

IMFG

Institute on Municipal
Finance & Governance

MUNK
SCHOOL
OF
GLOBAL
AFFAIRS

IMFG PAPERS ON
MUNICIPAL FINANCE AND GOVERNANCE

No. 11 • 2012

Hungary:
An Unfinished
Decentralization?

Izabella Barati-Stec
Corvinus University, Budapest



UNIVERSITY OF
TORONTO

IMFG Papers on Municipal Finance and Governance

Hungary: An Unfinished Decentralization?

By
Izabella Barati-Stec

IMFG
Institute on Municipal
Finance & Governance

MUNK
SCHOOL
OF
GLOBAL
AFFAIRS

 UNIVERSITY OF
TORONTO



Institute on Municipal Finance & Governance
Munk School of Global Affairs
University of Toronto
1 Devonshire Place
Toronto, Ontario, Canada M5S 3K7
e-mail contact: info.imfg@utoronto.ca
<http://www.utoronto.ca/mcis/imfg/>

Series editor: Philippa Campsie

© Copyright held by author, 2012

ISBN 978-0-7727-0885-4
ISSN 1927-1921

The Institute on Municipal Finance and Governance (IMFG) at the Munk School of Global Affairs at the University of Toronto focuses on developing solutions to the fiscal and governance problems facing large cities and city-regions. IMFG conducts original research on Canadian cities and other cities around the world; promotes high-level discussion among Canada's government, academic, corporate, and community leaders through conferences and roundtables; and supports graduate and post-graduate students to build Canada's cadre of municipal finance and governance experts. It is the only institute in Canada that focuses solely on municipal finance issues and large cities and city-regions. IMFG is funded by the Province of Ontario, the City of Toronto, Avana Capital, and TD Bank.

The IMFG Papers on Municipal Finance and Governance are designed to disseminate research that is being undertaken in academic circles in Canada and abroad on municipal finance and governance issues. The series, which includes papers by local as well as international scholars, is intended to inform the debate on important issues in large cities and city-regions.

Dr. Izabella Barati-Stec is an associate professor in the Faculty of Economics at Corvinus University, Budapest. She holds a Ph.D. in economics and has been on the faculty since 2003. In fall 2011, she was a visiting scholar at the Institute of Municipal Finance and Governance. Her research topics cover municipal investment finance, municipal credit market participation, and resource and task allocation among levels of government. Her research has resulted in several publications, as well as presentations at international conferences. She has participated in projects of the World Bank, the Canadian Urban Institute, and the European Union.

Acknowledgements

This work was conducted in part while I was a visiting scholar at the Institute of Municipal Finance and Governance at the Munk School of Global Affairs, University of Toronto, and with the generous support of IMFG and Budapest Corvinus University. I am grateful to Enid Slack, Almos Tassonyi, Andre Côté, and Philippa Campsie for their help in the preparation of this paper. They read the paper through several times and their comments and questions made me focus on the contents. Enid Slack and Almos Tassonyi also offered help and constant encouragement throughout the whole process of writing.

Papers on Municipal Finance and Governance

1. *Are There Trends in Local Finance? A Cautionary Note on Comparative Studies and Normative Models of Local Government Finance*, by Richard M. Bird, 2011.
ISBN 978-0-7727-0864-9
 2. *The Property Tax—in Theory and Practice*, by Enid Slack, 2011.
ISBN 978-0-7727-0866-3
 3. *Financing Large Cities and Metropolitan Areas*, by Enid Slack, 2011.
ISBN 978-0-7727-0868-7
 4. *Coping with Change: The Need to Restructure Urban Governance and Finance in India*, by M. Govinda Rao and Richard M. Bird, 2011.
ISBN 978-0-7727-0870-0
 5. *Revenue Diversification in Large U.S. Cities*, by Howard Chernick, Adam Langley, and Andrew Reschovsky, 2011.
ISBN 978-0-7727-0872-4
 6. *Subnational Taxation in Large Emerging Countries: BRIC Plus One*, by Richard M. Bird, 2012.
ISBN 978-0-7727-0874-8
 7. *You Get What You Pay For: How Nordic Cities are Financed*, by Jorgen Lotz, 2012.
ISBN 978-0-7727-0876-2
 8. *Property Tax Reform in Vietnam: A Work in Progress*, by Hong-Loan Trinh and William J. McCluskey, 2012.
ISBN 978-0-7727-0878-6
 9. *IMFG Graduate Student Papers. Development Charges across Canada: An Underutilized Growth Management Tool?* by Mia Baumeister; *Preparing for the Costs of Extreme Weather in Canadian Cities: Issues, Tools, Ideas* by Cayley Burgess, 2012.
ISBN 978-0-7727-0880-9
 10. *The Reform of Business Property Tax in Ontario: An Evaluation*, by Michael Smart, 2012.
ISBN 978-0-7727-0883-0
-

Hungary: An Unfinished Decentralization?

Izabella Barati-Stec

Abstract

After 1990, Hungary took steps toward decentralizing public administration and decision-making power. Administrative decentralization, however, was not matched by the same level of fiscal decentralization, creating tension and disparities among Hungarian municipalities. The revenue-raising ability of local governments in Hungary—especially after the economic downturn in 2008—is very low. The debt service of municipalities is also considerably higher than before 2008, a situation that can be explained in part by the change in the value of Hungarian forint relative to the Euro and the Swiss franc, the currencies in which half of Hungarian local debt is denominated. This situation is sharpened by unhealthy municipal financing practices, such as financing operating expenses from investment revenues or from loans. The indebtedness of the municipal sector increased 12.6 times from 2001 to 2007, and in 2007 about 83 percent of municipal borrowing was not backed by immobile assets or any revenue stream. This paper examines the system of municipal finance in Hungary with special attention to the current changes in the regulation and finance of Hungarian municipalities and the change in central control over municipal finances in general after 2008 (in part precipitated by the failure of borrowing rules created during the transitional period to prevent the current crisis in municipal finance), and suggests possible reforms to solve the financing problems of Hungarian municipalities.

Key words: Hungary, municipal finance, municipal borrowing

JEL codes: H21, H71, H77, H81

Hungary: An Unfinished Decentralization?

I. Introduction

In Hungary, as in many other Central and Eastern European (CEE) countries, 1990 was a time of euphoria. With the end of centralized planning, communities obtained the right to form local self-governments and to make decisions about the community on their own. Among the post-Communist CEE countries, Hungary was one of the first to take steps toward decentralizing public administration and decision-making powers.

Unfortunately, as shown in the research of Claessens and Djankov (1998) on CEE countries, decentralizing decision-making power¹ and increasing the number of government tiers (vertical decentralization) do not by themselves necessarily lead to greater accountability. Although expenditures have been decentralized, revenues have remained fairly centralized, even two decades after the transition to democracy. In Hungary, 46 percent of the local revenues originate from the central government in the form of different subsidies.² There is also a risk that if the central government in these countries faces hard budget constraints, it could easily cut the subsidies allocated to the local level³ and reduce the proportion of shared taxes redistributed to the local level.

To ensure public accountability, both expenditures and revenues should be decentralized to the local level. The reason for the close connection between fiscal decentralization and public accountability is simple. According to the “accountability” argument (Bahl 2000), if a resident pays taxes and fees directly to a local jurisdiction, rather than to a central jurisdiction, he or she will want more influence on how this money is spent. As a consequence, investments in local infrastructure that are realized from local funding sources are closer to the needs of citizens.

In Hungary, the result of this failure to provide adequate fiscal autonomy has been tension and asymmetries among Hungarian municipalities. In order to address these concerns, Hungary has introduced a series of structural and financial reforms to its administrative system since 1990. After 2005, further government reform plans focused on the need for some recentralization instead of broadening fiscal freedom at the local level. Current reforms include creating a new administrative level between the level of the counties and municipalities, moving

1. Decentralizing the decision-making power means that decisions affecting the lives of citizens will be made at the level where all stakeholders can express their preferences and influence the decision. This is called the subsidiarity principle, a general principle in European Union law.

2. In Poland, the proportion is as much as 50 percent.

3. This fiscal argument explains why municipalities should rely on local revenues as much as possible.

from a passive form of control over borrowing to an authorization process, and centralizing the provision of services such as education and health care.

The next section of this paper describes the Hungarian public administration system, with an emphasis on the circumstances and governance of local borrowing. It gives an overview of the main laws passed since 1990 concerning municipalities and their effects on municipal finance. The following section summarizes the financial resources of Hungarian municipalities. I then describe local borrowing and its regulation in Hungary and the systemic risks that characterize borrowing in Hungarian municipalities. Next, I evaluate the current changes taking place in Hungary and, in the conclusions, I make a few suggestions for possible reforms.

2. Designing a new system after central planning: Hungarian public administration

Among the Central European transition economies, Hungary was one of the first to reform its municipal system to introduce rules to accelerate the decentralization process.

In Hungary, three main waves of legislation were passed after 1990. The first created the framework for a decentralized public administration system. The second preceded accession to the European Union and ensured enhanced public accountability. Hungary's public administration system is now entering a third phase, with the recentralization of certain tasks and finances.⁴

This section outlines the main features of Hungarian public administration and highlights the characteristics that contribute to an imbalance between revenues and expenditures and an asymmetrical fiscal capacity in municipalities' potential to raise loans.

The levels of administration

In 1990, the Hungarian Parliament guaranteed the independence of municipalities through several laws, among which the most important were the Constitution and Act LXV (1990) on Local Governments. The old Constitution in force before January 2012 listed the rights of local governments and also regulated the organizations and mechanisms for the protection of these rights. Act LXV (1990) created a new form of public administration, laid down its operational rules, and regulated the scope and duties of public administration at each level of government.

Hungarian municipalities—which have an average population of 2,600⁵—are smaller than municipalities in most OECD countries. More than half of Hungary's municipalities have a population of fewer than 1,000 people. Although we can find even more fragmented systems in countries such as France and Switzerland, Hungarian municipalities have greater responsibilities than municipalities of the

4. For more on this question, see Krugman (2011) and Scheppele (2011).

5. Without Budapest, the capital city, the average municipal population is 2,600. If Budapest is included, this number is 3,100.

same size in other OECD countries. This situation raises the question of economies of scale. Many small settlements, although obliged by Act XCV (1990) to provide services such as collecting and treating waste water and garbage, are not able to fulfil such responsibilities or carry out the necessary investments on their own. In older democracies,⁶ forced amalgamations have sometimes been used⁷ to solve this problem.

In Hungary, the strongest impediment to forced amalgamation is the negative memory of the council system before 1990,⁸ when forced cooperation among municipalities deprived small villages of basic services. As a result of this history, voluntary municipal associations were favoured by the state subsidy system in the early 1990s.

The creation of notary districts was another way to counter high administration and service delivery costs. A “notary district” in Hungary is a group of municipalities that employs only one person as notary for fulfilling administrative tasks in all of them, thus saving on administrative expenses. These municipalities also offer their public services together. Neighbouring municipalities with fewer than 1,000 inhabitants (the number in 2012 rose to 2,000) are required to create notary districts for the purpose of fulfilling their administrative responsibilities. The greater the number of inhabitants within a notary district, the higher the level of central government subsidies. The number of notary districts has risen slowly; there were about 500 of them in 2000 and there are about 700 today.

Municipal associations have also been created at the micro-regional level. Although micro-regions were not originally part of the post-Communist state administrative system, it is important to talk about them here, as after 2011 the government created a new level of public administration between the local and the county levels and placed it at the level of the micro-regions.

The creation of micro-regions was originally a requirement of the European Union. After accession, Hungary needed a territorial system that corresponded to the EU’s regional policies—a level of organization that could be the recipient of EU regional grants. Interestingly, this level used to be a formal government tier under the communist era, but its tasks were taken away in 1990. Deciding on the legal status of municipal associations—that is, whether they are a group of municipalities, or they represent a new governmental tier—has been on the agenda of Hungarian politicians since 1990.

6. Such as Denmark, Sweden, the Netherlands, Germany, or Canada.

7. Amalgamations, of course, also have negative effects, such as distancing citizens from decision-making bodies, the overuse of some services, and decreases in service quality (Swianiewicz 2010).

8. Hungary’s public administration system before 1990 could be characterized by a vertical integrity and hierarchy of settlements, in which bigger municipalities had greater rights and more political power, and upper tiers of the hierarchy were responsible for lower tiers.

The central government's tool for encouraging municipal associations is not to give them direct subsidies, but rather to threaten them with lower subsidies if they do not form an association. If the number of recipients of a particular service does not reach a level set by the government,⁹ the municipality is not eligible for a subsidy. Municipalities can be members of more than one association for different purposes. Of course, these multiple member associations are more complicated to administer, which is one impediment to their establishment. According to Hungarian legislation, municipal associations are financed through their members and entitled to state subsidies. They cannot levy taxes, however, making it difficult for them to issue bonds or borrow from a bank for investments. If a development is financed by an association and a bank loan is needed—which is typically the case—the bank would need to make contracts with each municipality. Given that some associations have more than 30 members, transaction costs can be very high.

There are two main differences between notary districts and municipal associations. First, notary districts are parts of the state administration system and serve administrative tasks, while associations are specifically created to deliver public services. Second, creating notary districts is obligatory under the aforementioned conditions, whereas creating associations is voluntary.

The next level of government is the county. Counties are responsible for tasks that must be carried out at a higher level than that of municipalities, although a municipality can take such tasks over if it has the necessary fiscal and management capacity. An example might be the maintenance of high schools or art schools. The potential hazard of this practice is that the county is often left with the most expensive tasks to carry out. The revenue-raising capacity of the county is limited, as under Act XCV (1990), a county government cannot levy taxes or collect fees. Having the most expensive tasks to carry out and not being able to raise their own revenues has meant that counties need to borrow to maintain the level of their services. This situation requires special attention from the central government, as the counties' total debt constitutes 15 percent of all local debt.

Hungary's territory is divided into seven regions. The circumstances of their creation were similar to those of the micro-regions; that is, the creation of regions was a requirement of the European Union for statistical reasons. Each region consists of three or four counties and the borders of the regions are the same as the outer borders of these groups of counties. The regional territorial development offices were delegated to this level and these offices were also responsible for the approval of EU grants. Figure 1 gives an overview of the Hungarian Territorial System and Figure 2 shows Hungary's seven regions, their regional centre cities and the counties within the regions.

9. The size of the association eligible for subsidy depends on the purpose of the association; for example, in the case of health care or education services, the minimum number of inhabitants in an association is 10,000.

Figure 1: The Hungarian Territorial System

Central Government
Regions (7)
Counties and Budapest (20)
Micro regions (174)
Local governments and notary districts (3,154)

Figure 2. Map of Hungary's territorial system



Funding of services: The composition of Hungarian municipal revenues

Although Hungarian municipalities have financial resources—such as local taxes and fees on services—that are independent from centralized decision making, own-source revenues represent less than one-third of the local budget. The local tax law—Act C on local taxes—came into force in 1991 and has been amended by the Parliament almost every year since. According to Act C, local governments have discretion over levying local taxes and over the tax rate. Act C describes the

tax types (the objects and payers of the tax) and the maximum level of tax a municipality can levy. Local decrees on taxation must stipulate (i) who pays the tax, (ii) the basis of the tax, (iii) any exemptions, (iv) the rate of the tax, and (v) the conditions of beginning and ending tax obligations.

The Hungarian Constitution and the Act on Local Governments also contain provisions on the financial resources that the state should provide when delegating a service to the local level. As the two laws do not use the same wording, it is possible to use each of them to support different arguments. According to the Constitution, the state should provide the “necessary” funding, but according to the Act on Local Governments, the state should provide “sufficient” financial sources for the delegated service. This term has been interpreted by the language of municipal lobbying to mean “the state must fully finance services delegated to local level.”

Hungarian municipalities are obliged to separate their current and capital budgets. A general rule is that current expenses should not be financed from investment income, but in practice this does sometimes happen.¹⁰ Furthermore, state subsidies and shared taxes may not be used for repaying loans. Adherence to this rule is ensured by keeping the amounts of transfers separate from own municipal income. The State Audit Office also regularly checks on how municipalities are using state subsidies.¹¹

With creative accounting, municipalities can evade these rules. In the same year, they may prove to creditors that they are in a sufficiently good financial situation to borrow for new investments while proving to the central government that they need emergency or “*vis major*” grants.¹²

Local taxes in the context of municipal borrowing

Under current legislation in Hungary, the main local taxes are the business turnover tax, the communal tax, the property tax, and the tax on tourism. The shared taxes are the personal income tax (PIT) and the vehicle tax.

The business turnover tax

The main local tax is the business turnover tax, which is paid by companies residing in a municipality. It constitutes about 16 percent of total municipal income. The business turnover tax is levied on the net income of the company, after the costs of services and materials (that is, non-labour inputs) are deducted.

10. For example, municipalities may sell assets through off-budget institutions or, as described later, issue general-purpose bonds.

11. When a municipality applies for state funding for investments, in addition to the general four-year managerial control, there is a special targeted audit every year of the investment. Municipalities must keep the amounts received from the state for investments on a special account.

12. In Hungary, the Latin term “*vis major*” is the equivalent of “*force majeure*” in English Common Law. A *vis major* grant in Hungary is given to a municipality that has become indebted because of reasons outside its control (such as a flood).

The base of the business turnover tax is mobile and, as a consequence, its payers can move into other settlements where the tax rate is lower, thus inducing tax competition. It is also exportable to the extent that the municipality taxes activities that may be paid for by consumers from other jurisdictions.

Although municipalities in economically depressed areas cannot collect much of the tax, other municipalities in the centre of the country can collect as much as 30 or 40 percent of their total revenues from this source. The state subsidy system is not enough to make up for differences among the regions.

The maximum rate is 2 percent, but the municipality can set a lower rate or can choose not to levy this tax at all. Since 2010 it has been collected through the central tax authority (Nemzeti Adó-és Vámhivatal, or NAV), but the recipients are local governments.

This tax fails almost every criterion used for evaluating local taxes.¹³ Besides being exportable and inducing tax competition, it distorts prices and is very sensitive to economic cycles; in 2008 local governments relying largely on this kind of tax almost went bankrupt when their biggest taxpayers had to close down.¹⁴ Its volatility makes the business turnover tax an unreliable source for backing loans.¹⁵ Furthermore, the tax is not independent of changes in the central government's economic policy, making it possible for the central government to interfere indirectly with local taxes. Labour costs, according to Hungarian legislation, cannot be deducted when calculating the tax and, as a result, the tax discriminates against the service sector, labour-intensive businesses, and municipalities with mainly this kind of industry.¹⁶

Replacing the business turnover tax with a tax on property is very difficult, however, since the municipalities that are best able to collect property tax represent a strong and wealthy lobbying force against such a tax.

The communal tax

The Hungarian Communal Tax is a head tax, levied on a per-capita base. It is a typical form of lump-sum tax. Although 60 percent of municipalities have introduced it, its revenue-generating capacity and economic impact are not significant. Communal tax income represents only 2 percent of municipal budgets, making its worthiness to be collected questionable.

13. There are five major criteria for evaluating local taxes: (i) efficiency; (ii) fairness; (iii) the cost of tax administration; (iv) the possibility of tax competition; (v) the possibility of exporting the tax. See Boadway and Kitchen (1999), Péteri and Davey (1998), Slack (2010), Szalai and Tassonyi (2004), and Tassonyi (2004).

14. Municipalities with a tax base from heavy industry, such as Miskolc or Dunaujvaros, were in a particularly difficult situation when their main taxpayers' revenue fell after 2008 (DH Online 2010).

15. When the Russian market collapsed, some Hungarian municipalities with taxpayer companies producing mainly for the Russian market almost went bankrupt.

16. For more information in Hungarian, see FigyeloNet (2008).

Property tax

The rate of the tax is set by the municipality. Property tax in Hungary in most cases is levied based on the size and location of the property. The law on local taxes allows municipalities to levy property tax based on market value as well, but in reality, many municipalities choose not to levy value-based taxes.¹⁷

The property tax is best administered by the local level, since it means identifying each parcel of land, as well as tracking land improvements and changes in ownership—records that are kept at the local level. This tax produces the most stable income for the municipality, and has a positive impact on improving creditworthiness.

Nevertheless, if property values fall as they did in the United States and some European Union countries such as Spain and Ireland after 2008, the property tax could also prove to be an unstable source of revenue. Municipalities in these countries were not able to finance their services at the previous levels because their income from property tax fell and they could not adjust fast enough to the unstable market. Although rates could be adjusted to counterbalance the effect of the crisis, there is a limit to how much tax one can raise. In the United States, property tax provides the largest source of local revenues and some American municipalities reported a more than 45 percent decline compared to the previous year (Paulais 2009).

Tax on tourism

This tax is typical in tourist areas. The amount of tax can be calculated based on the number of guest nights (300 Hungarian forints per night) or on the rate paid, in which case it is 4 percent (Tassonyi 2004). This tax is paid by the owner of the tourist business. The interesting feature of this tax is that the central government, when calculating normative transfers,¹⁸ takes into account the tax capacity of the municipality, including the tax on tourism in the touristic areas. If this tax is levied and collected, then the amount of the grant is raised by a corresponding amount. This provision encourages municipalities to levy this tax to the maximum level.

Personal income tax

Personal income tax (PIT) is a centrally collected tax that is partly redistributed to the local level. In 1990, 100 percent of the PIT was redistributed to the municipality from which the revenues originated, but in 2006, only 8 percent went to the originating municipality, and another 20 to 25 percent to other municipalities, while the remaining 65 percent was kept by the state. In 2011, the Hungarian government announced that the remaining 8 percent share of PIT that

17. If a property is sold, the new owner has to pay a duty based on the sale price. The sale price and the duty are then recorded in the land registry of the municipality. Municipalities sometimes use this data for assessing the value of property.

18. Normative grants are the contributions of the state to maintain public services. For calculating the sum of the normative grant, an indicator and a per-unit cost element are used. Indicators usually reflect the “load” measurement, e.g., the number of children in school. The cost elements are the same for every municipality, even though the real costs can vary.

has stayed at its origin will also be turned over to the central government. Employees have a choice between filing their returns themselves or authorizing their employers to file for them.

Vehicle tax

The vehicle tax was originally levied based on the weight of the vehicle, but in 2007 its calculation was changed. Now it is levied based on the horsepower (or kilowatts) of the vehicle and calculated on a sliding scale, meaning that the first deductions are possible after the car reaches four years of age. The starting amount is 340 Hungarian forints per kilowatt (at the time of writing the paper about \$1.70). Currently, 100 percent of this tax goes to the local budget, but the central government has plans to withhold 60 percent of it (Toth 2012). The income from the vehicle tax constitutes about 2 percent of local budgets.

Hungarian municipalities cannot use the income from the PIT and the vehicle tax for repaying loans, because they are shared taxes and only own-source revenues can be used for that purpose.

Transfers from the central government

Central grants represent another revenue source at the local level. The aim of transfers is to create a balance between the revenues and expenditures of different regions, because municipal responsibilities must be fulfilled everywhere. The main question is whether it is possible to design a grants system that balances expenditure needs and the allocation of revenues. Hungary gives grants to municipalities for capital investments and also for operating purposes; the latter are known as normative grants.

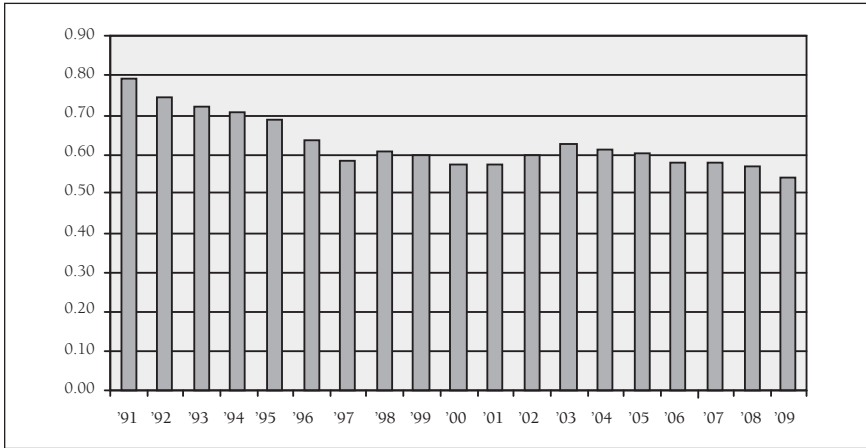
Unconditional grants¹⁹ are rare in Hungary, although this type of transfer would give the most autonomy to municipalities and is most consistent with Article 9 of the European Charter on Local Self-Government.²⁰ The purpose of unconditional grants could be to develop rural areas, create jobs, and reduce differences in regional development. Unfortunately, these grants rarely meet their goals. Their effect is usually smaller than the central government expects due to substitution—that is, the revenues that the municipality previously used for that purpose may be spent on another program and the municipality may reduce its own expenditures in the area of the grant. This is called the “fungibility problem” of grants.²¹

19. The main forms of grants are unconditional (general) grants, conditional non-matching grants, and matching grants. With unconditional (general) grants, the central government supports the municipality without any conditions on the use of the grant. Conditional non-matching grants are earmarked grants; the municipality can use them only for specific purposes. This type of transfer is the most appropriate method for local governments to meet national standards, regardless of their revenue capacity. Matching grants require subnational governments to contribute to a subsidized program. A typical form of matching grants is a partial cost reimbursement, which can be a very effective tool for the central government as it can direct municipal spending by lowering the local “price” of services.

20. Notwithstanding the provisions of the Charter, even EU grants come earmarked.

21. For a discussion on the fungibility of transfers, see Boadway and Shah (2009), 309–312.

Figure 3: Share of transfer-based revenues in municipal budgets



Source: www.bm.gov.hu

Figure 3 illustrates the share of transfer-based revenues in municipal budgets, an amount over which local governments have no direct influence.

Although centrally allocated resources cannot be used for loan repayment, the assessment of the creditworthiness of a municipality is affected by the perception of transfer dependence.

The availability of central transfers in Hungary has never been predictable, since the central level can cut transfers without agreement from the local level. Moreover, the factors affecting the changes in grant amounts are not set out in law. Thus municipalities are largely defenceless against central decisions on transfers. Cuts in subsidies can cause difficulties in debt repayment and municipalities that cannot raise local income must decide between fulfilling a service and repaying the debt. For many municipalities, the solution—which represents a serious threat to the state budget—is to keep repaying the debt from the local budget and to apply for emergency grants for providing local services. The availability of emergency grants creates the illusion that the municipality is able to maintain its services and finance its debt at the same time.

Table 1 summarizes the number of municipalities that asked for emergency grants in various years between 1993 and 2011. In Hungary there are

Table 1: Number of Hungarian municipalities receiving emergency grants

Year	Emergency grants	Percent of all municipalities
1993	165	5
1998	888	27
2002	1,279	40
2007	1,050	33
2011	1,182	37

Source: www.bm.gov.hu

approximately 3,200 municipalities, so in 2011, more than one-third of Hungarian municipalities needed this type of aid.

Transfer of property rights in 1990: A source of asymmetry

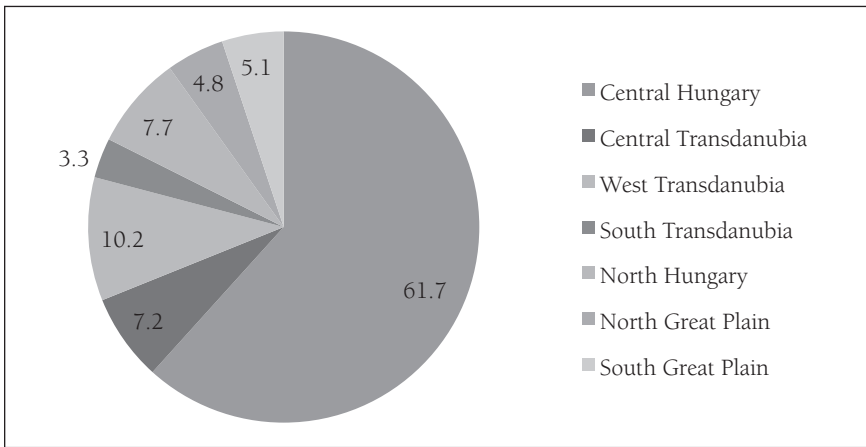
After 1990, municipalities acquired the assets necessary to fulfil services at their level, such as water treatment plants or garbage dumps, as well as buildings for administrative offices and schools. Many of these assets were sold in the early 1990s, as municipalities found it difficult to maintain them. The revenue from privatization was spent partly on other capital investments and partly on operating expenses. Of course, the value of these buildings and land depended on the economic development of the area, so better-off municipalities received assets that were much more valuable than those of less-well-off municipalities. The result was a gap between the fiscal capacities of municipalities.

The value of buildings and land a municipality possesses is important for creating public-private partnerships (PPPs). Because those who engage in PPPs and provide foreign direct investments prefer bigger cities and richer areas for their investments, and because the business turnover tax is the most important local tax, larger, richer municipalities tend to fare better than smaller, less wealthy ones. Based on interviews done by Corvinus University (Barati-Stec and Hőgye 2012),²² some municipalities have been able to finance large investments such as water and sewage infrastructure out of their operating budgets, because they had large business turnover tax revenues; other municipalities that cannot collect this tax and use it as collateral for loans or spend tax revenues directly on investments must rely on meagre state funds. This situation has further exacerbated the differences in fiscal capacity among municipalities.

In Hungary, municipalities can sell property (land or buildings) only under two circumstances. First, the property cannot be directly related to fulfilling obligatory local services. Second, the income cannot cover operating costs.

22. The Department of Public Policy at Corvinus University has conducted several surveys among Hungarian municipalities. In this paper, the author refers to two surveys, one done in 2010, the other in 2011. The research in 2010 examined the 100 largest Hungarian municipalities' investment techniques and economic and political expectations. The method used was in-depth interviews with mayors, other political leaders, and managers of the municipalities. In 2011, public policy students at Corvinus University interviewed representatives of 19 municipalities (they approached 24 municipalities, but only 19 responded) in the Budapest region. The purpose of the research was to identify municipal budgeting techniques and economic expectations and to assess municipal views about the current economic situation and legislative process in Central Hungary. These settlements are typically better off than the rest of the country, are most likely to have a larger tax base, and had substantial investments even during the economic downturn.

Figure 4: The distribution of foreign direct investment in Hungary after the transition, 1993



Source: Calculation based on OECD 2001: 87.

Regulations also prohibit municipalities from using strategically important land and buildings as collateral for loans.²³

Municipalities, however, have found loopholes in these regulations, since it is possible to reclassify municipal property.²⁴ Consequently, municipalities with operating deficits often reclassify their properties in order to sell them. Another way to get around the regulation is to sell assets through off-budget institutions. This can happen only with the approval of the municipality. Practices like this also raise the question of corruption.²⁵

3. Municipal borrowing in Hungary

Loan practices and moral hazard

In countries with a long history of democracy and independent local governments, the central level does not take responsibility for local indebtedness. However, this approach is not automatic in countries with a history of central planning.

23. Using buildings as collateral was a highly criticized practice of the Hungarian municipal credit market. On the one hand, the value of the asset often surpasses the amount of the loan; on the other hand, using an asset to finance a project to which it is not otherwise related is not economically efficient. The market for buildings and land can also be very volatile.

24. For example, buildings belonging to a local school cannot be sold, but if the school is moved into another building, the property becomes saleable.

25. In October 2011, Sandor Pinter, Hungary's Minister of Interior Affairs, denied the existence of corruption in Hungary. One month later, the Ministry of Public Affairs and Justice announced that the level of corruption threatens the operation of public administration.

In Hungary, municipalities borrow directly from banks rather than issuing bonds. Even in cases of bond issues, the buyer will be a bank. Because loan-financed investments are subject to central approval as part of the subsidy system, lenders often presume that the government—knowing the technical and financial characteristics of the project—has also approved the loan. By implication, the central government's approval was perceived as taking responsibility and offering guarantees for the loan. The latent guarantee made loan financing cheaper through reduced interest rates, enabling municipalities to access larger loans than they could otherwise afford.²⁶

If over-borrowing occurs on a large scale, the provision of public services can be jeopardized. If several municipalities raise larger loans than they are able to repay, the financial system is burdened as a whole and the creditworthiness of the country can be adversely affected (Liu and Webb 2011).

Laws passed in the pre-accession period include legislation on debt and bankruptcy of local self-governments, the regulation of financial activity (audit), and several amendments to previous regulations, such as the regulation on state subsidies, the supervision of local self-government decision-making, and amendments to acts governing civil servants and other public employees.

The 1995 Budget Act in Hungary introduced the first limits on municipal borrowing. The relevant paragraph was abolished by the Constitutional Court, however, for violation of procedures, but the main ideas on setting constraints on local borrowing were incorporated into the Act on Local Governments in 1996. According to these new rules, municipal borrowing may not exceed 70 percent of the municipality's own adjusted current income, which means that a municipality cannot incur loans that exceed 70 percent of the difference between its short-term income and short-term obligations in a given year.²⁷

Act XXV (1996) on Municipal Bankruptcy was unique among the countries of the region. It aimed to introduce hard budget constraints on local governments by asserting that the state is not responsible for local debt. This legislation was passed at a time when many municipalities, facing hard budget constraints, had introduced new local taxes to finance their obligations.

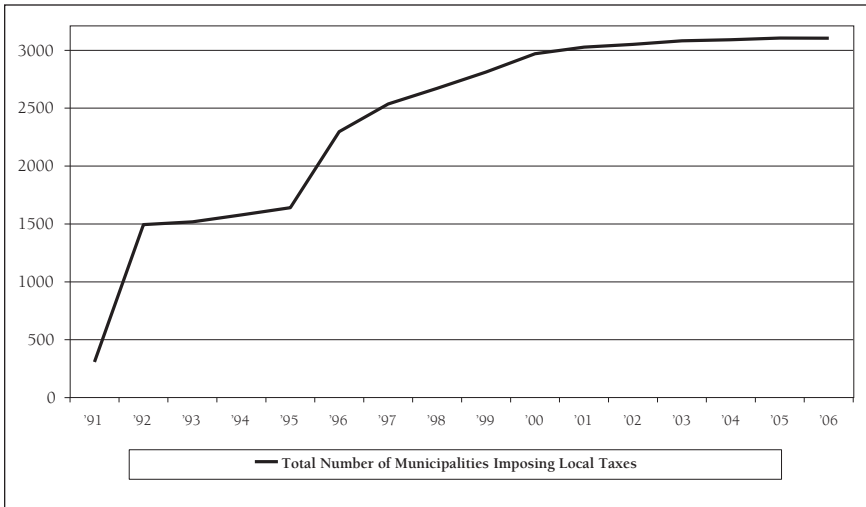
Figure 5 shows the sudden increase in the number of municipalities imposing some form of local tax in 1996 in response to the new regulation. We can also see that by 2000, almost all Hungarian municipalities introduced local taxes.

At the same time that many municipalities were introducing new local taxes, some sought out private partners for infrastructure investments. Figure 6 indicates

26. If a municipality pursues an unsafe fiscal policy resulting in the need for a bailout, the burden it imposes on every other municipality in the country is small, but the overgrazing municipality's gain is measurable. For this reason, more and more municipalities try to raise larger loans than they can repay (Gillette 2011).

27. The enforcement of this law was questionable. Some municipalities went beyond their borrowing limits and the Ministry of Internal Affairs found out about these cases only much later (Gál 2010).

Figure 5: Number of municipalities introducing some form of local tax



Source: Ministry of Interior Affairs, Hungary.

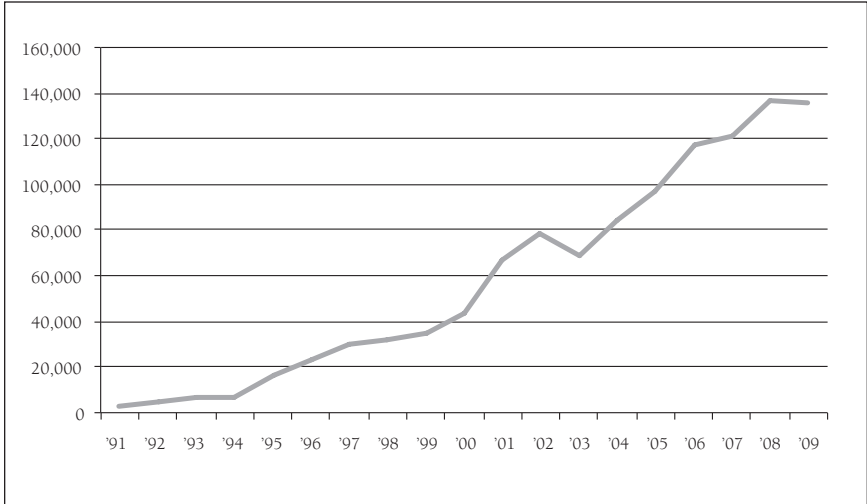
the increasing number of contracts between the two sectors (contracting out) and the amounts transferred by the municipalities to the private sector.

The Municipal Bankruptcy Act also laid down the procedures to be followed if a municipality falls 60 days behind its obligations. The purpose of this legislation was to help insolvent municipalities regain their financial strength while, at the same time, protecting the rights of the creditors.

During the debt adjustment process, the municipality and the creditors must first try to come to an agreement about the debt of the municipality. If this agreement cannot be reached, the creditors can file a court petition and the court decides whether to start the debt adjustment process. The decision not to start such a process can be appealed. A key element of the process is the appointment by the court of a trustee who prepares an emergency budget, makes decisions on what services will be carried out in the future (usually only the obligatory services), and prepares a plan about how to restructure the debt and reorganize municipal services. If the parties agree, the plan will be carried out. If there is no agreement, the court will order an inventory of sellable assets to be drawn up and reviewed by the court. These assets are then liquidated to pay the creditors. Appeals against each decision are possible.

In reality, almost all cases of municipal bankruptcy have been initiated by the municipality itself. Lenders assume that the state will sooner or later give additional “emergency” grants to cover municipal deficits. Moreover, as the result of a legal case, they likely would have had to write off a portion of their debt. Therefore, a safer strategy for lenders is to wait.

Figure 6: Amounts transferred by the municipalities to the private sector (in million Hungarian forints, nominal values)



Source: <http://www.bm.gov.hu/web/portal.nsf/html/onkgazd.html>.

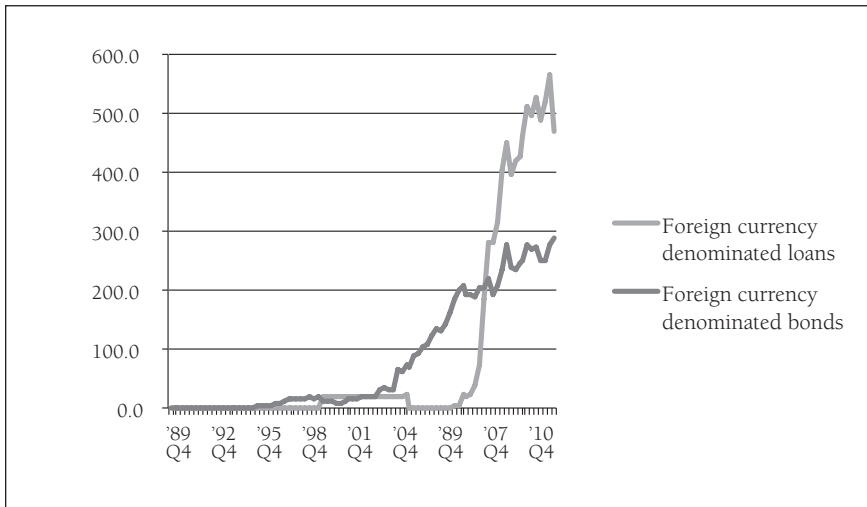
As a result, only a few municipalities have undergone this process, since most come to an agreement with their creditors before the court makes a decision, although many more have threatened strategic bankruptcies. About half the cases that have made it to the court have ended in rescheduled repayments; in other cases, the lender banks have had to write off the loans so the municipality could start with a “clean slate.”

Foreign currency loans

Municipalities can also raise loans in foreign currencies. In 2011, almost half of Hungarian local debt was denominated in Swiss francs, making debt service payments very expensive due to the very high value of the franc (see Figure 7). In 2010, municipal indebtedness amounted to US\$6 billion, 5 percent of the country’s GDP, partly due to changes in the exchange rate.

By itself 5 percent does not seem to be very high in comparison with other European countries. The average local public debt in the 27 EU countries was 5.6 percent in 2008. Higher numbers applied to Italy and France (both about 8 percent) or Spain (10 percent). What makes the Hungarian data alarming is the *rate of change*. The amount of Hungarian public debt rose more than 20 percent from 2007 to 2008, while the EU average for the same period is only 4 percent (Chatrrie 2009). From 2009 to 2010, \$4 billion local public debt grew to \$6 billion—another 50 percent change.

Figure 7. The change of foreign-currency-denominated loans and bonds of the Hungarian municipal sector (in billion Hungarian forints)



Source: Data from the Hungarian National Bank

4. Systemic risks of borrowing of Hungarian municipalities

The economic downturn in 2008 had a strong impact on municipal finance all over the world. In countries in which municipalities depend on property tax revenues, municipalities watched their property tax revenues sink as property prices fell, leading to difficulties in maintaining the level of services. Local governments that depended on more volatile revenue sources that directly depended on the economy, such as sales taxes or income taxes, were even worse off after 2008. In new democracies, where granting debt-raising power to local levels was an important part of the decentralization process and was often done without regulations that would ensure avoiding over-indebtedness, the problems were even bigger.

The unregulated and thus unrestrained growth of subnational debt during an uncertain economic situation can be very harmful, especially if the debt is used to finance operating expenses instead of capital expenditures.²⁸

In order to avoid this situation, many decentralized countries have introduced laws to ensure good fiscal behaviour at the local level. These *ex ante* rules are designed to tighten the constraints on local budgets by ensuring that, for example, municipalities do not engage in unhealthy practices when financing operating expenses, limitations are imposed on borrowing, higher levels of government are not made responsible for lower-level indebtedness (there is no possibility for

28. The lessons from certain U.S. municipalities have often been ignored; see Rodden et al. (2003).

bailouts), and municipalities cannot borrow beyond their limits.²⁹ With these regulations, central governments can ensure that local politicians have to think beyond their own term of office, demonstrate their commitment to creditworthiness, solve moral hazard problems, and stop free-riding (Liu and Webb 2011).

Some of the risks associated with local borrowing date from the time at which the rules about Hungarian public administration were designed. New laws and amendments to existing laws were aimed at minimizing these risks, but to some extent the risks remain.

This section summarizes and examines these risks one by one. The reason for this elaboration is that a risk is not the consequence of a single feature of municipal regulation, but the complex outcome of several conditions existing at the same time.

The risk of unbalanced budgets

Diminishing state subsidies, as a consequence of the hard budget constraint of the central budget, would not be a problem if municipalities were able to raise revenues on their own. The absorption capacity³⁰ of Hungarian municipalities, however—especially after the economic downturn in 2008—is very low. The debt payments of municipalities are also considerably higher than they were before 2008, which can be explained in part by the change in the value of Hungarian forint relative to the Euro and the Swiss franc, the currencies in which half of Hungarian local debt is denominated. Since the expenditures of municipalities are increasing and other revenue sources are shrinking, the risk of budget deficits is significant.

Lack of public accountability and access to information

Since 2000, many municipalities in Hungary have used public-private partnerships to create infrastructure, so that the costs of the investment were deferred (Hegedűs and Tönkő 2006). It is thus difficult to assess the real indebtedness of a municipality at any given date. Furthermore, due to the lack of regulation, future debt service does not have to be calculated ahead of time, so municipal decision makers have avoided appearing responsible for future indebtedness.

The main purpose of the public-private partnerships was to avoid direct municipal borrowing and to lengthen the financing period of the investment. In these cases, private borrowing is backed by municipal guarantees. After a certain period, the municipality assumes ownership of the assets. If the municipality has to repay the loan instead of a private company, the responsibility is further deferred.

29. Other reasons for central control could be: (i) local borrowing raises the cost of capital for the private sector; (ii) the state might compete for the same resources as the municipalities; and (iii) the debt of the municipal sector worsens the balance of the central budget.

30. Absorption capacity refers to the ability of municipalities (i) to raise local revenues and (ii) to obtain central or EU grants. The two are related, because grants are matching grants, thus municipalities need their own revenues in order to get EU or national grants.

As loans and bond issues are made in subsequent years, each one with a different grace period set in a negotiation process between the lender and the municipality, the municipality may have to start repaying all the loans at once. This situation, besides indicating incompetence on the municipality's side, also raises questions about the incentives of the banks in these situations. There are between 10 and 15 financial institutions in the Hungarian local credit market, making it very competitive. Even though municipalities' creditworthiness is low, the financial sector is willing to take the risks associated with local borrowing. Moreover, the market is not particularly transparent,³¹ so the banks find it difficult to estimate the creditworthiness of a municipal borrower.

Moral hazard and the risk of over-indebtedness of the sector

Moral hazard in the practice of Hungarian municipal borrowing is very high and deserves special attention. The indebtedness of the municipal sector increased 12.6 times from 2001 to 2007. In 2007, about 83 percent of municipal borrowing was not backed by any revenue stream or immobile assets (Homolya and Szigel 2008). When a bank officer was asked why the bank had offered a Swiss franc-based loan to an obviously uncreditworthy small municipality, the officer replied: "If we do not do it, another bank will." This behaviour increases the risk of over-indebtedness of the sector.

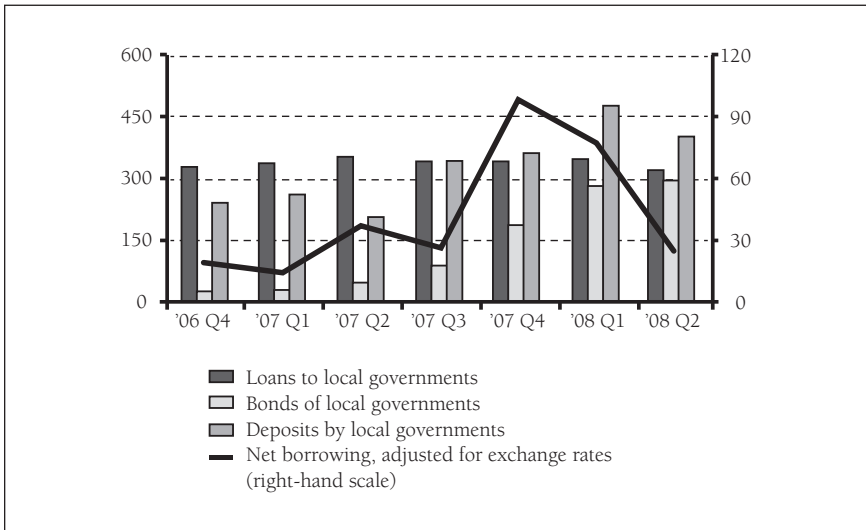
In 2007, municipalities borrowed substantially more than in previous years. This boom could have several reasons. Some municipalities borrowed while they still could, since tightening the borrowing regulation has been on the government's agenda for years (Homolya and Szigel 2008; HVG Online 2011b). Others raised loans in foreign currencies with a speculative purpose, because the interest rates made the loans appear to be a good investment. As shown in Figure 8, the borrowed money ended up in forint-based deposit accounts. The foreign currency debts were not hedged.

Carrying out unnecessary and costly investments

This type of risk is related to the design of the central subsidy system and the under-financing of local governments. Municipalities seek all possible revenues that they can raise. The targeted grants set priorities for municipalities from the higher levels and distort local preferences. Municipalities are likely to apply for grants for investments they do not need if that is the only way to get access to government funding. At the same time, the long-term maintenance cost of the investment is not taken into consideration. As a result of centralized financing, local decision makers are not publicly accountable for their actions. During the survey of 2011 done by Corvinus (Barati-Stec and Hőgye 2012), some municipalities noted that informing the public before making an investment means a short announcement in the local paper. Although they are obliged to do so by law,

31. According to a survey of bank experts undertaken by the National Bank in 2008 (Homolya and Szigel 2008: 26).

Figure 8. Local government loans, bonds, and deposits in 2007 and 2008, in Hungarian forints



Source: Homolya and Szigel (2008: 21)

they do not organize public hearings to discuss major investments—another proof that enforcement of laws is not effective.

Unhealthy financing mechanisms

Municipalities sell land and buildings through off-budget institutions,³² which makes it hard to trace how the revenue from these transactions is used. This practice further decreases transparency and suggests that capital income is being used to cover operating expenditures. Since municipalities can issue bonds for a “general purpose,” it is also possible that some of these bond issues are needed to cover operating expenses. According to a survey done in 2008 by the National Bank of Hungary (Homolya and Szigel 2008), only 50 percent of bond issues had a direct investment purpose, 10 percent were explicitly for financing operating expenses, and 40 percent were “general-purpose” bonds. Although “general purpose” means that the use of the bonds was not clarified at the time of the issue, so they could have been spent on investments or operating costs, it is likely that 50 percent of total bond issues were used to cover current expenses.

According to the results of a survey from 2010 by researchers at Corvinus University, municipal decision makers often assume that the central government

32. Off-budget institutions are institutions of the municipality that have a separate budget from that of the municipality. In fact, the budget of these institutions does not appear in the municipal budget, therefore it is very difficult to trace and publicly control their revenue flows and transactions.

will bail out insolvent municipalities. Furthermore, local officials often lack basic financial knowledge about borrowing. For example, they are unfamiliar with the risks associated with foreign currency loans and can rarely afford to hire budgeting, planning, infrastructure, or finance advisors to guide them.

5. Current changes in the regulation and finance of Hungarian municipalities

In this section, we will look at what the Hungarian government that was elected in 2010 has done to re-regulate local borrowing and reduce the indebtedness of the sector. The economic downturn in 2008 led to changes that were necessary to prevent an emergency. The government introduced a series of reforms concerning all levels of public administration and their finances.

Since the spending of the municipal sector represents almost 14 percent of Hungarian GDP, municipal finance imbalances will have a significant effect at the macroeconomic level. As the research of Escolano et al. (2012) shows, decentralizing spending improves fiscal performance.

Having high subnational spending in relation to the GDP is a characteristic of the northern countries (the proportions for Norway and Denmark are 32.9 and 13.1 percent of GDP, respectively). Decentralized spending is also a characteristic of some of the former Communist countries; in the Czech Republic the proportion is 11.9 percent and in Ukraine it is 12.6 percent of GDP (Slack 2009: Table 5).³³ However, the positive effect of decentralized expenditures is reduced if local governments depend largely on central transfers at the same time—another characteristic of former Communist countries (Escolano et al. 2012).

After 2008, Hungarian municipalities, as well as the central government, found themselves in a difficult economic situation. Markets were shrinking and the country's credit rating was downgraded.³⁴ Some companies that had provided the largest tax base for local governments closed down and the number of unemployed increased rapidly, placing an extra burden on municipal budgets. The state cut back subsidies to the local sector for stabilization purposes by 6 percent in 2009 (from 66.6 billion to 62.4 billion Hungarian forints). Another 70 billion forints for raising public servants' wages were taken away from the public sector.

The number of municipalities declaring insolvency between 1996 and 2007 was 22. Since 2009, however, there have been 23 new cases. Although the

33. In Central and Eastern European countries, however, decentralization of expenditures is not matched with the same level of decentralization of revenues as in the Northern countries. In the Nordic countries, high levels of own-source revenues are matched with a high level of spending freedom. These countries are fiscally decentralized, but in Hungary, although expenditures are decentralized, municipalities still largely depend on the central government for revenues.

34. On November 7, 2008, Moody's changed the state sovereign rating to A3 from A2. On March 1, 2009, it was downgraded to Baa1. S&P changed its rating on November 17, 2008, from BBB+ to BBB and, in March 2009, to BBB-.

insolvent municipalities during the first 10 years were mainly small settlements, more recent information suggests that bigger municipalities are also planning to file for bankruptcy (HVG Online 2011a). There was an obvious need for change in the system.

With respect to municipal regulation and finance, the change of two laws is important—the Constitution and the Act on Local Governments. To change either of these pieces of legislation requires a qualified two-thirds majority—a very large consensus among the members of Parliament. In 2010, the new FIDESZ–KDNP (Young Democrats–Christian Democrats) government gained this rare two-thirds majority in the national elections, making these legal changes possible.³⁵

Constitutional changes

The new Constitution took effect on January 1, 2012. When the old Constitution was no longer in force, many regulations that were included in it that affected municipalities also became nullified, while new laws to regulate municipalities had not yet been created. The old Constitution included a paragraph about municipal associations, stating that forming municipal associations is a free decision of the member municipalities and higher levels of government cannot force municipalities to carry out tasks together. The new Constitution, however, vaguely states that other, sectoral laws can oblige municipalities to cooperate while carrying out tasks. Also, the new Constitution does not comply with the requirement of the European Charter of Local Self-Governments, which states that municipal rights should be protected by the country's Constitution. This provision was criticized by the Venice Commission.³⁶ There are plans for incorporating into the Constitution laws to order municipalities to give up assets to the central level or other municipalities without compensation.

In many cases, municipalities still use public assets as collateral for loans. If the state takes these assets over without taking over the obligations—and it is not yet clear whether the state will have this power—the safety of these loans is undermined. This situation raises the question of the safety of property rights in Hungary, as a municipality could still be liable for the debts, but the bank's rights would not be enforceable.

35. Although some of the reforms were desirable and had long been talked about in Hungary, the international critique of the practices of the new government make it unclear how their actions will be accepted, carried out, and evaluated. The first steps of the government, after its election in 2010, such as making last-minute decisions, cutting the power of the media and the constitutional court, and not consulting with stakeholders, were highly criticized, not only in Hungary but by the EU and other international forums as well.

36. The European Commission for Democracy through Law (the Venice Commission) was established in 1990 for dealing with emergency issues in constitutional matters.

Structural changes and reallocation of tasks

The creation of a new formal level of micro-regions that would replace free associations of municipalities has been on the government's agenda for more than 10 years. This step would shift some of the more expensive tasks to this level from the local level. In-depth interviews with municipal representatives in 2010 by researchers at Corvinus University suggest that municipalities generally do not oppose a new formal level between them and the counties. The services that municipalities would prefer to put at the micro-regional level are education, health care, solid waste, and sewage collection and treatment. According to the central government, however, some of these tasks will be centralized,³⁷ even though municipalities strongly oppose the centralization of such services. The results of the survey done by Corvinus University in 2011 (see footnote 21) indicate that municipalities would rather cooperate with each other than let the state take over.

The main task of municipalities, according to the government's plans, will be to reduce local unemployment, although practical examples suggest that unemployment is best dealt with at the micro-regional level so that the municipality, local businesses, and representatives of adult education institutions can work together.

Plans to amend the Act on Local Government include delegating tasks to the micro-regional centres, but the micro-region itself is still undefined. The lack of definition creates confusion among local decision makers about the future tasks, finances, and relationships of these municipalities.

Local finance

The financing of public administration is also undergoing fundamental reform. As local tasks are uploaded to higher levels, some revenue sources will also be taken away from local governments.

The government has two options for dealing with the business turnover tax; it has not yet been decided which one will be implemented. One option is to centralize the business turnover tax; the second is to leave the business turnover tax as a local tax, but allow the central government to take away a portion of this tax from municipalities that collect "too much of it."³⁸ This second proposal could be difficult to carry out, since it is likely to violate local government property rights.³⁹ Furthermore, even if it is legal and implementable, this kind of regulation is counterproductive, as municipalities would have no incentive to raise the tax rate if the extra income will be taken away from them. They would rather keep the

37. For more information on centralized schooling, municipal finance, and state takeover of schools in Hungarian, see HVG Online (2012a, 2012b) and Tossenberger (2012).

38. It is questionable what the term "too much" means.

39. Local taxes in Hungary are genuine local taxes, meaning that the central government cannot decide what the municipalities will do with the tax income; it is their property. Taking away a part of any local tax would violate this right.

tax low (a form of tax competition) and attract companies into the region to ease unemployment.

The Personal Income Tax will not remain untouched, either. The remaining 8 percent local share will be centralized, making this a central tax instead of a shared tax. Public finance literature argues that redistribution is better kept at the central level and should be financed from taxes that are not regressive. PIT revenue creates a good basis at the central level to serve redistributive purposes (Slack 2009).

While PIT and the business tax are centralized, municipalities will be encouraged to collect property taxes.⁴⁰ Even though municipalities have been reluctant to use property tax, mainly because it is difficult to introduce and it is opposed by citizens, all the municipalities that participated in the survey by Corvinus University in 2011 favoured local tax reform. Because the central government has levied new central taxes (such as a tax on car insurance known as the “accident tax”) and raised the VAT to 27 percent, the highest percentage in the European Union, municipalities are concerned about not being able to collect the property tax, even if they levy it.

Regulation of local borrowing

The government is developing new rules for local borrowing to control municipal overspending and prevent municipal bankruptcies. The conditions listed in the previous section make the introduction of new borrowing rules reasonable, although they are likely to be met by intense opposition at the local level.

In the future, instead of the Local Bankruptcy Act, the act on municipalities would describe the procedures to be followed in case of insolvency. The form of control over borrowing will change. A municipality will have to ask for permission to borrow from a higher-level government; decisions will be made on a case-by-case basis. The current financial situation and indebtedness of municipalities explain the shift in the decision-making power, especially in light of other reforms of the government aimed at recentralization.

The central government and county-level representatives signed an agreement in October 2011 covering the bailout of the counties’ debt and taking over county tasks and assets. Before the details of this transaction were discussed, municipal associations argued that the county assets are worth more than the amount of debts, so bailouts would not be needed.

After a lengthy negotiation period, the counties signed the agreement according to which the state took over all of the assets of and the tasks performed by these institutions. Currently, a similar negotiation is going on between the state and the municipalities about education. Municipalities are unwilling to give up

40. The property tax is a good source of revenue for financing non-excludable local services, such as street lighting or the maintenance of public roads and parks. It is non-exportable, does not create tax competition, is easy to administer and, because it is paid directly into the local budget, enhances citizens’ awareness about how it is spent.

responsibility for elementary education and their power of nominating school directors and hiring teachers.⁴¹

6. Conclusions: suggested reforms based on Hungarian tradition and international examples

Overall, changes to ensure an accountable and financially independent local system in Hungary are desirable. After 1990, the system of Hungarian public administration became extremely decentralized administratively, but with a low level of municipal fiscal freedom. Hungarian municipalities were given the right to collect own-source revenues, such as taxes and fees, but their size, tasks, financial resources, and therefore their revenue-raising abilities varied widely. The central subsidy system was not able to counterbalance these disparities, making fulfilling local tasks and carrying out investments very difficult in most municipalities.

Another aspect of imbalance in the system is that municipalities could get access to market loans, but lenders could not make good decisions, since the requirements for a well-functioning market—e.g., access to information—were not met. Public accountability was not ensured and because local own-source revenues represent only about one-quarter of total revenues, this situation was not likely to change. Municipalities did not hold regular public hearings on planned investments and there were no forums for expressing public opinion. According to the results of a survey of municipalities in Central Hungary in 2011 by Corvinus, local officials did not support public involvement in their decisions.

The municipal level wanted reforms that would lead to greater fiscal decentralization, more local autonomy, and increased transparency. The government elected in 2010 had the chance of completing the decentralization process that started 20 years ago, but instead, has used the situation in 2008 to start a massive recentralization process.

The examples of older democracies show that the creation of a new micro-regional level can ease the financial burden on the local and county governments and balance the task allocation and tax-levying rights among the different levels. When certain tasks are carried out for larger numbers of people, the per-capita cost usually decreases. This is typically true for services that have high constant costs, such as garbage disposal, sewage treatment, and gas utilities. In some countries with fragmented municipal systems (such as France), in order to reach economies of scale, municipalities are obliged to carry out tasks together or to form associations. The increase in the number of inhabitants served has advantages in other areas of municipal management as well, such as decreasing the administrative cost of the municipality. Smaller municipalities normally operate with higher administrative costs per capita. As the number of inhabitants increases, per-capita administrative costs decrease faster than other costs increase (for example, the cost of enforcing laws and regulations will increase).

41. Municipalities are so desperate to maintain this control that some have even re-classified school buildings as residential rental units, so that the state cannot take them over.

In Hungary, municipalities have already had a long working relationship with each other at the level of micro-regions. This level would be appropriate for organizing local services such as water and sewage treatment, health care, or employment services. As a consequence, the micro-regions should be given taxing and revenue-raising powers to finance the services they provide. This step would reduce the problems of small and under-financed municipalities. Special taxing power would also make this level more independent from central decisions.

This level would need to collect the necessary revenues directly from the citizens using the service, since borrowing for the necessary investments is possible only if the borrower—the micro-region—is able to raise revenues on its own.

There is no doubt about the need to change the regulation of municipal borrowing. Currently, the government treats the local level uniformly, even if the problems and borrowing capacities of small and large municipalities vary greatly. The same is true for municipalities and counties. Differentiating among different-sized governments when regulating borrowing would be reasonable, since larger and richer municipalities, having a larger tax base, are more likely to be creditworthy than their smaller counterparts. The right of larger municipalities⁴² to introduce special taxes should also be examined. Special rights could be given to cities that are or could be the centre of economic development in their region. This reform could be introduced gradually. First, the city of Budapest could be given this special right (about one-fifth of Hungary's population lives in the capital), then, based on the lessons learnt, the group of special-tax cities could be broadened to the five to seven largest Hungarian cities.⁴³

The idea of creating credit associations, special municipal banks, bond banks, or other institutions for small municipalities where borrowing is pooled should be considered in Hungary. Special banks are traditional in Europe, where the savings of citizens were kept in the local savings banks that collected the citizens' money in order to finance local investments from it. We find examples of this practice in Germany, Belgium, and the Netherlands.

Municipal Development Funds (MDFs) work much the same way as the special municipal banks. The shareholders include municipalities and sometimes other levels of government, so besides providing loans, these organizations act as a channel for various forms of government subsidies. Instead of giving loans directly to the municipal sector, MDFs may give loans to banks with municipal clients to enhance the municipal credit market from the "supply" side. Their main objective is to "push" banks into a situation in which their interest is to develop loan products for municipalities, and therefore to indirectly promote cooperation

42. About 50 percent of Hungarian local debt is raised by 30 municipalities, out of a total of 3,200 municipalities.

43. The largest Hungarian cities are Budapest (pop. 2,000,000), Debrecen (206,225), Miskolc (170,234), Szeged (169,678), Pécs (156,974), Győr (130,476), and Nyíregyháza (117,597).

between banks and municipalities. The purpose of MDFs is to improve the efficiency of local investments. They offer additional services, such as help with business and technical plans and assistance in seeking additional funds for investments (Barati-Stec 2003). If these institutions borrow on behalf of small municipalities, administrative costs could be reduced and better borrowing rates achieved. This would represent an improvement in light of current borrowing practices, whereby members of municipal associations have to make separate contracts with a creditor to cover the financing needs of shared investments.

The decentralization process follows a different path in each country and change does not occur all at once. Hungary has a history that made it impossible to introduce good practices in 1990, such as the amalgamation of municipalities to fulfil some tasks or improve revenue-raising power at the micro-regional level. However, over time, Hungary could learn from the practices and examples of mature democracies to broaden municipal rights rather than curtailing them, provided that the necessary financial safeguards are in place.

Works Cited

- Bahl, Roy. 2000. *Intergovernmental Transfers in Developing Countries: Principles and Practice*. World Bank Discussion Paper. Washington, D.C.: World Bank.
- Barati-Stec, Izabella. 2003. *The Practice of Municipal Infrastructure Finance in Hungary: Modelling Municipal Investment Activity*. Dissertation. Budapest University of Economic Sciences and Public Administration. Budapest. http://phd.lib.uni-corvinus.hu/453/4/barati_izabella_en.pdf
- Barati-Stec, Izabella, and Mihály Hógye. 2012. Önkormányzatok költségvetés-készítési gyakorlata (Budgeting techniques of municipalities.) Pro Publico Bono Online. http://www.propublicobono.hu/pdf/Barati_H%C5%91gye.pdf (accessed October 10, 2012).
- Bird, Richard M., and Almos Tassonyi. 2003. Constraining subnational fiscal behaviour in Canada: Different approaches, similar results? In Jonathan Rodden, Gunnar S. Eskeland, and Jennie Litvack, eds., *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, 85–132. Cambridge, Mass.: MIT Press.
- Boadway, Robin, and Anwar Shah. 2009. *Fiscal Federalism: Principles and Practice of Multi-level Governance*. New York: Cambridge University Press.
- Boadway, Robin, and Harry Kitchen. 1999. *Canadian Tax Policy*. Third Edition. Toronto: Canadian Tax Foundation.
- Chatrie, Isabelle. 2009. Economic outlook: Sub-national public finance in the European Union. Dexia Crédit Local, presentation made in Brighton, December 11.
- Claessens, Stijn, and Simeon Djankov. 1998. *Politicians and Firms in Seven Central and Eastern European Countries*. Policy Research Working Paper Series 1954. Washington, D.C.: World Bank.
- DH Online. 2010. Dunaújváros a csőd szélén? (Dunaujvaros at the verge of bankruptcy?) Dunaujvarosi Hirlap. http://www.dh-online.hu/kronika-a_varos/20100511_juliusig_biztosan_kinlodik_a_varos (accessed February 22, 2012).

Escolano, Julio, Luc Eyraud, Marialuz Moreno Badia, Juliane Sarnes, and Anita Tuladhar. 2012. *Fiscal Performance, Institutional Design and Decentralization in European Union Countries*. IMF Working Paper. WP/12/45. Washington, D.C.: International Monetary Fund.

FigyeloNet. 2008. Iparüzési adóban versenyeznek. (Property Tax - Race to the bottom) August 6. http://fn.hir24.hu/vallalkozas/2008/08/06/iparuzesi_adoban_versenyeznek/ (accessed February 18, 2012).

Gál, Erzsébet. 2012. *Az önkormányzati adó- és követelésminősítésének elmélet és gyakorlati problémái*. (Theoretical and Practical Challenges of Municipal Credit Rating). Ph.D. Dissertation. Miskolc University.

Gillette, Clayton P. 2011. *Political Will and Fiscal Federalism in Municipal Bankruptcy*. Law & Economics Research Paper Series Working Paper No. 11-13. New York: New York University School of Law.

Hegedűs, József, and Andrea Tönkö. 2006. *Az önkormányzati gazdasági társaságok szerepe a helyi önkormányzatok vagyongazdálkodásában: feltételes kötelezettségvállalás problémája*. (The “contingent liability” problem.) Budapest: Városkutatás Kft.

Homolya, Dániel, and Gábor Szigel. 2008. Lending to local governments: Risks and behaviour of Hungarian banks. *Hungarian National Bank Bulletin* 3(2), 20–29.

Hungarian Ministry of Interior Affairs (now the Ministry of Public Administration and Justice), Hungary. <http://www.bm.gov.hu/web/portal.nsf/html/onkgazd.html> (accessed February 18, 2012)

HVG Online. 2011a. Önkormányzati adóssághegy: a politika miatt fékezhettek be a bankok (Municipal debt mountain: Banks hitting the brake for political reasons). August 26. http://hvg.hu/gazdasag/20110826_onkorm_hitel_bankok (accessed February 18, 2012).

HVG Online. 2011b. Ezermilliárd fölél rüg az önkormányzatok adóssága (Hungarian municipal debt over 1000 billion). September 12. http://hvg.hu/gazdasag/20110912_onkormanyzatok_adossagallomanya (accessed February 18, 2012).

HVG Online. 2012a. A járások miatt kevesebb pénz kaphat az önkormányzatok. (Due to the ‘Jaras,’ municipalities might get access to less money). April 13. http://hvg.hu/gazdasag/20120413_onkormanyzatok_finanszirozasa (accessed April 13, 2012).

HVG Online. 2012b. Magyar Nemzet: új központi iskolafenntartó alakulhat. (A new school management institute could be set up) April 13. http://hvg.hu/itthon/20120413_kozponti_iskolafenntarto (accessed April 13, 2012).

Krugman, Paul. 2011. Depression and democracy. *New York Times*, New York Edition, December 12, A23.

Liu, Lili, and Michael Waibel. 2010. *Managing Subnational Credit and Default Risks*. WPS5362. Washington, D.C.: World Bank.

Liu, Lili, and Steven B. Webb. 2011. *Laws for Fiscal Responsibility for Subnational Discipline: International Experience*. WPS5587. Washington, D.C.: World Bank.

OECD. 2001. Territorial Reviews. *Hungary. Territorial Economy*. Paris. OECD.

Paulais, Thierry. 2009. *Local Governments and the Financial Crisis: An Analysis*. Washington, D.C.: The Cities Alliance.

Péteri, Gábor, and Kenneth Davey. 1998. *A helyi önkormányzatok pénzügyi rendszer átalakítás lehetőségei* (Possibilities for reforming the local government system). Nagykovácsi: Helyi Önkormányzati Local Know-How Program.

Petersen, John E. 1999. *Sub-national Debt, Borrowing Process and Creditworthiness*. Washington, D.C.: World Bank.

Scheppele, Kim Lane. 2011. Hungary's constitutional revolution. *New York Times*, December 19. <http://krugman.blogs.nytimes.com/2011/12/19/hungarys-constitutional-revolution/> (accessed February 18, 2012).

Rodden, Jonathan, Gunnar Eskeland, and Jennie Litvack, eds. 2003. *Fiscal Decentralization and the Challenge of Hard Budget Constraints*. Cambridge, Mass.: MIT Press.

Slack, Enid. 2009. *Guide to Municipal Finance*. Nairobi: UN-HABITAT.

Swianiewicz, Pawel, ed. 2004. *Local Government Borrowing: Risks and Rewards: A Report on Central and Eastern Europe*. Budapest: Local Government and Public Service Reform Initiative. Open Society Institute.

Swianiewicz, Pawel. 2010. If territorial fragmentation is a problem, is amalgamation a solution? An East European perspective. *Local Government Studies* 36 (2), 183–203.

Szalai, Akos, and Almos Tassonyi. 2004. Value-based property taxation: options for Hungary. *Environment and Planning C: Government and Policy* 22(4), 475–632.

Tassonyi, Almos. 2004. Landbased taxes in Hungary. In Richard M. Bird and Enid Slack, eds., *International Handbook of Land and Property Taxation*, 219–235. Cheltenham: Edward Elgar.

Tossenberger, Adél. 2012. Nem államosítás, csak átvétel: Az érintetteknek fogalmuk sincs, miről van szó (Not nationalization, only takeover: Affected municipalities have no idea what is going on). HVG Online, April 13. http://hvg.hu/itthon/20120413_iskolak_allamositasa (accessed April 17, 2012).

Toth, Kata. 2012. Gépjárműadó: Fájdalmas változás jöhet. (Vehicle tax: A painful change might happen). Napi Gazdaság Online. http://www.napi.hu/ado/gepjarmuado_fajdalmas_valtozas_johet.521590.html (accessed August 16, 2012).



ISBN 978-0-7727-0885-4
ISSN 1927-1921