

# The Practice of Municipal Finance in Hungary

Izabella Barati

Department of Public Policy  
Corvinus University of Budapest, Hungary

Institute on Municipal Finance and Governance (IMFG)  
Hungarian Studies, and the Centre for the European, Russian, and Eurasian Studies (CERES)  
University of Toronto

September 27, 2011



# Structure of the presentation

Description of the Hungarian public administration system

Structure of municipal finance in Hungary

The research on investments of Hungarian municipalities



# Location of HUNGARY in Europe

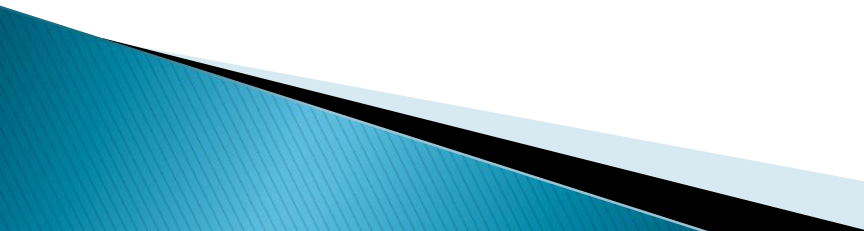


Map not to Scale

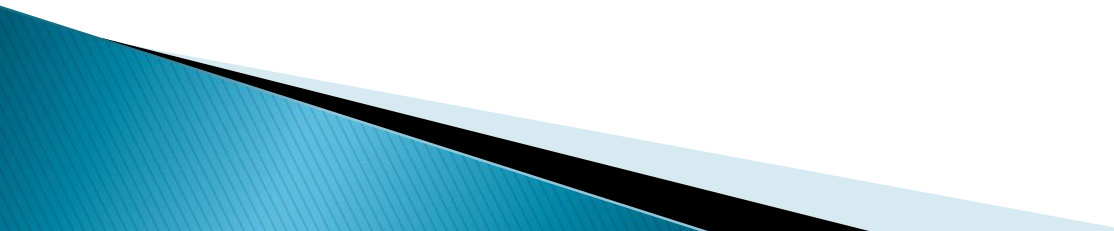
Copyright © 2006 Compare Infobase Limited

# Factors influencing the formation of the Hungarian municipal system

## ▶ History

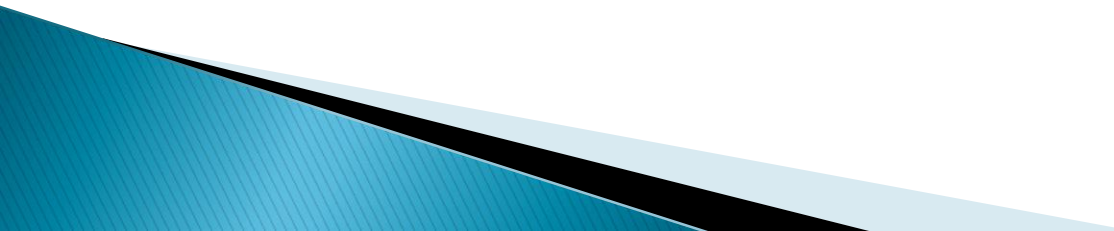
- -1990 Central planning
  - 1990-2000 Creating the legal framework of public administration
  - 2000-2004 Pre-accession period, public accountability
  - 2004 - European Union member country
- 

# European Charter of Local Self Governments

- ▶ Instead of common norms
  - ▶ Accepted in 1985, in force since Sept 1998
  - ▶ Political, financial and administrative independence of local govts.
  - ▶ Constitutions should guarantee municipal rights
  - ▶ Subsidiarity principle
- 

# Addressing the challenges in Hungary Part I.

## Legislation during the first stage (the transition stage)

- Constitutional changes (crucial modification of the previous one);
  - Acts on local self-governments (including municipality and county level) focusing on the new structure and operational rules;
  - Acts on free local elections, defining the different electoral system and process at several level of local governments;
  - Acts on civil servants and public employees;
  - Acts on the scope and duties (mandatory and voluntary tasks) of public administration at each level;
  - Acts on property transportation from the state to the local governments;
  - Financial regulation of local governments;
  - Juridical protection of the decision-making power of local governments;
  - Special status and rights of the capital city.
- 

# Addressing the challenges in Hungary Part II.

## Legislation after the transition stage

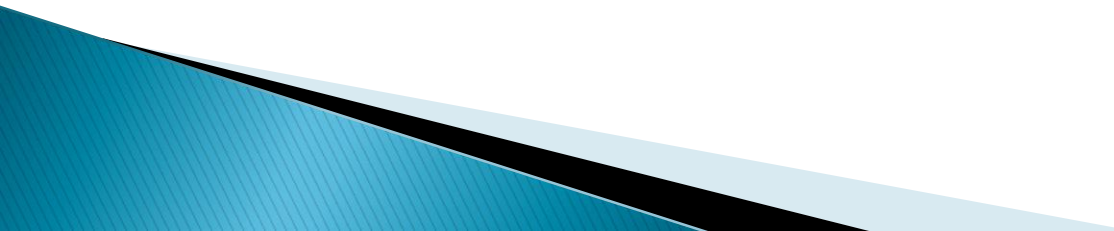
- ▶ Financial activity regulation (audit)
- ▶ Acts on debt and bankruptcy of local self-governments
- ▶ Amendments of system of state subsidies
- ▶ Act on the association and cooperation of local self-governments
- ▶ Act on supervision of local self-government decision-making
- ▶ Amendments of acts on civil servants and other public employees
- ▶ Act on regional development and land use planning

(Hungary is entering a third stage: re-centralization)



# Hungarian specifics

## Public Administration system

- Regions
  - Counties - Lack of middle level
  - Municipalities - Small municipalities (3200)
- 



# Regions

Regional heritage  
XVIII-XIX century

Judicial system

Soldier's districts, education districts

Organization of churches

Offices of the railway system

Post offices



# Regions in Hungary



# History of counties

## County (comitatus)

- King's county
- Border county
- XIII. century „noble county” introducing the functions of the „notary” and the „appointed judge”
- Peasant county: cooperation of neighboring villages against the Turks along the borders of the country

# Counties in Hungary



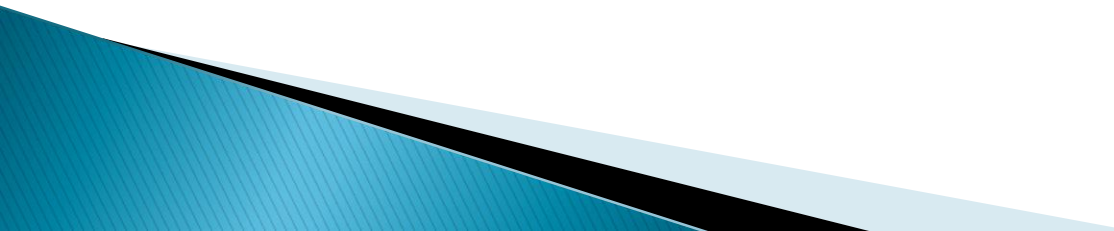
# The county

County governments (19)

County administration offices

Special administrative bodies

# Municipalities

- ▶ Same rights and obligations
  - ▶ Very decentralized system
  - ▶ 3200 municipalities (10 million people)
- 

# Size of local governments

	Number of local govts.	Average population of local govts	Number of local govts before amalgamation	Reductions
<b>Hungary</b>	<b>3194</b>	<b>Average size of a municipality with Budapest: 3100 Without Budapest : 2600</b>		
Austria	2 301	3 400	3 500 (1970)	34 %
Belgium	589	17 200		
Denmark	275	19 100	1 391	80%
Finland	455	11,200		
France	36,559	1,600		
The Netherlands	636	27,000	1,050 (1950)	39%
Luxemburg	118	3,400		
Germany	16,121	5,000		
Baden-Württemberg	1111		3379 (1968)	67%
Italy	8,104	7,000		
Portugal	275	34,200		
Spain	8,082	4,800		
Sweedeen	288	30,900	2,500 (1950)	88%

# **Public Finance in Hungary**

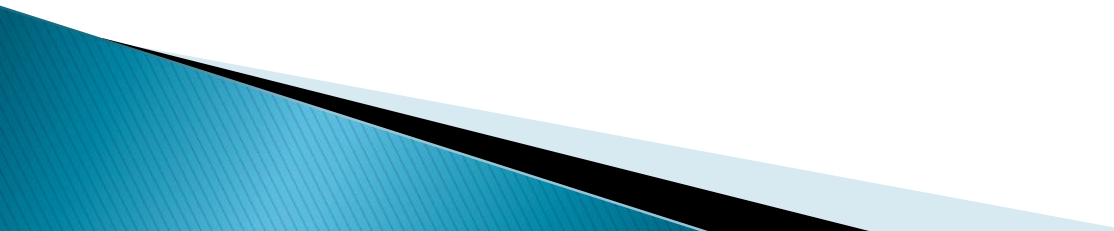


# Functions (expenditures) of the municipalities

The principal duties of the local governments are as follows:

- township development; environmental protection (protection of important local natural sites, etc.)
- local housing
- water supply, drainage, flood prevention;
- liquid waste disposal;
- maintenance of public roads and other public areas;
- local public transportation;
- public cleaning;
- local government fire brigade as well as local defense and civil defense duties;
- participation in the local energy supply;
- participation in the handling of local unemployment; nursery and primary school education;
- basic health and social services;
- support for local child programs;
- provision of local public facilities, general education, culture and sciences;
- support of local sport;
- ensuring the rights of the national and ethnic minorities and ensuring the opportunity for healthy life.

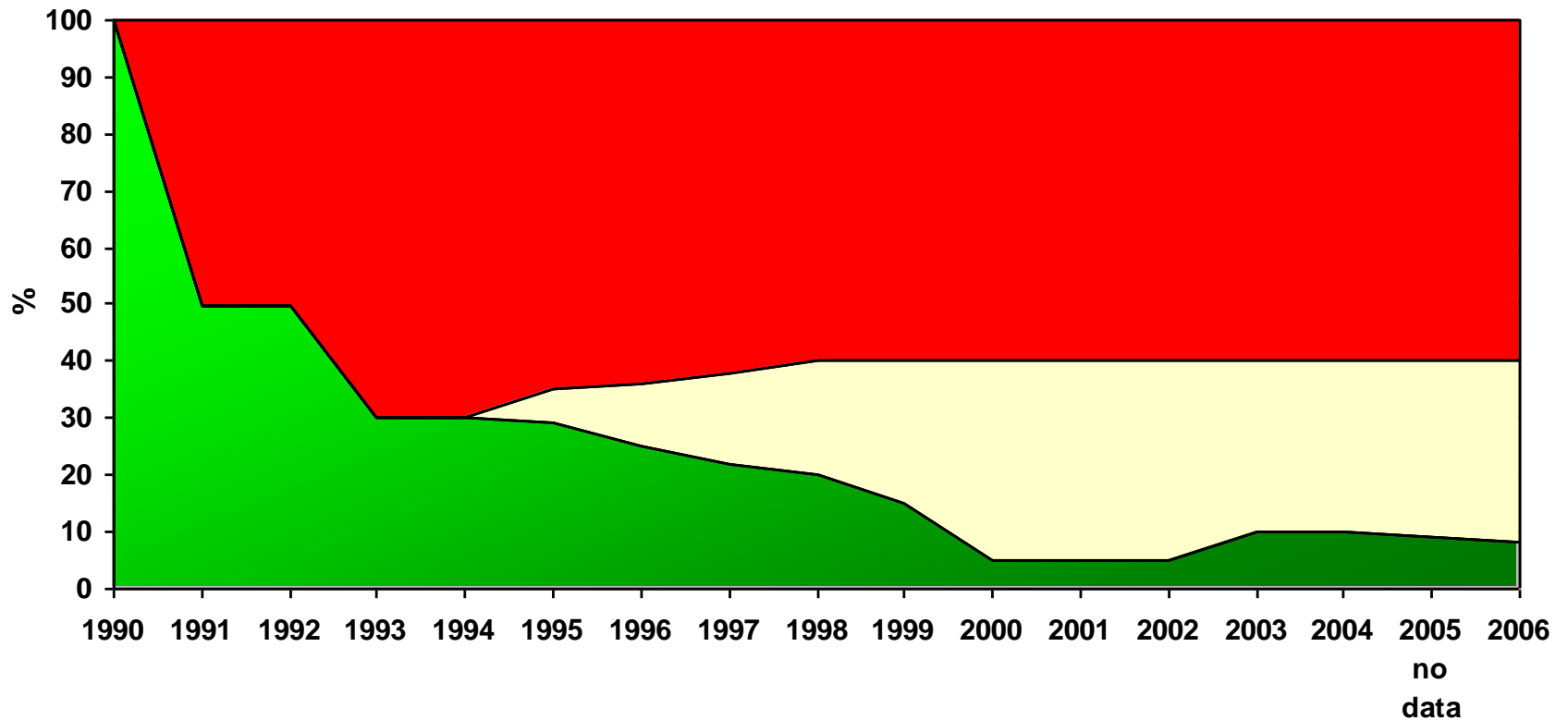
# Extra tasks assigned in sectoral laws

- The provision of potable water
  - Maintenance of public cemeteries
  - Public lighting
  - Support for local civic organizations
- 

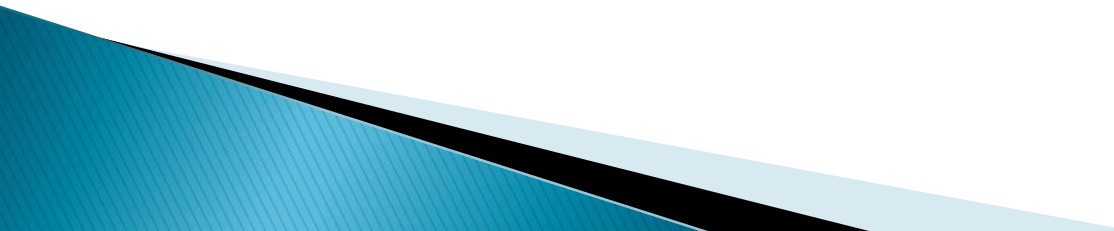
# Local revenues

- ▶ Own sources
  - Fees (12%)
  - Local taxes (business turnover tax 16%)
  - Shared taxes
    - PIT (17 %)
    - Vehicle tax (2-4%)
  
- ▶ Central subsidies (70% in 1990 to 49% in 2009)
  - Non-conditional (fits best local preferences)
  - Conditional, non-matching (earmarked)
  - Matching
  
- ▶ Borrowing
  - Debt service must be covered by operating balance (net operating balance)
  - Total debt of Hungarian municipalities - 4 billion \$ in 2009, 6 billion \$ in 2010

# PIT „returned” to the point of origin and through compensation mechanisms, 1990-2006

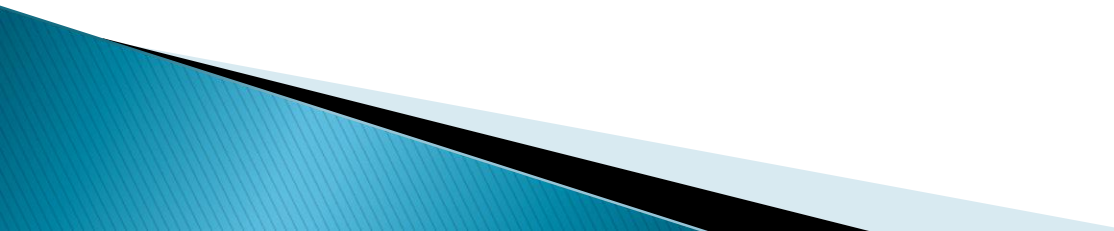


# Tax sharing

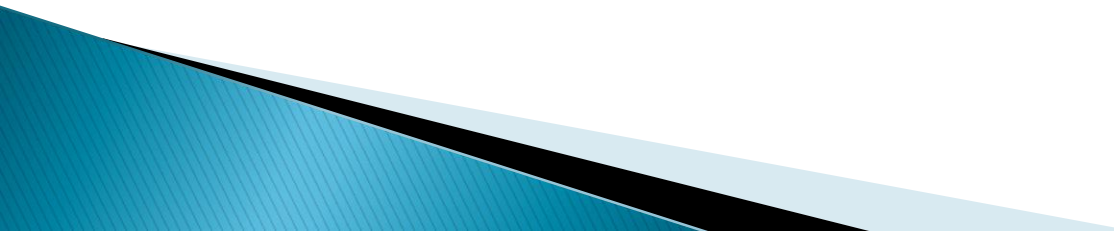
- ▶ Vehicle tax is shared, 100% of this type distributed to the collector jurisdiction
  - ▶ PIT sharing is a mixture of vertical and horizontal distribution (its change over the last years is a typical example for central government's actions when facing hard budget constraints)
- 

# Capital expenditures

Capital spending for

- maintenance
  - new investments
  - amortization
  - citizen's needs
  - environmental problems
  - international agreements
  - spiral effect of delaying investments
- 

# Revenue sources for investment purposes in Hungary

- State subsidies („cheapest” for the local government – „free” money)  
48%
  - International subsidies (mostly matching grants)
  - Own sources
  - Private sector
- 

# Research Question

„What factors determine how much money a municipality invests in infrastructure?“



# The two waves

2001

- ▶ Sponsored by the University of Economic Sciences
- ▶ Questionnaire by emails and postal mail to all Hungarian municipalities
- ▶ Rate of answers 35%
- ▶ Weighted data
- ▶ Descriptive analysis and regression model (independent variable is the investment ratio in the budget)

2010

- ▶ Sponsored by the Hungarian Scientific Research Foundation
- ▶ Questionnaire by emails and postal mail to all Hungarian municipalities – rate of answers is just above 10 %
- ▶ In depth interviews with the 100 biggest municipalities - rate of answers 80 %
- ▶ Weighted data
- ▶ Descriptive analysis and regression model (independent variable is the investment ratio in the budget)

# Descriptive data I.

## Types of planned investments

```
graph TD; A[Types of planned investments] --> B[in 2001 for all municipalities]; A --> C[in 2010 for smaller municipalities the same as 10 years ago while for bigger municipalities];
```

in 2001 for all municipalities

- Water
- Sewage
- Road improvements

in 2010 for smaller municipalities the same as 10 years ago while for bigger municipalities

- District heating
- Public transport
- Education
- Rain water drainage

# Descriptive data II.

## Sources of financing these investments

### In 2001

#### Widespread:

- Regional grants
- Targeted grants
- Other centrally allocated grants

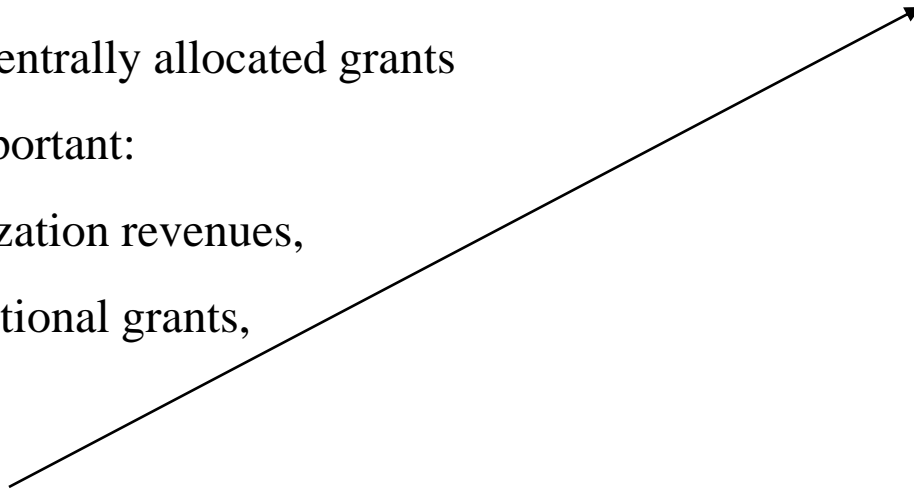
#### Less important:

- Privatization revenues,
- International grants,
- PPP
- Loans

### In 2010

#### Widespread:

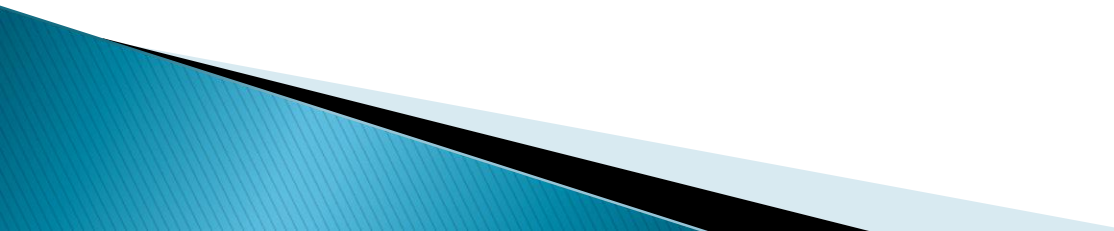
- Grants
- Loans(!!!)





# Descriptive data III.

	2001	2010
Collateral for loans	Mostly immobile assets	Mostly income generated by the investments
Reasons for cooperation with other municipalities:	Only for short term (grant application)	Long term considerations (lower operating costs)

# Methodology

- ▶ Regression analysis
  - ▶ What factors influence the amount a municipality spends on investments
  - ▶ 26 independent variables reduced to 3 in 2001 and to 2 in 2010
  - ▶ Performed the analysis for different sized groups of municipalities
- 

# Regression analysis in 2001

- ▶ Smaller than 10000 inhabitants of the dependent variable  10-50% of the deviations
- ▶ Larger municipalities  50-80%

Loans more important in smaller municipalities

Reasons

1. the difference among the financial resources available to the two groups
2. the preferences of the central subsidy policy
3. the expenditure structure of investments

# Comparison of results in 2001 and 2010

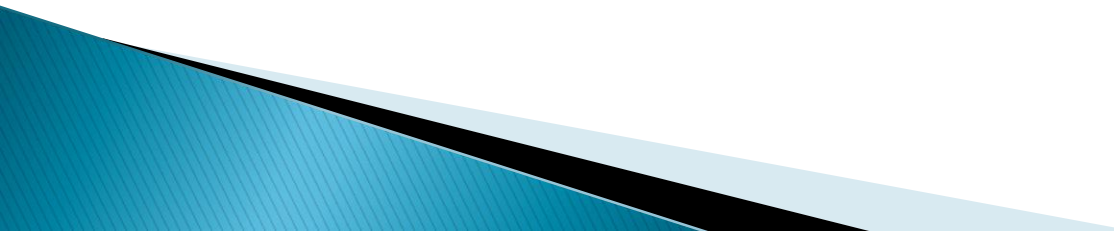
2001

- ▶ R<sup>2</sup>=10-50% depending on the size of the settlement
- ▶ Independent variable
  - **Loans**
  - **Fees + taxes**
  - **Central subsidies**

2010

- ▶ R<sup>2</sup>=99%
- ▶ Independent variable
  - **Taxes**
  - **Fees**
  
- Loans had to be taken out because of multicollinearity
- Central subsidies did not play an important role
- (For larger municipalities only)

# Since 2009...

- ▶ Loan raising in foreign currency
  - ▶ Unregulated bond issues
  - ▶ Bankruptcies after 2009
  - ▶ Decentralization of power did not bring fiscal discipline (as shown by Claessens and Djankov)
    - Municipalities got engaged in unhealthy borrowing
    - Excessively indebted
    - Revenues were not decentralized (taxes)
    - Moral hazard
- 



# Current research

- ▶ Change in state control over municipal loan raising
  - ▶ How public accountability is ensured
  - ▶ Lessons to be learned from Canada
- 