municipality may introduce tax reliefs (i.e. tax credits, tax allowances and exemptions) in addition to those prescribed explicitly by the law. During the 1990s, a large number of local governments successfully attracted new investors by exempting them from the tax for a limited or unlimited period, often on condition that they create a certain number of jobs. Due to a conflict with the European competition law, however, an amendment to the local tax law in 2001 obliged municipalities to cancel all unlimited tax reliefs or transform them into limited ones before 31 March 2003. The last tax reliefs given for a limited period expired at the end of 2007.⁴ The statistics of the coming years will reveal whether the end of the era of tax reliefs induced a massive outflow of capital from the previously attractive jurisdictions or whether other advantages such as skilled labour or good infrastructures were able to compensate for the loss of a preferential tax treatment.

In order to avoid an accumulation of tax liabilities (e.g. holiday homes are subject to the building tax, the communal tax on private individuals and the tourism tax simultaneously), the law stipulates that if several types of tax are levied on the same object, the taxpayer is liable only to one tax. This rule does not exclude the operation of several tax types on the same type of object, but then the local tax decree must specify which tax is applicable to which category of taxpayers.

Since its amendment of 1997, the law has provided a 'conditionally exempted' status to civil organisations, churches, foundations, public bodies, public companies, certain public utilities, voluntary mutual pension funds, private pension funds,

⁴Art. 21–22 of the Act L of 2001 on the Amendment of Selected Financial Acts.

Table 6.3: The system of local taxes in Hungary, as of 31.12.2006
 [Source: the author, based on Act C of 1990 on Local Taxes incl. amendments (status of 31.12.2005)]

Tax category	Taxable object	Minimum tax reliefs	Taxpayer	Tax base	Maximum rates / year
Property taxes					
Building tax	(Parts of) buildings for residential and other purposes	Exempted: emergency accommodation; buildings owned by social care or health care providers; government institutions*, churches etc. Suspension of tax liability for individuals over 65 years and disabled persons.	Owner of the building	Useful floor area (m ²) or its adjusted fair value (AFV= 50% of actual FV)	HUF 900/ m ² of useful floor area (from 2005, LGs may adjust it for inflation), or 3% of the AFV
Land tax	Vacant sites	Sites subject to a building ban; sites owned by public transport companies; forests etc.	Owner of the site	(as above)	HUF 200/ m ² of useful floor area (+inflation) or 3% of the AFV
Communal tax					
on private individuals	(Parts of) buildings for residential and other purposes; vacant sites		Owner of the building or the site; private individuals holding rental rights of a residential real estate owned by non-private individuals	(as above)	HUF 12,000/ taxable object (+ inflation)
on enterprises	Employment of labour			Adjusted average statistical number of those employed by the taxpayer in the jurisdiction	HUF 2,000/ employee (+inflation)

Business tax (IPA)		
Business activities; existence of a head office or other business unit in the jurisdiction	Tax allowance: 90% of the tax base resulting from business operations abroad (if they are taxed abroad); tax allowance for job creation; proportional tax allowance for temporary business activities.	Owner of the business entity
	Net sales – (purchasing costs of goods sold + value of subcontractors' performance + purchasing costs of materials); simplified for small businesses	From 2000, 2 % of the tax base; lower maximum rates for temporary business activities

Tourism tax		
Duration of stay	Exempted: individuals below 18 and over 70 years; those staying in social or health care facilities; those staying in the jurisdiction on account of employment, entrepreneurship or studying.	Number of guest nights or the payable boarding charge
or: Buildings suitable for use as holiday accommodation	Owner of the building	HUF 300/night / person (+ inflation) or 4 % of the boarding charge
		HUF 900/ m ² of useful floor area (+ inflation)

* Legal persons belonging to the general government sector and partly financed through the public budget (e.g. public schools, museums, libraries, etc.)

252 government institutions and private schools that had no corporate tax liability or transfer liability vis-a-vis the central budget in the preceding year.⁵

Formal taxing powers constitute an important factor of revenue autonomy, but the extent to which these powers are used in practice is even more decisive.

Between 1991 and 2005, local governments in Hungary made increasing use of their local taxing powers. While tax revenues collected by local authorities (row 2 in Table 6.2) accounted for 2.4 per cent of the aggregate budget of the local government sector in 1991, this proportion rose to 13.8 per cent by 2005. During the same period, the number of municipalities levying some sort of tax increased from 308 to 3,105 (Table 6.4). This is a clear signal of the growing need for independent local resources, but it is also a result of a new regulation in 1995 according to which local governments not levying any local tax are excluded from the bailout grant system (the so-called *önhiki*, see Section 6.6.6).

While the spatial pattern of local fiscal policies shows considerable disparities, researchers have found no clear relationship so far between the economic situation of municipalities and their tax policy decisions. Several villages with small tax bases and weak development potential, but also medium-size towns in the role of regional centres, apply the maximum rate in every tax category, particularly if the grants from the central government fail to cover the costs of mandatory public services. Other municipalities decided to abolish certain local taxes or to provide generous tax reliefs (as long as this was allowed) in order to keep those few taxpayers in place (Box 6.1).

6.2.2 Local business tax The most popular tax category among local governments is the local business tax (*iparüzési adó*, IPA): in 2006, only 501 local governments out of 3,152 did not collect this type of tax. Those jurisdictions that introduced it gained on average 84.7 percent of their local tax yield and 12.5 per cent of their total GFS revenues from this source (Table 6.5 and Figure 6.3).

While taxes on property and income (the latter via piggybacking or revenue sharing) dominate local taxation in most countries of the world, the IPA belongs to none of these categories. It is a traditional turnover tax levied on gross receipts minus deductions at all stages of production (SZALAI, 2005). The pyramiding (cascade) effect that had characterised the tax in its early years has gradually disappeared. Today it resembles more a value-added tax, with the costs of goods, materials and subcontractors being deductible from the gross sales figure. However,

⁵Art. 11 of the Act CIX of 1997.

Table 6.4: Number of municipalities by category of tax levied, 1991–2006 [Source: Ministry of Finance]

Tax category	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Tax on residential buildings	55	163	169	153	156	188	213	215	239	296	337	353	359	373	373	378
Tax on non-residential buildings	65	456	470	495	510	597	628	633	658	687	697	695	713	731	734	732
Land tax	35	319	312	316	328	392	394	388	382	380	390	395	396	416	402	404
Communal tax on private individuals	89	794	839	834	839	1,296	1,470	1,525	1,661	1,858	1,981	2,030	2,094	2,154	2,190	2,203
Communal tax on businesses	95	537	561	587	607	786	846	825	806	764	746	737	721	713	703	701
Tourism tax	116	326	328	371	357	428	468	482	518	541	587	615	639	671	681	698
<i>on duration of stay</i>	70	198	196	239	223	270	298	314	348	377	416	447	474	509	519	534
<i>on buildings</i>	46	128	132	132	134	158	170	168	170	164	171	168	165	162	162	164
Business tax (IPA)	132	454	504	592	656	1,122	1,437	1,607	1,892	2,226	2,354	2,426	2,499	2,548	2,639	2,651
Council tax	n.a.	n.a.														
Nb of municipalities levying a tax	308	1,494	1,518	1,578	1,640	2,297	2,537	2,672	2,813	2,970	3,027	3,052	3,082	3,091	3,106	3,105
Total nb of municipalities*	3,074	3,092	3,108	3,114	3,125	3,126	3,127	3,131	3,131	3,135	3,135	3,135	3,145	3,145	3,145	3,152
% of municipalities levying a tax	10.0	48.3	48.8	50.7	52.5	73.5	81.1	85.3	89.8	94.7	96.6	97.4	98.0	98.3	98.8	98.5

* Including the capital but not its 23 districts

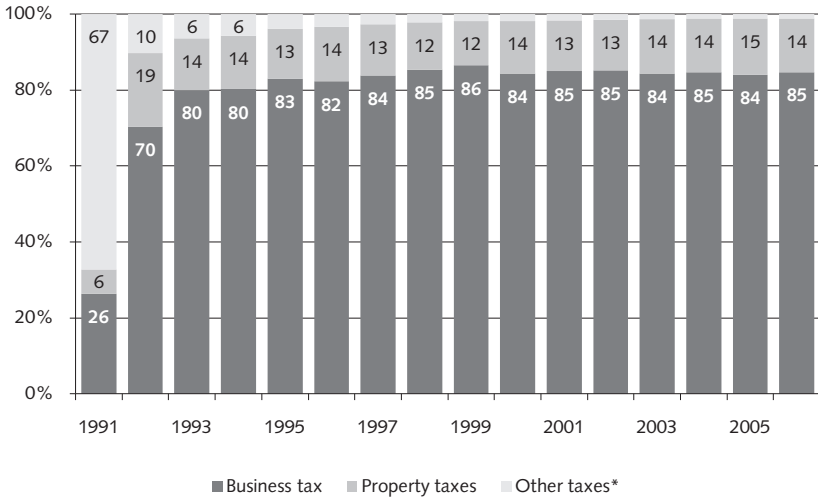
Box 6.1: Local strategies for a successful fiscal policy

As from January 1, 2007, the village of Tenk (1,262 inhabitants) in Northern Hungary abolished the local business tax (IPA), taking a loss of HUF 6 to 7 billion in tax revenues a year. The local council argued that the central government's New Equilibrium Programme aimed at the reduction of the general government deficit by 7 per cent between 2006 and 2008 significantly increased the fiscal burden on businesses. The insolvency of the few local enterprises would not only deprive Tenk of IPA revenues but it could potentially provoke a cutback in personnel or even a complete shutdown of business operations. In 2006, the two main enterprises in Tenk provided jobs to 1/3 of the active population.

Csomád (866 inhabitants), situated 32 km to the north of Budapest, is another example of a municipality without IPA. The liberal fiscal policy has allowed the local government not only to keep local enterprises in place but also to attract new investors. The businesses now regularly contribute to the development of the municipal infrastructure (including schools) on a voluntary basis and the sum of these contributions largely exceeds the tax revenue of previous years.

Experience suggests that it is mainly the small and geographically isolated villages that refrain from local taxation. Lacking adequate roads and public transport facilities, they can hardly hope to defeat the nearby towns in the competition for taxpayers, so that fiscal policy remains their only weapon. Several villages that had introduced a tax now have to write off large amounts of irrecoverable debt incurred by enterprises that went bankrupt.

With its unique success story, Györe (769 inhabitants) in Southern Hungary provides an astounding example of self-management. The village is flourishing despite the fact that it does not collect any taxes, it has never signed a loan or sold any of its assets. Half of the local population is employed by the two sewing factories and the syrup factory that rent land and buildings from the local government against a symbolic fee, while the rest live on subsistence farming. Thanks to the citizens' commitment towards the common good (which is surprising in a situation that would normally create fiscal illusion) and the rigorous management of local finances, Györe can save much on the expenditure side of the budget and still boast with a fully developed public infrastructure that is entirely financed via tax revenue sharing and norms-based grants. According to the mayor, the only problem with this strategy is that it produces excellent scores in the development rankings and consequently excludes the municipality from most of the capital grant programmes of the central government. For an economist, of course, this argumentation is questionable. From the perspective of local accountability and efficiency, it would be more appropriate to finance the total current expenditure via local taxes and the total capital expenditure via debt, as this would ensure a better match between decision-makers, taxpayers and beneficiaries. Besides, it would liberate useful resources in the national budget for other purposes.



* The business tax corresponds to the IPA. Property taxes equal the sum of the taxes on residential and non-residential buildings, the land tax, the communal tax on individuals as well as the tourism tax on buildings (holiday estates).

Figure 6.3: The changing composition of local tax revenues [Source: the author, based on Table 6.5]

Table 6.5: Local tax revenues by categories, 1991–2006 (million HUF) [Source: Ministry of Finance; GDP deflator: IMF (1998, 2007)]

Tax category	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<i>At current prices</i>																
Building taxes	200	2,119	2,294	3,255	4,145	8,313	10,752	13,056	16,629	22,262	26,259	29,178	34,098	38,240	44,440	47,896
Land tax	15	394	474	710	813	1,296	1,717	1,811	2,262	3,099	3,242	3,943	4,476	5,346	5,184	5,705
Communal tax on private individuals	304	420	530	516	747	1,492	1,980	2,698	3,422	4,557	5,087	5,578	6,308	7,162	7,954	8,275
Communal tax on businesses	646	933	1,222	1,200	1,075	1,174	1,178	1,161	1,354	1,192	1,192	1,155	1,148	1,164	1,153	1,268
Tourism tax	362	855	917	1,054	1,131	1,966	2,402	2,784	3,220	3,834	4,445	4,315	4,563	4,736	5,114	5,635
on duration of stay	270	455	510	745	768	1,505	1,878	2,147	2,396	2,942	3,275	3,224	3,316	3,548	3,858	4,357
on holiday buildings	92	400	407	309	363	461	524	637	824	892	1,170	1,091	1,247	1,188	1,257	1,278
Business tax (IPA)	2,500	12,110	21,652	27,257	38,472	66,130	93,133	124,316	171,476	186,822	226,460	252,603	271,995	310,536	334,077	380,158
Council tax	5,451	390														
Total	9,478	17,221	27,089	33,992	46,383	80,371	111,162	145,826	198,363	221,766	266,685	296,772	322,588	367,184	397,923	448,936

At constant prices (base year = 1995)

Building taxes	442	3,856	3,441	4,087	4,145	6,874	7,502	8,093	9,498	11,354	12,379	12,699	13,912	15,004	17,056	17,988
Land tax	33	717	711	891	813	1,072	1,198	1,123	1,292	1,581	1,528	1,716	1,826	2,098	1,990	2,143
Communal tax on private individuals	672	764	795	648	747	1,234	1,381	1,672	1,955	2,324	2,398	2,428	2,574	2,810	3,053	3,108
Communal tax on businesses	1,428	1,698	1,833	1,507	1,075	971	822	720	773	608	562	503	468	457	443	476
Tourism tax	800	1,556	1,376	1,323	1,131	1,626	1,676	1,726	1,839	1,955	2,096	1,878	1,862	1,858	1,963	2,116
on duration of stay	597	828	765	935	768	1,244	1,310	1,331	1,369	1,501	1,544	1,403	1,353	1,392	1,480	1,636
on buildings	203	728	611	388	363	381	366	395	471	455	552	475	509	466	482	480
Business tax (IPA)	5,528	22,037	32,478	34,222	38,472	54,680	64,979	77,057	97,942	95,286	106,760	109,942	110,976	121,845	128,215	142,777
Council tax	12,052	710														
Total	20,956	31,338	40,634	42,678	46,383	66,455	77,557	90,390	113,299	113,108	125,723	129,166	131,619	144,072	152,718	168,608
GDP deflator	0.452	0.550	0.667	0.796	1.000	1.209	1.433	1.613	1.751	1.961	2.121	2.298	2.451	2.549	2.606	2.663

258 enterprises using predominantly services that are produced ‘in-house’ (and that cannot thus be expensed) still suffer from the cascade effect.⁶

Consecutive amendments of the law ordered an increase in the applicable maximum rate and a simultaneous narrowing of the scope of the tax base according to the schedule in Table 6.6. The final impact of these interventions on local revenues may be positive or negative. However, the curious feature of this system is that the central government keeps changing the rules for a tax that it had previously delegated into local competence. It does so presumably in order to protect taxpayers from possible encroachments by local authorities, but in a well-functioning economy with sufficient mobility, taxpayers need no tutelage: they can simply choose the jurisdiction that best meets their preferences in terms of taxes and benefits.

In 2005, 85 per cent of all municipalities levying an IPA applied a rate of above 1.4 per cent and 45 per cent collected the maximal rate of 2.0 per cent. The average rate was 1.9 per cent (MINISTRY OF FINANCE, 2007). Notwithstanding these regional differences, in his empirical study involving municipalities with more than 5,000 inhabitants, SZALAI (2005) found no evidence of a veritable tax competition, apart from some signs of strategic interactions between local governments. Capital mobility in Hungary seems to be too limited to induce interjurisdictional competition. Another finding in the study corroborates this assumption: municipalities with stronger tax bases tend to apply higher tax rates because they do not fear the out-migration of capital. The stronger tax base is meant here in terms of a few successful enterprises and not in terms of a large population; indeed, a higher number of inhabitants tends to lower the average tax rate, reflecting the reduced expenditure need in the presence of economies of scale. The only area where capital is relatively mobile is the Budapest agglomeration. Here, the municipalities situated closer to the core of the agglomeration tend to apply lower tax rates than those in the periphery (Box 6.2).

The dependence on the IPA makes local budgets vulnerable to changes in the local economic structure. Several towns boasting with a prosperous industry

⁶Direct business taxes (on corporate income or sales) at the regional or local level exist in three other European countries outside Hungary: Italy (*imposta regionale sulle attività produttive, IRAP*), Germany (*Gewerbesteuer*) and Ukraine. A number of other countries (such as Austria, Denmark, Finland, and Ireland) impose non-residential property, which can be regarded as another form of local business taxation. With its *taxe professionnelle*, France originally imposed payroll and fixed assets, whereby the payroll component has been gradually removed from the tax base. The number of employees is the basis of local business taxation in Belgium and Portugal, similarly to the Hungarian communal tax on businesses. For more detail, see BIRD (2003).

Table 6.6: Amendments to the IPA system between 1990 and 2006 [Source: the author]

Year	Tax base*	Max. rate**	Legal source
1990–1992	NS	3.0 %	Act C of 1990
1993–1995	$NS + i - (g + s)$	8.0 %	Act LXXVI of 1992
1996–1997	$NS + i - (g + s)$	1.2 %	Act XCVIII of 1995
1998	$NS + i - (g + s + 0.33m)$	1.4 %	Act CIX of 1997
1999	$NS + i - (g + s + 0.66m)$	1.7 %	Act CIX of 1997
01.2000–09.2005	$NS + i - (g + s + m)$	2.0 %	Act CIX of 1997
10.2005–12.2005	$NS + 0.5i - (g + s + m) - (x + r + e + c)$	2.0 %	Act LXXXII of 2005
from 2006	$NS - (g + s + m) - (y + x + r + e + c)$	2.0 %	Act LXXXII of 2005

where

NS	net sales; i.e. gross receipts minus returns, discounts, allowances, VAT, and consumption taxes
<i>i</i>	interests received
<i>g</i>	costs of goods used in production
<i>s</i>	value of subcontractors' services
<i>m</i>	costs of materials used in production
<i>x</i>	excise tax paid
<i>r</i>	car registration tax paid
<i>e</i>	energy tax paid
<i>c</i>	cover charge received (in restaurants)
<i>y</i>	royalties received

* From 1995, specific rules apply to financial services and insurance companies, government organisations, churches and civil organisations.

** The maximum rates apply to regular (i.e. not temporary) business activities.

An illustrious example of the core-periphery phenomenon in taxation is the town of Budaörs (25,725 inhabitants, 11 km from Budapest) that has deliberately kept its local business tax rate at 1.7 to 1.8 per cent of the adjusted net sales ever since the introduction of the tax in 1995. This is 0.2 to 0.3 percentage points lower than the rate applied by the city council of Budapest. Together with the numerous tax reliefs provided until the end of 2007, this smart fiscal strategy has led to a spectacular local economic boom in Budaörs characterised by the settlement of hypermarkets and about a hundred small innovative enterprises and the corresponding rapid improvement in the public infrastructure and collective goods and services in the jurisdiction. In 2007, about half of the municipal budget (7.5 billion out of 15 billion forints) consisted of IPA revenues, which implies a 10 per cent increase from the previous year. Within the current revenues, the share of the IPA amounted to 70 per cent (Ön-Kor-Kép, 2007).

It might somewhat surprise that the very core of the Budapest agglomeration, the capital city itself, applies an IPA rate of 2.0 per cent. One possible reason is that, contrary to the surrounding municipalities that experience a tough competition, Budapest does not need to fear an outflow of capital, thanks to the highly developed infrastructure and the abundance of skilled labour.

during the socialist era and hoping for buoyant revenues from the IPA had to experience a painful decline shortly after transition. Box 6.3 provides an example.

Business cycles, too, have a direct influence on corporate turnover figures and thus on the IPA revenues. This influence, however, cannot be clearly separated in the time series from other effects, notably the effects of tax base, tax rates, and the number of local governments levying a tax. On one hand, as Table 6.6 showed, a series of amendments to the local tax law gradually reduced the scope of the formal (legally defined) tax base of the IPA. The effective tax base was even smaller, due to the multitude of exemptions and deductions granted to major investors particularly in the 1990s, even though the additional IPA paid by the suppliers of these investors and the firms providing the accompanying infrastructure (roads, landfills, etc.) could partly neutralise this effect. On the other hand, the number of municipalities introducing the IPA and the legally defined maximum rate continuously increased during the period under review, and those municipalities pursuing an attractive fiscal strategy could experience a boom in IPA revenues once the preferential tax agreements had expired. Even if it is virtually impossible to separate from each other the components of the long-term IPA revenue trend of a municipality,

The Nitrokémia chemical company in Balatonfűzfő (4,311 inhabitants) used to provide employment to some 6,000 people. Unable to cope with the financial hardship resulting from the post-socialist transition, the factory gradually decreased its production before closing down operations in 1994. Local tax revenues, particularly the IPA, dropped so dramatically that the municipality is unable to raise the necessary funding to participate in central government matching grant programmes. Currently, the only way of developing the local infrastructure is via privatisation and borrowing, to the extent that lenders accept the risk related to a low level of recurrent revenues. The new biotechnological complex to be set up by a group of investors on the same spot in the coming years could put an end to the penury.

Box 6.4 shows how this part of the public budget in a major industrial town can become a function of economic cycles in the national and global markets.

The strong reliance of local governments on the IPA is all the more remarkable as, in general, there are not many valid arguments in favour of taxing businesses locally (BIRD, 2003). The IPA in particular lends itself to tax exportation resulting in poor accountability of public expenditure decisions, but not to any of the other efficiency problems cited in the literature (distortion of choices, fiscal competition—except for some sporadic examples such as Budaörs, see Box 6.2). However, political and economic actors deplore its effects on equity and economic growth. As for the latter, the IPA imposes substantial costs and barriers to the expansion of enterprises, thus hampering job creation and investments. The equity effects are far more complex. Beside the selective cascade effect hitting the service industry, the IPA is criticised because the enterprise has to pay invariably, regardless of whether it makes a profit or a loss.⁷ Moreover, while local enterprises provide 82–85 per cent of the local tax revenues through the IPA, they use only a small fraction of the communal infrastructure PÉTERI (2007, p. 18). The rest of the taxpayers contribute much less to the common budget, particularly as in several municipalities, private individuals are fully exempted from any kind of tax, which means that they benefit from a

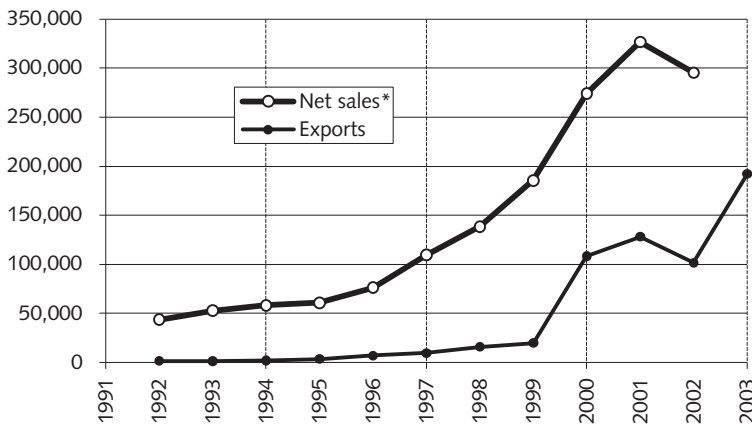
⁷At the same time, the idea of replacing the IPA with a ‘more equitable’ local corporate income tax (see later in this section) has been attacked from several sides because it hits only the profit-making enterprises although they are not the only ones to use the local infrastructure. Both of these (seemingly contradicting) equity arguments are justifiable, but on different grounds: one relies on the ability-to-pay principle while the other one makes use of the benefit principle.

262 **Box 6.4: Tatabánya: continuing dependence despite successful economic restructuring** [Source: the author, based on Antalóczy (2004)]

The town of Tatabánya (70,541 inhabitants), a major stronghold of the Hungarian heavy industry during the Soviet rule, experienced a similar shock when the demand for mining products collapsed. However, the successful privatisation of the related enterprises triggered an inflow of further direct (mainly foreign green field) investments particularly in the domains of engineering and process industries that could partly benefit from local tax abatements and exemptions from the mid-1990s. The integration of local enterprises into the world economy and their dependence on the global business cycles are most visible in the development of exports from the late 1990s (see Figure 6.4).

Since its introduction in 1995, the IPA has always been the decisive component within local tax revenues but its share fluctuated between 69 and 82 per cent (Figure 6.5).

The tax exemptions granted to the first major investors expired in the early 2000s. The entry of these mainly foreign enterprises as new taxpayers into the local government accounts coincided with a recession in the world economy, which explains why the share of IPA revenues of Tatabánya fell so abruptly in 2002 (even though the yield continued to grow in absolute terms), dragging down the total volume of municipal tax revenues. The business cycle effect is mitigated to a certain extent by the distribution of the tax burden across a large number of enterprises in different sectors. The hundred most important taxpayers account for only 55 per cent of total tax revenues.



* Net sales are equivalent to the IPA basis calculated according to the schedule in Table 6.6.

Figure 6.4: Net sales and exports of local enterprises in Tatabánya (million HUF) [Source: Antalóczy (2004)]

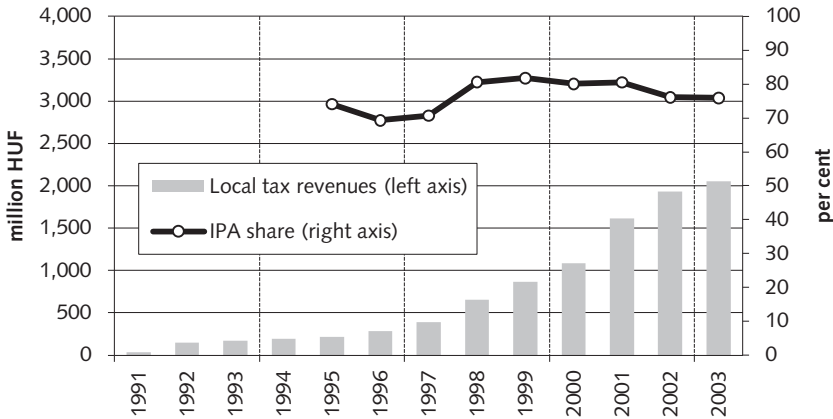


Figure 6.5: Local tax revenues and the share of IPA in Tatabánya
[Source: Antalóczy (2004)]

range of local public services without ever paying for them.⁸ Finally, interregional equity is hurt as well, since business activities are randomly distributed across the jurisdictions. If there are spatial trends, they only exacerbate the existing disparities, as industrial clusters normally benefit from favourable self-reinforcing processes affecting employment, innovation and growth. In 2000, 88 per cent of the total own tax revenues of the local government sector (dominated by the IPA to 84.2 per cent) were collected in towns and cities (of which the half in Budapest) that, however, represent merely 8 per cent of all municipalities. Only 12 per cent of the total tax revenue accrued to the villages that account for 92 per cent of local governments (LÓRÁNT *et al.*, 2002, p. 367). According to OECD data, per capita IPA revenues are 27 times higher in the capital than in villages, and 8 to 9 times higher than in towns BIRD (2003, p. 702). Nevertheless, the village of Kékkút with only 79 inhabitants registered the highest per capita IPA revenue in the country (about HUF 1 million in 2002, or 4.6 times as high as that in Budapest; CSÉFALVAY *et al.*, 2005), thanks to the presence of a prosperous mineral water company.

⁸In order to verify that firms in Hungary pay too much compared to the benefits they derive from local public services, one should be able to estimate the 'business share' of local public expenditures, as has been done for Canada and the United States in different empirical studies during the 1990s (references in Bird 2003: 697).

Since 1999, the central government has made considerable effort to reduce these disparities by considering the revenue raising potential of municipalities in the distribution of norm-based grants (see Section 6.6.2).

Because of the adverse effects of the IPA particularly on equity and economic growth, its potential elimination has been on the political agenda since early 2005. Until mid-2007, it seemed as if the European Court of Justice could ban it on the grounds that no member state of the European Union is allowed to have two VAT-type levies. However, the legal inquiries finally revealed that the IPA was different from a VAT and found no valid argument against this type of sales tax at the local level of government. Regardless of this outcome, the Parliament might decide to abolish the IPA on the medium term as soon as a fair compensation is found for the ensuing revenue loss of HUF 380 billion at the municipal level. The type of revenue to replace the IPA will necessarily have an influence on the financial autonomy of local governments. The quest for a solution is embedded into a general reform of the local tax system that will be briefly discussed at the end of this section.

6.2.3 Taxes on property The second most important source of local own revenue is the property tax. These are primarily levied on buildings and land, but also the communal tax on individuals and the tourism tax levied on holiday estates are property taxes in the economic sense.

The inequality of distribution of the fiscal burden between businesses and households in connection with the IPA is further exacerbated by the practice of building taxation. In 2006, 732 local governments imposed a levy on non-residential buildings, while only 378 taxed residential buildings. Regrettably, the statistics give no clue about the extent of overlapping between these two groups (i.e. the number of municipalities taxing both items), nor about how much of the overall yield of HUF 47,896 million was collected from the owners of residential buildings (thus private individuals) in 2006.

Although local governments can choose to assess the tax upon the fair value of the asset, only five municipalities made use of this possibility in 2006. The rest simply took the useful floor area as the basis of calculation, even though empirical studies suggest that there is only a weak correlation between property size and the taxpayer's ability to pay, just as well as between property size and the benefits derived from local public services (SZALAI and TASSONYI, 2004, p. 241). By contrast, there seems to have a positive relationship between property value and ability-to-pay (BALÁS and KOVÁCS, 1999, p. 12).

From the perspective of local autonomy, however, the determinant factor is

not fiscal equity but the buoyancy of revenues. BALÁS and KOVÁCS (1999, p. 13) note that while both value-based and area-based property taxation may provide a strong revenue basis for local governments, the yield of the value-based tax grows together with inflation, while the real value of the yield of area-based taxes decreases with inflation. In order to resolve this problem, the Parliament has recently amended the Act C of 1990 on Local Taxation by adjusting the maximum tax level for yearly inflation in every tax category that involves the number or size of tax objects instead of their value (see Table 6.3). The amendment does not permit to make any retrospective adjustment for the period 1996–2004,⁹ but the first experience suggests that there is no demand for it anyway: in 2006, only a few local governments made use of their right to apply the new maximum rates that keep up with the inflation (MINISTRY OF FINANCE, 2007).

While value-based local property taxation has a genuine potential in Hungary, several administrative and political hurdles in both the time and the space dimensions are blocking the change. As for the spatial limits, local tax administrations do not have enough experts to assess the value of all properties in the jurisdiction; moreover, because of confidentiality provisions the central authorities do not provide them sufficient information to make these assessments. On the time axis, re-evaluation on a yearly basis is virtually impossible for lack of tax assessment capacity, and any sort of indexation is necessarily arbitrary and seldom reflects the market value. However, even if a regular assessment of every object were feasible, it is not sure that value-based property taxes could bring in significantly more revenue than the present area-based taxes. On one hand, BIRD (2001b, p. 6) argues that ‘valuation is an art, not a science, and there is much room for discretion and argument with respect to the determination of the base of the tax’. Value-based property taxes are also costly to administer in a rapidly changing environment (typical to developing and transition countries) and it is difficult to adjust revenues from this source to the growing expenditure needs of local governments. Hence, even if a local government operates an efficient value-based property tax, it is an illusion to assume that this source is able to cover anything more than the costs of property-related public services (DAVEY and PÉTERI, 2004a). On the other hand, based on a survey involving six towns, BALÁS and KOVÁCS (2004, p. 267) find that in each of these towns, a single value-based property tax applied with the maximum rate could produce more revenue than the currently collected local taxes altogether. At present, however, local governments do not make sufficient use of

⁹The last increase of the legal maximum levels of the area-based building and land tax took effect on 01.01.1996 (see art. 2–3 of the Act XCVIII of 1995 on the Amendment of the Act on Local Taxes and the Act on Vehicle Tax).

266 their taxing power even with regard to area-based taxation. Instead of applying the legal maximum rate to wealthy taxpayers and granting reductions or exemptions to the needy, they apply a generally narrow tax base and low tax rates in order to avoid political and social tensions among the electorate.

The communal tax on private individuals is second on the list of the most commonly applied tax categories: 71 per cent of the local governments collected it in 2006. Even though several municipalities apply different rates according to the geographical situation and/or the actual use of the real estate, the tax is simple to administer. In addition, due to the fact that in 2006, only 189 municipalities applied a rate of HUF 12,000 or above per taxable item (MINISTRY OF FINANCE, 2007), it does not impose too heavy a burden on local residents. On the other hand, the same low rates make the communal tax on private individuals a weak revenue source contributing on average less than two per cent to total tax revenues and 0.26 per cent to the overall local budget.

The fourth type of property tax, the tourism tax on holiday homes and other buildings that may be used for accommodation, may be a primordial source of revenue in major tourist destinations but totally negligible in other municipalities. With the growing dominance of other tax categories, the share of this tax within overall local tax revenues declined from 2.3 per cent in 1992 to 0.3 per cent in 2006.

All four categories of property taxes taken together, we find that property owners contribute 14.1 per cent to local tax revenues and around 0.04 per cent to overall local revenues. How much they receive from the benefits generated by local public goods and services is not clear. In any case, it is plausible to assume that natural persons and most of the public sector organisations holding properties generate and consume a higher amount of local government spending than their actual contribution to the budget. Natural persons have often no other liability than the property tax, while many public sector organisations are exempted from the tax on buildings and land. In contrast, private companies that are owners of land and buildings and additionally subject to IPA realise a negative net fiscal benefit, contributing more to the budget than what they receive out of it in terms of public services. However, for lack of analytical data, the hypothesis cannot be verified.

6.2.4 Other taxes The last category includes the former council taxes (in force until the end of 1992), the communal tax on enterprises, and the tourism tax levied on non-residents based on the duration of their stay in the jurisdiction.

The council taxes were no genuine local taxes, as the central planning authority dictated rates, base and all other parameters. Yet, they counted as the most important source of local own revenues in the first years of transition when the new system of local taxes was not yet fully operational.

Upon their introduction, both the communal tax on enterprises and the tourism tax on non-residents became moderately important revenue sources, together contributing 6 to 10 per cent to the overall local tax revenues every year between 1991 and 1994. By 2006, however, their share dropped to 0.3 and 1.0 per cent respectively, as they gave way to more productive taxes on business turnover and property. This trend is not necessarily deplorable. Enterprises pay the communal tax in function of the size of their staff, which discourages the creation of new jobs. As for the tourism tax, the spatial distribution of the tax base is uneven and local governments can do hardly anything to improve their potential with regard to this revenue category.

6.2.5 Some major constraints on local tax autonomy Speaking in terms of constraints as proposed in Section 3.4.3, we can observe relatively wide formal tax autonomy at the local level (the number and scope of direct legal constraints being limited), paired with a low effective autonomy due to various factors.

1. Subnational revenue effort is comparably weak for three reasons. First, the central government and the social security funds receive the major part of public revenues and leave little room for the decentralised governments to levy additional taxes in their jurisdiction (this is what we called the ‘fiscal crowding-out’ effect in Section 3.4.3). Table 6.7 shows the relative shares of tax resources attributed to the various sub-sectors of general government in 2005 in a selection of unitary countries in Europe. The figures presented in the column ‘subcentral government’ also include the relevant parts from revenue sharing between levels of government, which suggests that the proportion of own taxes, i.e. the part over which SNGs have power to vary the rate or base, is even smaller. With only 6.2 per cent of the general government tax revenues attributed to SNGs, Hungary is far below the average of the sample and fits into the range of the most centralised countries

such as Ireland, Greece, or Portugal. Second, as the share of own revenues in the local budget is small, even a substantial relative increase in the share of local taxes within general government taxes has only a moderate effect on the revenue situation of the municipality. For local policymakers, there is no point in assuming the political consequences of a tax increase if it can only moderately contribute to the planned improvements in service provision (Fox, 2004). Third, local governments fear (not without any reason) that the central government would reduce the volume of grants and transfers in response to an increase of local tax levels (Fox, 2004). A particular case in point is the fear of losing eligibility for the deficit grant.

2. Most of the taxes assigned to the local level are not sufficiently productive. In 2006, three out of five taxes (the land tax, the communal taxes and the tourism tax) contributed each less than 0.3 per cent to the total GFS revenues, while the building tax and the IPA brought in 1.6 and 12.5 per cent, respectively (data from the Ministry of Finance).
3. A third reason for a low level of effective tax autonomy in Hungary is the poor demographic and socio-economic situation of several local communities.

DAVEY and PÉTERI (2004b, p. 217 f.) find that the current level of local taxation in Hungary is unsatisfactory for both fiscal and accountability reasons. As the fiscal argument goes, local governments have been long time subject to a fiscal squeeze (notably during the 1990s) and it is time for them to exploit their full tax potential as well as for the central government to grant them additional formal taxing powers. According to the accountability argument, local authorities do not feel committed to raising the revenues they spend. Both the quality and the efficiency of local financial management could be improved if local decision-makers were forced to take tough decisions on revenue generation and assume responsibility vis-a-vis the taxpayers. The accountability argument does not call for an increase in the overall level of taxation but rather a shift in the relative shares of tax room occupied by the centre and the local governments.

Table 6.7: Attribution of tax revenues to sub-sectors of general government as percentage of total tax revenue, 2005 [Source: OECD (2007b, p. 28)]

	Supranational organisations	Central government	Subcentral government	Social Security Funds
Czech Republic	0.5	41.5	15.1	42.9
Denmark	0.4	64.4	33.0	2.2
Finland	0.2	53.9	20.7	25.2
France	0.6	40.1	11.5	47.9
Greece	0.9	63.8	0.8	34.5
Hungary	0.3	62.9	6.3	30.5
Ireland	0.4	84.9	2.1	12.6
Italy	0.3	52.3	16.6	30.8
Luxembourg	0.5	67.7	4.5	27.3
Netherlands	1.1	61.1	3.9	33.9
Poland	0.0	48.6	11.4	39.7
Portugal	0.0	60.1	6.2 ^e	33.7
Slovak Republic	0.4	49.3	11.3	39.1
Spain	0.4	36.5	30.2	32.8
Sweden	0.6	56.4	32.2	11.2
Turkey	0.0	69.9	7.6	22.4
United Kingdom	1.0	75.4	4.8	18.8
<i>Unweighted average</i>	0.4	58.2	12.8	28.6

^e estimated by the OECD Secretariat.

6.2.6 Attempts to improve the system of local taxes

Having recognised the immanent weaknesses of the system of local government taxes, the central government has been considering various reform options since 2003. Some of these aim to neutralise the adverse effects of certain taxes without too much attention to how this would affect local revenue autonomy. The proposed introduction of an additional compulsory IPA allowance for durable increases in workforce, as a measure to encourage employment, is but one example. Other proposals intend explicitly to enhance local revenue autonomy, such as the elimination of the tax rate ceilings or the right to deviate +50 per cent from the upper ceiling. While there are no systematic and readily accessible data on the tax categories, deductions and rates applied by the individual municipalities in the period under review, sporadic information¹⁰ suggests that many local governments have not yet exploited the maximum potential in local taxation.

This might be a reason why the more recent wave of discussions focuses more on the possible abolition of the economically harmful IPA and the optimal compensation mechanism. Given the dominance of the IPA in most local government budgets, the way this revenue source is compensated will have a crucial impact on the fiscal autonomy of municipalities. Increasing the local revenue share from the centrally collected personal income tax or the withholding tax, as proposed by the Tax Reform Committee of the Ministry of Finance in spring 2005, could provide municipalities with additional block grants but reduce their influence on the volume of revenues. However, it is not yet clear whether the new rule on revenue sharing would be anchored in the ALG or another statutory law or merely in the annual Budget Act. Local surcharge on any of the centralised income taxes has been proposed as another solution to compensate the lost IPA; however, such a surcharge would possibly be even more sensitive to business cycles than the current IPA (BIRD, 2003, p. 700). Finally, an independent local tax on corporate income or wealth would not resolve the problem of interjurisdictional disparities, and the profit tax in particular would not be immune to equity problems (see footnote 8 on page 263). A full deductibility of the IPA from the national corporate income tax has been so far the only proposal that could have neutralised the adverse effects on investment and employment while leaving local revenue autonomy intact, but in the end it has not been elaborated.

The Convergence Programme 2006–2010 (GOVERNMENT OF THE REPUBLIC OF HUNGARY, 2006) envisages the introduction of a compulsory value-based local property tax on residential buildings, offices and land from 2008. The aim is to

¹⁰See e.g. MINISTRY OF FINANCE (2007).

promote investment and job creation and to replace a part of the IPA as well as the totality of the area-based taxes on buildings and land and the so-called communal taxes. The reform idea has been softened in the meantime: the value-based taxation would be optional and not start before 2009.

The share of local tax revenue to general government tax revenue in Hungary is far below the average of the sample of unitary countries (6 per cent in Hungary, compared to 13 per cent in the OECD sample; see OECD, 2007a, p. 92). Yet, enhancing local taxing powers does not seem to be the most important objective of the reform of local taxation, perhaps because the formal powers are already wide enough. The cause of the low level of effective taxation is related to the way municipalities make use of their formal taxing powers. Indeed, most of them seem to make use of their room for manoeuvre by setting tax rates lower and tax reliefs higher than the respective limits fixed by the law. Yet, while the upper limits on tax rates are reasonable insofar as they permit to minimise disparities, the lower limits on tax reliefs and their frequent amendments are an unnecessary encroachment upon local autonomy. Moreover, regarding the subnational sector as a whole, the reason why counties are prohibited from raising any taxes in spite of their growing expenditure responsibilities is unclear.

6.3 Non-tax revenues

6.3.1 Overview Subnational governments in Hungary are allowed to collect the following types of non-tax revenues:

- revenues from the operation of public service facilities (user charges, administrative fees, sales of products and services, etc.; administrative fees correspond to row 3 in Table 6.2);
- interests received (row 4 in Table 6.2);
- VAT returned;
- revenues from entrepreneurial activities (profit, dividends, etc.);
- rental fees, leasing and concession fees;
- fines (related to the protection of the environment, monuments, traffic, etc.);
- donations (especially to schools and social service facilities).

In 2006, municipalities earned 13.3 per cent of their total GFS revenues from non-tax revenues, while the same sources accounted for 7.9 and 21.7 per cent of the respective aggregate budget of micro-regions and counties (data from the Ministry of Finance). As counties latter have no taxing powers, non-tax revenues are their only source of current own revenues. The actual collections are significantly higher in both categories of local governments, but the massive outsourcing of local public services to the private and non-profit sectors makes that much of the non-tax revenue (particularly user charges) collected in a jurisdiction is landing on the accounts of service providers. Currently, there are only vague estimations about the overall amount of such off-budget revenues (Hegedús 2004).¹¹ Official statistics are silent about the amount of user charges collected by local governments, which is also a reason why they do not appear on a separate row in Table 6.2.

6.3.2 User charges Depending on the type of non-tax revenue, the autonomy of local governments is subject to various constraints. With regard to user charges, the legal constraints apply directly to the service provider that may also be the local government itself. In public education, health care and social services, the level of user charges is mainly determined in the corresponding sector-specific law and line ministry decrees (based on the Act LXXXVII of 1990 on Price Setting). In other policy areas such as drinking water supply, sewage and waste management, the law describes in detail how providers should calculate the level of user charges. In the case of outsourcing, the municipal executive is free to approve or reject the providers' calculations, but it seldom has sufficient capacity to check these for correctness, so that the level of the user charge is ultimately determined through political negotiations characterised by asymmetric information in favour of the provider. Mayors who find that the proposed price is politically unacceptable are sometimes ready to pay the difference out of the municipal budget instead of continuing the negotiations, as is typical of the domain of public transport. In yet other policy areas (use of public space, parking regulations, etc.), price setting is at the full discretion of the provider although he is obliged to consult the municipal executive (HEGEDŰS, 2004).

Officially, the central government justifies its intervention in the field of user charges with equity arguments, but in reality, the underlying reason has more to do with efficiency than with equity. Recent observations show that despite of the existing legal regulations on price setting, there are remarkable interregional disparities in the levels of user charges in some policy areas. A part of these

¹¹In the terminology of the IMF Government Finance Statistics, this term corresponds to 'revenues from quasi-governmental operations'.

disparities are due to the geographical differentiation entailed in the relevant legal acts, another part may be explained with variations in the operational efficiency of network infrastructures, while a third part is due to differences among local governments in the extent to which they exploit their autonomy. The difference in the price of one cubic metre of drinking water between the lowest and the highest charging jurisdiction is about sevenfold. The variance of sewage charges is even higher (HARGITAI, 2006). Taxpayers can do nothing about the fact that the soil is more sensitive, or water purification is more expensive, in a geographical area than elsewhere. For such 'equity' considerations, the central government decided in July 2006 to harmonise the method of price calculation across providers in the drinking water and sewage sectors. In fact, however, the harmonised calculation method allows citizens to compare the prices across the various jurisdictions, and hence it facilitates a horizontal benchmarking between service providers, which ultimately promotes efficiency in service provision.

Local authorities could certainly make a better use of their formal powers and increase their revenues from user charges if they revised the actual rates and improved collections. DAVEY and PÉTERI (2004a, p. 136) argue that such measures would have no impact on the financial situation of municipalities, since the marginal revenue would flow (in the case of outsourcing) into the budget of the service provider instead of the municipal budget. This argumentation might seem plausible at first sight but it is hard to defend in the context of a holistic budget. While it is true that the additional user charges collected on outsourced services accrue directly to the service provider and not to the municipality, they allow the latter to reduce the volume of subsidies paid to the provider in order to help balance his budget (with drinking water prices kept artificially low, hardly any waterworks can break even). Moreover, since the amount of user charges should correspond exactly to the costs of service provision (wherever the law prescribes cost recovery levels and prohibits profit making), it is anyway an illusion to expect user charges to produce a revenue surplus.

Even if adjusting user fees to cost recovery level would make sense from an economic point of view, political and strategic considerations work in the opposite direction and impose serious endogenous constraints on revenue autonomy. Unlike service providers, local governments assume ultimate responsibility for the user charge levels by virtue of their right to approve or reject the providers' proposals. Several municipalities keep user charges below the cost recovery level in order to avoid confrontation with the local electorate. In order to compensate the provider for the revenue loss resulting from such policy, they often subsidise the entrepreneurial activities (those unrelated to the public service) pursued by

274 the latter. By doing so, they sometimes engage themselves in risky ventures that jeopardise the balance of the public budget.

Local governments also tend to charge lower prices to households than to businesses, which is fully in line with the providers' interest, since it is easier to collect fees from organisations than from individuals. Moreover, strategic horizontal interactions have been observed among holiday resorts situated around the Lake Balaton. Many of them have stopped charging entrance fees in public open-air baths and have even granted clients free use of the surrounding parking places and bicycle racks. The underlying idea is to attract tourists in order to boost the turnover of nearby hotels, restaurants and shops that would in turn pay a higher amount of business tax to the municipality while reinforcing their own market position against competitors in other holiday resorts. Whatever smart this tactics might appear, it is questionable from the perspective of allocational efficiency because it implies a shift of the tax burden from the beneficiaries of a public service to the entrepreneurial sector. This is against the spirit of the fiscal equivalence principle according to which the groups of taxpayers, beneficiaries and decision-makers should overlap as far as possible. From the point of view of autonomy, the only concern is about the vicious circle of fiscal competition: the more a municipality engages in the race to the bottom, the more limited its room for manoeuvre with regard to the realisation of local expenditure programmes.

6.3.3 Revenues from entrepreneurial activities, rental, leasing and concession

Local governments may also raise revenues through entrepreneurial activities (profit, dividend) as well as through renting public assets (e.g. leasing and concession fees). According to art. 82 para. 1/b of the ALG, these are part of the own revenues of local governments and are not subject to any legal restriction. However, because much of this revenue is raised and managed by off-budget entities contracted for service delivery, only a fragment of it appears on the accounts of municipalities (row 1 in Table 6.2). Between 1991 and 2000, local governments took over, established, or invested in, about 1,200 limited or joint-stock companies providing fee-based or market services (e.g. in manufacturing and agricultural production), and set up another 400 off-budget entities offering non-profit services such as public libraries, social services, road and park maintenance (KOPÁNYI and HERTELENDY, 2004, p. 339 f.). In several municipalities, the amount of off-budget revenues may even exceed that of the on-budget revenues. Moving activities back and forth between the two categories has become a key policy instrument (HEGEDŰS, 2004, p. 335). Since business entities are not part of the general government, their operations do not appear in the

government finance statistics. In 2002, on-budget revenues from dividends and concession fees (and possibly other categories of entrepreneurial revenue that the statistics do not mention explicitly) amounted to HUF 11.1 million for the entire local government sector, which corresponds to 0.6 per cent of the aggregate GFS revenues realised at the local level in that same year (MINISTRY OF THE INTERIOR, 2003).

One risk factor concerning the role of the local government as entrepreneur is the fact that enterprises may go bankrupt, with potentially grave consequences for the local government as a public entity charged with responsibility for the welfare of the local community. While several large towns may internally have elaborated a rating system to assess the risk of such ventures as well as a set of measures to address bankruptcy situations, the overwhelming majority of municipalities presumably lack these sorts of rating instruments and emergency plans.

6.3.4 Fines Local governments may impose fines on private and legal persons as a penalty for minor offences against the law in all those cases that have not been explicitly delegated to another public authority. These are regulated in the Act LXXIX of 1999 on Offences and the Government Decree no. 218 of 1999 (28 December) on Specific Offences. Data on fines are not collected systematically for the aggregate local government sector. Therefore, this revenue item does not appear on a separate row in Table 6.2; it is nevertheless included in the current own-source revenues in row 1. According to the data of the Ministry of the Interior for 2004, local governments imposed a fine in 50,194 cases, whereby towns resorted to this measure about four times as often as rural settlements did, probably because there is a similar difference in the number of the offences. This proportion is also reflected in the resulting revenues: while villages collected ‘only’ about 97 million forints in fines, towns realised more than 430 million (corresponding to less than 0.1 per cent of the respective total amounts of GFS revenues). There is no significant difference in the average amount of fine, however: this was 9,055 forints in rural settlements, 10,892 forints in urban areas, whereas art. 16 para. 2 of the Act LXXIX of 1999 allows a maximum of 30,000 forints for breaches explicitly regulated in a local government decree. Already in 1996, the Ministry of the Interior deplored the overly indulgent behaviour of local governments towards breaches against the law. In 1995, the average fine amounted to roughly 2,600 forints (compared to the legal maximum that was 10,000 forints at that time), and one-third of the procedures were cancelled (ÖN-KOR-KÉP, 1996). While setting fines within the legal limits is a genuine local affair, low penalties have implications not only for social justice but

276 also for the overall local budget, since a part of the local revenue potential remains unused.

6.4 Revenues from property

The last category of local own-source revenues consists of capital revenues resulting from the sales of tangible and intangible assets, shares and public enterprises, as well as certain compensation payments from within and outside the central budget.

In 2006, revenues from property (row 10 in Table 6.2) amounted to 320,233 million forints at current prices, or 12.2 per cent of the total GFS revenues of the overall local government sector (data from the Ministry of Finance; see also Figure 6.2). There are remarkable differences in the revenue potential of the various categories of local government. Throughout the 1990s, capital revenues accounted for 18 to 20 per cent of the budgets of capital districts, while they were a much less reliable source for the capital city where their budget share fluctuated between 6.2 and 27.4 per cent. Towns and villages could ensure about 8 to 11 per cent of their budgets from this source on a yearly average.

While revenues from the sale of land, tangible and intangible assets (row 11 in Table 6.2) as well as compensation payments from outside the state budget (row 15) were relatively stable throughout the period under review, the other categories showed more dynamics. The privatisation of former state-owned assets (sale of shares and enterprises, rows 12 and 13) yielded abundantly during the 1990s and permitted the realisation of many an investment programme (and in some cases also the reduction of the operational deficit), but revenues from this source declined rapidly once the most valuable items had been sold (see Figure 6.6). The increase in the volume of compensation payments from the central budget (row 14) has two reasons. First, as a compensation for the gas distribution companies that the central government had privatised on its own initiative between 1993 and 1995, about 630 local governments received shares of public companies at a total face value of 62 billion forints. Second, local governments were compensated in a similar form in 2000 for the value of urban lands used by privatised enterprises. The available data (sale of shares in 1997 and 2000, row 12) suggest that they sold the shares almost immediately in order to finance some planned investments, or at least they transformed them into other financial assets.

Finally, the grants for infrastructure development from Brussels (row 16) appeared simultaneously with Hungary's accession to the European Union (EU) and rose rapidly in the subsequent years. Classifying the EU development grants under

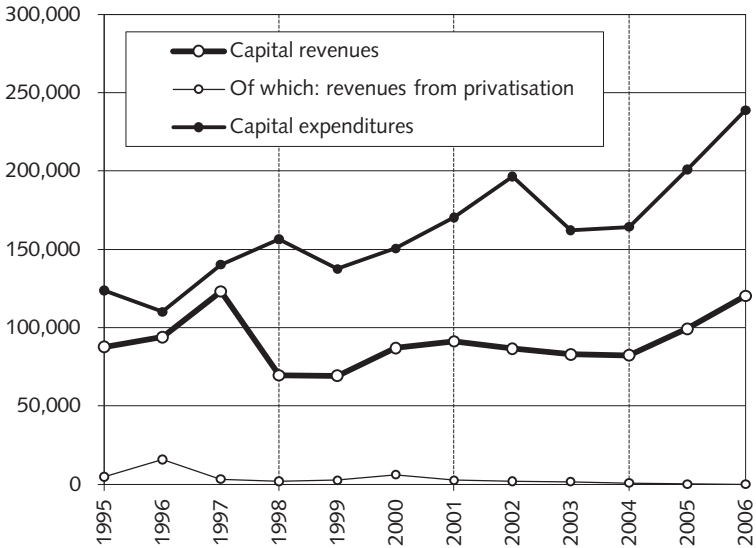


Figure 6.6: Capital revenues and expenditures of municipalities 1995–2006 at constant prices (base year = 1995, million HUF) [Source: the author, based on data from the Ministry of Finance]

278 capital revenues (instead of intergovernmental grants; row 17 in Table 6.2), was a deliberate choice of the central government.

While capital expenditures accounted for 17 to 23 per cent of the total expenditures of municipalities between 1995 and 2006, capital revenues contributed merely 9 to 13 per cent to the overall budget. As Figure 6.6 shows for the municipal sector as a whole, revenues from property grow at a slower pace than capital expenditures do, which exacerbates the initial imbalance of the local 'capital budget'. This phenomenon could be worrying if the decentralised finance system did not follow the principle of a unified budget presented in Section 6.1.2. However, thank to this principle, local governments may freely combine recurrent revenues with capital revenues to finance any type of expenditure item. Indeed, the explanatory report to Act CXXVIII of 2007 on the Implementation of the Budget of the Year 2006 of the Republic of Hungary confirms that local governments increasingly rely on current revenues for financing their investment programmes.

Figure 6.6 shows also how the importance of privatisation revenues decreased over the years as municipalities sold out of their most valuable assets. After the sale of municipal enterprises (which local governments did mainly in the hope to improve service quality, not to generate additional revenues), the only type of asset that remains to be sold is real estates. These are, however, limited. BALÁS and HEGEDŰS (2004, p. 105 f.) warn that with the sale of real estates, local authorities could lose those assets that they use mainly as collaterals for loans, which may be a hindrance to future borrowing.

6.5 Shared revenues

6.5.1 Overview Having started with only one tax category (personal income tax) and one favoured level of subnational government (municipalities) in 1990, the legislative continuously enlarged and refined the system of revenue sharing during the subsequent years in order to accommodate various policy interests and to adapt revenue flows to the needs of the different groups of SNGs. In 2006, shared revenues (row 5 in Table 6.2) accounted for 17.5 per cent of the municipal budget (total GFS revenues) already, compared to 15.8 per cent in 2000 and 13.5 per cent in 1995 (data from the Ministry of Finance).

Efforts to improve the system made the distribution formulae increasingly complex throughout the years. Administrative simplicity and predictability were sacrificed for more equity. Table 6.8 shows the development of revenue sharing

from 1990 to 2007. Columns 3 to 6 contain effective rates calculated by the author in order to render the sophisticated legal rules operational and comparable throughout the period.

Table 6.9 shows the importance of revenue sharing for the municipal level in monetary terms.¹² The four tax categories—personal income tax, motor vehicle tax, tax on agricultural land rent, and luxury tax—taken together, shared revenues account for about one-sixth of the overall budget of the local public sector. Their importance grew from 13.5 per cent in 1995 to 19.8 per cent in 2004 and slightly decreased in the following two years. Together with grants and transfers (row 17 in Table 6.2), they provide about 55 to 65 per cent of local GFS revenues (data from the Ministry of Finance).

6.5.2 Share of the personal income tax In 1990, at the introduction of the resource-oriented model of revenue assignment, the entire revenue from the personal income tax (PIT) was returned to the municipalities on a derivation basis. For this reason, the PIT originally figured among the own-source revenues in the local government accounts. In the following four years, the total subnational share of PIT declined gradually to 30 per cent before it took an upward turn in 1995 to reach 40 per cent by 1998. Regardless of the upward trend in the overall share, the percentage returned to the municipalities on derivation basis started to sink simultaneously and never reached the level of 1994 (30 per cent) again (row 6 in Table 6.2).

The exclusively derivation-based revenue sharing was undoubtedly cost-efficient but, together with another buoyant revenue source, the IPA, it produced serious horizontal fiscal disparities during its five-year regime. Besides, the enactment of pre-primary and primary education and social care as mandatory tasks of local governments necessitated a major increase in the level of norm-based grants (see Section 6.6.2); this was financed through a decrease of the derivation-based

¹²A numerical example may be helpful at this point. According to art. 22 of the Act CXXXIII of 2000 on the Budget of the Republic of Hungary for the Year 2001, SNGs together are entitled to 40 per cent, or 286,536 million forints, of the personal income tax (PIT) collected in 1999. This amount is redistributed as follows: (1) every municipality receives back 5 per cent of the PIT that the national tax authority collected in its jurisdiction (derivation-based distribution); this adds up to HUF 35,817 million. (2) Another 28.05 per cent of the national PIT collections, or HUF 200,948 million, are redistributed in the so-called 'normative' way. This means: (2.1) HUF 14,500 million are transferred to the counties as PIT revenue share (Annex 4, point 2, of the Budget Act); and (2.2) HUF 186,448 million are redistributed among all SNGs in the framework of the system of norm-based grants (Annex 3; Annex 8, points I–IV). Finally, (3), 6.95 per cent, or HUF 49,771 million, serve to feed the system of municipal revenue equalisation (Annex 4, point 1). Minor changes in the effective figures (at year-end) are possible.

Table 6.8: The development of the revenue sharing system between 1990 and 2007 [Source: the author, based on the national Budget Acts of the period 1990–2006]

Year	Personal income tax ¹	Motor vehicle tax	Tax on agr. land rent	Luxury tax				
	Overall SNG share (%)	of which	Share returned to municipalities on a derivation basis (%) ⁴					
	2	3	4	5				
		returned to municipalities on a derivation basis	distributed according to "norms"	distributed among all countries on a per capita basis				
			distributed among all SNGs as norm-based grants ²	distributed among municipalities ³				
				revenue equalisation				
				among municipalities ³				
				6				
				7				
				8				
				9				
1990	100.0	100.0	-	-	-	-	-	-
1991	50.0	50.0	-	-	-	-	-	-
1992	50.0	50.0	-	-	-	50+	-	-
1993	30.0	30.0	-	-	-	50+	-	-
1994	30.0	30.0	-	-	-	50+	-	-
1995	35.0	29.8	0.3	4.4	0.5	50+	-	-
1996	36.0	25.0	1.0	6.5	3.5	50+	-	-
1997	38.0	22.0	1.8	8.8	5.3	50+	-	-

1998	40.0	20.0	2.1	10.4	7.5	50+	100	100	-
1999	40.0	15.0	2.3	15.1	7.6	50+	100	100	-
2000	40.0	5.0	2.0	25.8	7.2	50+	100	100	-
2001	40.0	5.0	2.0	26.0	7.0	50+	100	100	-
2002	40.0	5.0	2.0	26.5	6.6	50+	100	100	-
2003	40.0	10.0	2.3	19.8	7.9	100	100	100	-
2004	40.0	10.0	2.1	20.0	7.9	100	100	100	-
2005	40.0	10.0	1.7	20.0	8.3	100	100	100	-
2006	40.0	10.0	1.9	19.7	8.5	100	100	100	100
2007	40.0	8.0	1.0	22.8	8.3	100	100	100	100

¹ Any discrepancies in the totals are from rounding figures to the nearest whole number.

² From 1997, figures include grants for municipalities lagging behind.

³ From 1990 to 1994, municipalities with a low (derivation-based) PIT share were entitled to a so-called PIT supplement financed from outside the PIT revenue pool. 1995: mixed financing. 1996-1998: PIT supplements are financed from the PIT revenue pool. 1999: PIT supplements are replaced by indirect revenue equalisation.

⁴ From 1990 to 2002, the share of the motor vehicle tax amounted to 50 per cent of the minimum tax receipt (calculated at the lowest possible rate) plus 100% of any additional tax receipt accruing to the local government from the voluntary application of a higher rate.

282 PIT share from 100 to 50 per cent in 1991. Two years later, the new expenditure responsibilities defined in Act III of 1993 on Social Administration and Social Services necessitated a similar action, which made the derivation-based PIT share melt from 50 to 30 per cent. However, these instances of internal reallocation of the PIT revenues were not completely transparent; neither the annual Budget Acts of 1991 to 1994 nor any other law mentioned them explicitly.

A major change came in 1995, when for the first time, PIT revenues were divided into three segments: one part was returned to municipalities on a derivation basis, another part was distributed among SNGs according to various service-specific formulae (the so-called ‘norms’, see Section 6.6.2) and a third part according to fiscal capacity indicators. In the revised system, also counties can benefit from the national PIT collections, albeit to a much lesser extent than municipalities.

The PIT revenue share is one of the major pillars of the municipal budget and, by virtue of its unconditional character, it is a key component of local revenue autonomy. However, since both the overall revenue share and its distribution among SNGs are anchored in the Budget Act and hence subject to annual changes, any attempt of local governments to plan their revenue flows for several years in advance is doomed to failure. Its poor predictability makes the PIT revenue share an important but not fully reliable element of local autonomy. Moreover, for technical reasons, municipal PIT shares are calculated from the PIT revenues that had been collected two years earlier. Because of the inflation, this time lag produces substantial revenue losses for local governments in real terms.

The other three tax categories that are subject to revenue sharing—vehicle tax, tax on land rent, and luxury tax—are collected and administered by the municipalities. The reason why they figure under shared revenues is that the municipalities cannot influence their parameters such as rate, base and exemptions: all of these are determined by the national legislation.

6.5.3 Share of the motor vehicle tax At its introduction in 1992, the motor vehicle tax (row 7 in Table 6.2) was based on the weight of cars, buses, trucks, and other road vehicles with an engine, while a lump-sum tax applied to motorcycles, trailers, caravans and campers.¹³ Local governments were allowed to keep 50 per cent of the collected revenues; the rest had to be transferred to the central tax authority. The Act LXXXII of 1991 on Motor Vehicle Tax also established the applicable rates from which the local governments

¹³From 01.01.2007, the motor vehicle tax has been based on the age and performance (in kW) of the vehicle. Motorcycles are no longer exempted (art. 92–98 of the Act LXI of 2006 on the Amendment of Selected Financial Laws).

Table 6.9: The importance of revenue sharing for the local budget, 1990–2006
[Source: Ministry of Finance]

Year	Shared revenues accruing to local governments at current prices (million HUF)					Shared revenues within total GFS revenues (%)
	Personal income tax	Motor vehicle tax	Tax on land rent	Luxury tax	Total	
1	2	3	4	5	6	7
1990	70,894	–	–	–	70,894	n.a.
1991	47,019	–	–	–	47,019	n.a.
1992	62,986	2,331	–	–	65,317	n.a.
1993	48,953	2,480	–	–	51,433	n.a.
1994	61,298	2,465	–	–	63,763	n.a.
1995	92,944	2,472	–	–	95,416	13.5
1996	98,780	7,056	–	–	105,836	12.6
1997	126,006	7,910	–	–	133,916	12.8
1998	169,590	8,842	125	–	178,557	15.4
1999	180,091	11,444	1,632	–	193,167	14.8
2000	210,239	12,622	2,157	–	225,018	15.8
2001	247,672	14,062	2,424	–	264,158	16.0
2002	288,368	14,584	2,550	–	305,502	16.2
2003	366,253	30,009	1,456	–	397,718	18.6
2004	406,899	45,941	289	–	453,129	19.8
2005	391,573	49,177	194	–	440,943	17.8
2006	406,919	51,266	167	104	458,456	17.5

Revenues are shown not as budgeted but as effectively realised.

n.a.: impossible to calculate because of the missing data on municipal GFS revenues.

284 could not deviate before the amendment of the law in 1995.¹⁴ Starting from that year, they were allowed to retain 50 per cent of the minimum revenue (based on the rate figuring in the national law) and the whole of what had been collected additionally, due to higher local rates. Another major change occurred in 2003 when municipalities were allowed for the first time to keep 100 per cent of the revenues.¹⁵ Thus, in practical terms, the motor vehicle tax has been removed from the system of revenue sharing and transformed into a genuine local tax, even though local governments cannot yet influence any other tax parameter than the rate. Revenues from this source are constantly growing, although this trend is more solid in urban areas because of the higher number of registered vehicles. Thus, while the motor vehicle tax, and particularly the two reforms mentioned above, enhances the revenue autonomy of local governments, it also contributes to growing disparities among the jurisdictions, although by far not as much as the IPA or the PIT do.

6.5.4 Tax on agricultural land rent The taxation of income that private and legal persons derive from the rental of agricultural land (row 9 in Table 6.2) is regulated in art. 74 of the Act CXVII of 1995 on Personal Income Tax and is thus part of the PIT regime. Initially designed to feed the central budget, all revenues of the tax on land rent were returned to the collecting municipalities from 1998. However, the tax parameters such as base, rate (25 per cent) and exemptions continue to be determined by the PIT legislation. After a steady growth to 2.5 billion forints in 2002 (which made still only 0.14 per cent of total GFS revenues) for the local public sector as a whole, revenues from this source suddenly dropped without any change in the legislation.

6.5.5 Luxury tax With the Act CXXI of 2005 on Luxury Tax, a new local tax category (row 8 in Table 6.2) appeared on 1 January 2006, hitting private residential buildings of a market value of above 100 million forints (the rate is 0.5 per cent on the value exceeding this limit). This measure is revolutionary insofar as it is the first nationwide experiment with value-based property taxation at subnational level. The law determines the valuation guidelines and sets minimum and maximum values for each type of municipality in each county, but local governments have still some room for manoeuvre in the assessment. The only

¹⁴Act XCVIII of 1995 concerning the Amendment of Act C of 1990 on Local Taxes and Act LXXXII of 1991 on Motor Vehicle Tax.

¹⁵Art. 21 para. 1 of the Act LXII of 2002 on the Budget of the Republic of Hungary for the Year 2003.

blemish on this otherwise equitable regime is that every municipality is obliged to introduce and administer the luxury tax, which makes it a sort of a ‘deconcentrated tax’. In the first year of application, the luxury tax yielded only 104 million forints, significantly less than expected, due to the low number of luxury villas over the country and the proliferating practice of tax avoidance. The owner can easily escape the tax by transforming a large villa into a condominium or by making it over to his own enterprise.

6.6 Intergovernmental grants and transfers

6.6.1 Overview The Hungarian public finance terminology makes a distinction between intergovernmental grants (‘state contributions and subsidies’, *állami hozzájárulások és támogatások*; row 17 of Table 6.2) and flow-through transfers (‘transfers within the public budget’, *államháztartáson belüli átutalások*; row 26). Although these categories do not have any exact definition in the literature, the subordinated revenue items (rows 18 to 25 and 27 to 30, respectively) suggest the difference in the contents.

Grants are direct contributions from the national budget to the costs of the mandatory and optional responsibilities of subnational governments. Since its complete renewal in 1990, the grant system has become extremely complicated. Grants are manifold and arrive through various channels from the central budget. Although most of them are still unconditional, the period under review witnessed a light shift towards project-oriented, conditional (matching) grants. Whether general or conditional, grants have to be used appropriately. Using operational grants for debt repayment is forbidden. Local governments are accountable for all their expenditures financed by grants and are obliged to return inappropriately used or wrongfully accepted grants (including interests) to the national budget. For each grant fund, the available pool is determined every year in the Budget Act. Today, four major categories of grants can be distinguished: norm- (or formula-) based grants, centralised appropriations, investment grants, and deficit grants (*önhiki*). Although the central government has an explicit fiscal equalisation policy, there is no distinct fund for this purpose. Rather, allotments in virtually every grant category are differentiated according to the needs and/or the revenue capacity of local governments. PIT revenue shares and norm-based grants play a crucial role in channelling equalisation transfers to the neediest municipalities.

286 **6.6.2 Norm-based grants** With a share of about 21 per cent of total GFS revenues and more than 70 per cent of the total volume of intergovernmental grants in 2006), norm-based grants (*normatív támogatások*; rows 18 and 19 in Table 6.2) constitute one of the main pillars of the decentralised revenue system. The underlying idea is to compensate subnational governments for the respect of minimum standards set by the legislative in the various domains of mandatory public services. These non-matching grants are thus supposed to finance at least a part of the local current expenditures. They cover virtually the entire range of local service responsibilities.

About four fifths of the total amount of norm-based grants are unconditional (general-purpose) grants (row 18 in Table 6.2), while the rest is conditional (earmarked; row 19). Yet it is common to both types of norm-based grants that they are at least nominally supposed to be spent on a target expenditure area, even though receivers of general norm-based grants are allowed to use the amount as they like. Another common characteristic of norm-based grants is that their distribution is based on formulae ('norms') that may involve the population size, the number of beneficiaries, or other output indicators relevant to the specific type of local public service for which the grant is (nominally) proposed. In some cases, the basic amount of norm-based grant is defined as a band between a minimum and a maximum value; the effective amount is then calculated on the basis of specific needs indicators. Box 6.5 provides three examples of general norm-based grants.

Earmarked norm-based grants (row 19 in Table 6.2) are regulated in a separate annex of the annual budget law, distributed on the basis of service-related output indicators and earmarked for the specific public service to which they are associated. Municipalities providing didactical services for schools (e.g. advanced vocational training for the teaching staff) or municipal public works programmes are among the beneficiaries of this arrangement. Norm-based grant supplements are very similar in scope to some of the centralised appropriations (Section 6.6.4; row 22 in Table 6.2).

In order to account for regional disparities, the central budget provides for a general-purpose supplement to the norm-based grant in order to assist municipalities with low financial capacity. This means that the system of norm-based grants has an equalisation component. This subject will be further elaborated in Section 6.6.3.

The total amount of norm-based grant that the local government receives is the sum of the amounts calculated after each of the 15 to 45 'norms', or service-specific allocation rules, whereas the number of 'norms' depends on the counting method (PÁLNÉ KOVÁCS, 2004, p. 103 ff.; FOX, 2004, p. 152; GURNIK et al., 2005,

p. 10 f.). One of the underlying notions is correspondence: revenues should be provided in accordance with the various types of expenditures provided in each municipality, which is important because a number of services are not provided in all municipalities. Another key notion is equity: norms should be sufficiently differentiated in order to take account of the disparities in the expenditure needs of municipalities. DAVEY and PÉTERI (2004a, p. 139) deplore the proliferation of ‘norms’, however. Indeed, the allocation rules are manifold, complex and rather volatile (changing almost every year), which makes it difficult for local governments to estimate how much they are going to receive from one year to another.¹⁶ The Ministry of Finance (GURNIK et al., 2005) explains the current chaos with the ALG that orders the Parliament to provide for the necessary funding whenever it imposes a new mandatory responsibility to subnational governments.¹⁷ Sector-specific laws (in particular those on public education, social affairs and culture) introducing a multitude of new tasks since 1990 are just as much responsible for the proliferation of norms. Finally, line ministries and lobby organisations in almost every policy area tend to believe that local government executives (enjoying full autonomy with regard to the use of most of the norm-based grants) do not provide sufficient funding to the public service facilities operating in *their* domain. They view thus highly specialised task-related norms as a guarantee of independence of those facilities vis-a-vis the local authority. Regrettably, this prejudice runs against the logics of the resource-oriented revenue regulation and shifts the system towards simple task financing (expenditure orientation).

The principle of correspondence—matching the amount of grant to the volume of mandatory expenditures provided in each municipality—may seem rational at first sight, but in fact, it can dangerously exacerbate the adverse effects of a suboptimal expenditure assignment. The example of social policy shows that norm-based grants, paired with the assignment of tasks according to jurisdiction size, makes large municipalities better endowed in social services and facilities than small ones. It is clear that large settlements have to deal with a greater volume of tasks. However, if we ask *where* the central government has contributed more to an improved access to social services, the answer is clear: in large municipalities that, consequently, dispose (in absolute and relative terms) of a higher amount of resources for the realisation of social policies than do small jurisdictions.

¹⁶For an excellent overview of the amendments made to the system of norm-based grant during the 1990s, see PÁLNÉ KOVÁCS (2004) or FOX (2004).

¹⁷Art. 1 para. 5 ALG, see Box 4.2.

1. General tasks of municipal governments

a) Municipal governance, administration, and sports

Basic amount: HUF 1,400 per capita but not less than HUF 1,500,000 per municipality. Where the number of inhabitants does not reach 500, the basic amount is at least HUF 3,000,000 per village.

This contribution to the fundamental mandatory tasks and services (particularly municipal governance, administration, and sports) is provided to municipal governments on the basis of their population size.

b) Public transport

Basic amount: HUF 515 per capita.

This contribution to the public transport services is provided to municipal governments (except the capital city, its districts, and the counties) in proportion to their population size.

2. Management of residential fluid waste

Basic amount: HUF 100 per m³

This amount is allocated to municipalities that provide fluid waste collection services to residents living in neighbourhoods not connected to the sewage network. Grants are distributed in proportion to the volume of residential fluid waste collected and disposed in officially authorised sites. They are supposed to contribute to the reduction of the average amount of residential user charges.

3. Tasks related to the access to lodging

Basic amount: HUF 1,150 to 2,200 per capita, but not less than HUF 200,000 per municipality.

This amount contributes to financing subventions that municipalities provide to their residents in order to facilitate their access to lodging. Grants are calculated on the basis of the population size and further differentiated according to the endowment of the municipality in social infrastructure and dwellings and to the ratio of dwellings connected to drinking water and sewage pipelines. The distribution formula consists of the following parameters:

- the share of residents aged between 18 and 59 years within the total population (weight = 0.15)
- the share of registered unemployed persons (the average calculated from the monthly labour market statistics of November 2004, February, May, and August 2005) within the total population (weight = 0.30)
- the share of marriages registered in 2003 and 2004 within the total population (weight = 0.10)

- the number of habitable rooms available on 01.01.2005 divided by the total population (weight = 0.05)
- the share of dwellings not connected to the drinking water and sewage network (weight = 0.4).

Moreover, large municipalities also have a better chance to acquire capital development grants for social policy purposes, due to their enhanced capacity to write successful proposals and mobilise own resources for matching purposes (HERPAINÉ MÁRKUS, 2005). Analogous considerations apply to the health care system where only those municipalities are obliged to provide specialised services and, correspondingly, only those municipalities receive the related norm-based grant and apply successfully for investment grants that have ‘inherited’ or established a hospital or an outpatient clinic in their jurisdiction. Both rules of expenditure assignment (based on jurisdiction size and on the availability of facilities, respectively) together with the norm-based grant system seem to be at least in part responsible for the significant horizontal disparities in terms of access to, and quality of, health care and social services described in Section 5.2.4.

The fact that the majority of norm-based grants is not earmarked (although the allocation formula is often linked to certain service-specific indicators) reflects the willingness of the central government to create a flexible revenue system. For some authors (e.g. FOX, 2004, p. 152; PÁLNÉ KOVÁCS, 2004, p. 102), the large number of mandatory responsibilities turns this flexibility into an illusion. In contrast, advocates of certain policy areas may possibly wish to see even more restrictions on the use of norm-based grants. Indeed, grants allocated originally to cover the costs of minor public services are increasingly used for financing more cost-intensive key services such as primary education, thus making the initial idea of a responsibility-based grant allocation more or less hollow. In addition, as PÁLNÉ KOVÁCS (2004) observes, in the absence of monitoring and sanctions, norm-based grants are provided regardless of service quality. However, as long as no conditions apply to the use of the grant, there is no reason to condemn those local governments that disregard the underlying philosophy of a responsibility-based grant allocation and use the amount for another purpose than the one initially envisaged by the designer of the distribution formula.

Somewhat contradicting the flexibility argument, another rule fostering sector neutrality in service provision obliges municipalities providing health and/or social services via outsourcing to cede at least a part of their norm-based grant allotment

290 to the external service delivery agent.¹⁸ Thus, while local governments are normally free to use their general-purpose norm-based grant allotment as they wish, their freedom is restricted in the domains of health and social services as soon as they contract another organisation for service delivery. Such interference with local revenue autonomy seems to go beyond the declared objective of ensuring sector neutrality. Besides, it is not clear why the law should protect non-governmental organisations, churches and private enterprises against potential encroachments (or just dominant behaviour) by local governments. There seems to be no legitimate counter-argument against letting market mechanisms do their job: the compensation of service costs could be (as it is, normally) subject to negotiations and become an integral part of the contract between the municipality and the agent.

In recent years, the relative value of norm-based grants with regard to the actual service costs has sunk rapidly (DAVEY and PÉTERI, 2004a, p. 139). Cost estimates from some municipalities suggest that on average, norm-based grants cover about half of the kindergarten costs and 80 per cent of the secondary school costs Fox (2004, p. 153). On the other hand, norm-based grants are declaredly no cost-reimbursement grants: the values attached to the individual 'norms' are not based on actual expenditures or costs of service delivery. For lack of explicit national rules about the specific minimum characteristics in the delivery of mandatory services, a cost- or expenditure-based norm system is anyway inconceivable. In most expenditure categories, most local governments spend more than just the amount of the norm-based grant. However, it is difficult to say whether they spend more in order to provide superior service levels, or because operational inefficiencies increase the unit cost of service provision.

¹⁸In 2001, art. 126 of the Act III of 1993 on Social Administration and Social Services was completed with the following rule: 'Churches in their function as facility owner that have signed an agreement with the central government are entitled to grants for their basic services in the domain of personal care' (whereby personal care includes all social services except social aid and in-kind assistance; art. 54 of the Act LXXIX of 2001). Two years later, this rule was refined as follows: 'The local government is obliged to pay non-public institutions and churches in their function as facility owner an amount equivalent to the costs of service provision minus revenues from user charges. The source of this payment must be the norm-based grant' (art. 35 of the Act IV of 2003).

6.6.3 Equalisation components in the norm-based grant system

As has been mentioned in the preceding section, the 'norms' also entail differentiation according to the revenue potential of the beneficiary municipalities.

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For the first time in 1995, the central government converted a part of the subnational PIT share into norm-based grants with an equalisation purpose (see column 6 in Table 6.8). The idea was to reduce horizontal disparities arising from the differences in the revenue generation potential that the previous (purely derivation-based) redistribution of the PIT was obviously not able to handle. The contribution of the PIT to the norm-based grant pool grew steadily. By 1997, however, variation in the local business tax (IPA) revenues became even more serious. Besides, the weight of IPA in the overall budget of the local public sector came very close to that of the returned PIT, eventually calling for the elaboration of a horizontal revenue equalisation scheme involving not only the PIT but also the IPA-raising capacity of municipalities. The key indicator of the system, per capita tax capacity (*adóerőképesség*), is calculated as the per capita amount of IPA revenue that a local government can potentially realise by applying the tax rate that corresponds to the effective average. The effective average rate is a sort of a benchmark defined every year in the national Budget Act, based on observations about the IPA rates that municipalities effectively applied during the precedent year. For example, in 2004, the benchmark rate was 1.4 per cent compared to the maximum applicable IPA rate of 2.0 per cent. Another key element of the system is the set of equalisation limits laid down in the annual Budget Act for each category of local government (since 2003, some of the categories have been further differentiated by population size). These equalisation limits mark the minimum levels of endowment that every municipality in the given category should reach after equalisation. The per capita minimum endowment consists of the derivation-based average PIT share and the potentially realisable average IPA revenue, both characteristic of the given category (and size group) of municipality.

In a next step, for each municipality, the sum of the effective derivation-based PIT share and the IPA tax capacity (both expressed per capita, in forints) is compared with the relevant per capita minimum endowment (i.e. the equalisation limits). Those jurisdictions where the sum of the PIT share and the IPA capacity is lower than the minimum endowment are entitled to a grant supplement in the framework of norm-based grants equal to the differential between these two amounts. For those municipalities where the sum of the returnable PIT share and the IPA capacity would exceed the typical minimum endowment in their category, the PIT share and, if necessary, also the allotment of norm-based grants are cut according to a progressive schedule.

The current system of equalisation is horizontal and indirect. It is horizontal because it seeks to attenuate disparities between jurisdictions situated at the same level of government, and because the fund is closed-ended. It is indirect because grant allotments are differentiated according to the financial capacity of the jurisdictions and the nature of their tasks (DAFFLON, 1981, p. 10 f.); in other words: local governments not providing a given public service cannot benefit from the norm-based equalisation supplement offered in addition to the respective norm-based grant. Since 2000, municipalities voluntarily assuming county competences have received a proportionally larger equalisation supplement if they were net beneficiaries, in order to account for their enhanced service responsibilities. Net contributors in a similar position have been allowed to reduce their liability by the amount of marginal expenditure incurred through enhanced public service provision. Following a three-year period in which net contributors could be deprived of up to 100 per cent of the sum of their PIT share and their norm-based grant allotment, in 2003, the grant reduction rate was maximised at 80 per cent. Also since 2003, net contributors have been allowed to reclaim 25 per cent of their contribution in the following year if they invested at least the same amount of own-source revenues in infrastructure development during the fiscal year. Another number of rules apply to the technique of estimating IPA revenues, correcting for wrong estimations, applying the grant reduction schedule and several other features of the system. Rules change rapidly and the rationale behind them is not always straightforward for local financial officers.

Table 6.10 shows the 'gains and losses' of local governments by category for the years 2001 to 2004. Due to its strong revenue raising potential, Budapest is clearly the most important net contributor of the fiscal equalisation system. The final amount of norm-based grant to which it would have been entitled (once all 'norms' have been added up) was cut by 8.6 to 16.8 per cent in the period under review. All the other categories of local government benefit from the system, although the positive figures in the 'Reduction' columns indicate that there are a few net contributors in every category. Not surprisingly, the total benefits calculated for the various categories are inversely related to the size of municipalities belonging to these categories: villages come out as major beneficiaries of the equalisation. Overall, in 2004, merely 81 municipalities (2.6 per cent of the local government sector) were richer than the average, and 60 municipalities (1.9 per cent) were not affected by the equalisation (they did not contribute to the system, nor did they benefit from it). These facts reflect the excessive fragmentation of the territorial administrative structure characterised by a large number of local governments with a wide range of responsibilities but limited revenue capacity (KECSKÉS et al., 2005).

Table 6.10: Grant supplements and reductions by local government category, 2001–2004 (%) [Source: Kecskés et al. (2005)]

Local government category	2001		2002		2003		2004	
	Supple- ment	Reduc- tion	Supple- ment	Reduc- tion	Supple- ment	Reduc- tion	Supple- ment	Reduc- tion
Capital city	0.0	8.6 ¹	0.0	10.5 ¹	0.0	16.8	0.0	15.6
Towns with county rights	4.3	0.7	4.8	0.7	10.9	1.6	9.8	0.9
Other towns	20.2	3.1	22.5	3.4	38.7	3.5	42.4	3.3
Villages	34.0	1.3	38.4	1.3	53.3	1.5	58.5	1.3
Total²	58.5	13.7	65.7	15.9	102.9	23.4	110.7	21.1
Difference financed from the PIT revenue pool		49.8		54.8		79.5		89.6
Number of municipalities affected	2,991	83	3,001	81	3,006	88	3,027	81
Total nb of municipalities affected by the equalisation		3,074		3,082		3,094		3,108

¹ The data on the capital city for 2001 and 2002 include the 5 billions of HUF transferred from the capital government to the capital districts.

² The 5 billion of HUF transferred to the capital districts are excluded from the total.

Between 2001 and 2004, the number of local governments benefiting from revenue equalisation grew constantly. The table also reveals that the central government recycled a growing part of the subnational PIT share in order to cover the difference between the 'savings' made to the national budget through the reduction of norm-based grants in the rich jurisdictions and the additional outlays incurred in favour of the poor jurisdictions (column 6 in Table 6.8). The data suggest that in the four years following 2000, the gap became almost twice as large (HUF 89.6 billion in 2004, compared to HUF 49.8 billion in 2001), although the change is 'only' 1.5-fold if we take account of the inflation during that period.

The system of indirect revenue equalisation provoked various reactions across the municipalities. Particularly in the first few years upon introduction, local governments in the net contributor position vehemently objected to the grant reduction. Box 6.6 reports about the case of Paks. On one hand, it is certainly disputable whether the arguments of producing nationwide spillover benefits and developing local public infrastructure are sufficiently strong for exempting a municipality from playing the game of solidarity. On the other hand, it is just as questionable whether a fiscal equalisation scheme financed by only 2 to 3 per cent of all municipalities is sustainable on the long term.

Another problem is the excessive fragmentation of the resources serving fiscal equalisation. In 2004, for example, the distribution of HUF 58.5 billion provided the roughly 2,800 beneficiary villages a supplement of HUF 21 million per village on average. Even for the smallest rural villages with an average level of HUF 159 million of total GFS revenues, this amount is rather modest, although it marks a relatively high increase (+33 per cent on average) in the level of intergovernmental grants. For towns, the proportions are even lower. It is nevertheless true that, as the central government argues, a good equalisation policy should never discourage the generation of local own revenues. For this reason, the fiscal capacity formula considers only about 60 to 70 per cent of the maximum applicable IPA rate, and the progressive schedule of grant reduction does not concern those jurisdictions whose tax capacity exceeds the respective minimum endowment by 25 per cent or less. The objective is not full equalisation of the revenue situation but merely a reduction of the disparities. The jury is still out on the question about the performance of the fiscal equalisation policy with regard to the stated objective. As long as rules change as frequently as they have done since 1999, the lack of comparable data permits no valid conclusion.

Box 6.6: A net contributor to the fiscal equalisation scheme: Paks

Situated about 120 km to the south of Budapest, the industrial town of Paks (20,426 inhabitants) accommodates the only nuclear power plant of Hungary. Thanks to the steady growth of own-source revenues (HUF 2,528 million in 1998 compared to HUF 575 million in 1992) that offset the inflation and the corresponding decrease in the real value of central government grants, Paks was able to maintain a stable financial position throughout the 1990s.

The introduction of the new revenue equalisation scheme in 1999 led to a sudden decline in Paks' revenues. While in 1999, the municipality received back a PIT share of HUF 282.4 million following the principle of origin (accounting for 8.2 per cent of its GFS revenues), in 2000, it not only had to renounce his claim but its overall grant allotment was curtailed by further HUF 243.6 million (Bor, 2000). In consequence, the sum of norm-based grants and the derivation-based PIT revenue share (HUF 536 million) fell almost to the level of 1992 (HUF 497 million). The revenue loss prompted the municipality to design a severe austerity programme including a 10 per cent reduction of the staff and the consolidation of several public service facilities.

Rightly or not, the local government executive deplores the fact that Paks receives virtually nothing back from the national budget, while its residents have to support the environmental and health risks related to the nuclear power plant that produces 35 to 40 per cent of the total energy consumed in the country. Moreover, the town made significant effort in the past decades to adjust the level of public infrastructure (which was practically zero at the start-up of the power plant in 1976) to the needs of the rapidly growing local population.

6.6.4 Centralised appropriations Beside the earmarked norm-based grants mentioned above, there is another category of earmarked grants, with the only difference that this latter may cover both current and capital expenditures. These so-called centralised appropriations (*központosított előirányzatok*, row 22 in Table 6.2) contribute to the costs of specific local government tasks for which there is no other support from the central budget, or they encourage the provision of services that match certain national preferences but are not necessarily in the (short-term) interests of local governments. Correspondingly, the declared grant priorities vary from year to year, as does the amount of the available funds. Examples include the assistance to the organisation of local public transport, the maintenance of urban road systems, the renewal of ferries, or a contribution to the expenditures related to the reduction of administrative staff. Some of the centralised appropriations are accessible to every municipality, while others are allocated through a competition mechanism.

6.6.5 Addressed and targeted grants Since 1992, the central government has assisted subnational investment programmes with conditional grants of the ‘targeted’ (*céltámogatások*) or ‘addressed’ (*címzett támogatások*) type (row 23 in Table 6.2).

The so-called targeted grants are related to certain types of infrastructure defined in the annex of the Act LXXXIX of 1992 on the System of Addressed and Targeted Grants of Local Governments, following the national priorities. Targeted grants are supposed to co-finance small to medium scale projects with a variable matching rate. The priorities of the period 2002–2004 include sewage pipelines and treatment plants (matching rate: 40 to 60 per cent), medical equipment for hospitals and outpatient clinics (40 per cent), and regional landfills (40 per cent).

Addressed grants are reserved for particular large-scale projects producing substantial spillover benefits especially in the domains of water management, health and social care, public education, culture. They are provided case by case on a non-matching basis. Both funds are closed-ended and, unlike in the case of norm-based grants, the overall pool size determined in the annual Budget Act is not the sum of the actual infrastructure needs of municipalities. Consequently, even in the areas of delegated functions, local governments have to go through a competitive bidding process. Nevertheless, the system is undeniably much more transparent than the ad-hoc bargaining that characterised the allocation of investment grants during the socialist period.

The seven councils for regional development manage three further investment grant programmes (subsumed in row 24 in Table 6.2) whereby the annual Budget

Act determines the size of the grant pool, the central government sets out the rules of eligibility and distribution in a decree, but the regional development councils can follow their own spending priorities. The so-called Vis major grant is reserved for the prevention and minimisation of losses resulting from natural catastrophes. The regional equalisation grants for development (*területi kiegyenlítést szolgáló fejlesztési célú támogatások, TEKI*) are addressed to less developed municipalities. Finally, the targeted decentralised appropriations (*céljellegű decentralizált támogatások, CÉDE*) is accessible to all local governments and non-governmental organisations for all purposes. All programmes disburse small grants (under 200 million forints).

Further discretionary grants are available from various sector ministries and from the three extra-budgetary funds for environment protection, roads, and water management. The spending priorities are determined by the Parliament and some overlapping is possible.

Recent studies have shown that in its current form, the system of investment grants creates adverse incentives. Several municipalities prioritise local investment projects according to their potential to generate external funding; whether a specific project will be implemented depends entirely on the availability of central government funding. Grants also induce distortion in local investment patterns. They lead to overinvestment in areas of high national but low local priority, and ultimately to liquidity problems if the financial costs associated with future projects (interest, debt service, and the costs of service delivery related to the new infrastructure) have not been appropriately taken into account (KOPÁNYI et al., 2004; JÓKAY et al., 2004). Thus, while investment grants as such enlarge the room for manoeuvre of local governments (at least of those whose efforts in the competition for the limited funds are crowned with success), they may ultimately restrict local autonomy by making the municipality run into a financial bottleneck. A thorough review of the incentive system could help to eliminate the adverse effects of investment grants on local financial autonomy.

Besides, the poor coordination of the various investment grant programmes spurs local governments and their institutions (schools, libraries, hospitals, etc.) to apply for every possible grant and for multiple grants serving the same project. The immense volume of applications makes the administration of grant programmes extremely costly and promotes the use of political (instead of economic and technical) criteria in the evaluation of bids. Fox (2004) provides an excellent overview on these and other challenges related to the coordination of investment grants.

Finally, the wide variety of grant programmes makes the individual programmes less reliable. Specifically in relation to targeted grants, the Parliament has the

298 right to modify the rules and/or suspend the disbursement of grants following the macroeconomic situation of the country.

6.6.6 Deficit grants The previous sections presented a series of intergovernmental grants designed for financing current and capital expenditures of local governments. The discussion of deficit grants (row 21 in Table 6.2) in this context may be surprising to the reader. Indeed, following the theory of public finance, deficit grants (also called bailout grants) are one-off revenue allotments provided by a higher-level authority and therefore not part of the structural revenues of local governments. The case of Hungary provides for a remarkable exception in two respects. First, because of certain failures in their design, deficit grants in several municipalities became part of the structural (recurring) GFS revenues over the years. Second, as one of the few countries in the world, Hungary has institutionalised a normal bankruptcy procedure that is analogous to that of private enterprises. Even if it is difficult to separate the revenue function from the balancing function, we propose to postpone the discussion of deficit grants as instruments for balancing the budget to Chapter 7. In the present section, we will focus our attention on their function as revenue source.

Local governments may resort to three categories of deficit grants:

1. The so-called *önhiki*, serving to stabilise the financial position of local governments that have run into a deficit through no fault of their own (introduced in 1991);
2. Grants addressed to local governments coping with persistent insolvency through their own fault (introduced in 1996). These grants may be used for three purposes: (a) as a repayable interest subsidy for loans signed in order to restore liquidity, (b) as an operational grant to help the municipality ensure the basic public services during the bankruptcy procedure, and (c) for covering the salary of the trustee during the procedure.
3. Grants for bridging short-term liquidity gaps in the operational budget of municipalities that do not fulfil the *önhiki* criteria (introduced in 2000). In some cases, these grants are repayable and/or earmarked.

For each of these grant categories, the rules of eligibility are laid down in the annual Budget Act. The most dominant category is *önhiki* accounting for 87 to 99 per cent of all deficit grants throughout most of the 1990s and 2000s (data from the Ministry of Finance).

A final category of local revenues consists of monetary transfers from other parts of the general government that benefit other agents (mainly contracted partners) rather than the local government itself (rows 27 to 30 in Table 6.2). In principle, they are similar to earmarked grants, since local governments are obliged to forward them to the facility to which the transfer is addressed, or spend it on a well-defined public task. As long as the volume of the transfer is tailored to the expenditure that it is supposed to cover, this intergovernmental fiscal arrangement has a neutral effect on the local budget and indirectly on local autonomy as well.

However, as has already been suggested in Section 5.2.4 (see particularly Box 5.1), budget neutrality is not provided with regard to the most important flow-through item, namely, cost reimbursements from the National Health Insurance Fund (row 27 in Table 6.2). These account for 75 to 85 per cent of the overall volume of flow-through transfers and 8 to 10 per cent of the total GFS revenues of the local government sector and consist predominantly of the social security contributions. SNGs are obliged to transfer these funds to the facilities that, on their turn, may only use them for financing operational expenditures related to the performed health services. The past decades witnessed a continuous decrease in cost reimbursement levels, so that local governments are forced to co-finance health services from other sources. Besides, in their role as facility owners, most of them need to mobilise additional resources in order to maintain and develop the physical infrastructure for which the NHIF transfers provide no coverage. The difficulty of financing health care expenditures from the available resources has already prompted several municipalities to apply for *önhiki*.

Another major category of flow-through transfers consists of the so-called special government funds (*elkülönített pénzalapok*, row 28 in Table 6.2). These funds are established with the purpose of financing (or co-financing) selected government activities from resources generated outside the general government (contributions of various economic actors, donations, fines, etc.). In 2006, there were six special government funds of which the Labour Market Fund was the largest (managing HUF 295.6 billion), followed by the Innovation Fund for Research and Technology (HUF 36.7 billion) and the National Nuclear Fund (HUF 28.1 billion).

Budgetary Autonomy

The last chapter of this study investigates the meaning of local budgetary autonomy in Hungary. In Section 3.4.1, we defined local budgetary autonomy as the right and ability of local governments to modulate the budget constraint both within one generation of taxpayers and between successive generations. Starting with the presentation and evaluation of the account model of the Hungarian local public sector in Section 7.1, we will analyse the dynamics of deficits and surpluses for the overall local government sector between 1995 and 2006 (Section 7.2). Section 7.3 discusses some of the factors that led to the permanent and growing deficit of the sector in the 2000s. Methods and instruments to overcome vertical fiscal balance are presented in Section 7.4. Finally, Section 7.5 shows how the legislation on municipal bankruptcy promotes a greater sense of budget responsibility among local policymakers. 301

7.1 The account model of local public administration

As has been mentioned in Section 6.1.2, local governments in Hungary (as other government tiers as well) have a unified budget. Current and capital revenues are collected in the same fund and serve together as a basis for financing the totality of current and capital expenditures (see Section 5.2.2). In the structure of the budget, these four categories appear on different rows but do not constitute two distinct funds. Also the balance sheet, a compulsory element of the annual draft budget, includes separate lists of the current and capital items.

Given the possibility of cross-financing between current and capital items, there

302 is no 'golden rule' in the legislation that would require a balanced position (or surplus) of the current account over the cycle and tolerate deficit only on the capital account (i.e. debt for investment purposes). Nevertheless, a survey conducted by SZALAI et al. (2002) suggests that many a local government in Hungary considers the 'golden rule' as a principal goal of budget policy; some of them have even declared this goal in a local government decree.

Box 7.1 presents the Statement of Government Operations as recommended by the International Monetary Fund in the GFS Manual (GFSM) 2001. Two main analytic balances can be derived from this scheme. (Current) revenue minus (current) expense equals the net operating balance which is the summary measure of the ongoing sustainability of government operations IMF (2001, p. 38). Subsequently deducing the net acquisition (acquisitions minus disposals and consumption) of nonfinancial assets, we receive the net lending (+) / borrowing (-). While the Ministry of Finance in Hungary regularly calculates this latter balance to find out whether the subnational public sector and its subsectors produced a deficit or a surplus by the end of the fiscal year, the access to the net operating balance is more difficult. This is due to the fact that the structure in which the Ministry of Finance currently presents its data on intergovernmental grants does not allow us to separate current and capital revenues clearly from each other. Norm-based grants, theatre grants and other explicit operational grant programmes can obviously be classified as current revenues, while addressed and targeted grants, Vis major grants and other explicit investment grant programmes belong to the capital revenues. In contrast, the available data on the so-called centralised appropriations (row 20 in Table 6.2) and other grants (row 25) include both operational and investment grant elements. As for the centralised appropriations, the annual Budget Implementation Acts contains only the target spending areas and the respective figures, and although one might be able (with some risk of error) to separate operational expenditures from capital expenditures under these target spending areas, the figures reflect the total amounts of grants paid out to all categories of subnational units (villages, towns with or without county rights, the capital city and its districts, micro-regions, and counties) so that a partial analysis for municipalities only is not feasible. The category of 'other grants' is even less transparent.

According to the GFSM, government entities may adjust their net lending / borrowing position by rearranging transactions in financial assets and liabilities. All proceeds from privatisation (including the sale of fixed assets) are included as financial items, and subsidies given in the form of loans are recognised as an expense IMF (2001, p. 46). At the end of the fiscal year (on 31 December) and after

Box 7.1: Statement of Government Operations according to the GFSM 2001
[Source: IMF (2001)]

TRANSACTIONS AFFECTING NET WORTH:

REVENUE

- Taxes
- Social contributions [GFS]
- Grants
- Other revenue

EXPENSE

- Compensation of employees [GFS]
- Use of goods and services
- Consumption of fixed capital [GFS]
- Interest [GFS]
- Subsidies
- Grants
- Social benefits [GFS]
- Other expense

*NET / GROSS OPERATING BALANCE**

TRANSACTIONS IN NONFINANCIAL ASSETS:

NET ACQUISITION OF NONFINANCIAL ASSETS[†]

- Fixed assets
- Change in inventories
- Valuables
- Nonproduced assets

NET LENDING / BORROWING [GFS][‡]

TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):

NET ACQUISITION OF FINANCIAL ASSETS

- Domestic
- Foreign

NET INCURRENCE OF LIABILITIES

- Domestic
- Foreign

* The net operating balance equals revenue minus expense. The gross operating balance equals revenue minus expense other than consumption of fixed capital.

[†] Acquisitions minus disposals and consumption of fixed capital.

[‡] Net lending / borrowing equals the net operating balance minus the net acquisition of nonfinancial assets. It is also equal to the net acquisition of financial assets minus the net incurrence of liabilities.

304 taking into account all the transactions in financial assets, the so-called *overall fiscal balance* (which is a non-core balance in the GFS) should be zero.

Following art. 90 of the ALG, the local executive is responsible for a prudent management of local finances, while the mayor has to ensure that financial management is in line with the legal regulations. The local government must bear any consequence resulting from a financial deficit, whereby deficit is understood in the sense of a negative overall fiscal result (thus *after* borrowing), and not as a net borrowing position. The law also stipulates that the central budget does not account for local government liabilities.

Regrettably, the way in which the GFS account model is implemented in Hungary softens the budget constraint for local governments in two ways. First, deficit grants figure under operating revenues, thus ‘embellishing’ the net operating balance and consequently also the net lending / borrowing position, seemingly reducing or even offsetting the deficit. In the case of *önhiki* (Section 7.4.2), a possible reason for this choice is that it is not a genuine deficit grant aimed at balancing the *overall* budget. Eligible are those jurisdictions where the sum of norm-based grants and (potential) local tax revenues (calculated with the maximum rate) falls below the sum of mandatory expenditures. The comparison is made between two subgroups and not two totals. Beside norm-based grants and local taxes, municipalities need not mobilise any other revenue sources in order to become eligible for *önhiki*. In this sense, *önhiki* may also be regarded as just another source of revenue, a grant supplement to handle (partial) vertical imbalances, similarly to equalisation grants that handle (partial) horizontal disparities.¹

However, local governments in Hungary are allowed to plan for a deficit *ex ante* and to complete their draft budget with the amount of *önhiki* they are likely to apply for (and receive) during the following fiscal year. They are even offered an advance payment covering the first seven months of the year. If they do not meet the eligibility criteria of the *önhiki* programme, they have to cut back expenditures, increase own-source revenues, or sign a short-term liquidity loan in order to comply with art. 90 of the ALG that requires balance or surplus in the overall budget. Similarly to *önhiki*, prospective short-term liquidity loans may also be included into the draft budget, even if it is not sure whether the municipality is going to receive the amount of loan it is asking for. Thus theoretically, local governments can never run into a deficit on the operating side of the budget, except if the sum of *önhiki* and short-term liquidity loans is not high enough to fill the gap.

¹We use the attribute ‘partial’ because *önhiki* considers only norm-based grants and local taxes, while the equalisation grant is based solely on the origin-based PIT revenue share and the local business tax (see Section 6.6.3).

This worst-case scenario leads directly to a bankruptcy filing. With the right to plan for a deficit and balance the budget *ex ante*, the legislature made a considerable concession to local governments, jeopardising the credibility of the bailout policy stated in the ALG.

Second, revenues from privatisation appear under the transactions in non-financial assets, against the GFSM recommendation of treating all proceeds from privatisation under financial transactions (thus outside the net lending / borrowing position) even despite the fact that privatisation is the disposal of an existing asset. The logic behind the GFSM recommendation is that privatisation typically generates one-off revenues and should therefore not be treated on an equal level with structural (recurring) revenue sources.

Such concessions in legislation would probably be unnecessary if the intergovernmental fiscal system permitted local governments to plan for budget balance rather than for a deficit. However, revenue and expenditure flows are hardly predictable, so that intelligent financial planning remains an illusion for most municipalities. Art. 91 of the ALG requires SNGs to draft an economic programme in every political cycle, including the objectives and tasks related particularly to infrastructure development, spatial planning, job creation, local tax policy, the improvement of the quality of local public services. Besides, most of the sector-specific laws oblige municipalities to prepare medium and long-term strategies about the provision of the related public goods and services. However, as SZALAI et al. (2002) point out, these rules do not require local governments to compare the cost effects of planned programmes to the expected volume of revenues. In consequence, local governments do not take account of the financial constraint during the planning phase, which often results in postponing or cancelling planned expenditure programmes due to the shortage of funds. Nevertheless it must be noted that even if the sector-specific rules were stricter about the feasibility of local strategies, municipalities would have a hard time making reliable forecasts on their revenue situation because of the frequent amendments to the intergovernmental finance system (particularly grants and transfers but also the national framework of local taxation).

306 7.2 The development of vertical fiscal balance between 1995 and 2006

Table 7.1 reiterates the major categories of local government revenues and expenditures and shows the net lending / borrowing positions of the municipal sector in the years 1995 to 2006 at current prices.² The bar chart in Figure 7.1 recapitulates the development of this latter measure at current prices.

Net lending / borrowing positions varied turbulently during the period under review. In seven years out of twelve, the municipal sector ran into deficit. Not surprisingly, the largest deficits of the period were incurred in the election years 2002 and 2006. However, it is remarkable that for the first time in 2003, the vertical fiscal balance was negative even though there were no elections. The local government sector stayed in the net lending position in the subsequent years as well.

As has been stated in the previous section, the net operating balance measures the ongoing sustainability of government operations. It shows whether there is any cross-financing between the current and capital items of the budget; that is, whether local governments use the operational surplus for covering the deficit in the capital accounts, or vice versa. Because of the mixed character of the centralised appropriations and the subcategory of 'other grants' in the budget of the Hungarian local government sector (subsumed in row 14 in Table 7.1), operational and capital grants cannot be separated correctly from each other. From this mixed category, a certain share is supposed to cover operational expenditures, so that its elimination from the formula of the net operating balance automatically produces an underestimation bias.

Nevertheless, the net operating balance calculated in this way (thus from the 'clean' figures in rows 7, 8, 11 and 15 on the revenue side and rows 2 and 3 on the expenditure side) provides a preliminary answer to the cross-financing question. The results in row 17 show that the balance of the hypothetical current account (hypothetical because the such an account does not figure in the law) is positive throughout the period except for the 'austerity years' 1995 and 1996 (stagnation or decrease of grants and other current revenues in real terms compared to the

²A comparison with Table 6.2 reveals some minor differences in the figures. This is due to the fact that the figures in rows 11 to 14 in Table 7.1 had to be calculated indirectly. First we had to decompose the aggregate volume of intergovernmental grants into various subcategories (grant programmes) and then subtract the amounts granted to the counties and (from 2005) to the micro-regions in each subcategory of grants. This allowed us to construct two main aggregates (operational and capital grants) as well as a mixed category. The deviations from the aggregates of Table 6.2 are likely to have their origin in the inconsistency of the data sources.

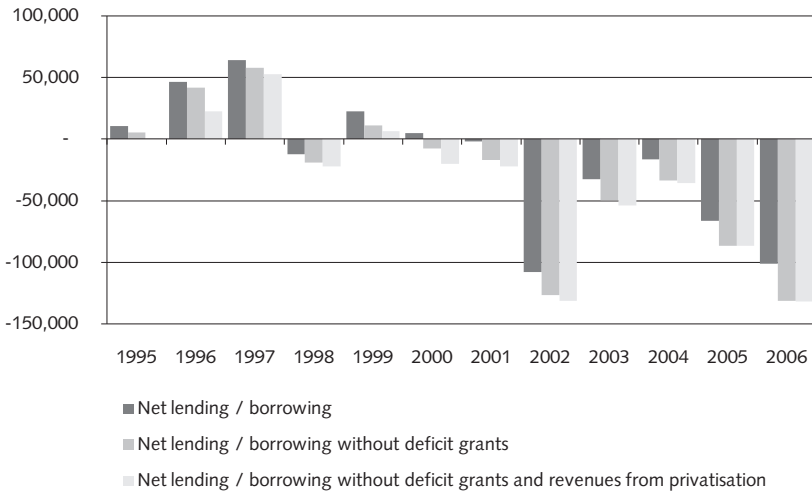


Figure 7.1: **Net lending / borrowing of local governments 1995–2006 at current prices (million HUF)** [Source: the author, based on data from the Ministry of Finance]

Table 7.1: Net lending / borrowing of local governments 1995–2006, at current prices (million HUF)
 [Source: Ministry of Finance]

#	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
1	696,776	791,755	981,478	1,173,599	1,278,797	1,423,518	1,649,807	1,988,642	2,175,794	2,308,962	2,553,682	2,763,348	
Total GFS expenditures (2+...+5)													
2	Current expenditures	507,371	581,080	689,144	798,543	903,701	987,030	1,113,410	1,343,903	1,590,167	1,677,866	1,790,585	1,885,568
3	Current grants and subsidies paid	65,650	77,484	89,724	120,015	126,506	131,750	162,822	181,194	176,399	201,451	228,448	228,482
4	Capital expenditures	123,755	133,191	201,041	252,505	240,729	295,125	361,513	451,508	397,227	418,839	523,481	635,986
5	Loan disbursement	-	-	1,569	2,536	7,861	9,613	12,062	12,037	12,002	10,806	11,169	13,312
6	Total GFS revenues (7+8+9+12+14+...+17)	707,382	837,989	1,045,311	1,161,273	1,301,360	1,428,604	1,647,934	1,880,733	2,143,289	2,292,586	2,487,452	2,662,343
7	Current own revenues	148,184	207,070	279,920	345,278	408,720	449,410	509,695	571,988	591,715	666,814	708,790	762,555
8	Shared revenues	95,416	105,836	133,916	178,557	193,167	225,018	264,158	305,502	397,718	453,129	440,943	458,456
9	Revenues from property	87,756	113,622	176,448	112,246	121,367	170,734	193,601	199,016	203,260	209,875	258,870	320,233
10	of which: revenues from privatisation	4,894	19,141	4,863	3,305	4,561	12,248	5,518	4,325	4,169	2,159	430	261
11	Operational grants	221,226	223,049	256,054	268,425	295,278	321,917	363,656	395,751	575,100	591,084	636,494	588,482
12	of which: deficit grants	5,445	4,459	6,218	6,550	11,506	12,810	14,875	18,951	16,966	17,367	20,138	30,496
13	Capital grants	18,161	17,908	29,144	41,612	45,302	48,957	75,301	76,182	60,142	58,362	85,672	97,308

14	Centralised appropriations & Other	41,601	51,728	26,248	49,666	57,536	14,005	25,274	92,493	34,965	45,134	79,714	134,199
15	Flow-through transfers	88,609	109,301	131,586	148,882	163,828	180,345	187,108	214,261	251,015	246,646	252,521	274,750
16	Other revenues	6,430	9,476	11,996	16,607	16,163	18,218	29,141	25,541	29,375	21,542	24,447	26,360
17	Net operating balance [GFS] (7+8+11+15)-(2+3)	-19,587	-13,308	22,608	22,584	30,785	57,911	48,386	-37,596	48,983	78,356	19,716	-29,806
18	Net lending / borrowing [GFS] (6-1)	10,606	46,234	63,833	-12,326	22,563	5,086	-1,873	-107,909	-32,505	-16,376	-66,230	-101,005
19	Net lending / borrowing without deficit grant [GFS] (6-12-1)	5,161	41,775	57,614	-18,875	11,057	-7,723	-16,748	-126,860	-49,471	-33,742	-86,368	-131,501
20	Net lending / borrowing without deficit grant and rev. from priv. [GFS] (6-10-12-1)	267	22,634	52,751	-22,180	6,496	-19,971	-22,266	-131,185	-53,640	-35,901	-86,798	-131,762

310 previous years; a consequence of the Bokros reform package) as well as the election years 1998, 2002, and 2006. It seems therefore that the net operating balance is not responsible for the perpetuation of the net lending position in the overall budget. On the contrary, it is rather the surplus of the current budget that allows several municipalities to carry out their planned (or promised) investment programmes particularly in the year following the elections SZALAI (2005, p. 16). Obviously, cross-financing in any direction is unthinkable for about one-third of all local governments that would not even be able to balance their current budget without *önhiki*.

Table 7.1 (rows 18 to 20) and Figure 7.1 show that both deficit grants and the proceeds from privatisation have a real impact on the year-end fiscal result of the local government sector. Their relative importance depends on the volume of the deficit or surplus that municipalities would realise in the absence of these items. In 2000 and 2001, they saved the local government sector from slipping into the red (see Table 7.1); in the rest of the period, they either boosted the surplus or contributed to lowering the deficit. The importance of the revenues from privatisation was the highest in the first half of the period, whereas since 2004, they have hardly made any difference any more.

The trend of repeated and growing vertical fiscal imbalances gives more reason to worry than the actual size of the deficit. During the 'red' years of the period, the net lending of the local government sector accounted for merely 1.5 to 3.5 per cent of the consolidated general government deficit, except for 2002 when the share of the local sector was 6.6 per cent (data from the Ministry of Finance). For the rest of the period, municipalities served rather as a counterbalance to the negative results of the general government.

7.3 The sources of deficit

Even in a system of unified budgets, local government accounts should be sufficiently detailed to allow conclusions about whether the deficit emerged from a mismatch of operating revenues and expenditures or whether it is due to an imbalance of the transactions in fixed assets (including investments). If it emerged in the operating budget, another question is whether it is the mandatory or voluntary expenditures that tilt the balance.

Just as the sources of deficit are diverse, it is also impossible to attribute the current trend of local governments' turning from net lenders into net borrowers to a single factor. A part of the municipalities fall regularly back into the deficit trap

because of a mismatch between current revenues and expenditures, while others slip into the red because of a poorly planned investment programme. Jurisdictions with low tax capacity find it difficult to finance even the basic public services, while others get into trouble because of their overly bold attitude with regard to voluntary functions.

Poorly funded mandates are certainly one of the main reasons behind the vertical fiscal imbalance of the current budget. In Section 3.4.4, we considered the mismatch between the volumes of mandated operational expenditures and intergovernmental grants as an indirect legal constraint on the budgetary autonomy of local governments, in the belief that if the centre fully reimbursed the costs of delegated functions, then local governments could dedicate their own-source revenues entirely to modulating the local budget constraint. This is particularly true for small towns and villages whose revenue generation potential is relatively modest compared to the vast amount of public service functions with which they have to deal.

In order to determine the importance of poorly funded mandates, we should be able to look behind the figures. However, due to the high complexity and volatility of sector-specific laws, calculating how much of the actual local government expenditures were mandated in a given year and which part resulted from voluntary activities (new, more, or better services) necessitates an extremely time-consuming micro-data analysis of the nearly 3,200 municipalities. On the revenue side, norm-based grants are provided more or less in proportion to the estimated costs of service provision, but their amount is declaredly below the actual cost level; other intergovernmental grants and transfers as well as local own-source revenues are supposed to fill the gap. Inspired by the European Charter of Local Self-Government, the ALG stipulates the following: ‘Simultaneously with the definition of mandatory tasks and competences, the National Assembly shall ensure the material conditions of their execution; in addition, it shall make a decision on the size and type of contribution from the public budget (art. 1 para. 5 ALG, translation by the author).’

However, the sector-specific laws from which most of the new tasks emerge usually ignore the financing question and seldom increase the resources of local governments by assigning them additional revenue raising power or any specific revenue (PÁLNÉ KOVÁCS, 2004). In consequence, communes often find themselves constrained to co-finance delegated expenditures from a revenue basis that hardly increases from one year to another (DAVEY and PÉTERI, 2004a).

The lack of transparency in the calculation of cost estimates and the corresponding reimbursement turns ‘unfunded mandates’ into a popular but dangerous

312 argument. The most controversial issue is whether the central budget should cover the costs of local mandatory functions fully or partially. The various lobby organisations of SNGs plead for full reimbursement, referring to the above-mentioned rule in ALG. However, the wording of the law is ambiguous. The expression 'ensure the material conditions' says nothing about whether the Parliament has to do so via grants and transfers exclusively, or whether it can also meet this requirement through a corresponding enlargement of local taxing powers. The assignment to 'make a decision on the size and form of contribution from the public budget' suggests that the first interpretation is the right one; in principle, however, nothing impedes the Parliament from setting the level of contribution at zero. Also the definition of local governments 'becoming insolvent through no fault of their own' (the primary criterion of eligibility for *önhiki*) suggests that norm-based grants and local tax revenues together (and not norm-based grants alone or in combination with other grants) should be sufficient to cover total operating expenditures.

Regardless of the lawmaker's intention, local politicians react to the problem of poorly funded mandates most often with the demand for additional grants and/or for a re-assignment of expenditure functions. In fact, both types of reaction suggest the ignorance of the fact that financial capacity is not an exogenous variable. Local governments may influence it through both the expenditure side (e.g. through improving efficiency in service delivery) and the revenue side of their budget (e.g. through increasing tax rates and/or introducing new user charges). Moreover, economic growth enlarges the tax base, which leads to additional revenues over time, even though few municipalities have recognised this so far (SZALAI et al., 2002). As has been shown in Chapter 6, for a multitude of reasons such as strategic horizontal interactions or the fear of political risks, only few local governments exploit their full potential for raising revenues or reducing expenditures. One could thus argue, as the saying goes, 'give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime.'

Nevertheless, the counter-arguments cited in Section 3.4.4 also merit some reflexion.

First, the suboptimal utilisation of formal taxing powers at the local level in Hungary has much to do with what we called 'fiscal crowding out' in Section 3.4.3. The high rates of national taxes discourage local governments from further increasing the pressure on taxpayers.

Second, if municipalities have to spend a part of their own resources on mandatory functions, they might not have enough revenue left for financing voluntary expenditures. As PÁLNE KOVÁCS (2004, p. 96) observes, in line with the ALG that stipulates the primacy of mandatory tasks, local governments in a financial

bottleneck situation are expected to cut voluntary expenditures first. This is a painful step that implies giving up an important component of local expenditure autonomy. It is even more painful if it is obvious that the financial hardship is due to poorly funded mandates and not to an oversized concert hall or an ill-designed school bus service. In addition, despite the arguments in favour of a unified budget, some revenue sources are just not adapted to filling the gap in the current budget. User charges are raised in order to cover the costs of the related public good or service; for this reason, they are normally earmarked and cannot be spent in any other policy area than the one in which they were raised. Debt is the optimal instrument for investment funding because it allows local governments to spread the investment costs over more than one generation of taxpayers; for the same reason, it is not equitable to use it for financing current operating expenses.

Poorly funded mandates are just one of the several possible reasons for a deficit. Analysing nine cases of municipal bankruptcy between 1996 and 1998, JÓKAY et al. (2004) explain how voluntary tasks can also lead to vertical fiscal imbalance. In their view, the in-built asymmetry between the unfettered right of municipalities to assume voluntary functions and the scarcity of their revenue sources makes fiscal imbalance virtually unavoidable. Following the ALG, the only principle to respect with regard to voluntary functions is the primacy of mandatory functions: municipalities have to fulfil their mandatory tasks before assuming any other competence. However, this principle was eventually hurt when local governments (initially in a good financial position) assumed a number of voluntary functions beyond their actual financial capacity. The lack of internal municipal controlling mechanisms and the limited capacity of the Hungarian State Audit Office, but also wrong practices of accounting, reporting and auditing contributed to the crisis in many a municipality.

The survey carried out by JÓKAY et al. (2004) suggests that typically small towns and large villages tend to underestimate their financial capacity and continue assuming voluntary tasks, which eventually leads to (or exacerbates the existing) fiscal imbalance. Few of them make use of their legal power to increase local tax rates to the legal maximum, or to organise administrative tasks and service delivery in co-operation with other municipalities. Other factors of recurring fiscal imbalance include (i) the depletion of financial reserves accumulated during the period of economic boom, (ii) the high rate of debt service compared to the financial capacity, and (iii) the poor organisation of service facilities.

Voluntary tasks often involve new investment, such as the construction of a public theatre or the conversion of a former industrial site into a centre for sports and recreation. Examples from the practice suggest that among all investments, it is

314 mainly the ones related to voluntary tasks that drive municipalities into insolvency. Referring to art. 1 para. 6/b of the ALG that allowed local governments to pursue entrepreneurial activities at their own risk, several municipalities decided to venture into this domain without being actually prepared in terms of know-how and management skills. Commercial banks initially considered local governments as reliable borrowers. However, the allocation rules of central matching grant programmes for investments allowed municipalities to bring in loans as part of the match. Many of those applicants who received less than they had expected returned to their bank to negotiate for a higher amount of loan, because abandoning the project would have implied giving up the grant as well. Assuming additional debt without the necessary debt service capacity is what ultimately drove these municipalities into bankruptcy (JÓKAY et al., 2004).

Not only the voluntary functions but also mandated ones generated a large volume of investment during the period under review. According to a report of the State Audit Office (SAO, 1997), the need for modernising the depleted public infrastructure inherited from the socialist era drove many a municipality into huge local investment programmes. Rather than deliberating the real needs of the local constituency and comparing it with their financial room for manoeuvre, most of them oriented their development policy at the terms and conditions of central investment grant programmes. In contrast to operating expenditures that the central government attempts to compensate at least in part, no reliable revenue source is automatically available for financing the construction and renovation of public hospitals, schools, temporary shelters, etc. The available investment grants are limited and the competition is tough; besides, grant flows are unpredictable and therefore little adapted to long-term financing. Norm-based grants and flow-through transfers from the National Health Insurance Fund cannot be used for capital development. In most municipalities, own-source revenues are hardly enough for covering operating expenses, not to mention capital outlays.

In another report, the State Audit Office of Hungary observes serious fiscal imbalances already in the draft budgets of local governments (SAO, 2007a, p. 20). Planned revenues (without deficit grant) did not cover planned expenditures in ninety per cent of the municipalities surveyed in 2006. The imbalance was caused by operating expenditures in around three-third of these municipalities, while half of them had a gap in the capital budget. According to the SAO, the reasons behind the deficit planning have been the same for several years: (i) inefficient service provision, (ii) under-utilisation of infrastructure capacities, (iii) engagement in voluntary tasks beyond the financial capacity limits, (iv) planning errors, and (v) oversized capital expenditures.

7.4.1 Overview Depending on the source of the deficit (net borrowing position) in the overall budget, local governments may follow different paths in order to obtain a zero overall fiscal result and thus comply with art. 90 of the ALG. Without pretention of full accuracy, we tried to illustrate these paths in Figure 7.2. Such schemata make it usually easier to understand complex systems or processes, but they bear the risk of oversimplifying reality. Our flowchart is no exception to this rule. Therefore, rather than describing every single step in words, here we try to complete it with a few comments in order to bring it closer to reality. We divided the diagram into four channels, from [1] to [4], in the hope that they make the discussion easier to follow. Two remarks are indispensable at this point.

First, it needs to be emphasised that Figure 7.2 relates to balancing the budget *ex ante*, at the very beginning of the drafting stage. It is possible that the local government applying for an *önhiki* grant, an investment grant or a commercial bank loan receives eventually nothing or less than expected. Instead of cutting or abandoning certain expenditure programmes, it is then likely to switch to alternative funding options, for instance, a short-term liquidity grant as a substitute for *önhiki*, or a long-term loan as a substitute for the investment grant. For fear of making the diagram overly complex, we did not include these reactions, even if a part of them may occur in the drafting stage.

The second remark to the flowchart concerns the channels [1] to [4]. The figure is structured according to the original (or primary) causes of the vertical fiscal imbalance. In reality, vertical fiscal imbalance cannot always be explained with a single factor but rather with a combination of factors that together provoke a chain reaction. A commercial bank loan facilitating the construction a swimming pool (voluntary capital expenditure) may impose interest obligation on the current budget to the extent of jeopardising the provision of basic public services (mandatory current expenditure). As we will see, this does not make the municipality automatically eligible for *önhiki*. Neither interest expenses nor debt repayment is part of the acceptable expenditures under the grant regime, and in order to become eligible, the municipality is first obliged to downsize or postpone the investment programme in order to obtain a balance between planned capital expenditures and capital revenues.

In the following sections, we are going to treat the two main options for obtaining a zero overall fiscal result *ex ante*, namely, applying for an *önhiki* grant (Section 7.4.2) and borrowing (Section 7.4.3). Filing for bankruptcy is not going to

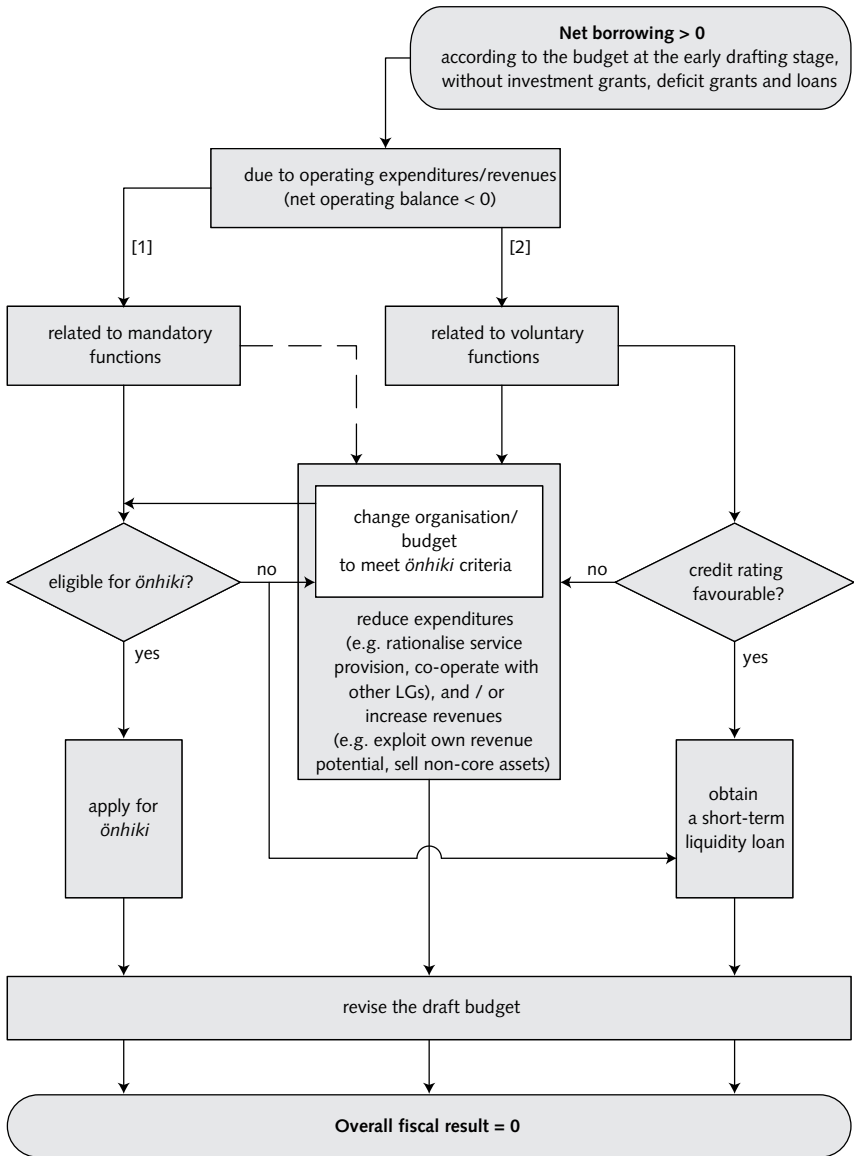
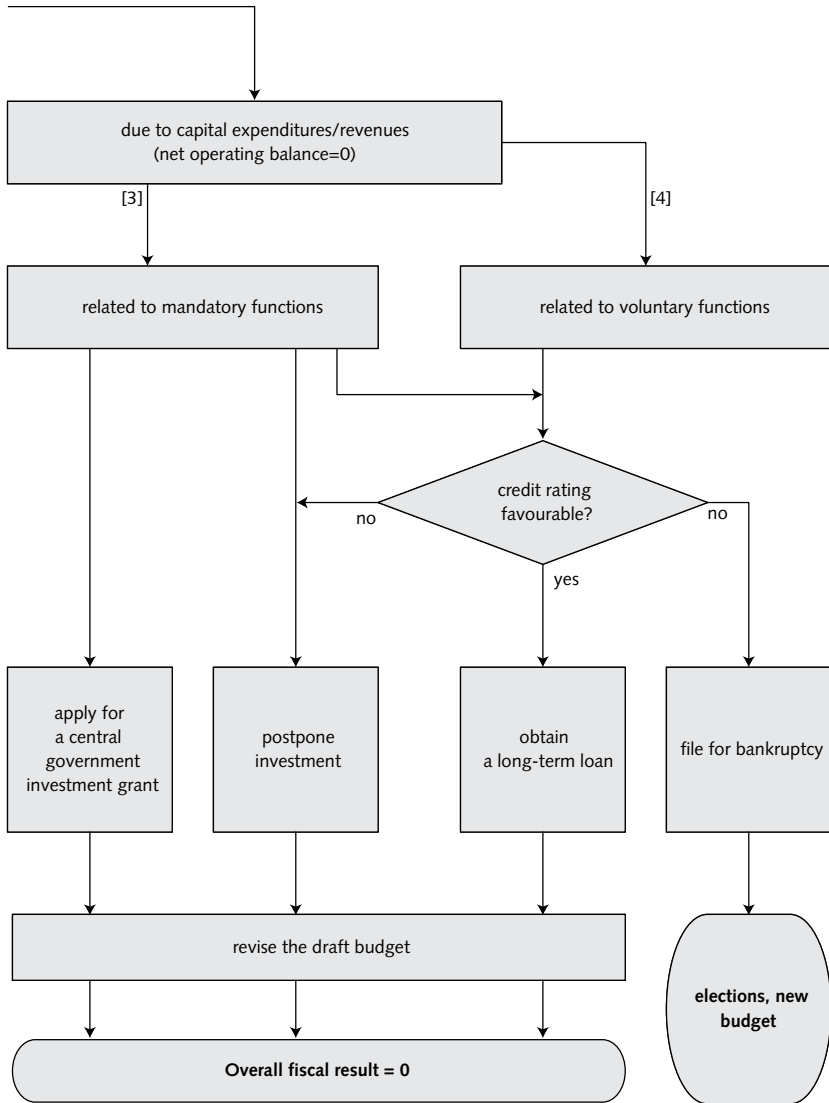


Figure 7.2: Options for balancing the budget ex ante [Source: the author]



318 restore budget balance, yet, it is a solution: a final solution for municipalities with irreparable budgets. Bankruptcy will be briefly discussed in Section 7.5.

7.4.2 Önhiki Municipalities facing a gap between current revenues and current expenditures related to mandatory tasks (channel [1]) are likely to comb through their draft budget once again to see whether there is a potential for further cost containment or revenue generation. However, probably only a few of them will stop at this point (their choice is indicated with the staggered arrow). The majority will check whether they fulfil the other conditions to become eligible for the *önhiki* grant, the deficit grant that has been introduced briefly in Section 6.6.6.

Since its introduction in 1991, *önhiki* (an acronym for *önhibájukan kivül*, ‘through no fault of their own’) has helped insolvent subnational governments preserve their independence in managing their financial affairs, i.e. avoid bankruptcy.³ Following art. 1 para. 6/b of the ALG, ‘municipal local governments that come into difficulties through no fault of their own are entitled to additional support from the state’. Originally conceived as a measure to strengthen local democracy and to assist local governments through the difficulties of transition (GURNIK et al., 2005), *önhiki* became a popular and relatively easily accessible means of bridging operational deficit. Eligible are those municipalities that are unable to finance their mandatory operating expenditures from the sum of their operating revenues in spite of a maximum effort to exploit the potential for cost containment and revenue generation. Applicants must be able to prove that they have rationalised their institutions and service delivery as much as possible, make a due revenue effort, and manage their portfolio of real and financial assets in a way to generate income for financing basic services (JÓKAY et al., 2004).

From 1991, the rules of eligibility changed almost every year (Box 7.2), alike the directives concerning application procedure and grant calculation published in a joint decree by the Ministry of the Interior and the Ministry of Finance. The present system excludes those local governments that manage their affairs in an inefficient way. Beside a number of further conditions, the municipality is *not* eligible:

- if it had 500 or less inhabitants on 1 January of the year preceding the grant application, and it does not belong to any district secretariat;⁴

³Counties are also eligible for *önhiki*, but in order to preserve the focus on *local* financial autonomy, in the following we will not deal with this category of SNG.

⁴District secretariat is a basic form of association in which local governments with less than 2,000

- if it runs no other public service facility than the office of the local executive (except if it participates in an inter-municipal co-operation agreement);
- if the capacity utilisation in the pre-primary and primary education facilities is below 50 per cent (if population < 3,000), or 70 per cent (if population > 3,000), respectively (special rules apply to participants of inter-municipal co-operation agreements and to the municipalities with less than 500 inhabitants);
- if it has not introduced (nor is it planning to introduce) any type of local tax;
- if it has a bank deposit of at least three months in term
- if its planned capital expenditures exceed its resources for capital development (including communal taxes, 20 per cent of the property taxes, investment grants, 70 per cent of the conditional norm-based grant for public education and information technology, loans, etc.)

Box 7.2: Sixteen years of *önhiki*: milestones in the regulation [Source: the author, based on Gurnik et al. (2005)]

1991 – The *önhiki* is introduced in the annual Budget Act. All grant applications are evaluated by the Parliament. The objective is ensuring the continuous operation of local facilities delivering basic public services. Newly established local governments are also entitled to a one-off start-up grant in proportion to their population size.

1992 – The discrimination between new and existing municipalities is cancelled. Grant applications are evaluated by the central government.

1993 – The conditions of eligibility are laid down in Annex 6 of the Budget Act. Applications may be submitted once during the running fiscal year. Municipalities benefiting from a targeted grant for an investment programme are excluded from the grant.

1995 – Applications may be submitted twice a year. Municipalities benefiting from a targeted grant are no longer excluded. As a new rule, however, applicants must demonstrate that local capital revenues provide a sufficient coverage for capital expenditures.

inhabitants operate a joint office for the daily administration (art. 39 to 40 ALG). In 2005, 1,690 municipalities were organised in this form; together, they were running 631 district secretariats.

1996 – Before taking a final decision, the Minister of Finance consults the Local Government Committee of the Parliament.

1997 – Since the first round of applications is not evaluated before 15 July, grant recipients of previous years still coping with liquidity problems in the running fiscal year are allowed to apply for an advance payment to cover the expenditures of the first six months.

1998 – The right to apply for an advance payment is extended to new applicants. The amount of grant payable to a municipality is adjusted to the average operational expenditure level characteristic of the given category of municipality. (Today, the system helps the poorest municipalities to reach 90 per cent of the average operational expenditure level and disregards those that perform at 110 per cent of the average.)

1999 – Advance payment can be required for the first seven months of the year. Further modifications are made in the calculation in order to filter out capital-related deficits and to take account of increases in current own revenues.

2000 – Municipalities with a population below 1,100 are excluded from *önhiki* if the capacity utilisation in any of their educational, social and health care facilities is lower than 50 per cent; a 70 per cent ratio applies to those with a population above 1,100. Villages with less than 500 inhabitants are exempted from this rule if they run only one facility per category and/or if their primary school provides only four years of education. The definition of capital revenues (that *önhiki* applicants cannot use to cover operational expenditures) is completed by further revenue items.

2001 – The benchmark population size underlying the criterion of capacity utilisation is modified from 1,100 to 3,000. Further amendments are made to the calculation method. The amount of grant cannot exceed the level of short-term loans budgeted for the given fiscal year.

2003 – A part of the *önhiki* grant must be repaid at the end of the year if the actually realised level of current revenues exceeds the budgeted one, or if the municipality received a supplement to the norm-based grants during the year.

2004 – Minor amendments to the criterion of capacity utilisation. A further modification applies to the way of calculating the differential between the actual level of local operational expenditure and the respective national average.

2005 – With regard to the communication between the Minister of Finance and the Local Government Committee of the Parliament, prior consultation is replaced by annual ex post information. The criterion of capacity utilisation is restricted to pre-primary and primary

education facilities. Municipalities with less than 500 inhabitants that cannot fulfil the criterion may receive a reduced amount of *önhiki*. The goal is to encourage more efficient service provision through inter-municipal co-operation.

The ministerial directives define carefully which categories and levels of expenditure and revenue are taken into consideration in the evaluation of the demands. Expenditure is accepted up to the level of the operating expenses of the previous year (except for expenses financed by NHIF transfers) multiplied by the expected rate of inflation in the running year. The considered revenue categories include the operating revenues of own public service facilities (e.g. user charges and fees), local taxes, norm-based grants, equalisation supplements and flow-through transfers (except for NHIF transfers). Again, the system takes into account the revenues of the previous year indexed to inflation. Within local taxes, the expected level of IPA cannot be lower than the potentially realisable average (*adóerőképeség*)⁵.

On the whole, the conditions of eligibility are well-designed and consistent with the main objective of the *önhiki* fund. However, three features of the list of accepted outlays and expected revenues may cause irritation.

First, the range of expenditures taken into account is not limited to the mandatory ones, although *önhiki* declaredly pursues the objective of restoring vertical fiscal balance in order to ensure the continuous provision of the delegated public services. The Ministry of Finance argues that even if the list does not distinguish between expenditures related to voluntary and mandatory functions, the typical *önhiki* applicant is in deficit because of the latter. It must be noted that the complexity of sector-specific regulations makes it virtually impossible to separate mandatory and voluntary outlays within the same policy area.

At the same time—and this is the second problem related to the conditions of eligibility—the list of accepted outlays includes interest expenses. Therefore, the interests on a loan that financed the construction of a new concert hall may drive the municipality into a deficit in the operating part of the budget. Luckily, but somewhat inconsistently, debt repayment cannot be acknowledged as an expenditure under the *önhiki* rules.

Third, it is not clear why, out of the five categories of local taxes, only IPA is taken into account at the average rate. Particularly in the field of taxation and

⁵As has been explained in Section 6.6.3, the so-called *adóerőképeség* is the key indicator of the fiscal equalisation system. It is calculated as the per capita amount of IPA revenue that a local government can potentially realise by applying the tax rate that corresponds to the effective average of all municipalities.

322 user charges, villages could make a greater effort than they do at present. At the same time, fiscal competition (or more generally, the desire to remain attractive to existing and potential taxpayers) sets a natural limit to tax increases.

In principle, *önhiki* is an open-ended fund in the sense that SNGs meeting the eligibility criteria automatically receive a share of it. The overall size of the fund is determined in the annual Budget Act but may be amended during the fiscal year if the demand turns out to be substantially higher than in the previous year. Oddly enough, municipalities are allowed to ‘plan for the deficit’, that is, to include the expected amount of *önhiki* into their budget for the following year, even if they are not sure whether they will ultimately receive anything. Balancing the budget at least *ex ante* is therefore a relatively easy task for local governments in Hungary: the *önhiki* on the revenue side caters for a nominal equilibrium in every case.

Local governments are strictly forbidden from using *önhiki* for covering capital expenditures; otherwise, the grant could not fulfil its basic role of closing the fiscal gap on the operating side. Thus, the principle of the unified budget is dropped here for the sake of restoring the basic functions of local governments in distress. As we saw in Section 7.1, the Hungarian public sector accounting system does not distinguish between current and capital budgets in order to provide maximal freedom to decentralised governments with regard to the use of their resources. However, a clear separation is made as soon as the financial situation of the municipality calls for an immediate and exclusive concentration of all available resources on the maintenance of a basic level of public services.

Figures 7.3 and 7.4 show the importance of *önhiki* for the municipal sector during the period 1993–2004. As the graphs suggest, the volume of *önhiki* grants disbursed in the local government sector grew steadily in nominal terms, except for 1996 where the Bokros austerity package necessarily dampened central government spending. Following the relatively modest 900 millions of forints in 1993, grant disbursement in nominal terms almost doubled from 1998 to 1999 and hit the 16-billion-mark in 2002. The growth is less spectacular if we take inflation into consideration, but even at constant prices, the total volume of *önhiki* grants more than quintupled between 1993 and 2002. At the same time, the Ministry of Finance has repeatedly warned the public opinion not to dramatise the growing number of *önhiki* cases. After all, less than 1 per cent of the total GFS revenues of the local public sector (and 1 to 2 per cent of the sum of intergovernmental grants and the PIT share) have been sufficient so far to guarantee the continued provision of basic public services in every municipality (GURNIK et al., 2005). Besides, experts working on municipal bankruptcy procedures are convinced that the deficit grant

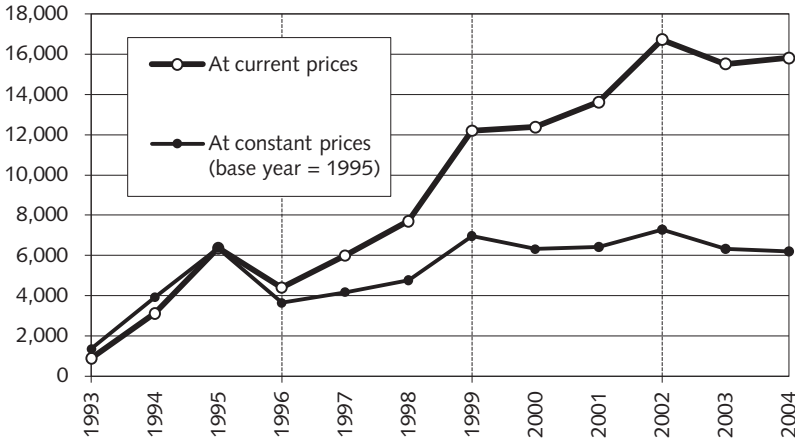


Figure 7.3: Total önhiki grants allocated between 1993 and 2004 (million HUF)
[Source: the author, based on data from the Ministry of the Interior]

system has prevented many a local government from bankruptcy (JÓKAY et al., 2004).

While the overall amount of public money allocated under the *önhiki* system is indeed not dramatic, the created incentives are more than alarming and cry out for a thorough revision of the intergovernmental fiscal system and service delivery structures especially in the most fragmented regions of the country.

One reason for the constant increase of the total grant disbursements is the fact that most beneficiaries resort to *önhiki* repeatedly and some of them even depend on it for their survival. According to a recent study of the TÁRKI Social Research Institute, between 1991 and 2000, 72 per cent of the 3,179 municipalities benefited from *önhiki* at least once, while 28 per cent never applied for the grant (SZABICS and MÁRVÁNYKÖVI, 2004). Estimates from the Ministry of the Interior suggest that deficit grants are given to approximately 800 small villages every year, signalling that the latter cannot fulfil their mandatory responsibilities because of the poor opportunities to realise economies of scale. Moreover, a quarter of the towns and two-thirds of the counties received *önhiki* in 1998, 1999, and 2000 (JÓKAY et al., 2004, p. 605).

A simple descriptive method (comparison of group averages) followed by logistic regression allowed SZABICS and MÁRVÁNYKÖVI (2004) to describe some major differences between the beneficiaries and non-beneficiaries of *önhiki* and to identify

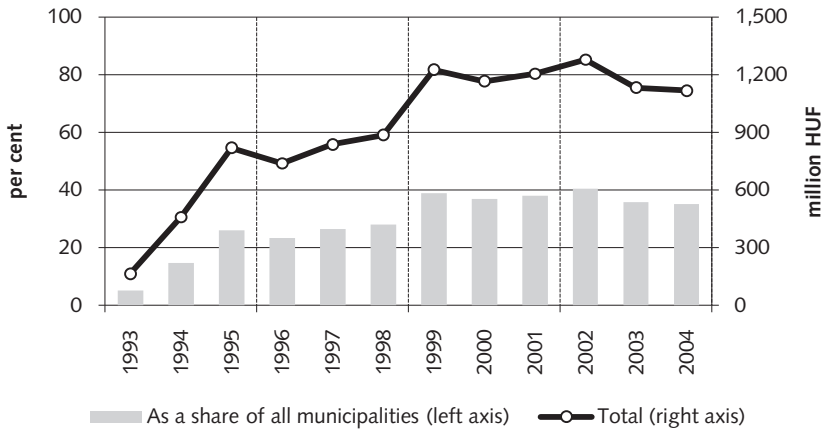


Figure 7.4: **The number of municipalities benefiting from önhiki between 1993 and 2004** [Source: the author, based on data from the Ministry of the Interior]

some of the factors that make SNGs more susceptible to fiscal imbalances in their operational budget. In a second step, the authors compared occasional *önhiki* recipients with those that resort to the grant on a regular basis to find out about the key determinants of grant dependence.

According to the results, *önhiki* recipients on average exhibit a higher proportion of welfare recipients and unemployed in their constituency (poverty indicators) than do non-receivers. The share of individuals of working age is smaller and the share of persons aged above 60 is higher (demographic indicators). Inhabitants have a lower number of cars and phones, and there are less registered enterprises and retailers in the jurisdiction, whereas there is no difference in the number of flats connected to the drinking water network (modernity indicators).⁶ Rather than access to drinking water (which was provided in 91.2 per cent of households in 2006 according to data from the Hungarian Central Statistical Office), other domains of public infrastructure such as roads or telecommunications may be in a completely different stage of development in beneficiary and non-beneficiary jurisdictions.

Not surprisingly, many of these variables are interrelated. A high unemployment

⁶All indicators are relative measures (per 1,000 inhabitants) in order to ensure the comparability of jurisdictions of different size.

rate implies shrinking revenues from the personal income tax and a higher volume of social aid. The high number of old persons explains why the death rate is higher in the *önhiki* jurisdictions, but ageing local population also means less taxpayers. The scarcity of enterprises may result from the difficulty of accumulating the seed capital and/or from the gloomy prospects for profit generation; in any case, the lack of business initiatives reduces the level of local business tax over the years. As own-source revenues shrink and expenditure needs rise, the tension in the local budget mounts gradually and prompts especially young skilled workers to move to another jurisdiction with better employment opportunities and a higher level of net fiscal benefit.

The interplay of these circumstances makes local governments more vulnerable to minor economic shocks. The last straw that ultimately drives them into a situation of insolvency is typically an insignificant external shock to the economy, such as a wage increase of local public employees ordered by the central government, a modification of the VAT rate schedule, or rising energy prices.

As for its geographical situation, size and administrative status, the typical *önhiki* recipient is a small village situated in South-Transdanubia, in the northern part of the Great Plain, or in North-Hungary. Between 1991 and 2000, an average of 76 per cent of the villages with less than 1,000 inhabitants received a grant. The authors could confirm thus a negative relationship between population size and the risk of insolvency. Not surprisingly, the three regions exhibiting the highest share of *önhiki* recipients are those with the most fragmented territorial structure.

Even more interestingly, comparing the average values of the poverty and demography indicators of beneficiary jurisdictions with the national average, it turns out that municipalities that applied for a grant once or twice between 1991 and 2000, are either on the level of the average or in a more favourable position. Those depending on *önhiki* (having received the grant during seven years or more during the period under review) are almost exclusively small villages with a population of less than 1,000, situated in the northern part of the Great Plain or in North-Hungary.

While the system of *önhiki* gave thousands of municipalities the feeling of increased (or at least, restored) financial autonomy over the years, in fact, it is just another warning signal indicating that the current system of revenue and expenditure assignment is unable to guarantee effective autonomy, as it cannot create the necessary conditions for the independent management of local affairs. If the characteristics of a typical *önhiki* recipient are identical with those of an average municipality, as SZABICS and MÁRVÁNYKÖVI (2004) confirmed, then any local government operating smoothly during several years may happen to slip into the role of a grant applicant overnight. The volatility of the legal rules governing

326 intergovernmental finances and the general exposure of local governments as small open economies to macroeconomic shocks only contribute to the uncertainty. At the same time, the results of the TÁRKI study also suggest that the fiscal equalisation policy does not perform the way it should; or else, the central government would not need to distribute vertical grants to resolve a problem that is inherently linked with horizontal inequalities.

The future of *önhiki* is uncertain. The Ministry of Finance views it as a complementary mechanism that must necessarily accompany the current norm-based revenue regulation. Following their argument, the sum of locally generated revenues and central government grants cannot take account of the situational differences in the conditions of local public service provision. On the other hand, in order to preserve local self-government as an institution, the continuous provision of the fundamental local public services needs to be ensured in one way or another PUSKÁS (2000, p. 117). The central government faces, however, a mounting discontent on the side of those municipalities that have never benefited from *önhiki*. They claim that the system of deficit grants conserves an ill-designed pattern of revenue and expenditure assignment and helps thousands of inefficiently operating municipalities survive at the expense of a well-managed minority. *önhiki* allows its beneficiaries to continue the mismanagement without any risk of sanction and penalises those municipalities that try to make ends meet even in periods of economic hardship.⁷

While maintaining *önhiki* could indeed perpetuate moral hazard problems, hurt interjurisdictional equity and delay intergovernmental fiscal reform, the question of how to banish it requires careful deliberation. Hardening the budget constraint makes sense from a macro-economic point of view, but it works only if local governments are provided adequate conditions for a responsible management of their finances.

Any radical cutback of the grant allotments or the complete eradication of *önhiki* without any other change to the revenue system bears the risk of a massive growth in the number of bankruptcy cases among subnational governments. The economic and political consequences of such a measure would be devastating.

For dealing with SNGs that fell into a deficit trap, Bird advocates a follow-up procedure to ensure that beneficiaries make an effort to avoid insolvency in the subsequent years: 'Emergency central support may sometimes be needed to resolve such debt problems. If so, however, any such support should carry with it

⁷ See e.g. the written contribution of András Rapcsák MP, Archives of the Hungarian Parliament, contribution no. K/3261, <http://www.parlament.hu/iromany/fulltext/03261txt.htm>, date of retrieval: 06.12.2008.

the obligation to introduce and make effective any necessary reforms under the supervision of a review board' BIRD (2000, p. 20).

It is doubtful, however, whether a reform of the local policies and budget enforced by a watchdog can help municipalities improve their performance, especially if the central government recognises that they became insolvent through no fault of their own and they had exploited their full potential to reduce the deficit.

Rather than abolishing *önhiki* or forcing beneficiaries to revise their budget once again, it may be perhaps wise to investigate the reasons why hundreds of municipalities are dependent on the deficit grant. The key question is why the available grants, including the equalisation component of the norm-based grant that is supposed to correct situational disparities described by SZABICS and MÁRVÁNYKÖVI (2004), have not been able to complete local own-source revenues in a way to ensure vertical fiscal balance in municipalities that have otherwise done every effort in order to rationalise their operations and exploit their revenue potential. In a second step, depending on the results of such a study, the central government and the legislative could redesign intergovernmental fiscal relations in a way to help recurring beneficiaries break the vicious circle of *önhiki*. Once the quality of revenue assignment is improved to a level where equalisation grants alone can ensure budget balance even in the neediest municipalities, there will be no need for *önhiki* any longer.

Alternatively, or as an accompanying measure, the central government could strengthen financial and technical support for inter-municipal co-operation (which it has actually been doing for the last few years already) and consider possible ways of encouraging the amalgamation of municipalities. Considering that much of the *önhiki* dependence is related to the territorial fragmentation of the country, the centre could promote amalgamations in general, while offering enhanced support to the excessively fragmented regions and special incentives to local governments that are willing to amalgamate with one or more *önhiki* recipients.

7.4.3 Borrowing If a municipality facing fundamental operating difficulties 'through no fault of its own' does not fully comply with the eligibility criteria of the *önhiki* programme and is unable to adjust its institutions and budget in the short run, it is expected to resort to the financial market in order to balance the local budget. Since its budget is unsustainable, chances are rather low that it will obtain anything else than a so-called liquid loan that is subject to relatively soft rules, as we will see later on.

As Figure 7.2 suggested, short-term borrowing is likely to be an option also for local governments that ran into an operating deficit because of oversized expen-

328 ditures in the domain of voluntary competences. As long as they are considered credible by the market participants, a revision of the expenditure and/or revenue plan will be the second-best option for balancing the budget.

Long-term borrowing is mainly used for the implementation of investment programmes whose costs would otherwise explode the municipal budget. These may be related to both voluntary and mandatory tasks. The difference is only in the alternative funding options. For financing new infrastructure in relation with a delegated function such as health care or environmental protection, local governments are more likely to apply for an investment grant from the central budget; although loans and bonds may also play a role as subsidiary revenues when the grant falls short of the expectations, or as part of the local government matching. Besides, long-term borrowing is one of the most important instruments of local budgetary autonomy, as it allows municipalities to adjust revenue levels to expenditure levels by involving several generations of taxpayers.

Notwithstanding the broad range of situations in which it could be solicited, borrowing plays only a minor role in local government finance. As Figure 7.5 shows, between 1995 and 2002, only 0.3 to 3.5 per cent of total expenditures were financed from debt. The election years 1998, 2002, and 2006 feature particularly high borrowing levels, even though the cyclical movements are less spectacular than in the domain of public expenditures. The local maximum value in post-election year 2003 is presumably due to promised investment programmes.

The weak significance of debt as a funding source also manifests itself in the share of debt-related expenditures within the local budget. For most of the period under review, interest expenses accounted for 0.6 to 0.8 per cent of total GFS expenditures, while debt repayment equalled 1 to 2 per cent of the overall expenditures (including all other transactions in financial assets outside the GFS, see Table 5.1). In 1995 and 1996, the respective shares were substantially higher (1.5 and 1.9 per cent for interest payments and 2.4 to 2.5 per cent for debt repayment). If pure local government data were available for the period 1990–1994 as well, we could probably demonstrate that 1995 and 1996 represent the end of an era where borrowing used to be a much more popular funding instrument in the decentralised public sector. Analysing respective data of the overall subnational government sector (including counties), BALÁS and HEGEDŰS (2004) come to this conclusion and explain it with the absence of borrowing rules, limits on debt service and reporting requirements between 1990 and 1995. The same authors warn that the data cover only a part of the subnational government sector. Off-budget entities (see Section 6.3.3) are not included, although they are presumably much more active on the financial markets

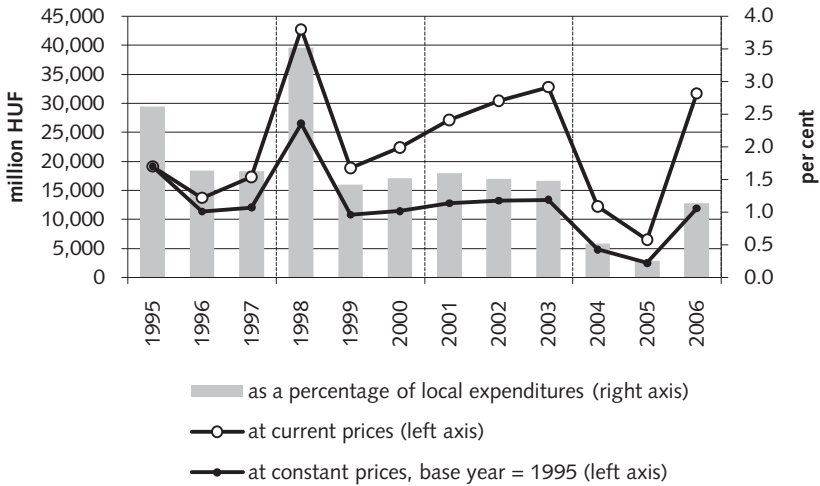


Figure 7.5: The development of local government borrowing 1995–2006 [Source: the author, based on Balás and Hegedűs (2004); data from the Ministry of Finance]

330 than local governments are, due to their role in providing infrastructure-intensive public services such as drinking water and heating.

Even if the adoption of fiscal rules has dampened local borrowing to some extent, concluding that the low levels of debt result from an overly restrictive national regulation would be fallacious.

The theory of fiscal federalism and decentralisation proposes various approaches to systematising the policy instruments aimed at controlling sub-national borrowing and debt.⁸ Here we follow the proposal of TER-MINASSIAN and CRAIG (1997) who distilled a wide range of country experiences into four broad categories:

1. *Reliance on market discipline* requires that financial markets exert effective control over subnational borrowing.
2. *Co-operative approaches* imply that fiscal rules emerge from negotiations between the central government and lower levels.
3. *Rules-based approaches* are based on standing rules specified in the constitution or in laws. These specify e.g. the absolute level of indebtedness, the purpose of long-term borrowing, etc.
4. *Direct control* of the central government over subnational borrowing may take the form of an annual limit on the overall debt of individual jurisdictions, the review and authorisation of individual borrowing operations, etc.

The Hungarian approach to controlling subnational borrowing and debt combines the reliance on market discipline (1) with certain formal rules (3).

Reliance on market discipline has primary importance. According to art. 88 of the ALG, local authorities may obtain a loan from any domestic or foreign financial institution (except for central banks) and issue bonds on both domestic and foreign markets. Lenders assess them directly for creditworthiness. Borrowing and bonds issuance are admitted for both operating and investment purposes and thus on both short and long term. However, long-term loans cannot be signed without the approval of the local assembly. Temporary liquidity gaps hampering the continuous provision of public goods and services may be bridged with a so-called liquid loan that must be repaid within the same year. Another manifestation of the dominance of market mechanisms is the law on municipal bankruptcy (Section 7.5).

⁸See e.g. TER-MINASSIAN and CRAIG (1997), DAFFLON (2002b), or SWIANIEWICZ (2004a).

As a secondary approach to controlling local borrowing and debt, the Parliament adopted certain fiscal rules starting from 1996 (not applying to the liquid loan):

- Core assets, norm-based grants, other central government grants, the PIT revenue share and intergovernmental flow-through transfers cannot be used as collateral.⁹
- The upper limit to annual expenses resulting from borrowing, bonds issuance, leasing, and the provision of guarantees is the adjusted current own revenue of the local government that is calculated as

$$B_t^{\max} = ACOR_t = 0.7 \times (COR_t - SL_t), \quad (7.1)$$

where B_t^{\max} is the upper limit of borrowing in year t , $ACOR_t$ the adjusted current own-source revenue in year t , COR_t the current own-source revenue budgeted for year t (including local taxes, administrative fees, motor vehicle tax, interests received, fines, dividends; rental fees, leasing fees, and other revenues related to the asset for which the debt was incurred as well as other own-source revenues), and SL_t the short-term liabilities (equivalent to interest expenses, debt repayment, leasing fees, accounts payable, and other liabilities) due in year t .

- Local governments that sign a loan must have their budgets audited independently. The independent auditor has to make sure that the municipality does not hurt the above-mentioned rules.
- Following art. 90 para. 2 of the ALG, the central government refuses any responsibility for the default of local governments, which is equivalent to a formal no-bailout commitment.
- Further minor restrictions concern the issuance and trading of local government bonds. This is regulated in the Act CXX of 2001 on Capital Markets.¹⁰

As has been mentioned in Section 7.1, local governments may voluntarily adopt a ‘golden rule’ that restricts borrowing to the single purpose of capital development.

Other regulations indirectly affecting the borrowing and debt behaviour of local governments include the obligation to cash-based accounting, recording the assets at face value, and monitoring by the State Audit Office.

⁹See footnote 38 on page 230.

¹⁰These rules appeared originally in the Act CXL of 1996 on the Issuance of Securities, on Investment Services and the Stock Exchange.

Although the fiscal rules are not overly strict, they are already prohibitive for small villages with a modest level of own-source revenues, according to a survey conducted by BALÁS and HEGEDŰS (2004). The fragmented territorial structure is also one of the constraints on the increase of bonds issuance: villages have difficulty presenting collaterals and stable own-source revenue flows that are, however, vital for creditworthiness. However, fiscal rules are not the only factor excluding small jurisdictions from the credit market. Other factors include poor debt management capacity and a low level of the individual demand for loans that does not allow the bank to realise a profit. Enhanced horizontal co-operation between the smallest municipalities is a possible remedy to this situation.

Large towns seldom reach the official borrowing limit, partly because the limit is already higher due to the substantial amount of own-source revenues (*ACOR*_{*t*} criterion). By contrast, small towns with relatively modest revenue capacity but high ambitions in terms of public service provision and infrastructure development have a tendency to exploit their borrowing rights to the maximum.

Statutory rules on borrowing and debt are just one factor behind the relatively modest volume of loans and bonds in the local government sector. At least two other factors merit consideration.

First, the alternative revenue sources of local governments are highly unpredictable. This fact evokes three problems:

1. It makes it difficult for lenders to assess the creditworthiness of municipalities and hence act as a natural impediment to borrowing (KOPÁNYI et al., 2004, p. 67).
2. Investment grants and shared revenues are often used as complementary resources for funding investment. The limited transparency and reliability of these revenue sources jeopardises the implementation of the whole investment programme.
3. A high share of such revenues in the local budget increases uncertainty about whether the municipality will be able to cover debt repayment and interests as well as the maintenance and operation of the new infrastructure and the related public services during the following years.

Second, indebtedness is associated with a (perceived or real) political risk. In the survey conducted by BALÁS and HEGEDŰS (2004), half of the responding municipalities reported about the negative attitude of the local assembly towards borrowing. Surprisingly, the aversion is the greatest in large towns, although they

7.5 Local government bankruptcy

One cannot discuss local budgetary autonomy in Hungary without taking into account the institution of municipal bankruptcy. It is certainly not something that enhances budgetary autonomy. The opposite is true: once a local government has filed (or has been filed) for bankruptcy, it actually gives up self-government and subordinates itself to the court and the trustee.

If the institution of bankruptcy does not enhance budgetary autonomy, at least it has a positive effect on budget responsibility. As has been discussed in Chapter 3, autonomy and responsibility are two sides of the same coin, two notions that are inherently connected.

The risk of municipal insolvency appeared in the decentralised system as soon as 1990 when the ALG conferred local governments the property and management right of virtually all local public assets together with the right to get involved in for-profit entrepreneurial activities, to manage portfolios of securities, and to borrow without any restriction.

The need for bankruptcy legislation emerged in the summer of 1995 when four severely indebted municipalities (Bakonszeg, Bátorliget, Nágocs, and Szerencs) experienced such a serious crisis that they lobbied for a bailout from the central government. The investigations revealed that all four villages had become insolvent because of own management failures. In spite of this finding, the central government created an ad-hoc fund of 250 millions of forints. Following the publication of the related central government decree, three out of the four municipalities applied for and received a one-time repayable grant for covering the costs of basic public services.¹¹ In November, a similar grant was provided to a fourth municipality (Páty). The modalities of the grant repayment were supposed to appear in a separate law on debt adjustment. Since the intervention threatened to create a precedent with unforeseeable contingent liabilities for the central budget the government decided to regulate the issue of municipal insolvency as soon as possible (JÓKAY et al., 2000). This task was completed with the adoption of the Act XXV of 1996 on Municipal Debt Adjustment that is the first law on municipal bankruptcy in Europe, inspired by the bankruptcy rules of private law. Table 7.2 provides a brief overview of the procedure.

¹¹Government Decree no. 1092 of 1995 (28 September); see also SAO (1996).

Table 7.2: Municipal bankruptcy procedure according to the Act XXV of 1996
[Source: the author]

Initiation	As a rule, the procedure must be initiated by the local government in distress, but it may also be initiated by the creditor(s). The Court appoints a trustee, if the local government or any of its institutions failed to meet its debt obligation within 60 days after the deadline.	
Phases	<ol style="list-style-type: none"> 1. Setting up a commission for debt settlement 2. Emergency budget 3. Reorganisation programme (expenditure cuts, exploitation of revenue potential, co-operation with neighbouring municipalities etc.) + Settlement proposal 4. Negotiations with creditors 	
	5a. If there is an agreement, the Court concludes the procedure	5b. If there is no agreement, the Court decides on the distribution of local government assets
	6a. Execution of the agreement.	6b. The Court concludes the procedure.
Constraints on the municipality	The local government is obliged to ensure the continuous provision of basic public services. It may not assume new obligations nor sell any of its assets.	
Funding	As a rule, the local government assumes the costs of the legal procedure, but it may apply for central government grant both for covering the salary of the trustee and for financing the continuous provision of basic public services during the procedure.	

The institution of municipal debt adjustment has been a success ever since its introduction. Until 2005, there were only eighteen bankruptcy filings involving sixteen municipalities (GURNIK et al., 2005), most of them suffering from the consequences of oversized and financially unsustainable investment programmes. According to inquiries by JÓKAY et al. (2004) for the period 1996–2000, all villages that asked for debt adjustment were of small size, and most of them were engaged in large infrastructure projects such as gas supply or sewage pipelines that were both technically and financially unrealistic.

The low number of filings suggests that the bankruptcy law exerts its real impact not so much through the sanctioning of those few villages that failed but through warning off the rest. One could argue that the deficit grants (*önhiki* and the ones reserved for financing the municipal debt adjustment procedure and other sources of vertical fiscal imbalance) weaken the effect of the bankruptcy legislation. Indeed, as has been mentioned in Section 7.4.2, many more local governments would have to face bankruptcy if there were no bailout grants. It is also possible that deficit grants and bankruptcy legislation together weaken the forces of the market. Just as it is easy to plan a deficit *ex ante* and apply for *önhiki* in order to bridge the gap, it is also relatively easy to file for bankruptcy, especially if the central government offers further grants for covering the costs of the procedure. However, there is presumably nothing more frightening for a mayor than the mere thought of a possible liquidation of its municipality and the distribution of assets. The tenacious insistence on autonomy caters for extreme caution in the management of the local budget, thus turning the mere existence of bankruptcy legislation into an effective measure against irresponsible behaviour.

PART III

Conclusions and Outlook

Understanding Local Financial Autonomy

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In the Introduction to this piece of research, we formulated two sets of research questions with the aim to channel the inquiry through the realm of local financial autonomy. The purpose of the present chapter is to summarise the major findings that may contribute to elucidating those questions.

Chapter 8 shows to what extent the literature review in Part I could help identify the main components and constraints of local financial autonomy, to clarify its relationship to other objectives of a decentralised system, and to understand the challenges related to measuring autonomy. Chapter 9 summarises the major insights about the determinants of local financial autonomy in Hungary.

This first group of research questions about the components, constraints, context, and measurement of local financial autonomy has received an adequate, albeit not exhaustive answer in Part I. Five major issues merit some reflexion here.

1. The review of the literature on fiscal federalism and decentralisation revealed that local autonomy has rarely been in the focus of scientific analysis, although it is generally recognised as a central term in the discussion about multi-level government systems. Local autonomy appears thus to be one of the most commonly cited but also one of the least precisely defined terms in the decentralisation vocabulary. Lacking a universal definition, local autonomy is a rather vague issue. As a theoretical concept and a higher-level principle of territorial organisation, it tends to be overvalued. This may have its origins in the European political discourse on territorial reforms during the 1980s where local autonomy emerged as a valence issue, a subject that united public opinion rather than dividing it. Even today, and presumably in

most countries of the world, policymakers at all levels of government are willing to recognise and support, at least in words, the vertical decentralisation of power and the resulting autonomy of subnational levels.

However, because of the very fact that local autonomy is conditional upon power sharing, it becomes a highly contentious issue as soon as it comes to implementation. The question of 'who should decide what in a federal system' (DAFFLON, 1978) is all the more important as the general government with all its subsectors must be able to manage the country to success (in whatever way success is defined) through the sum of its decisions. The autonomy of governments (at any level) becomes thus subordinated to higher objectives such as economic growth, optimum level of employment, political stability or social cohesion. In its relations to the role of the state, namely allocation, distribution and stabilisation, local autonomy involves important trade-offs. If society values some other objectives higher than it does local autonomy (which is more likely than the opposite case), then less autonomy may be of a higher value for the achievement of these objectives.

With his double definition of local autonomy as 'freedom to' (regulate and legislate in own interests; also called the *power of initiation*) and 'freedom from' (oversight by higher tiers of the state; also called the *power of immunity*), CLARK (1984) sets the benchmark at the level of absolute (perfect) autonomy, which is far too idealistic and therefore unsuitable for the practice of decentralisation. Another problem with this early definition of autonomy is the ignorance of the effective capacity of local governments to make use of their freedom. Hence, it is not surprising that those more recent definitions combining the notion of right with that of capacity (ability) have had a longer and greater impact on territorial reforms worldwide than those that promote the right component only. The definition laid down in the European Charter of Local Self-Government (COUNCIL OF EUROPE, 1985a) is a key example. By integrating the notion of *ability* into the broader concept of local autonomy, the Council of Europe urged its member countries to enhance the financial, administrative, technical, professional, etc. capacity of their local governments. Considering the diversity of domains in which decentralised authorities need to be empowered in order to make use of their rights, it is clear that *ability* and *financial autonomy* are not synonyms. Rather, the definition of each aspect of autonomy (political, administrative, judicial, financial autonomy, etc.) entails right and ability as the two constitutive elements. In consequence, conceiving financial autonomy as the sum

of expenditure autonomy, revenue autonomy, and budgetary autonomy, as we proposed in Section 3.4, implies that both right and ability appear as constitutive elements in each of these three subcategories (or again, aspects) of financial autonomy.

2. If the financial autonomy of local governments is limited, it means that either their rights are trimmed (or defined narrowly) or they lack the ability to make use of those rights, or both. Hence, it seems to be appropriate to consider exogenous legal constraints on local financial autonomy as restrictions on the *rights* of decentralised authorities, and exogenous non-legal (economic, cultural, geographical, etc.) constraints as restrictions on their *ability*. These recognitions have ultimately led us to draft the three matrices of constraints in Section 3.4 (Figures 3.4 to 3.6) that proved to be useful as a lecture grid for the subsequent practical analysis of local financial autonomy in Hungary, although they are not free from overlapping and would possibly merit some further extension and refinement. Besides, both right and ability are further restrained by endogenous factors (arising from some autonomous decisions of the local government or the local community) that, however, the present study was not able to cover in detail.
3. Identifying and describing the exogenous constraints in the greatest possible detail appears to be a key condition for a correct measurement of local financial autonomy. At least this is what we could learn from the review of the existing measurement approaches in Section 3.5. Simple (general) measures such as the GFS indicator of subnational expenditure (or revenue) within the general government expenditure (revenue), the GDP, or another macroeconomic variable, fail to provide a reliable result because they disregard the fact that subnational governments may have no influence on a part of their expenditures and/or revenues, these being delegated or dictated by a higher-level authority or determined by other (non-legal) factors. The more recent and also more sophisticated approaches (see e.g. BELL et al., 2006 for expenditure autonomy, BLÖCHLIGER and KING, 2006 for revenue autonomy) involve at least some of the exogenous constraints. A deeper knowledge of the constraints would help to refine the measurement techniques, whereby there is an obvious trade-off between the simplicity of the formula and the number of variables (constraints) involved. Complicated models with a large number of specific constraints may not be suitable for cross-country comparisons. For instance, the duty of the counties in Hungary to take over certain expenditure responsibilities from the municipalities upon request by

the latter is an important restriction on the counties' expenditure autonomy but completely unknown and irrelevant for decentralised governments in another country. Such sophisticated models are, however, useful for analysing the change in the scope of local financial autonomy in a given country within a given period, on condition that the cost of access to the relevant data is not disproportionately high.

4. The crux of all techniques of measuring local financial autonomy is the fact that one can integrate an infinite number of constraints (even if one limits the model to the exogenous ones) and still obtain a result that potentially overestimates the real extent of autonomy—as do all four qualitative approaches presented in Table 3.6 for measuring subnational revenue autonomy. The overestimation bias of quantitative models is less significant; however, a substantial part of the constraints is not quantifiable. More comprehensive inventories of constraints such as the ones proposed in Figures 3.4 to 3.6 may contribute to a further refinement of the indicators of local financial autonomy. The questions as to whether it is necessary to include any endogenous constraint into the measurement formula and if yes, which ones, opens avenues for further research.
5. Finally, the examination of constraints—particularly of legal constraints—raises the question about the conditions under which it is justifiable for higher-level authorities in a decentralised government system to impose such constraints on the lower level(s). The review of the literature about the relationship between local autonomy and the principle of subsidiarity (Section 3.6) reveals autonomy as being the underlying socio-philosophical idea of subsidiarity. Indeed, the first part of the principle of subsidiarity is relatively clear: every task belongs to the lowest competent level. By contrast, the second part that specifies the conditions of legitimate withdrawal of a competence from the lower authority is usually marked by vague expressions such as 'incapacity', 'undertaken more effectively', or 'cannot be sufficiently achieved'. For the practical implementation of the universal principle of subsidiarity in a given local institutional context, it is essential that the various governmental actors (at various levels) agree upon the meaning of these expressions as well as upon the conditions justifying the withdrawal of competences from the lower level. As a general rule, we propose that the following conditions be met simultaneously:

- Within the limits of its competence and capacity, the higher authority has offered all reasonable assistance to the lower authority in order to address the (managerial, administrative, financial, etc.) incapacity of the latter;
- The lower authority has already exploited every opportunity within its competence in order to regain capacity or it is unwilling to search for an autonomous solution;
- Either the demand for a re-assignment of the competence comes from the lower authority or, if it comes from the higher authority, it is consulted with the lower organisation before any action is undertaken.

Even if adopting this formula, the negotiating authorities still need to define the terms ‘reasonable assistance’, the ‘limits of competence and capacity’ of the higher authority, the effort that can realistically be expected from the lower authority to exploit its potentials, and the contents of ‘consultation’ between both levels.

Local Financial Autonomy in Hungary: Lessons to Learn

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As one could expect, the study of fiscal decentralisation in Hungary and its impact on the financial autonomy of local governments resulted in a multitude of findings. The initial question as to whether the scope of local autonomy has decreased since the start of the decentralisation process cannot be concluded with a simple yes/no answer. Both expenditure and revenue autonomy and the freedom to modulate the local budget constraint have been subject to antagonistic forces. The reader may remember that we postulated local autonomy as being just one of several concurring objectives in a multi-level government system. According to the normative theory of constitutional economics, the assignment of responsibilities and revenues should be consistent with the economic role of government that consists (simply formulated) in increasing efficiency while achieving some degree of equity and stability. It follows that local autonomy, the extent of which is determined by the division of expenditure and revenue powers among the various levels of government, is ideally subordinated to equity, efficiency and stability. Following this line of argumentation, local authorities should desire neither more nor less autonomy than what is necessary for ensuring that the general government system fulfils its economic role. Autonomy in this context is not an objective *per se*, but rather an instrument that allows the achievement of other objectives. The optimum degree of decentralisation (and hence, the optimum degree of autonomy) cannot be determined objectively, as the positive effects of decentralisation on efficiency and its adverse effects on equity can only be estimated with a certain

346 error. How much autonomy we consider as desirable depends ultimately on the importance we attach to efficiency as opposed to equity.

While this argumentation may sound overly normative and perhaps slightly conservative, it contributes to a better understanding of the forces that influenced the degree of local financial autonomy in Hungary throughout the 1990s and the 2000s. If we consider local financial autonomy as the right and the ability of local authorities to manage their financial affairs, then we can conclude that each of these components has been subject to different kinds of influence.

The first component, right, has mainly been modulated through legislation according to the preferences of citizens (as perceived by their elected representatives) in terms of efficiency and equity. Quite in the spirit of fiscal federalism theory, measures enhancing local financial autonomy came to the fore whenever the society pleaded for more efficiency in resource allocation, whereas autonomy was restrained whenever the quest for more equity, stability, or other goals that can be better achieved in a centralised setting, dominated the public discussion. The indirect regulation of local financial autonomy through the expenditure and revenue assignment requires continuous monitoring and adjustment, all the more because on some occasions, the rights of local governments were trimmed more seriously than what equity or stability considerations could justify.

Whereas financial autonomy in terms of rights changed in the same direction for all local governments more or less, the second component of autonomy, ability, has developed differently across the jurisdictions. Some local authorities have succeeded in strengthening their managerial, technical and financial capacity, thus filling their formal (legal) autonomy with real content. Among other qualities, they are successful in tailoring the supply of public services to local needs, in setting adequate tax prices, and in pursuing a sound and sustainable debt policy. Other municipalities that lack adequate conditions or capacity are lagging behind in applying the letter of the law for the benefit of their constituency. Economic and political cycles as well as the demographic challenge may also influence the ability of certain local governments to make use of their formal powers.

The main output of Part II is a vast set of qualitative and quantitative (partly processed) information that allows us now to compile a nearly exhaustive catalogue of the exogenous determinants of municipal financial autonomy in Hungary (Table 9.1).

The catalogue consists of two major vertical blocks—positive and negative determinants of local financial autonomy (components and constraints, respectively)—linked together by upward and downward arrows in the middle to indicate of the domain(s) of autonomy they affect in the first instance. Furthermore, each

negative determinant is completed with a reference to the relevant matrix of constraints (Figures 3.4 to 3.6 proposed in Chapter 3) and the corresponding element of that matrix. The catalogue includes some of the endogenous restrictions as well, without claim of completeness, however.

The catalogue proposed in Table 9.1, particularly the list of constraints, may be a first step towards measuring the expenditure, revenue and budgetary autonomy of the municipal sector in Hungary. The identification and description of constraints that has been the main objective of the present piece of research is notably only a part of the challenge of measurement. The next step consists in the integration of these and other, not yet identified constraints into the measurement device (a qualitative model or an indicator formula) provided that the latter has previously been revised and extended in order to accommodate the new constraints.

Neither qualitative tools of measurement (typology, ranking, etc.), nor quantitative indicators can do without an appropriate system of weights. However, in order to assign weights to the variables in a model for measuring local financial autonomy, one needs to have some approximate information about the relative importance of the individual constraints. Such information is hardly obtainable without a quantitative analysis of the related data. But even a purely qualitative analysis of local financial autonomy (from the institutional perspective) delivers more reliable results if it is based on solid statistics that allow the analyst to judge the relative importance of the issues raised.

Regrettably, the inadequate quality and structure as well as the poor accessibility of the data on the subnational government sector in Hungary make it difficult, for the time being, to carry out any profound statistical analysis of the constraints local financial autonomy.

As a key component of this job, one should be able to separate the actual expenditures on delegated and deconcentrated (mandatory) functions or tasks from those on devolved (voluntary) functions or tasks. This implies, within each function, the ability to distinguish between that part of the expenditure which results directly from a legal provision (a mandate) and the rest that reflects the preferences of the local constituency. Such distinction is impossible, however, for the following reasons:

1. In each policy sector, local government responsibilities are affected by a multitude of legal provisions of various origins. These legal provisions are frequently amended and the related information is diffuse. Table 5.2 on the assignment of functions and their classification into mandatory, optional and subsidiary categories is the output of several days of meticulous work,

Table 9.1: The determinants of local financial autonomy in Hungary, 1990–2006 [Source: the author]

#	Factors increasing local financial autonomy (components)	EA	RA	BA	Factors decreasing local financial autonomy (constraints)	Category of constraint (reference to Fig. 3.4 to 3.6)
1	The right to get separated from, or amalgamate with, another local government (4.1)	↑	↑	↑	[Endogenous] Bias towards splitting of municipalities → Excessive fragmentation of the territorial structure (4.2.1) → Low efficiency of public service provision, low financial capacity in small villages (5.2., 5.3) → Growing need for equalisation (reducing autonomy also for strong municipalities) (6.6.3)	Fig. 3.5 Fiscal equalisation
2	The power of general competence (4.1)	↑				
3	Consideration of jurisdiction size and financial power in the assignment of expenditures (4.2.3)	↑		↓	Voluntary tasks assumed beyond financial capacity put municipal finances under pressure (7.3)	Fig. 3.6 Lack of capacity to manage debt
4	Lack of effective legal, financial, political sanctions in the case of non-performance of delegated responsibilities (5.2.5)	↓			Inadequate differentiation in the assignment of health and social care functions (5.2.4)	Fig. 3.4 Statutory assignment of responsibilities

↓		Large number of delegated responsibilities including 'merit goods' (5.2.2)	Fig. 3.4 Statutory assignment of responsibilities
↓		Frequent amendments to the legal framework of expenditure assignment; proliferation of delegated functions outside the ALG (5.1.1)	Fig. 3.4 Statutory assignment of responsibilities
↑	5	The right to assume any business activity that is not related to public services but at least does not jeopardise the fulfilment of mandatory functions (4.1)	↑
↓		[Endogenous] Insolvency of own enterprise puts pressure on municipal finances (7)	Fig. 3.6 Lack of capacity to manage debt
↑	6	The right to manage local public property independently, including the sale of assets (4.1)	↑
↑	7	The right to transfer competences to the county within the limits of the law (5.2.5)	↑
↓		The institute of competence transfer reduces the autonomy of the counties in those policy domains where they are obliged to take over the function from the municipality upon request by the latter (5.2.5)	Fig. 3.4 Competence transfer

Table 9.1: (cont.)

#	Factors increasing local financial autonomy (components)	EA	RA	BA	Factors decreasing local financial autonomy (constraints)	Category of constraint (reference to Fig. 3.4 to 3.6)
8	The right to decide whether to provide public services independently or in co-operation with other local governments (5.3)	↑				
9	The right to select one's preferred mode of service delivery (including in-house provision, contracting and the founding of municipal enterprises (5.4)	↓			[Endogenous] General aversion against interjurisdictional co-operation in service delivery (5.3)	Fig. 3.4 Interjurisdictional co-operation
10	The right to manage local public resources independently (4.1)	↑				
11	The entitlement to contributions from the central budget in proportion to the volume of newly imposed mandatory expenditures (4.1; 6.1.3)	↑			Creeping centralisation through a growing number of sector-specific regulations (simple-majority laws and government/ministerial decrees) (5.4.1) [Endogenous] Poor design of many service delivery contracts (5.4.2)	Fig. 3.4 Quality and quantity standards Fig. 3.4 Quality and quantity standards

12	The right to generate own revenues (4.1; 6.1.3)	<p>↑</p> <p>↓</p> <p>↓</p> <p>↓</p>	<p>Lack of clarity about which proportion of the expenditures are covered through contributions (7.3)</p> <p>Frequent amendments to the rules of eligibility (distribution) and the size of the pool (6.5 to 6.7)</p> <p>Government/ministerial decrees imposing new sector-specific regulations seldom assign additional revenues to the local level (7.3)</p> <p>Poor contribution of the local level to general government tax revenues (6.2.5; 7.3)</p> <p>Poor potential for generating structural own-source revenues especially in crisis-hit industrial towns and small rural villages with ageing and/or declining population (6.2.5)</p>	<p>Fig. 3.6 Fiscal imbalance</p> <p>Fig. 3.5 Frequent amendments to the legislation on local taxes and grants</p> <p>Fig. 3.6 Fiscal imbalance</p>
13	The right to raise taxes with a local scope and to modify their parameters (base, rates and reliefs) within the limits of the law (6.2)	<p>↑</p> <p>↓</p> <p>↓</p> <p>↓</p>	<p>Local taxes: upper limits on rates; prescribed minimum tax reliefs; centrally defined tax bases (6.2.1)</p> <p>Weak performance of taxes assigned to the local level (land tax + tourism tax + communal taxes < 1 % of local GFS revenues) (6.2.5)</p> <p>[Endogenous] Under-utilisation of tax autonomy especially with regards to the taxation of households (6.2.3)</p>	<p>Fig. 3.5 Weak local tax effort due to 'fiscal crowding-out'</p> <p>Fig. 3.5 Demographic and socio-economic conditions</p> <p>Fig. 3.5 Statutory rules on local taxes and user charges</p> <p>Fig. 3.5 Low productive efficiency of own-source revenues</p> <p>Fig. 3.5 Fear of loss of popularity</p>

Table 9.1: (cont.)

#	Factors increasing local financial autonomy (components)	EA	RA	BA	Factors decreasing local financial autonomy (constraints)	Category of constraint (reference to Fig. 3.4 to 3.6)
14	Continuous adjustment of the upper limits of local tax rates in the national legislation (6.2.1; 6.2.2)		↑		Frequent amendments to the framework law on local taxation (6.2.1)	Fig. 3.5 Statutory rules on local taxes and user charges
15	The right to raise non-tax revenues such as user charges, fees and fines, and to modify their parameters within the limits of the law (6.3)		↑		User charges: centrally defined maximum level (e.g. public education, health care) or calculation method (e.g. drinking water, sewage, waste) (6.3.2) [Endogenous] User charges often below levels of cost recovery (6.3.2) [Endogenous] Under-utilisation of fines as additional resources (6.3.4)	Fig. 3.5 Statutory rules on local taxes and user charges Fig. 3.5 Fear of loss of popularity Fig. 3.5 Fear of loss of popularity
16	Availability of grants and transfers as complementary resources for the municipal budget (6.1)		↑		Frequent amendments to the rules of eligibility (distribution) and the size of the pool (6.5 to 6.7)	Fig. 3.5 Frequent amendments to the legislation on local taxes and grants

↓ Mismatch between delegated expenditures and grants (poorly funded mandates, 7.3) → risk of transfer dependence

17	↑ Dominance of unconditional elements in the system of intergovernmental grants and transfers (including shared revenues) (6.5 to 6.7)	↑	↓ Mismatch between delegated expenditures and grants (poorly funded mandates, 7.3) → risk of transfer dependence	Fig. 3.6 Fiscal imbalance
18	↓ Introduction of the motor vehicle tax in the revenue sharing system (1992); increase of LG share from 50+ to 100% (2003) (6.5.3)	↓	↑ Sector-specific regulations on service delivery turn the flexibility created by the dominance of unconditional grants and transfers into an illusion (5.4.1; 6.6.2)	Fig. 3.4 Quality and quantity standards
19	↑ Introduction of the tax on agricultural land rent in the revenue sharing system (1998) (6.5.4)	↑	↑ Obligation for every local government to introduce and administer a luxury tax → 'deconcentrated tax' (6.5.5)	Fig. 3.6 Statutory assignment of resources
20	↓ Introduction of the luxury tax in the revenue sharing system (2006) (6.5.5)	↓	Weak revenue potential; leeway in the law (6.5.5)	Fig. 3.5 Low productive efficiency of own-source revenues

Table 9.1: (cont.)

#	Factors increasing local financial autonomy (components)	EA	RA	BA	Factors decreasing local financial autonomy (constraints)	Category of constraint (reference to Fig. 3.4 to 3.6)
21	Distribution of norm-based grants in accordance with the volume and types of expenditures provided by each municipality (6.6.2)	↑				
				↓	The proliferation of norms reduces the transparency of the intergovernmental fiscal system and complicates financial planning at the local level (6.6.2)	Fig. 3.5 Frequent amendments to the legislation on local taxes and grants Fig. 3.6 Fiscal imbalance
22	Reduction of horizontal needs and revenue disparities via equalisation component of the norm-based grant (6.6.3)	↑	↑			
			↓		The disposable revenue of net contributor municipalities shrinks because of the equalisation (6.6.3)	Fig. 3.5 Fiscal equalisation
23	Availability of addressed and targeted grants for financing local public investments (6.6.5)	↑				
			↓		Low transparency and reliability of the available investment grants due to multiple grant sources and frequent amendments of the rules (6.6.5)	Fig. 3.5 Frequent amendments to the legislation on local taxes and grants
		↓			Distortion of local spending priorities through investment grants (6.6.5; 7.3)	

24	Availability of deficit grants for handling unexpected financial bottlenecks (6.6.6)	↑	(Risk of) dependence on the deficit grant for the continuous daily operation and service provision (7.4.2)	Fig. 3.6 Fiscal imbalance
25	Availability of flow-through transfers (from the NHIF) for financing health services (6.7)	↑	Prohibition of using NHIF transfers for investment purposes (6.7)	Fig. 3.5 Conditions on grant eligibility and spending purpose
26	The principle of the unified budget (4.1; 6.1.2; 7.1)	↑	Continuous decrease in cost reimbursement levels through the NHIF transfers (6.7)	Fig. 3.6 Fiscal imbalance
27	The right to plan for a deficit ex ante and complete the draft budget with the prospective amounts of deficit grants and loans (4.1; 7.1)	↑	The budget cannot be closed with a deficit at year end (7.1) The <i>ōrihiki</i> grant is not automatically available and cannot be used for investment purposes (7.4.2)	Fig. 3.6 Statutory rules on deficit, borrowing and debt Fig. 3.5 Conditions on grant eligibility and spending purpose

Table 9.1: (cont.)

#	Factors increasing local financial autonomy (components)	EA	RA	BA	Factors decreasing local financial autonomy (constraints)	Category of constraint (reference to Fig. 3.4 to 3.6)
28	The right to borrow within the limits of the law (7.4.3)			↑		
				↓	Restrictions on the use of certain revenues as collaterals (7.4.3)	Fig. 3.6 Statutory rules on deficit, borrowing and debt
				↓	Upper limit on the annual expenses resulting from borrowing and other financial market transactions (7.4.3)	Fig. 3.6 Statutory rules on deficit, borrowing and debt
				↓	No bailout by the central government (for indebted municipalities that do not meet the <i>ônhiki</i> criteria) (7.4.3)	Fig. 3.6 Credible no-bailout policy
				↓	Fiscal rules are prohibitive for small municipalities → limited access to loans (7.4.3)	Fig. 3.6 Poor access to borrowing
				↓	Poor predictability of other revenues serving as collaterals, as matching parts, and/or as sources for future debt service and operational expenditures related to the investment (7.4.3)	Fig. 3.6 Poor reliability of resources completing debt
				↓	Risk of insolvency potentially leading to bankruptcy (7.5)	Fig. 3.6 Credible no-bailout policy

yet it provides only a snapshot view of the situation on 01.01.2006. In order to find out whether local expenditure autonomy increased or decreased compared to an earlier date, the entire matrix needs to be reproduced for that date.

2. No information is available about the expected average costs of a new local government task as calculated by the Ministry of Finance. Calculating these average costs indirectly, through decomposing the marginal increment in grant allotments in the annual Budget Acts, bears a substantial risk of error because the Budget Acts are not explicit about the causes behind the change in a specific grant allotment or in the allocation formula.

The expenditure data according to the functional classification of expenditures are available in the annual statistics collected by the Győr-Moson-Sopron County Directorate of the Hungarian State Treasury, but they fail to provide sufficient detail on the questions above, and the preparation of the underlying micro-level data according to the desired criteria demands several man-days of work.

Dealing with the available mass of information on intergovernmental grants represents another challenge, again due to the high number and complexity of grant programmes. Under these circumstances, the estimation of the volume of unfunded mandates is virtually impossible. Likewise, it is hard to make an educated guess about whether the claim of local governments and their interest organisations, according to which a growing part of mandatory responsibilities must be financed from own-source revenues, is justified or not.

Furthermore, as a consequence to the principle of the unified budget, the local government statistics of the Ministry of Finance lack a systematic distinction between current revenues/expenditures on one hand and capital revenues/expenditures on the other. In order to calculate the net operating balance and detect whether there is any cross-financing between operational spending and investments (an important lever of local budgetary autonomy), a clear separation is needed especially in the categories of centralised appropriations and other grants.

By conducting a micro-level survey among local government officials, reviewing the analytical accounts of a sample of municipalities through a longer period, or working with a panel of independent experts, one could possibly make up for some of the deficiencies in the statistics. Because of time limitations, such methods could not be applied in this first (rather exploratory) phase of research.

There is a scope for improvement also in the selection and structure of the data intended for the wider public. The ongoing political debate about local financial

358 autonomy could clearly benefit from a clear separation between county, micro-regional and municipal data. Even if the national Constitution postulates the identity of their legal status as local governments, their expenditure responsibilities and revenues are to a large extent different, so that the annual financial reports of the aggregate local government sector published by the Ministry of Finance are of little use for the debate about financial autonomy in the individual subsectors.

Better data are likely to provide a fruitful basis for further research into specific questions of local financial autonomy in Hungary. By way of an example, it would be particularly interesting to quantify the secondary effects of poorly funded mandates on local expenditure autonomy. Notably, it can be suspected that in order to guarantee the continuous provision of basic public services, local governments facing a financial bottleneck because of poorly funded mandates are willing to cut voluntary expenditures first. Abandoning such expenditures implies, however, the loss of a crucial element of local autonomy (PÁLNE KOVÁCS, 2004, p. 96). A targeted analysis of the financial data of a sample of municipalities could deliver some insights into the importance of this phenomenon.

Further research is needed also into the reasons behind unfunded or poorly funded mandates and the possible (proactive) solutions. One of the key questions is whether unfunded mandates could be avoided by assigning a fixed percentage of the general government budget to the local government sector (DAVEY and PÉTERI, 2004a, p. 142) or, on the contrary, such an arrangement would be too rigid and produce even more unfunded mandates in light of the rapidly changing volume of delegated expenditures. Developing this idea further, several experts in the past few years proposed drafting a separate law on the expenditure and revenue regulation of the subnational government sector (KECSKÉS et al., 2005, p. 14). It would make sense to examine from the perspective of Constitutional Economics whether the separation could reduce the financial dependence of the subnational sector from the general government budget insofar as as the available grants would no longer be determined in the annual Budget Acts. Alternatively, the result of such investigations could confirm the position of the Ministry of Finance according to which the decentralised government system in Hungary is not yet mature enough to ensure the successful regulation of subnational finances outside the general government budget and independently from the national economy that is still in the phase of transition.

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Although financial autonomy is a recurrent notion in the literature on fiscal federalism and decentralisation, it has seldom been the focus of scientific analysis. This book explores the meaning of financial autonomy at subnational levels of government, its relationship with the principle of subsidiarity, as well as its impact on the three economic branches of government activity: allocation, distribution, and stabilisation. The major contribution of the book is a structured overview of the factors that may potentially impinge on the freedom of subnational authorities with regard to their budget decisions. This analytical tool may help pave the way towards the elaboration of more accurate techniques for measuring subnational financial autonomy in future. A tentative application of the new theoretical framework is provided in the second part of the book that delves into the complex issues of municipal revenue and expenditure autonomy in Hungary after 1990.