

Chapter 7:

Strengthening Hard Budget Constraints in Hungary

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As is the case in most of the countries of Eastern Europe and the Former Soviet Union, the system of intergovernmental finance in Hungary has undergone radical change since the early 1990s. The move from a centralized, government-controlled economy toward one that is more decentralized and driven by market forces poses particular challenges for maintaining hard budget constraints. The roles and responsibilities of different levels of government are in flux and new institutions are evolving. All of this occurs in the context of important political changes.

The case of Hungary demonstrates that, despite the intensity of such a transition, steps can be made to strengthen and maintain a hard budget constraint among different levels of government. Not all measures and aspects of the system contribute to hard budget constraints (indeed, some do just the opposite), but on balance the Hungarian system has developed some noteworthy mechanisms for assuring that most of the liabilities of the local levels of government are not passed up to the center. Perhaps of greatest importance in this area is the legislation established in 1996 on municipal debt adjustments. Three key channels that influence hard budget constraints are considered here: 1) the system of intergovernmental finance and the degree to which it encourages or discourages hard budget constraints, 2) the political incentive structure in Hungary and how it influences the actions of localities and 3) the system of capital markets and the critical role its evolution has played in the strengthening of hard budget constraints in

Hungary. Given the embryonic nature of land markets and the property tax, a fourth potential channel of land markets is not addressed.

I. The System of Intergovernmental Finance and its Impact on Budget Constraints

It has been almost a decade since Hungary began to transform its system of intergovernmental finance and much has been accomplished in putting sound foundations in place. While the system of intergovernmental relationships has made great progress, some key features of this system nevertheless imply that local governments do not face a strict hard budget constraint. In what follows, the main features of the intergovernmental system are reviewed, including the structure of government, expenditure assignments, the system of transfers and budgetary processes.

The structure of government

Hungary is a relatively small country with a population of 10 million people, has a unitary government system with 19 counties, 23 “cities with county rank” and about 3200 local (municipal) governments.² The Constitution and the 1990 Law on Local Self Government establish that the basic rights of all local governments, regardless of size, are equal. This was a major step in the restoration of democracy in Hungary. However, the current legislation sets the stage for very fragmented activities with many small local governments required to provide a broad range of services. The average size of

¹ World Bank

² This section draws heavily on World Bank, 1999b (draft). For a discussion of developments of the intergovernmental finance system in the early 1990’s see Bird, Wallich and Peteri (1995).

Hungary's municipalities (including Budapest) is 3,249 people and over half of Hungary's municipalities have a population below 1,000.

The evolving legislation has tried to address issues of fragmentation and efficient service delivery through the role of the intermediate levels of government (the counties and regions). As a reaction to their dominant role in the system prior to transition, the role of counties was greatly minimized by the 1990 Law on Local Self Government. In 1996 the Government adopted the Act on Regional Development and Physical Planning. This legislation aims to create a new balance between the central and local governments through the development of new subnational decision-making units that will elaborate regional development plans and priorities. Development Councils for larger regions have been formed on a voluntary basis and these Councils are expected to become more formalized over the next five years.

Local governments have also been encouraged to create municipal associations in order to provide services more efficiently. There are now over 200 such associations operating in Hungary (Hegedus and Peteri, 1997). Act No. 135 on the associations and cooperation of local governments has the objective of improving the quality of public services. While several forms of association are recognized by the Act, none are recognized as entities with the authority to dispose of their own resources nor to become the direct independent recipient of budgetary funds, nor to be held accountable as an entity.

Expenditure responsibilities

There has been a considerable decline in Hungarian public expenditure as a share of GDP since the early 1990s, reflecting both efforts at stabilization and a more general shift in the role of government. Total general government expenditures as a share of GDP has fallen from 60.7 percent in 1994 to an estimated 45.3 percent in 1998. Of these, local expenditures have fallen from 17.4 percent of GDP in 1994 to 12.7 percent of GDP in 1998. As a share of total general government expenditure, however, the local government share has remained stable at about 22 percent of total expenditures.

The Law on Local Government defines a wide range of local government functions. Ten functions are mandatory: provision of potable water, kindergartens, primary education and daily child care, health care, welfare services, public lighting, local roads, cemeteries and protecting the rights of national ethnic minorities. Other potential local services include: urban development; protection of built and natural environment; housing; water management; sewage; local public transportation; public cleansing; fire service; public safety; participation in energy supply; provision of public (cultural) places; subsidies to culture, art and sports; and support to develop a healthy way of life among the community. The list of potential services to provide at the local level is very broad and even the ten mandatory functions imply considerable responsibilities.

While intended to promote flexibility, the use of “potential” responsibilities leaves a degree of ambiguity in the system that promotes a lack of clarity and contributes to softer budget constraints. Typically communities try to carry out as many functions as they can because they are the basis for receiving budgetary transfers. The option of passing a voluntary responsibility to a higher (usually the county) level most frequently

occurs when a community is not able to meet the costs of providing that service. The knowledge that services can be “passed up” may lead to less emphasis on efficient delivery and meeting budgets than when local governments have specific responsibilities that they must carry out. It thus acts to soften the budget constraint. In addition, a system in which local governments may choose to provide a service or not each year generally leads to instability in service provision and may also discourage investment in the provision of a given service. It also suggests that some functions may be assigned to local governments that are too small to carry out the responsibility efficiently.

While local governments are accorded substantial responsibilities, they are not always given autonomy over decision making in these areas. There are a wide range of laws and other sectoral legislation that have an impact on local government activity (Pal-Kovacs, 1998). For example the Act on Public Education (1993) clearly separates the tasks assigned to county governments and precisely defines the institutional and professional requirements of implementation, thus imposing many measures on local governments. The Act specifies that full operational expenses are not covered by the state budget and that own incomes of the institution are part of financing. At the same time it specifies that the normatives of the state budget cannot be less than 80 percent of total expenses paid for public expenditure on education by local governments two years earlier. This does not promote local government autonomy nor does it assist the rationalization of expenditure.

Another example is Act No. 114 on Health Care. This Act specifies that patients are eligible for health care in a place which can be approached by the use of “regular public transportation.” It also defines quite carefully the professional requirements and

the division of labor among various workers and which tasks are to be financed out of the central budget. The basis of financing is the “capacity utilization agreement,” which decides how much assistance the owners and maintainers of the institutions are entitled to from the Health Insurance Fund, although each year this tends to come down to negotiation. The appendix of the Act defines the evolution of hospital beds for the five coming years. Generally the spirit of this Act is that the local governments perform the role of owner of the infrastructure, but have little role in decision making beyond that.³

The large number of sectoral laws that affect local governments and the annual budget laws generally have an important influence on local government autonomy that is not entirely in keeping with the Law on Local Government. While the Law on Local Government legislates a large degree of autonomy to municipalities in service delivery and standards, in practice, both sectoral laws and the annual budget laws constrain that autonomy by defining many of the specific terms and conditions under which localities must operate. In general, this undermines an effective system of intergovernmental finance and hard budget constraints because it separates decision-making authority from accountability and makes local governments less responsible for their decisions and for their performance.

Revenue assignments

As seen in Table 1, the total revenues of local governments in Hungary have fallen from about 16 percent of GDP in 1993 and 1994 to 12.0 percent of GDP in 1998.

³ Other sectoral acts and laws that have a significant impact on local government activities include the Act on Social Administration and Social Care; the Act on Protection of Cultural Possessions, Public Library Service and Public Education; the Act on Protection Against Fire; the Act on the General Rules of the

In 1998 local authorities raised about 10 percent of their total revenue in local taxes. While this share is much greater than it used to be (it increased significantly after the fiscal stabilization of 1994/95), it is still only a small portion of total local government revenues when compared with transfers (see below). Local taxes include taxes on business, property, tourism and the communal tax that are entirely within municipal discretion. In the case of these taxes, local governments can decide whether to levy the tax at all. They are also able to set the tax rates within given limits and are responsible for assessment and collection. In addition, municipalities receive a portion of shared taxes which are discussed below as part of the system of intergovernmental transfers.

While in 1997, 81 percent of municipalities made use of at least one local tax, most localities do not employ the full range of tax instruments (or the maximum rates) at their disposal (Davey and Peteri, 1998, p. 76). There are a number of possible explanations for this. First, given that national tax rates in Hungary remain relatively high, mayors are reluctant to add an additional tax burden because the political costs may be perceived to be excessive. Second, local governments have garnered revenues through privatization and the selling off of assets and this has reduced the need to assess taxes directly. However, the pool of saleable assets is rapidly diminishing and such a strategy is not sustainable. Finally, many of the incentives in the system of intergovernmental finance tend to encourage local governments to search for sources of finance from higher levels of government in the form of grants (to be discussed below) rather than bear the cost of imposing new or higher local taxes. This reliance on revenues other than local taxes tends to encourage local governments to be less careful with the use of resources,

Protection of the Environment, and the Act on the Shaping and Protection of the Built Environment, and the Yearly Act on the Budget.

because they do not bear the political brunt of having to raise the revenues for the financing of services.

Table 1: Local Government Accounts, 1993-98 (in % of GDP)

	1993	1994	1995	1996	1997	1998
Total Revenues	16.1	15.9	13.6	13.0	12.8	12.0
Own Current Revenues	3.0	2.8	2.6	3.0	3.3	2.9
Revenue Sharing with Central Govt.	1.4	1.5	1.7	1.6	1.7	1.9
Transfers from Central Govt.	7.7	7.3	5.7	5.0	4.3	4.2
Transfers from Other Public Sector	2.8	2.9	2.4	2.4	2.4	2.2
Capital Revenues	0.7	0.9	0.8	0.6	0.6	0.5
Other Revenues	0.5	0.5	0.4	0.4	0.5	0.3
Total Expenditures	17.2	17.4	13.9	13.0	13.1	12.7
Current Expenditures	13.5	13.7	11.5	10.9	10.5	10.2
Capital Expenditures	3.1	3.3	2.4	2.1	2.6	2.4
Other Expenditures	0.6	0.4	0.0	0.0	0.0	0.1
Balance	-1.1	-1.5	-0.3	0.0	-0.3	-0.7
Net Financing	0.5	1.0	0.2	0.3	0.3	0.4
Privatization Revenues	0.2	0.3	0.5	0.7	1.0	0.5
Net Borrowing	0.3	0.7	-0.2	-0.4	-0.7	-0.1
Residual	-0.6	-0.5	-0.1	0.3	0.0	-0.3
Memo item:						
Borrowing/Borrowing Cap (in %)	117	167	81	27	19	30

Source: Ministry of Finance

The system of transfers

As seen in Table 1, even though the magnitude of transfers has declined over time (in both nominal and real terms), they still provide over two thirds of local government resources. In addition to the shared revenues (which constitute 12 percent of intergovernmental transfers in 1998), Table 2 sets out the four principal mechanisms for transfers in Hungary: normative grants (45 percent of total), earmarked operating grants (39 percent), investment grants (8 percent), and deficit grants (1 percent). Overall the system of transfers in Hungary is one of the most advanced in transition economies. Most of it is formula-based and there are some important mechanisms for correction of transfer

amounts. However the system is also highly complicated, promotes “grantsmanship” and, deficit grants in particular, tend to discourage a hard budget constraint.

Shared Taxes	
PIT	93,500
Vehicle tax	8,500
Tax on Land Rent	1,000
Shared Revenues Total	103,000
Normative Grants	
Normative Subsidies from Central Budget	369,633
Normatives Total	369,633
Earmarked Operating Grants	
Subsidies to theaters	4,770
Subsidies for local fire protection	11,600
Other subsidies (Centralized Appropriations)	37,822
Supplementary Grants to Central Public Education	6,507
Funds from Social Security	190,900
Funds from EBFs	19,000
Funds from budgetary (Chapters) Institutions	8,000
Budgetary Supplements and Refunds	1,000
Earmarked Operating Grants Totals	279,599
Investment Grants	
Addressed and targeted subsidies	43,000
Accumulation revenues within the state budget	9,000
Investment Grants with Regional Equalization	9,000
Decentralized Targeted Oriented Grant	4,300
Investment Grants Total	65,300
Deficit Grants	
Deficit Grant (ONHIKI)	7,200
Deficit Grants Total	7,200
Total Grants	824,732
Source: Compiled from Ministry of Finance Documents. See Fox, 1998	

Shared taxes. Local governments receive percentages of the personal income tax (PIT), vehicle, and property transactions taxes, representing a budgeted HUF 103 billion in 1998 or about one-sixth of local revenues.⁴ Sharing of the Personal Income Tax (PIT) provides

⁴ Municipalities also receive 30 percent of environmental fines.

about 85 percent of total derivation-based revenues, or HUF 89 billion in 1998. These derivation-based PIT revenues represent one-half of the 40 percent of national PIT revenues that are earmarked for local governments.⁵ Local governments receive fifty percent of the nationally established motor vehicle tax and all of any additional revenues if they choose to impose a motor vehicle tax surcharge. Also, county administrative offices collect a tax on land and property transactions. Thirty percent is remitted to the municipality of origin, 35 percent stays with the county office to finance administrative expenses, and the remaining 35 percent is placed in a pool and provided to counties on a per capita basis.

The PIT distribution is made more equal by guaranteeing local governments a minimum per capita amount. In 1998, villages were assured of at least HUF 8,000 per person and towns of at least HUF 9,800 per person. The minimum amount has been escalated rapidly in recent years and is expected to cost HUF 33.34 billion in 1998, up from HUF 9.9 billion in 1996. The minimum PIT distribution combined with the needs based normatives described below provide a significant equalization component to the overall transfer system.

Normative Grants.⁶ Local governments and counties receive grants based on the value of a series of normatives. Most of the revenue from normatives goes to towns and villages, but about HUF 9.5 billion goes to the counties. The normatives effectively create a complicated formula-based grant structure, linked mostly to expenditure needs. The total amount of normative-based revenue going to a local governments is calculated by adding

⁵ The other half is used for equalization purposes and is allocated based on a set of normatives discussed below.

the amount to be received from each of the approximately 50 normatives.⁷ The revenue provided according to the normatives is generally not earmarked, and may be spent for any purpose that the recipient government deems appropriate. However, local governments' expenditure flexibility is often less than it appears, because delivery of many services is mandatory, and, as discussed above, mandates and standards in other laws effectively prescribe certain expenditures.⁸

There are at least 26 education normatives, usually based on the number of students.⁹ For example, HUF 67,000 is provided for each kindergarten student and HUF 96,000 for each secondary student in grades 11 through 13. In some cases normatives are designed to provide incentives, as when a greater amount is given for non-resident students to encourage local governments to cooperate in service delivery. The Ministry of Culture and Education recognizes that the values are not based on an analysis of actual costs, but the normatives are set to cover education wages, or about two-thirds of total education costs. Cost estimates provided by local governments suggest that the normative values are sufficient to finance about 50 percent of kindergarten costs and about 80 percent of high school costs. There are also 7 pupil-based education grants for

⁶ This section draws heavily on Fox, 1998.

⁷ Analysts have given different totals for the number of normatives, depending on how normatives are counted when multiple normatives are applied to a single situation.

⁸ Also, recipient governments can expect political pressure from advocates for each service to spend the revenues for the purposes on which the normatives are based.

⁹ Many of the beneficiary normatives require careful compilation. Schools must follow detailed instructions on how to calculate the number of students. Many normatives, such as the number of students in classes 9 and 10, the number in classes 11 through 13, the number eating lunch at school and so forth, may apply to the same school, so many separate counts must be kept. One case was observed where 23 normatives applied to a single school. Generally these normatives are based on the average number of students each day, so daily counts (and sometimes more than once per day) must be maintained. Further, the academic year crosses two fiscal years so schools and local governments will normally need to follow two different sets of definitions and normative values during the same academic year.

ethnic schools and programs. The ethnic normatives differ from others in that the moneys are earmarked for specific purposes.¹⁰

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

The other major normative is also provided on a per capita basis, with the amount transferred to local governments varying between HUF 2,500 and HUF 12,500 per person. The specific amount given depends on the extent of unemployment, percent of the population that is paying PIT, and percent of the population that is under 18 and over 65. The intent is to provide greater funding to municipalities that have larger social welfare responsibilities, though in a recent analysis of spending patterns the Ministry of Social Welfare found no relationship between program expenditures and factors in the formula. Beneficiary-based normatives are also used for social welfare purposes. Five types of beneficiaries are identified including for homes for the elderly, homeless, handicapped, and orphaned, and for rehabilitation purposes.

Budgeting for normative grants begins with agreement between the government, Parliament, and local governments on the total amount of normative grants to be distributed. In the fall prior to the budget year, as part of the national budget planning process local governments provide estimates on the expected number of beneficiaries and

¹⁰ The normatives are generally described in Annex 3 of the budget, but each of the earmarked grants are contained in separate annex. For example, the ethnic normatives are presented in Annex 8.

the other factors that go into calculating the normative grants. The totals of these estimates are used to set average amounts (the normatives' values) that are the basis for the distribution across governments. Then, the normative values are used to calculate the amount that each local government is to receive. The local governments do not learn the amount they are to get until March of the year the money is to be provided. Payments based on these calculations are regarded as preliminary, and the actual normative payments are determined after the number of beneficiaries is determined at the year's end. Local governments are paid additional amounts if they underestimated the number of beneficiaries and must repay excessive amounts if they overestimated beneficiaries. Interest is charged if the difference between the total estimated and total actual amount exceeds 5 percent. The State Audit Office inspects some municipalities to determine if the counts given by schools and other sources is accurate. A final reconciliation based on the audits can result in additional payments to local governments or a return of money if there were overpayments.¹¹

Earmarked Operating Grants. Funds from a number of grants are earmarked for operating purposes. These include annual grants for theaters and fire protection and the ethnic normatives mentioned above. In addition, a series of grants termed "centralized appropriations," totaling HUF 37.8 billion in 1998, are given for earmarked purposes.¹² The specific purposes often vary by year. In 1998 these grants were made for children's programs (HUF 9.5 billion), teachers' education (HUF 3.5 billion), textbooks (HUF 1.6

¹¹ The State Audit Office examines normative grants in about 500 municipalities per year, and performs comprehensive audits in about 40 to 50 other municipalities.

¹² Accumulation revenues inside the state budget and funds from budgetary institutions are not categorized as centralized appropriations because they may also be provided to entities other than local governments.

billion), severance pay for employees (HUF 1.5 billion), subsidies for public utility user fees (HUF 3.4 billion), public utility investment (HUF 2.5 billion), and old age protection (HUF 5.1 billion). Sectoral Ministries also have revenues to finance delivery of specific operational programs, and some of these funds are granted to municipalities. In the budget accounts these are termed funds from budgetary institutions. The total value of these programs is expected to be HUF 8 billion in 1998. The grants from centralized appropriations and funds from budgetary institutions are normally provided directly through sectoral Ministries and they often have considerable flexibility for making the specific allocations of these grants.

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

Investment Grants. Investment grants are made to finance specific projects that normally are selected through competitive bidding processes.¹³ The funds are generally earmarked, since they are intended for specific projects. The projects often involve implementation across several years, so the grantors frequently make multi-year commitments. Since local governments sometimes are unable to provide their cost share, the funds remain unused in about 10 percent of the cases where investment grants are made.

¹³ In most cases the transfer of these funds occurs as payment on the basis of invoices for actual expenditures, rather than through direct transfers to local governments.

Four categories of investment grants are made directly through the central government budget. Other grants may be made through the centralized appropriations described above. For example, in 1998 an appropriation was budgeted to provide funding for sewer systems in Budapest and the 22 county rights cities.

Addressed and targeted grants are the largest categories of investment grants. Projects financed through these grants are estimated to comprise 60 percent of all local investments. Addressed grants generally provide 100 percent funding, and are made for large projects that have significant spillover benefits. The projects are selected by the Parliament, normally after recommendations from the Ministry of Interior and the sectoral Ministries.

Targeted grants are usually for smaller projects with lower spillovers, and are matching grants with an average of 50 to 60 percent national and 40 to 50 percent local financing. The grant component is increased 10 percent if the grantee is a municipal association. Between 1993 and 1995 the percentage paid by the national government varied by type of project, from 90 percent for clean water projects to 30 percent for projects such as improving primary school classrooms.¹⁴

Priority areas for targeted grants are set in the annual budget law. The major priorities for 1998 included: solid waste management, rehabilitation of dilapidated primary schools, medical equipment, and sewage and water systems that are linked together. Project applications are reviewed by the TAKISZ offices, the Ministry of Interior and the sectoral Ministries. All municipalities are entitled to apply for targeted grants and applications that meet all criteria are automatically approved, though funding may in practice not be available.

Sectoral Ministries and extra-budgetary funds make grants for investments in the same manner as they do for operational purposes. These revenues are termed accumulation revenues within the state budget in the financial accounts, and are expected to total HUF 9 billion in 1998, down from HUF 10 billion in 1997. The extra-budgetary funds and sectoral Ministries each have priority areas that were established by Parliament, but each has considerable flexibility in making the grants. Local governments and non-government entities can apply for grants through these programs. Some programs require that a minimum percentage of the grants be made to local governments. For example, the Water Fund must provide 65 percent of its grants to local governments. Three extra-budgetary funds make grants to local governments, the Environmental Protection, Road, and Water Management Funds.¹⁵

Two additional grant programs are administered through the County Regional Development Councils that were recently formed in anticipation of EU accession. The regional councils are not local government bodies, though the councils include local government officials in addition to private sector representatives and others. These grant programs allow some investment funds to be allocated based on regional rather than national priorities. Grants from both programs must be made in accordance with the counties' development plans. The first program, regional equalization grants, is targeted for distressed and less developed municipalities.¹⁶ The subsidy is 10 percent greater if the grantee is a municipal association. The second program, regional development

¹⁴ "Subsidy System of Municipal Infrastructure Investments," The Urban Institute, March 1996.

¹⁵ The extra-budgetary funds are financed through a variety of means. For example, the Road Fund is mostly financed with an excise tax on fuel, but the portion available for grants to municipalities (less than HUF 1 billion) comes from a 25 percent share of the central government's part of the motor vehicle tax.

¹⁶ Formally, the regional development subsidies are made through the Ministry of Environment and Regional Development and the regional equalization grants are made through the Ministry of Interior. The

targeted appropriations, is available for all purposes and for both local governments and non-government entities. Either grants or recurrent subsidies can be given. The grants are made with the requirement that at least 20 percent of the funding comes from the local governments, though there is no explicit mechanism for ensuring that local governments meet their commitments. The Regional Development Councils normally provide grants of under HUF 200 million, and these programs are seen as being given in place of smaller targeted grants. Larger grants still must be obtained through the addressed and targeted programs. This financing dichotomy may provide incentives to increase or decrease the size of projects, depending on which structure offers the best terms and easiest access to grants.

In general, investment grants are poorly coordinated because there is a huge volume of applications and a large number of granting agencies. Municipalities often bid for every possible grant, with the hope of being successful on an acceptable share.¹⁷ As a result each municipality often applies for multiple grants for the same project and for grants for many different projects. There are many incentives for municipalities to bid for numerous grants. Uncertainty about the overall grant system encourages local governments to apply for funding, since they worry that financing will not be available later. All of the schools or other institutions in the same municipality may apply for the same grant program. Municipalities are not prohibited from simultaneously applying for and receiving grants for the same project through many of the programs described above. For example, water and sewer projects can obtain funding through the addressed,

Ministries use a scoring system (which is approved by Parliament) to determine the distribution of revenues across counties and then allow the Regional Development Councils to make the specific allocations.

¹⁷ One municipality indicated that it submits as many as 1000 applications annually, though only a small portion of these request significant resources.

targeted, environmental protection, water fund and regional grant programs, and possibly through others.

The large number of applications means that most grant programs have applications for much more financing than is available.¹⁸ Further, the volume of applications precludes comprehensive reviews of projects by the granting agencies. In fact, projects are seldom evaluated in terms of their economic viability. Factors such as whether the local government appears able to finance its share of the cost play a much greater role in the decision process than does project quality, even though the fungibility of resources means there is little information in a local government's apparent financial capacity. All of these considerations increase the chance that decisions are based on grantsmanship and political criteria. Small communities are disadvantaged the most because they do not have the resources to compete for as many projects.

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

¹⁸ For example, the Road Fund annually receives about 1000 applications, of which it can fund about 150.

A resolution (Resolution 263 of 1997) was adopted to allow more effective coordination of the resources managed by the Ministries and the extra-budgetary funds. The Resolution also allows the Treasury to monitor disbursements of grant funds from the different sources.¹⁹ The system for implementing the Resolution has not been fully developed as yet, and the resolution is best characterized as laying out an objective. The expectation is for a single tender to be issued for all projects of the same type. Local governments will apply once to the institution where the largest grant is being requested. The evaluation process for all prospective grants for each project is to occur simultaneously, with the institution receiving the proposal being responsible for coordination with other potential grantors. Presumably this will allow better overall targeting of investment funds, and will reduce the possibility for excessive grants. However, at this point Ministries have different willingness to cooperate in the disbursement of grants, with some wanting an improved process and others wanting to maintain their independent ability to influence the grant making process. While the Resolution is a step in the right direction, it is insufficient to achieve optimal project selection, design, and implementation.

Deficit Grants. Deficit grants are provided to assist local governments that have deficits “through no fault of their own” or local governments that go bankrupt. The total value of these grants is budgeted to be HUF 7 billion in 1998, up slightly from the 1997 level. During the year, the aggregate value of deficit grants can be increased using unspent funds from the addressed and targeted grant programs. The demand for these grants has

¹⁹ Resolution 263 also permits the Treasury to ensure that debts owed to the Central Government are met prior to any disbursement of funds.

been steadily increasing and in 1999 one third of all localities had applied for deficit grants.

A series of criteria has been established by Parliament to determine which local governments qualify for the grants. These criteria include: (a) municipalities must levy local taxes (in practice this seems to be interpreted as meaning the business tax), (b) capital expenditures must be less than capital revenues (presumably to ensure that current revenues are not being used to finance investments), (c) there must be no financial deposits with a duration of three months or more, and (d) the grants are only made to assist governments in covering mandatory tasks.

Applications for deficit grants are to be made to the TAKISZ offices by April 30th and September 30th of the year in which the grant is to be made. The TAKISZ offices analyze the applications to determine whether the local governments qualify. The findings are reported to the Ministries of Finance and Interior which make a joint decision on whether a grant should be made and for how much. The joint decision is then presented to Parliament for review.

These deficit grants provide perhaps the most specific disincentives to a hard budget constraint in the system, because local governments can increase their grant revenues through behavioral changes. Local governments have an incentive to raise less of their own revenues and to increase expenditures on mandatory services since deficit grants may potentially fill any gap. As a result, even local governments that appear to be in relatively good financial condition are able to apply for and receive deficit grants. Certain revenues can be shifted from covering mandatory to non-mandatory expenditures

and deposits can be held for periods just short of three months. The grant received by a municipality can depend heavily on its grantsmanship skills.

Budget Management and Execution

Since 1996-1997 the Government has made substantial efforts to improve budgetary management and execution by improving transparency, identifying contingent liabilities of different parts of the government, and by strengthening audit procedures (Polockova-Brixi et al, 1999). The Government has strengthened the role and competency of the Ministry of Finance and established a modern State Treasury. The Treasury is responsible for budget execution at all levels of government, making payments from a single government account, controlling ex- ante payments against budget appropriations, and recording them in a general ledger. This has greatly improved the efficiency of budget management.

In addition, the central government has been expanding its budget management system. The State budget proposal makes provisions for the main sources of potential financing pressure on the central government and the official three year forecast includes expected outlays on contingent government liabilities. The State Debt Management office reports the full list of state guarantees from a comprehensive data base of public liabilities, and reviews the terms of guarantee contracts. The Ministry of Finance submits to Parliament reports on the potential cost of both newly considered and existing programs of contingent government support. The State Audit Office is authorized to review government activities under both direct spending and contingent support programs, the adequacy of budgetary provisions and reserve funds with respect to risk

exposure, and the management of contingent as well as direct explicit liabilities. The Government has put in place both regulatory and enforcement mechanisms to minimize fiscal risks from local governments, which will be discussed at length in the third part of this paper.

In general the effort made by the central government to improve budgetary management and especially to identify and monitor potential fiscal liabilities and has been an important step in strengthening the hard budget constraint. Such measures make help to expose existing liabilities and clarify who will undertake the responsibility for meeting those liabilities.

Implications of the system for hard budget constraints

The current system of intergovernmental finance in Hungary present a mixed set of incentives for localities in terms of hard budget constraints. Numerous responsibilities are given to local governments either as mandatory or voluntary functions, and yet frequently fundamental decision making with respect to key management issues such as salaries and staffing remains with the center. This is particularly important in the social sectors, including health, education and social welfare. Given the small size of most local governments, many services are provided at a scale that is not economically efficient. Expenditure assignment therefore does not match the appropriate level for service delivery. Addressing this issue through the use of voluntary assignments gives localities an incentive to try to carry out functions that they are ill equipped to carry out and leads to losses that are eventually passed up to higher levels of Government.

Local governments also face few incentives to increase their own resource taxes. Local governments have access to a property, business and communal taxes, but they make small use of these. So even though the nature of local taxes is such that it largely taxes only local residents, because localities are not responsible for raising the bulk of their revenues through local taxes, the link between raising local revenues and using local resources effectively is weak.

While a good portion of the transfers received by local governments are based on a very specific formula, overall the system of transfers is quite complex and administratively burdensome. The nature of the system is such that it encourages localities to spend extraordinary amounts of time documenting information for the normatives or sending out applications for the wide range grants that are available. In the current system, a premium is placed on “grantsmanship” skills because transfers are the marginal source of revenue for most communities. Deficit grants in particular, create a set of incentives that discourage a hard budget constraint. The deficit grant system is based on gap filling and localities are squarely in a position to alter their behavior in ways that will improve their possibility for receiving deficit grants. Deficit grants, perhaps more than any other part of the system weaken hard budget constraints and the ever-increasing number of applications for these grants testify to their popularity.

While most of the above factors tend to push in the direction of soft budget constraints, at the same time, the Government has put in place some oversight mechanisms to that help to encourage hard budget constraints. The allocation of resources based on the normatives has a corrective mechanism, which is used regularly, with local governments returning resources in some cases or receiving resources in

others. The strengthened treasury, audit and budget management practices have helped to improve budget management. Finally, the specific identification of the liabilities of different levels of government and their regulation (see below) has made a critical difference in hardening budget constraints. Before turning to this, the next section considers how the changing political environment influences local government behavior.

II. Political Incentive Structures and their Influence on Budget Constraints

A fundamental premise that underlies much thinking on decentralization and its benefits, is that local citizens will be in a position to hold their local governments accountable for their actions through the political process. Either through “exit” (leaving a community) or “voice” (the press, election outcomes, etc), citizens have a mechanism for expressing their views on the effectiveness of the local government in carrying out its functions. In this section we consider the extent to which the existing political mechanisms in Hungary allow citizens to hold their local governments accountable and whether there is an incentive to do so. In Hungary, as in many transition economies, a political evolution is occurring hand in hand with economic transformation. Strengthened democratic processes and evolving political mechanisms work both for and against hard budget constraints, but on balance it appears that these political mechanisms work in favor of strengthening the budget constraint.

The balance of power between the center and the local governments

In Hungary, as in many other countries of the Eastern Europe and the Former Soviet Union, decentralization of authority takes on a particular importance as a symbol both of new-found democracy and of a backlash to the old regime. Thus when communities were given the authority to create self-governing entities, Hungary's 1500 local governments quickly blossomed into 3200. As discussed above, remnants of the old regime – such as the county structures—were quickly dispossessed of real authority. This large number of small communities has two important implications for the balance of power amongst different levels of government and its role in the evolution of hard budget constraints.

First, the large number of small local governments, their emphasis on self determination and the fragmentation that this implies has weakened the political strength of these communities. While a range of local government associations exist, they often have difficulties agreeing on agendas and have not yet been able to come together to create any significant political force that would be able to offset the authority of the center. The small size of most governments also minimizes the “too big to fail” phenomena that often leads to central government bailouts. In such an environment, the potential for local capture is much less significant.

Second, the center both in terms of the Prime Minister and the national legislature, plays a strong leadership role in determining and following through on agendas. While both the Prime Minister's office and the legislature see further reform of the intergovernmental system as a priority area, there is little direct representation of local interests in either body. General considerations of what is politically sustainable are taken into account by these central bodies. For example, in the on-going discussion of how to

deal with regional policy and strengthening the intermediate levels of government, the center has hesitated to impose a new administrative structure from above, as has been recently done in Poland. Instead, the center is pursuing a gradual program in which these regional structures are more likely to evolve with the support of local governments. However, the balance of political authority remains with the central government and local governments are not yet well-organized or strong enough to present a serious obstacle to the center branches of government.

Information and incentives to monitor

An important criteria for effective accountability is for local citizens to have the necessary information and incentive to monitor their governments. In general, local citizens have good information to monitor the budget process. Proposed budgets are published in local gazettes discussed thoroughly at city councils. But access to information does not extend as far as information on the contracts for public service delivery and pricing of services that local governments contract out. Information on public contracts is hard to obtain in Hungary. With only a few exceptions, local officials take the position that contracts by public entities with private companies are not public records and therefore citizens do not have a right to obtain such documents. Nevertheless, Hungarian law appears to have stronger public access standards than Western Europe. The Constitution (article 61) specifies that everyone has a right to information of public interest. Under the Hungarian Law on the Protection of Personal Data and Accessibility of Data of Public Interest (Act No. LXIII of 1992), the authorities are required to grant access for anyone to data of “public interest” unless the data is

specifically restricted by law. Data of public interest is broadly defined to include : “any information under processing by an authority performing state or local government functions or other public duties, except for personal data (Art. 2, section 3). Hungary also has a Business Secrets Law which protects “any fact information, solution or data connected to economic activities, the secrecy of which is in the reasonable interest of the entitled party. Hungarian Law does not set forth the relationship between the Accessibility of Data and the Business Secrets Law.

Unwillingness to provide information on public contracts seems to be based on a combination of European civil law distinctions between public and private matters, reactions to the invasiveness of the Communist regimes and a common view that private companies will be damaged by public disclosure of critical business data. Maintenance of the secrecy of public contracts is common in Western Europe as well as in other central European countries, although in recent decades there has been a strong trend towards allowing increased access.

As is the case with public contracts, submissions used for public price setting are not public record. For example the information submitted to the Ministry of Transport, Communication and Water management, which is used to set water rates for some 45 percent of the country, are not accessible under current practice. Furthermore the information used to justify local tariff subsidies for hundreds of water districts is not accessible. Without such information it is impossible for local governments to make informed price setting decisions and to develop expertise in the appropriate pricing of public services. It also implies that there is little or no accountability with respect to appropriate pricing (Baar, 1999).

Difficulties in getting this information may result from the fact, that given the configuration of intergovernmental finance discussed above, there is little incentive on fiscal grounds to monitor local governments and to hold them accountable. Since most resources and many critical decisions in terms of staffing and standards are made at the center, local governments are in a strong position to deflect the efforts of citizens to monitor and obtain information to the center. Without a strong degree of autonomy, local governments are in a position to argue that much of what they do is determined by central government actions.

Evolving democratic practices lend themselves to strong accountability

While the balance of power between the central and local government favors the center, and incentives for gathering information and monitoring remain relatively weak, in practice evolving democratic processes have created a strong degree of accountability at the local level.

One element of this is the acceptance of political alternance – the fact that smooth transfers of power have occurred between parties with opposing viewpoints. At the central level, Hungary is one of the transition countries that has managed to implement alternance among political parties. After many years of the Free Democratic Socialists, in the Spring of 1998 a new Government coalition of FIDES and the Agrarian Smallholders was elected. Such a transition of power is significant for local governments in that it signals the possibility for a change in power without automatic political destabilization. Democratic processes are strong enough to bear intense competition among parties at the central level and this is also reflected in the keen political

competition at the local level. This intense competition means that opposition parties closely scrutinize the activities of the group in power.

Local governments are elected and city councils are based on proportional representation. Typically, the focus of attention is on the individual mayor and the substance of his or her activities, rather than on a strong allegiance to the party line. Indeed, there is a relatively weak connection between party activities at the national level and those at the local level. Local councils have the authority to remove mayors in cases of demonstrated wrong-doing and this has been done in a number of cases. The intense competition among parties at the local level creates an important system of checks and balances which in turn creates an environment in which local governments are routinely held up to scrutiny and held accountable for their actions.

Thus, while there are weaknesses in both the availability of information and in the fiscal incentives to monitor, there are strong political incentives that create an environment in which local governments are closely scrutinized and held accountable for their actions. Overall, the existing political mechanisms have helped to improve oversight and to strengthen the hard budget constraint.

III. Subnational Borrowing and Its Regulation

Since the beginning of the transition, Hungary's financial sector has undergone a profound transformation with a movement towards a private, market-oriented financial system. These changes and regulatory developments have had an important influence on Hungarian capital markets as a whole, but they also have played an important role in

clarifying subnational liabilities and regulating subnational debt. These evolving capital market institutions have played a critical role in strengthening the hard budget constraint faced by local governments. In addition, it appears they have led to rather conservative borrowing behavior on the part of local governments.

The evolution of capital markets

The regulation of banking, capital markets and insurance has evolved considerably since 1989, when financial markets were opened to foreign joint ventures and smaller private banks.²⁰ The 1991 Banking Act established the State Banking Supervision Agency. The 1991 National Deposit Insurance Act provided insurance coverage for individual deposits up to HUF 1 million. The 1995 privatization law eliminated the required minimum public shareholding in banks and between 1994-1997, both private and foreign ownership in the domestic banking sector increased considerably. In 1996, the Consolidated State and Financial Capital Market Supervision Agency was established for both banking and capital market operations.

The outcome of these changes has been the development of an increasingly open and competitive financial sector. Short-term spreads have fallen and the maximum maturity of government bonds has increased from three to seven years. Public debt as a share of GDP has fallen, as has the Government's share in total credit demand. In 1998, the combined assets of the Hungarian banking sector reached 66 percent of GDP, while the total assets of the insurance industry amounted to 4 percent of GDP and those of the mutual and pension funds accounted for 5 percent of GDP. Stock market capitalization is now about 30 percent of GDP, although much of this is due to privatization rather than

issuance of new shares. Bond issues by private enterprises remain low reaching only 0.2 percent of GDP. These changes in the system herald an increasing pool of resources that local governments could potentially tap.

Subnational Borrowing and Regulation

As seen in Table 1, prior to 1995, local governments relied more heavily on borrowing than has been the case since that time. During the 1990-95 period, regulation of subnational borrowing was relatively limited. The 1990 Law on Local Government stated that central government will not assume responsibility for local debt. Through 1995, no limits were in placed on long or short-term local government borrowing. Authorization to borrow was provided entirely by the city and local governments could borrow for whatever purpose, at whatever terms the city council approved. The only additional regulation during this period was that revenues derived from the central government (shared revenue, transfer payments, normative grants, infrastructure grants, etc.) could not be used for loan repayment.

In 1994/95, several problems with subnational debt began to materialize (Jokay, 1999). Municipalities began to borrow long term to cover short term current deficits. Many borrowed for non-essential, non-public purposes. Debt began to be rolled over from year to year and in some localities late payments began to appear. In this environment, debtors and creditors began to lobby the national government for bailouts and for the Government to assume an implicit guarantee for mandatory public functions. A series of impending defaults in early 1995, raised critical questions of how to

²⁰ This section draws on World Bank, 1999a.

reorganize and reschedule local debt and maintain critical public services, without the central government assuming responsibility.

Debt Service Limits. Beginning in March 1995 a series of new Laws and regulations were put in place that had a fundamental impact on municipal access to capital markets. In March 1995 a decree was issued to place limits on new debt service.²¹ The debt service limit states that annual debt service on obligations beyond 1 year in maturity can only be 70 percent of locally generated revenues net of the portion of locally-generated funds used for operational expenses. Only local taxes, fees, business income and the like can be used for debt service. Resources from one-time asset sales are excluded from debt service. In addition, cash flows are not counted as debt, but all lease obligations, guarantees, bond issues banks loans, etc, are included if they are over one year. Finally, the legislation prohibits debt and debt guarantees secured only by collateral. Debt can only be secured by a freely available cash flow.

In the short-run these limits suggest a dramatic scaling back of municipal borrowing given the limited amount of own source revenues. This is borne out in practice. As seen in Table 1, net borrowing of local governments shifted from 0.7 percent of GDP in 1997 to -0.2 percent in 1995 and dropped further to -0.7 percent in 1997. In 1994, local borrowing represented 167 percent of what the cap would have been had it been in place in 1994. In 1995, local borrowing fell to 81 percent of the cap and then dropped even further to only 19 percent of the cap in 1997. While the debt service limits in part led to a dramatic reduction in borrowing in the short-run, they create positive

²¹ Effective January 1996 this debt service limit was added to the Law on Local Government.

incentives for increased collection of local revenues and reductions in operational expenses. They also promote better cost accounting.

The Municipal Bankruptcy Law. To date, Hungary is the only country in the region to put in place legislation regulating local government insolvency and bankruptcy. Act XXV of 1996 on Municipal Debt Adjustment has several objectives. The foremost is to prevent and pre-empt municipal defaults. In addition, the legislation aims to provide a clear administrative procedure for creditors to follow in the event of insolvency and to provide reorganization and workout procedures for the municipality. The legislation makes clear again that the central government will not guarantee local borrowing and specifies that sovereign guarantees require an Act of Parliament and are specifically limited by the Budget Law. The Law also sets out an approach that will ensure the provision of mandatory services even during periods of insolvency or workout.

The political consensus necessary to put such a law in place resulted from the period of dramatic fiscal instability in 1994/95. Parliamentary parties on both the opposition and the government side agreed that municipal borrowing posed a potential risk to the central budget. There was also an agreement that in order to achieve a balanced budget there should be a mechanism to maintain fiscal discipline. Two views existed in the Parliament: (i) a centralist view that intended to incorporate local governments into the Treasury system and access to capital markets would be subject to a central approval process and (ii) a liberal approach that stated that consequences for bad economic decisions should be taken up locally. The latter approach contained not only a message for the municipalities, but for the banking sector as well. After the costly waves

of bank consolidations in 1993/94, it was a statement addressed to OTP, the biggest creditor of the municipal sector, that no further rescues from the state could be expected.

The Socialists, as the majority coalition party, were not in the position to advocate the first solution, as they would have been accused of re-centralizing government. The Free-Democrats, the minority coalition party, never supported the first solution. Hence when the law was submitted to Parliament as a solution for fiscal risk generated at the local level, the ruling party coalition could easily ensure a two-thirds majority. Nonetheless, opposition MPs also voted in favor of the law for the general understanding of the need for fiscal stability. Thus there were no significant debates concerning the law.

The process of debt adjustment starts the day a petition request arrives at court (see Figure 1)²². The process can be started by either the municipality or by the creditor if the municipality meets one of the following conditions:

- if the municipality or its agency has not paid a certain invoice, or has not responded to a call for payment from a creditor not required to give an invoice, and has not disputed or paid the invoice within 60 days of presentation;
- if the municipality or its agency has not paid a debt it recognized within 60 days of the due date;
- the municipality or its agency has not paid an obligation called for by a binding court decree;
- the municipality or its agency has not paid an obligation called for by a previous binding bankruptcy court decree.

²² The following discussion is based on Charles Jokay's unofficial translation of the Act on Municipal Debt Adjustment (Law XXV of 1996) passed on March 26, 1996 by an 84 to 16 percent margin.

If the court determines that one of the above conditions hold, it will issue a decision to commence the debt adjustment process and publish the decree in the Enterprise Registry (the publication date is the official start of the process). The decision to begin the process will also correspond with the appointment of a financial trustee. The mayor of the municipality must ensure that the notification of creditors also appears within the Enterprise Registry and at least two national daily newspapers within 15 days. The mayor must also inform the county chief administrator, the budget and administrative office (Takisiz), the municipality's bank, and all the financial institutions serving the budgetary agencies of the municipality, the applicable tax, customs, social security and health insurance office.

After the beginning of the process all debts become due, even those that are not current. Creditors have 60 days to file a claim against the locality. If they do not do so, then they may not enforce a lien or take collection action against the municipality until 2 years have passed since the completion of the adjustment process in accordance with the court's settlement decree. At the same time all foreclosures, collections and lien enforcements cease. Once the process begins, municipalities are not allowed to assume additional debt, cannot establish enterprises, cannot purchase ownership interests in enterprises and cannot service debt assumed prior to the petition for debt adjustment except for those specifically stated in the crisis management plan.

The financial trustee basically takes on the job of monitoring the business operations of the municipality, ensuring the provision of mandated public services, implementing the emergency budget and briefing both creditors and government agencies

of progress. An interesting provision of the law is that within 90 days of the commencement of the process the financial trustee may petition the relevant court to annul contracts signed by the municipality up to a year before the filing of the adjustment petition. Contracts and obligations signed by the municipality that the trustee considers to be unduly disadvantageous to the municipality, or unduly disadvantageous to a third party fall into this category (although an affected party may file a complaint in response).

In addition to the trustee, a debt adjustment committee is formed with the following members: mayor, notary-clerk, chairman of the finance committee and an additional city council member. With the exception of the mandatory local services specified in para10 of the Law of Local Government, the debt adjustment committee has full authority to decide upon all issues. A draft resolution containing the emergency budget must be submitted 30 days after the commencement of the debt adjustment process.

After the emergency budget has been accepted, the financial trustee and debt adjustment committee prepare a reorganization program and proposal for compromise (debt workout) that forms the basis for negotiations with creditors. If the municipality fails to prepare these proposal within 150 days then the creditors can propose their own alternative. Both the reorganization plan and the compromise proposal are distributed to the local council and to all creditors, who are invited to compromise (debt workout) negotiations. If more than half of the creditors having claims (representing at least two-thirds of the value of the claims) can come to agreement with the municipality on a compromise than the compromise can be accepted. Disputed claims (and their value) are treated separately. The compromise agreement must be set out in writing and include: the

proposal for compromise accepted by the creditors, methods of execution and control; methods of satisfying the creditors; possible adjustments of deadlines, remission or canceling of liabilities; and all those considered essential to restore or maintain the solvency of the local municipality; and confirmation of the compromise by the creditors and the local municipality. If the agreement meets the requirements of the Act, the court finishes the debt adjustment procedure and orders the decision to be published in the Enterprise Registry. There is no right of appeal.

In cases where no compromise can be reached, the court moves to the process of asset liquidation. Liabilities are paid initially out of the emergency draft budget and in the meantime the financial trustee works out a plan for performance of mandatory functions, identifies which assets are needed to perform these functions and submits this report to the court, the municipality and all the creditors for their comment. After issuance of a court decree, the financial trustee must within thirty days list the claims of creditors according to their order of priority, and within sixty days must try public liquidation of the municipal assets available for debt adjustment at the highest possible price on the market. Within thirty days of after the deadline, the financial trustee will make a proposal splitting the assets among the creditors. Creditor claims can be satisfied by money or by transferring the unsold assets to the creditors, according to the priority of and proportion of the creditors' claims. The order of the priority among creditors is set out as follows:

- 1) regular personnel remuneration including severance payment due to dislocation for public service;
- 2) claims ensured by collateral, mortgage up to the value of the pledged property provided the property was pledged six months before the debt adjustment procedure

started (If there is more than one lien on the same property, order of performance is defined by the Civil Code.);

3) claims of the government related to a previous settlement for debt adjustment, repayable subsidies, and other central budget subsidies;

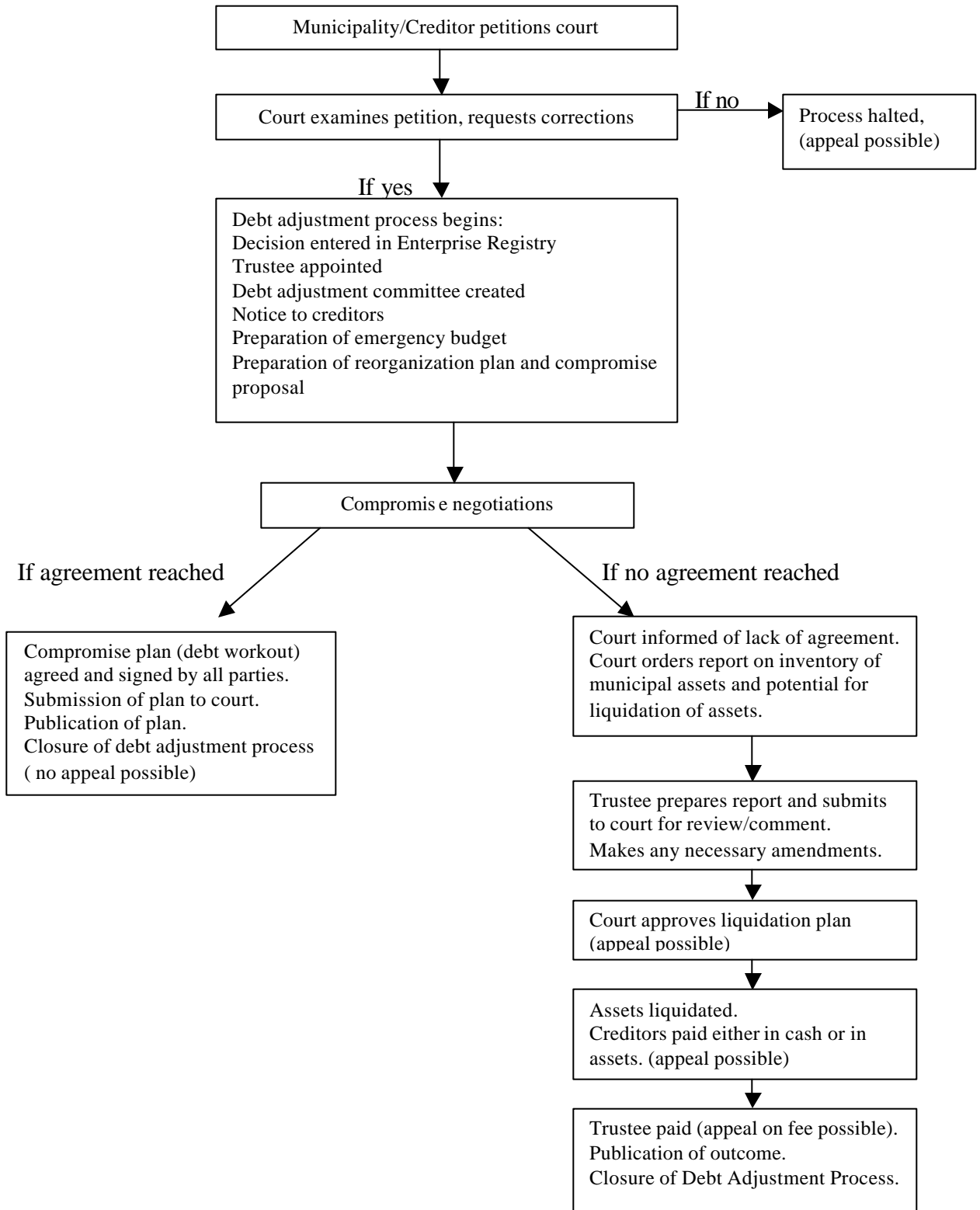
4) social security debts, taxes,

5) other liabilities.

The financial trustee must report immediately to the court when the job is done. The court will finish the procedure by decision and no appeal can be lodged against this decision. At the same time, the court will relieve the financial trustee from his job and set his fee. Finally the closing of the debt adjustment procedure is published in the Enterprise Registry.

Since the Municipal Debt Adjustment Law has come into force there have been nine municipal bankruptcy cases, two of which are still under way. The immediate cause of the bankruptcies ranges from investment in a failed business activity, guarantees issued without knowledge of the council, and local public investment programs (linked with gas supplies) beyond the financial capacity of the municipality. No cases have occurred because of current operations of municipalities, reflecting the role of deficit grants in preventing such cases. (World Bank 1999a, p. 5). Typically the size of the communities was under 10,000 citizens and although the size of the loans involved was small relative to the Hungarian capital market (HUF 100 million or 400,000 USD), the amount was typically large compared to the size of the locality's budget. In all of these cases, a compromise agreement was found and implemented. In some cases these

Figure 1 The Debt Adjustment Process



agreements relied on selling off the business asset under consideration, in others terms of repayment were stretched out over time. In no case did the central government provide assistance.

Regulation of Securities. Bond issues by local governments are authorized in Law Decree No 28 of 1982 and the issuance and trading of local government bonds is regulated by Act CXI On Securities, Capital Market and on the Stock Exchange. This sets information disclosure and audit requirements for localities. Local government borrowings (both bonds and loans) as well as guarantees and other contingent liabilities are recorded ex-post by the Local Government Department of the Ministry of Finance as part of the yearly submission of budget execution . Public bond issues are also registered with and must be authorized by the Supervision Commission, which was established under ACT CXII of 1996 on Credit Institutions and Financial Undertakings.

For public offerings, issuers are required to disclose information on their financial and income position and operations, both through annual reports and audits (Annex IV of Act CXI specifies the information that must be disclosed in the prospectus). Issuers are required to ensure the inspection of their annual reports by investors and at the same time send the annual report to the Supervision Commission. Local governments are also required to publish in a daily newspaper and in the exchange journal all information directly or indirectly affecting the value or return of the securities.

Supervision of local debt issues is also under the authority of the Supervision Commission, but with a relatively limited number of local bond issues, the Commission's experience is limited. To date it has focused on ensuring that issuance procedures have

been met and that supporting documentation is within the law. There is currently little activity on the part of ratings agencies or other institutions that might assess local government creditworthiness.

The legislation also covers audit. All county governments, cities with county rights, the capital city and its districts, and any city with annual expenditure above 100million HUF or that would like to borrow are required to have an annual audited balance sheet. An increasing number of localities are thus required to have an independent audit each year. The State Audit office may at any given point in time audit a locality, but given the State Audit Office's limited capacity only a small number of localities out of the total can be audited each year. In addition, the State Audit Office carries out thematic audits in which the Office focuses on a particular issue across a sample of local governments.

Implications for hard budget constraints

Municipal borrowing in Hungary had never been substantial, but the effect of implementation of the above measures is to effectively reduce local government borrowing by half²³. The legislation states clearly that the central government will not bail out local authorities and has backed this up by staying out of municipal bankruptcy negotiations and workouts. The detailed procedures and processes set out by the above legislation have the following implications:

²³ Until the mid-1990s Hungary's municipal debt market was dominated by the National Savings Bank which offered short and medium term lending instruments to municipalities that held accounts with the bank. Since 1994 OTP's market dominance has declined and other banks have begun to compete for market share, although the demand for municipal borrowing has declined.

First, localities are limited in the sources of funds they can use to repay debt, which places a strong constraint upon borrowing as long as own revenue resources remain low. This provides an incentive for local governments to make an effort to raise own resources. In turn, the greater use of own revenues is also likely to have the effect of increasing accountability as citizens want to be sure that their taxes are used well.

Second, the detailed processes and procedures set out for municipal debt adjustment lay out a clear picture, that in one way or another, the locality will ultimately be responsible for repayment of the outstanding debt. Localities are thus offered a conditional bailout (Inman, 1999) in which they get a break on immediate payment of the debt if they choose to cooperate and develop workout agreements. Alternatively, they may choose not to cooperate in discussions with creditors, but in this case they will be subject to asset liquidation. Either way the measures taken are formalized as court decisions and given special oversight. Localities seem to have a clear incentive to cooperate, since forced asset liquidation may yield little for the locality. All of the existing bankruptcies have either been resolved prior to compromise negotiations or through such negotiations.

An interesting aspect of the Law in the context of transition economies is the reliance on an independent court system for implementation. In Hungary, independence is granted to courts, judges and prosecutors by the Constitution. The 66/1997 Act on Organization and management of Courts and 67/1997 Act on the Legal Status and Remuneration of Judges regulates the mechanisms which ensure that independence. Judges are appointed by the President of Hungary based on the proposals of the National Council of Justice, an independent, professional, self-governing body of selected judges.

Judges' appointment is open-ended, except the head of the Supreme Court and that of the Regional High Courts whose appointment lasts for six years. In practice, courts and judges seem to be fairly independent. Although corruption occurs, it is not wide-spread due at least in part to the fact that, among civil servants, employees of the court are fairly well paid. While legally civil servants, there is a separate wage table and adjustment scale applied for them. The general professional quality of the courts requires some improvement, and processing of cases is usually slow. Corruption is usually linked to achieving faster processing and finalization of cases. The lengthy time required for successful completion of court action has created an incentive for local governments and creditors to come to an agreed workout plan rather than work their differences out in the courts.

The Municipal Bankruptcy Code also has a feature that may have special significance in transition countries. Given their new-found autonomy after years of dominance from above, the imposition of a trustee to manage a local affairs has a psychological cost that may be stronger than in localities in other non-transition economies. Localities have only recently had some degree of autonomy restored (however limited by the center) and the loss of this autonomy and self-determination is not something that most cities would currently take lightly. So both local governments and local councils treat issues that would risk this autonomy with great attention. Localities are therefore likely to err on the conservative side with respect to determining what they can borrow.

Finally, these regulations have also strengthened disclosure, supervision and oversight thus increasing transparency and reducing the potential that a locality will be

able to borrow significantly more than it can afford. In addition, central oversight on the part of the Supervision Commission also prevents localities from going overboard.

In sum, the measures and regulations that have been undertaken with respect to subnational borrowing and municipal debt adjustment provides strong institutional mechanisms supporting hard budget constraints. Those bankruptcies that have occurred have for the most part been resolved relatively quickly and to date without recurrence. To some degree the effectiveness of these mechanisms can be seen in the greater conservatism that localities are demonstrating with respect to taking on new debt. Indeed, local debt remains well below the thresholds set out by the cap. It will be of great interest to see whether these mechanisms maintain their effectiveness as local borrowing increases, as it is likely to do on the coming years.

IV. Conclusion

This paper has examined three mechanisms that can strengthen or undermine hard budget constraints. On balance, the system of intergovernmental finance discouraged hard budget constraints in a number of ways. By leaving some expenditure assignments uncertain, it affords localities the opportunity to overspend and then offload to others functions that are not financially sustainable. There is little or no link between taxation and the services provided, given the small amount of own revenues. Most importantly the system of grants, and especially deficit grants, gives localities very strong incentives to spend and very weak incentives to tax. In addition the incentives created by the system of transfers implies that little or no emphasis is placed on cost effectiveness and

accountability for mandatory services (which can be bailed out by a deficit grant), whereas other voluntary functions must be cost effective (they are subject to the municipal debt adjustment act).

The political mechanism of political accountability tends to strengthen hard budget constraints. The potential for local capture is limited, and given the large number and small size of localities, they are unable to convince the central government to provide bailouts. As pressures from below mounted for bailouts, the central government quickly put together a range of legislation that would hold local governments to payment of their liabilities. Finally, the intense competition among parties at the local level means that governments are constantly under scrutiny by the opposition and are held to a high degree of accountability.

The mechanism of regulation of subnational borrowing strongly supports the maintenance of hard budget constraints. It makes it clear that the central government will not take on the liabilities of local governments and the government has followed through on this in practice. The legislation promotes transparency and accountability and set out clear rules and procedures for dealing with bankruptcy within a community, which are implemented through the use of a trustee and overseen by the courts.

It is impossible to know exactly what weight each of these mechanisms carries. In the current environment, it seems that those factors supporting hard budget constraints outweigh those that undermine them. The effectiveness of the system as a whole can only be diminished by those parts of the system that create the wrong incentives. Certainly it seems clear that before considering borrowing, localities go to great extremes to receive transfers from the central government. A soft budget constraint with respect to

mandatory services (through deficit grants) combined with a hard budget constraint on other services does influence spending decisions and allocations.

Overall, however, the Hungarian case demonstrates that hierarchical arrangements can be effectively used to mitigate the worst manifestation of the soft budget constraint problem. The basic incentives set out by the system (allocation of responsibilities, limited local revenue autonomy and grants) are not ideal for encouraging market-based hard budget constraints. In addition, land, capital and even “political” markets (elections) are not yet strong enough to play the disciplining role that they play in some advanced industrial economies. However, the system is not overwhelmed by soft budgets because of the hierarchical constraints that have been put into place.

Institutional mechanisms have been developed that ensure that localities will ultimately be held accountable for any opportunism they engage in. The Law on Municipal Bankruptcy makes it clear that there will be no bailouts by the central government and that local governments are responsible for their own debts. In placing the process in the hands of an independent court system and in the hands of “trustees”, the government loses some discretion, but strongly sends a signal of the seriousness of its “no bailout” commitment. In addition, the government places limits on local government access to credit markets. Over time, as both credits and other markets develop and create their own disciplinary force, such controls are likely to become less necessary. Although such mechanisms help to protect against soft budget constraints and fiscal instability, they are not so blunt that voters and creditors simply see local governments as the administrative arms of the central government. While local government autonomy is

limited in some parts of the system, ultimately the localities are responsible for their own actions.

The Hungarian case thus suggests a method of addressing soft budget constraints in transition economies. At early stages of decentralization, create good laws that make it very clear that local government overspending will be painful. If high levels of vertical imbalance persist, place some borrowing restrictions on local governments. Of course the methods also rely on an independent court system and an ability to monitor and enforce rules. Over time, as markets develop and incentives in the intergovernmental finance system are improved, such restrictions may eventually be gradually reduced. Of utmost importance, however, is sending a clear to signal to localities, voters and creditors that local governments will be responsible for repayment of their own debts.

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