Decentralization and structural adjustment in Hungary

Paper for

2nd International Conference on Decentralization:
Federalism: The Future of Decentralizing States?

July 25-27, 2002

Manila, Philippines

By

József Hegedüs

Metropolitan Research Institute

2002 July

Executive summary

Hungary has gone through a radical structural change after the fall of the socialist block in Central-Eastern Europe. Two basic processes dominated the transition: privatization and decentralization. The Hungarian experiences have given evidence that political decentralization of the state sector can have a substantial contribution to an efficient economic adjustment in the transitional recession. Local governments under fiscal pressure enjoying broad expenditure autonomy have chosen the level and the form of public service provision which resulted in huge advantages both at macro and micro level. However, the Hungarian experiences show that the political, fiscal and administrative decentralization is a process with conflicts between different stakeholders. The sector ministries, the local government associations, different types of the local governments (small towns, big cities, the capital Budapest), and sect oral business groups (like service providers etc.) have different interest in the intergovernmental relations. The process of decentralisation has not been finished and in certain areas even a move towards centralization can be detected.

The process of Hungarian decentralization has been burdened with several conflicts related to the typical weak and sensitive points of the intergovernmental relations: fragmentations, unfunded mandates, unclear expenditure assignments, moral hazard, incentives and deficit grant, equity issue and equalization grants, etc. The badly designed instruments (like grants, laws, etc) have incurred a social cost on the transition, but this has not outweighed the benefits of the decentralization.

The three key elements of the process are 1. the democratic election of the local self-government; 2. substantial expenditure responsibility and autonomy, 3. hard-budget constraints on the independent local budgets.

In Hungary from 1990 the law has provided these key elements of successful decentralization. The local governments expenditures have been deducted by 10 % between 1991 and 2000 in real value, while in the level and the scope of services provided has not been decreased. However, the country missed important elements of a well functioning system, like trained central and local administration, modern accounting system, tradition of public participation, a well developed statistical system, institution of objective auditing, practice of local budgetary and financial management, etc. Hungary has learned a lot in the past 10-12 years, and it is time to start a modernization of the intergovernmental fiscal relations based on the experiences and the expectations of the EU accession.

Background: Hungary after the transition[1]

Hungary was part of the Austro-Hungarian Empire, which collapsed during World War I. The country fell under communist rule following World War II. In the more open Gorbachev years, Hungary led the movement to dissolve the Warsaw Pact and steadily shifted toward multi-party democracy and a market-oriented economy. Following the collapse of the USSR in 1991, Hungary developed close political and economic ties to Western Europe. It joined NATO in 1999 and has made the preparation to the accession to EU.

Table 1 Hungary among the countries waiting for accession to EU

Hungary has a population of 10 million people. Its economy has stabilized after the radical changes (privatization) in 1994-1997.

? **Table 2 Basic Facts:**

Population	(1 February 2001): 10,197,119 persons

[1] The study gives an overview of the local government finance system in Hungary focusing on the most important problems the system face to after a ten years experience in a decentralized system. The study was prepared with the help of the World Bank Institute. It draws on the research reports MRI has prepared in the last years (in partnership with the Urban Institute, Washington), especially in the program of SNDP (Subnational Development Program) which was a joint effort of the World Bank and other donor agencies (USAID, British Know How Fund, etc.)

Density of population	(31 January 2001): 109.6 residents/square kilometre
Capital:	Budapest
State form:	Republic
Administration structure:	19 counties and the capital city
Urban population:	64.6 per cent
Employment*(2000):*	agriculture 6.5 %, industry 33.7 %, other 59.7 %, unemployment is 6,9 %
Main religions:	Roman Catholic, Protestant (Calvinist and Lutheran), Greek Catholic, Jewish and Orthodox
Largest cities:	*(31 January 2001)* Budapest (1,775,203 residents), Debrecen (211,038 residents), Miskolc (184,129 residents), Szeged (168,276 residents), Pécs (162,502 residents) and Gyor (129,415 residents)
Per capita GDP	*(gross domestic product, 2000):* USD 4,528*, EUR 4,940 *(*calculated at the official medium exchange rate of the National Bank of Hungary)*
Exports within EU:	76.2% (as % of total national exports)

Source: www:/ ekormanyzat.hu

Decentralization: local government system in Hungary

1. Legal and political framework

The development of local public administration in East-Central European countries started out from the soviet "council" system. Behind the formal, very centralized structure of the councils the real power lay in the hand of the communist party having the same regional administrative structure as the council system. The formally (not in a democratic way) elected bodies did not have real power over the executive organs.

The reform of the Hungarian local government system started in the middle of the 80's. Before 1986, the distribution of investment funds to councils was not based on an objective evaluation of local needs and capacities. Instead, negotiation and political influence at the central, county and district[2] levels determined the revenues and expenditures allotted to each council. Many principles of financing municipals were established in the second half of the 80's. However, the reforms of the 1980s took place in an institutional and political environment which did not allow moving towards a political decentralization (political accountability of the elected bodies to their constituency) and thus an economically more efficient system.

The 1990 Local Government Act resulted in the political collapse of the former system and a new democratic system was introduced which gave the right to every settlement, even to the smallest one, to set up a municipal government to manage its own affairs. The new system is a unitary government with a two-tier subnational structure, where the municipal government provides services at settlement level, and the county government does so at the regional level. County governments have no right to direct municipalities, they are self-governing units with different responsibilities. The basic rights and power of local governments are exercised by an elected council. The council sets up committees with special rights. The directly elected mayor is the head of the office with two functions: execution of the council decisions and delegated state tasks. The major administrative function is managed by the chief administrator (notary). The Local Government Act decrees that towns, cities, the capital and its districts as well as counties have equal local governmental rights.

By 1990 the number of local governments multiplied to 3,154 (1999) from 1,523 as many of the local councils broke themselves into discrete units. This was a political reaction to the forced amalgamation policy of the 70s. The 19 counties, the middle tier, which used to be one of the strongest power centers still exist, but their responsibilities had been scaled back. The counties are now parallel authorities and unrelated to the localities. The local governments in Hungary have an average of 3,482 inhabitants, quite far from the average of 10,000 considered to be "optimal".

Budapest as the capital of Hungary has a population of 19 % of Hungary, and accounts for one-third both of GDP and Capital Investment. This role has been recognized in the law by defining special procedures in revenue allocation. The local governments of Budapest have joint revenues which have to be allocated among the

[2] Districts (járás in Hungarian term) have been abolished in 1974.

Municipality and the districts according to the expenditure needs. The central government established a general guideline for the revenue division among these local governments, but passed on the responsibility to the Municipality of Budapest to set up a revenue allocation system in the Capital. (Balás-Hegedüs, 1999).

The government is currently discussing the future of the regions. Today there are 7 statistical regions, and there are seven Regional Developing Councils with limited authority. There is a four-year program for regional reform, which would lead to the creation of seven regions with elected councils. One goal would be to create a regional structure which would be a new tier of the government (locally elected level of government). One of the purposes for creating regions is to be able to channel EU structural funds. However, in the case of the creation of regions, there is the question of the continued existence and role of the counties.

2. Expenditure assignment

The size of the overall public sector is large in Hungary, compared with other European countries. General government expenditures (including social security) were about 51 percent of the GDP in 1995 (10 percentage points lower than in the early 1990s), and 43 % in 2000. The plan is to reduce it to 40 % by the year of 2003. The local government expenditures have decreased from 16,5 % of GDP to 12, 8 % in the period of 1993-2000, In real value the expenditures have decreased by 20 %.

The Local Government Act of 1990 transferred a number of important public functions to lower tiers of government. Some tasks are defined as **mandatory**: provision of safe drinking water, kindergarten education, primary school instruction and education, provision of basic health and social welfare needs, public lighting, maintenance of local public roads and the public cemetery, enforcement of the rights of national and ethnic minorities. The law defines the tasks of the local governments in a fairly vague way. They are basically shared responsibilities, because both the legal and financial aspects of the services are highly influenced by the central governments. The services can be classified according to the revenue and expenditure autonomy of the local self-governments.

The largest expenditure category is education, where local governments as the service providers have a wide range of expenditure responsibility, including the possibility to stop services. Educational expenditures account for one third of the total expenditures. Primary education is mandatory for all localities. Secondary, technical, and vocational schools, while not mandatory, are typically financed by county governments or larger towns. The second biggest item is the health sector (one fifth of the total expenditures), but LGs act as agents of the National Health Insurance Fund in providing health services, including hospitalization - in the larger towns. Services are determined by the national government, and local governments are reimbursed for the cost of providing services and medicine. Investment outlays are also a local responsibility, though financial support is available from central investment grants. With the transfer of communal housing and other assets to localities, maintenance on houses and properties has become a local responsibility. Considerable responsibility for administrating social welfare and several forms of social assistance has also been delegated to localities through the Law on Local Self-Government and the more recent Law on Social Assistance (1993). Responsibilities include the management of long-term social care facilities, such as homes for the elderly and for the handicapped.

There is a good deal of flexibility in service delivery. The law has not defined either the minimum service delivery requirement, or how local services are provided. There are different institutional options for service delivery. The local government non-budgetary institutions have a significant role in the local government finance system. There are different forms, such as local government owned public companies, limited liability or share holder companies, NGO-s founded by local governments, and private companies owned partly or regulated by local governments. They have off-budget expenditures and off-budget revenues as well. The size of the off-budget revenues is estimated at 10-30 % of the total local government budget. (Hegedüs, 1999). According to a recent study local government owned enterprises have a net turnover of 40 % of the local government total expenditures. (Hertelendi-Koppányi, 2000)

The definition of tasks in the Law on Local Self-Government gives a wide room for local governments to define the quantity and the quality of the services, and even the way it is organized (contracting out, privatization, public-private partnership). This feature of the law and the flexible revenue structure **make the local government adjustment possible.** There are some exceptions from this, e.g. health care, and fire protection services.

The freedom of expenditure decisions not always welcomed by the representatives of the central governments is influenced by the sectoral legislation and the supporting grants system. The sector laws redefine the local government tasks. The interest of the sector policy makers to increase their share in the budget plays an important role in proposing modifying the sector laws. For example, the "Water Lobby" fights to redefine waste water service as a mandatory task, which – probably – would mean that the central budget should finance the investments in the waste water treatment plants under the supervision of the sector ministry. This is an example when the sector ministry cooperates with the local governments to achieve its particular interest against the other sectors.

The mandatory and optional tasks of local governments were defined in the Act on Local Governments but they are continuously being modified by the latest laws and regulations: Act on the Budget, Bankruptcy Act, Social Act, Housing Act (arrangements for constraint investments), Act on Public Education, etc. *A "quiet" reform is taking place in public finance.*

Sector laws could redefine the local government tasks in other ways. For example, the proposal for the Law on Waste Management (to be discussed this year by the Parliament) intends to take the waste management for business units out of the hand of local governments. This could cause a financial problem for local governments because of losing the advantages of the "economics of scale" and the possibility of cross subsidy.

? **Table 3Expenditure responsibility (1999)**

	Share in the local expenditures
General Public Services	14%
Defense	0%
Public Order and Safety	1%
Education	33%
Health	19%
Social Security and Welfare	16%
Housing and Commun. Amenities	9%
Recr. Cultr. Relig. Affairs	5%
Fuel and Energy Agric. Forestry. Fishing. Hunt	0% 1%
Mineral Resource	0%
Transportation & Communication	1%
Other Economic Affairs & Services	1%
Other Expenditures	1%
Total	100%

Source: OECD Hungary, 2001

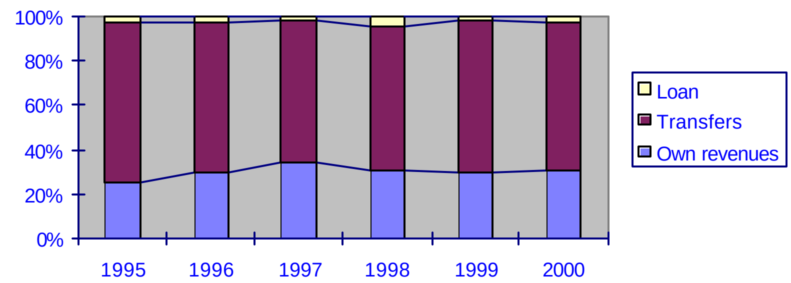
Housing is another example. In the new housing policy in 1999 the central government wanted to give more responsibility to local governments in managing the housing subsidy program. The proposal would give a matching block grant to local governments for support in the local housing sector. In the budget negotiation the local governments rejected this proposal arguing that they did not have own resources to supplement the central grant.

In 1995 the central government (which sets general policies in the area of social expenditures) decided to reform the health delivery system and to reduce the hospital capacity to around 10,000 beds, as a first step toward rationalization of the supply of curative health service. However, the local governments are the owners of several hospitals, therefore, on constitutional grounds, they are the only ones which ultimately have to approve the reduction in the number of beds in their own territory. The local governments and management of the hospitals have resisted the closure of hospital beds, creating a delay in the reduction in hospital capacity.(Lutz, et al, 1997, p 164) However, the real reason for that behavior was the lack of incentives, as the local governments had a very limited expenditure autonomy in the hospitals and the “political cost” of cost reduction could not lead to a financial benefit.

3. *Revenue assignment*

The Local Self-Government Act provides for a range of revenue sources to finance local government functions. The **local revenues** (accounted for 26-35 % of the total revenues in the last 5 years) include: five *local taxes* (tax on business, tax on plots, tax on buildings, tax for communal services, and a tax on tourism), *user charges*, and revenues from entrepreneurial activities, from the disposition of rental and commercial properties, and from assets.

The **central government fiscal transfer** (accounted for 63-71 % of the total revenues) includes normative grant, and several targeted matching grants and non-matching grants for investments.

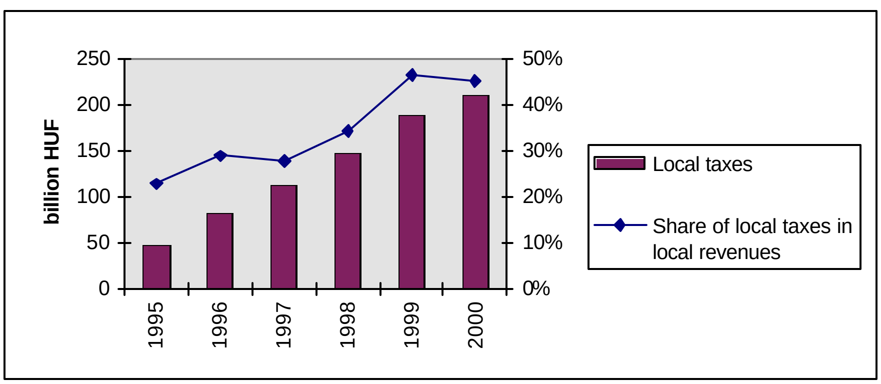


• **Table 4 The revenues of the local governments**

The local government can **borrow** to finance investments and to meet overdrafts or budgetary shortfalls, its share has not become substantial. The structure of the revenues (share of own revenues, transfers, and loan) proved to be quite stable in the last 5 years, while the whole intergovernmental fiscal system – as we will show -- has been modified frequently.

3.1. Local taxes

The Act on Local Taxes defines the municipal taxes. The 1990 Act assigns five taxes to local government: i) the business tax; ii) the communal tax (i.e., a poll tax and/or payroll tax); iii) the urban land tax; iv) the property tax on buildings; and v) the tourism tax. In practice, local governments must decide, at their discretion and by resolution of their respective councils, which of these taxes they want to levy in their jurisdictions. The respective tax bases and the ranges for tax rates are established by the central government.



• **Table 5 Local taxes in the own revenues**

The number of municipalities that levy at least one of the local taxes has increased each year. In 2000, 94 percent of municipalities levy at least one tax, compared to 73 percent in 1996. The two taxes which are most commonly levied are the business tax (2226 municipalities) and the communal tax on private persons (more than 1,800 municipalities).

Table 6. Local taxes collected by Hungarian local governments, 2000

Tax type		Number of local governments	tax revenue amount (billion HUF)	proportion (%)
Property tax	housing	296		
	non-housing	687	21995	9,9%
Land tax		380	3 001	1,4%
Communal tax	private	1 858	4 423	2,0%
	corporate	764	1 175	0,5%
Tourism tax		541	2 717	1,2%
Business tax		2226	188 623	85,0%
Total		2 970	221 934	100,0%

Source: egovernmnet.hu

*Note: * The two types of taxes on structures taken together*

Business tax: The business tax is a gross turnover tax levied on manufacturers. Retail sales are not covered by this tax. The maximum rate is set by the CG. The business tax may be levied on all enterprises, public and private, on gross sales revenue net of the VAT and other consumption taxes. **Communal Tax** can be levied on household dwellings (owned or rented) and on businesses. The **land tax** applies to urban land only and is levied on the property owners of idle (unimproved) lots. Its maximum tax rate is Ft. 200 per m2, or 3 percent on the “corrected value” of the plot. The corrected value is given by 50 percent of the “assessed value”, as determined by the local government. The assessed value is supposed to reflect the actual market value of land. Local governments can legally levy **property taxes on privately owned buildings**, such as flats, single family houses, summer cottages, garages, storehouses, workshops, and other residential housing. They can also levy taxes on commercial and industrial property. The tax may be levied on area size (m^2), or on the assessed value of the property. The maximum tax rates as established by the Central Government are HUF 900 per m2, or 3 percent of the “corrected value”. The corrected value is defined in the same way as that which applied to the land tax, as described above. The current **tax on tourism** includes rents, guest nights, and summer cottages. The maximum rates as established by the CG are HUF 300 per night for guests, 4 percent on the rental fee, and HUF 900 per m2 for cottages.

The total local tax revenues are quite low, not more than **7.5 % of the central government tax revenues** (VAT, PIT, corporate tax and consumer tax) **in 1999**. 90 % of Hungarian LGs levied taxes in 2000, but the majority – that is 85 % --of the local tax revenues comes from the business tax. Generally local government do not tax households, 6-8 billion HUF local tax is paid by the household sector, which equals to the amount the household sector pays for cigarette (7,5 billion in 1998).

3.2. User charges, fees

User charges and fees collected by local government institutions and public utilities, such as fees for meals in schools and nursery schools, fees for use of public place, parking fees, but the main revenues come from rents, user charges for garbage collection, gas and water supply. From the point of view of local government revenue structure, the user charges and fees collected outside the mayor's office and the budgetary institutions are off-budget revenues and they are not shown in the LG budget. (In this case there is only one budget item, the subsidy – if it exists at all -- that relates to the charges.) So, for example, parking fees could be part of the LG revenues, if they are collected by the budgetary institution, or could be off budget revenues if collected by an enterprise owned by the local government and responsible for parking services. The organizational structure of service delivery defines how these data are accounted for.

Local governments have the autonomy to set their own user charges and fees for public services like water, sewage, housing, district heating, garbage collection. However, they have no discretion over setting fees in education, social and health services. User charges (for water, garbage etc.) are generally agreed upon by the board of directors of the different companies, public enterprises, or mixed enterprises, where the local government is the main owner or shareholder. In the case of services given in concession to the private sector, adjustments in charges followed a procedure set by the law are agreed on with the local government. Therefore, in principle, local governments may recover the full cost of service provision.

3.3. Revenues from sales of local government assets

On the basis of Asset Transfer Law (1991), from the beginning of 1990 and through 1995, considerable assets were transferred to the local governments: (i) primary assets necessary for the functioning of the local administration, basic education, health and social services, which may only be sold in a limited way; (ii) assets related to the provision of network and infrastructure public services; (iii) publicly-owned housing; and, (iv) other assets to compensate municipalities for original ownership stakes of former council companies.

It is not easy to evaluate the effect of the property transfer to intergovernmental fiscal relation. The assets transferred could be managed by off-budget institutions (limited liability companies, foundations, etc.), which could generate revenues spent on services outside the LG budget. For example, property managed by an LG owned company could generate revenue which can be used outside the control of the local government.

• **Table 7 LG revenue from assets in million HUF, 1995-2000**

	1995	1996	1997	1998	1999	2000
Selling physical assets	43 699	42 968	51 242	51 404	53 000	47 100
as % of total revenue from assets	63,0%	47,5%	36,1%	72,4%	75,7%	85,5%
Selling shares	19757	27332	81251	15665	12000	7000
as % of total revenue from assets	28,5%	30,2%	57,3%	22,1%	17,1%	12,7%
From privatisation	5938	20064	9258	3969	5000	1000
as % of total revenue from assets	8,6%	22,2%	6,5%	5,6%	7,1%	1,8%
Total revenue from assets	69394	90364	141751	71038	70000	55100
as a % of the total own revenue	34,0%	32,2%	35,2%	16,7%	17,0%	11,9%
Total own revenue	203 946	280 706	402 218	424 718	410 693	461 850

Sources: Budget Laws

Revenues from local government property, as a share of total LG own revenues are substantial -- 32-35 % – in 1995-97, and there is a decrease in 1998, showing that this was a "one time revenue".

4. *Intergovernmental transfers*

Intergovernmental transfers provide about 65-70 % of the total LG revenues in thelast ten years. The transfers are categorized in the budget as shared revenues, normative grants, earmarked grants (grants for theaters), special grants (deficit grants), etc. From the analytic point of view we can differentiate between the derivation based tax sharing and the different grants (which can be earmarked or not, allocated on formula based or ad hoc).

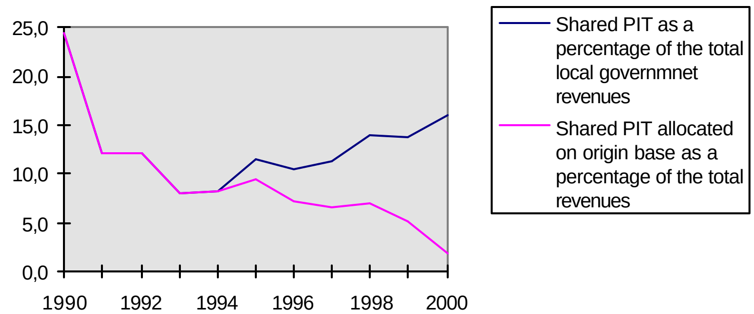
4.1. Shared taxes

In establishing municipal revenue sources, two national taxes were designated for sharing: the personal income tax (PIT), the motor vehicle tax, and the tax on land rents. (From the analytic point of view, even the Duty tax can be classified as shared tax.)[3] .

The PIT is shared based on the locality of residence of the taxpayer, but is distributed with a delay of two years. The percent share of PIT allotted to municipalities, and the rules for distribution is modified annually in the State Budget Law. In 1990, 100 percent of PIT was allocated to municipalities; since then this share has been reduced to 40 percent. Up to 1994, the full share of PIT was allocated directly on the basis of residence. Since 1995, the PIT has gradually evolved toward an additional form of

[3] Duty fee was close to 40 billion HUF in 1998. The revenues were allocated to finance the county local government and the municipal government of Budapest.

normative grant and equalization grant, with ever more complicated rules for its distribution and an additional share allocated to counties.



-

- **Table 8 Change of the significance of the Shared PIT in the LG revenues**

The figu re shows that PIT used to play a significant role in LG revenues, but its share decreased from 24 % to 2 %, which means that basically this type of transfer has been eliminated. In the year of 2000 only 30 billion HUF was budgeted for shared PIT.

The reason for this change was – according to the official view -- that PIT increased the horizontal inequity. But it seems not to be the whole explanation. The total expenditures of the LG sector has decreased by 10 % between 1991 and 2000 in real terms.To force LGs to adjust their expenditures from local governments which had more room for maneuvering should have taken resources away. Transfers with derivation origin gives less opportunity for central government to exercise fiscal pressure, and this was the main reason why the significance of the shared tax has been decreased.

The shared PIT always contained equalization part. Local governments having PIT revenue less than the minimum stated in the Budget Law had a **PIT supplement**. As this minimum was set quite high, most of the small local governments were eligible for this grant, which means that this is a *per capita grant for most of the local governments.* PIT supplement is given to the local government where the per capita share PIT is under the 90 % of the average per capita. The size of the equalization supplement equals to the difference between the local government per capita shared PIT and 90% of the average per capita PIT multiplied by the population of the local government. The source of this supplement wa s paid for out of central budget till 1996 from the shared PIT. *The local governments above this standard are not equalized down*.

The motor vehicle tax, which is according to the tax law a shared tax, had a “piggy backed” element. Local governments, at their discretion, can charge on top of the minimum level set by the central government an additional part up to a limit. 25 % of the local governments use this option, which represent more than 50 % of the population. The total revenue from this tax was 20,8 billion HUF in 2000.

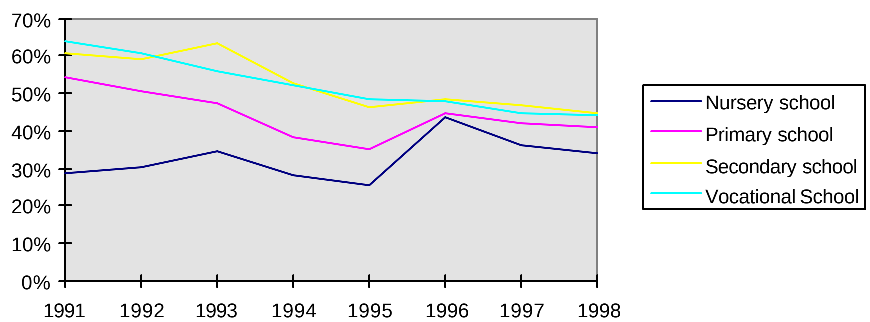
4.2. Grants

The intergovernmental transfers consist of different types of grants. The grants are different according to allocation principles (formula or ad hoc), matching rules, whether they are earmarked or not, etc. In the budget under one heading there are different types of grants mixed, which in itself is an indication of one of the weak points of the Hungarian grant structure.

a. Normatives

The largest transfer from the central government to municipalities is the **normative subsidy.** The real value of normative subsidies has declined over the period, as well as its share in local government budgets, from 42 percent to 28 percent of current revenues between 1993 and 1998. There are currently four types of normatives included within the normative subsidy: (a) per capita grants based on population, which are a proxy for service needs; (b) grants for core services, based on the number of beneficiaries; (c) capacity normative, such as based on the number of beds in homeless shelters;(d) matching grant for tourist tax.

The largest amount (two-thirds in 1998) of the normatives is distributed based on education criteria and the second largest for social welfare tasks. The criteria and types of normatives have been subject to annual adjustments. There was an attempt to simplify and reduce the number of normatives in 1995-96, but subsequent modifications have only further complicated the system. The calculation has become less transparent, with some elements of previous normatives currently distributed separately under the shared personal income tax.



• **Table 9 Grant/cost ratio in education between 1991-1998** [4]

Revenues of the normative grant are not earmarked in principle. But in the case of beneficiaries grants where the grant/cost ratio is lower than 1, the grant is earmarked. This is the case, for example, with the grant tied to education. Table 9 shows that the grant/cost ratio has been around 40-50 %. The normative grant system is calculated on the basis of estimated indicators of local needs mostly for the sectors of education and social welfare. Their value has come to represent less and less the cost of providing the services on which their calculation is based. Municipalities are required to make up the difference from other revenue sources, which ultimately reduces funds available for other priorities, and especially investment.

[4] Source: Miklós Balogh (2000)

b. Earmarked transfers from central government

The amount of other transfers from the central government and the State budget have increased considerably over the period. Their share in total revenues has been within a range of 20-24 percent, and in current revenues, from 25 to 29 percent. The largest of these transfers is the **social security transfer** for health care, which is sent directly to the health care institutions.

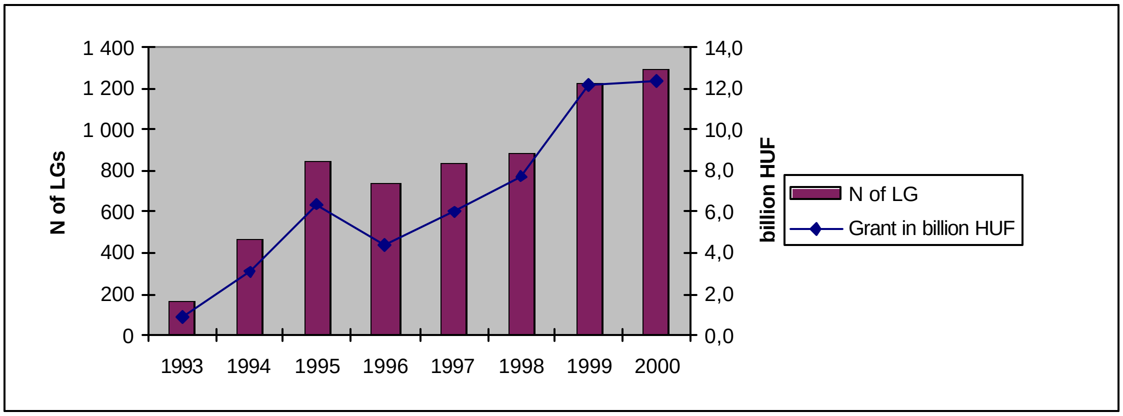
The other earmarked transfers are a collection of a number of disparate grants, including the theater subsidy, the municipal fire department subsidy, supplementary grants for education, the earmarked decentralization fund, the deficit grant and centralized allocations.

Centralized allocations are an additional type of normative, earmarked subsidy which finances a number of specific tasks. These include ad hoc grants and matching grants, and the funds distributed in this manner are quite significant, 30-50 billion HUF. The targets are determined by central government or Parliamentary priorities for local government actions.

c. Equalization grants

Horizontal equalization is an important issue in the intergovernmental finance system. There is no standardized budgetary scheme to equalize the fiscal capacity and the expenditure needs of the local governments. However, there are several intergovernmental grants which have an equalization effect more on an ad hoc basis. For example, PIT supplement (discussed above) from the beginning has been revenue equalizing, while the normative based on general needs criteria or formula using fiscal capacity variable (as the social policy normative) -- equalizes the expenditure needs. In the case of the capital investment grants the equalization is as important as in the case of expenditure finance. A specific equalization grant was used between 1991-1996 by the Ministry of Regional Development, but in 1996 it was gradually decentralized to the County Development Agencies.

In 1999 a new grant was introduced, "**grant to equalize fiscal capacity**", which amounts to 38 billion HUF (1999) and 44 billion (in 2000). This grant basically works in the same way as the PIT supplement, that is, equalizes the *revenue capacity* from the local business tax. It calculates the tax capacity of the local government and supplements up to a normative level. The norms were different according to the type of the settlements (villages 12 500 HUF, cities 16 5000 HUF, county seats 17 700 HUF and capital (with its districts) 20 000 HUF). This grant basically neutralizes the effect of the local business tax using a grant which is 22 % of total revenues.



- **Table 10 Number of local governments and cost of "deficit grant" program**

Deficit grant is for "local authorities incurring deficits through no fault of their own". The number of beneficiaries has increased rapidly over the period. In 1997 approximately 840 local governments (including a number of counties) received close to 6 billion HUF, compared to 1,289 local governments which in 2000 received two times more than before, that is, 12,4 billion HUF. The distribution of this grant is based on revenue and expenditure estimates of the municipality, and its functioning both discourages additional effort to raise own local revenues, and rewards inefficient expenditures. The deficit grant in principle is a normative grant with objective criteria for allocation (not discretionary). But in practice the rate of acceptance is changing (both in terms of the number of applicants and the sum they asked for). In 1998 50 percent of the money asked for was transferred to the local governments.

Budapest has more than two million inhabitants representing one fifth of the total population of Hungary. There are 23 districts and municipal governments with special revenue sharing procedures. The law on the capital (1991) and its amendment (1995) regulates a quite **radical revenues sharing procedure**. (Ebel, Simon, 1995) The Municipal Government and the district government with regard to their municipal rights are equal. The capital municipality is responsible for performing duties which concern the whole city (urban transportation, urban planning, public work and housing policy). The municipal government, however, has neither regulating nor supervising role over how districts perform their own duties. The act on the capital declares the revenue sources which have to be distributed among the Municipality and the districts: 1. PIT 2. normative grants based on the total population, 3. local business tax. The revenue pool is used as a gap-filling grant to LGs in proportion to their fiscal needs and the revenues tied to these needs. It means that equalization spread out to the revenues and tasks included in the scheme. The fiscal need is measured by the service level and its normative cost estimates, and the revenues as user charges, central grants tied to the services. In 2000, the total revenue redistributed is 52 % in the case of districts, and 46 % in the case of the Municipality of the total operational cost. (Balás-Hegedüs, 2000) The effectiveness of resource reallocation is questioned by the uneven distribution of the property stock (the latter is not subject to redistribution, although a version of the capital act would have ordered the redistribution of the yield of properties), and the strikingly uneven geographical distribution of capital investment, which is not part of the equalization procedures.

d. Investment grants

Addressed and targeted subsidies increased to 52.3 billion HUF in 2000. These subsidies back up municipal investments in priority areas, identified by Parliament annually (clean drinking water, sewage, education and health care), though in very different forms. In case of targeted subsidies the share of subsidy - as a percent of total investment costs - is set in each specific target area while addressed subsidies are discretionary decisions and often provide nearly 100% financing. Addressed subsidies were originally introduced to finance the continuation or completion of huge regional developments (hospitals, waste water plants) that had begun before the new decentralized municipal system. These objectives seem, however, to have been modified and addressed subsidies have been granted for new investments too, making the program economically unjustified. The volume of the two kinds of subsidies is defined by the annual budget law.

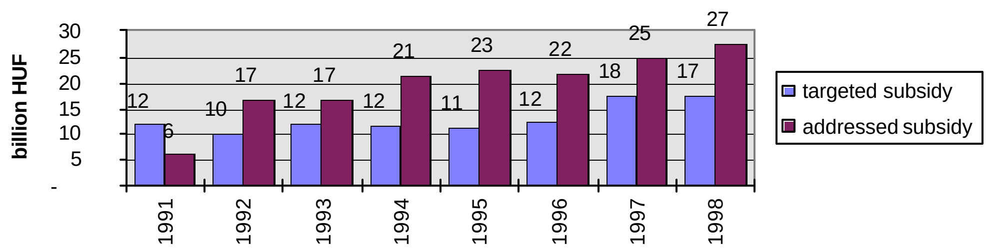
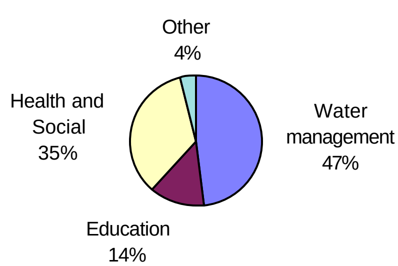


Table 11 Targeted and addressed subsidy in billion HUF between 1991-1998

The targeted subsidy is a matching grant, where the matching rates are determined in the Law of Targeted and Addressed Subsidy approved by the Parliament. The supported programs and the matching rates have changed in the last years. In 1999-2000 the priorities are building waste treatment plant and sewage network (50 % matching rate), investing into solid waste landfill (40 % matching rate), buying special medical equipment (40 % matching rate), and reconstructing educational buildings (50 % matching rate). In the last years the water sector was the most important area for the targeted and addressed subsidy,. 47 % of the grants were used in this sector.



- **Table 12 Distribution of targeted and addressed subsidy among sectors in 1991-1998**

Separated funds of the sectoral Ministries are another source of investment financing. Since mid-1996, the **grants for regional development** are distributed through the County Regional Development Councils (CDC). Three types of grants are available to municipalities through the CDC's: regional equalization grant, development subsidy and earmarked decentralization fund. Local investment priorities are set by each development council.

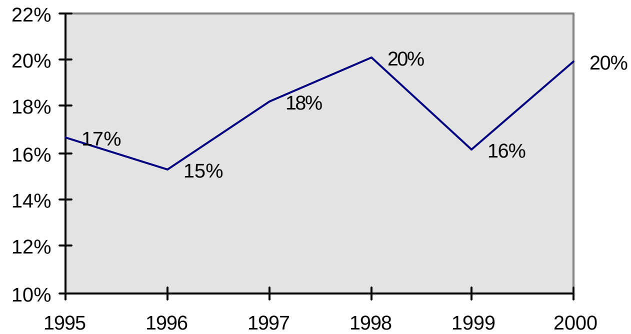
5. Borrowing

5.1. Local government capital investments

In 1990, local governments in Hungary became responsible for the investments in the areas they are responsible for according to the expenditure assignments. These represented huge investment needs in areas of infrastructure and environment, especially with respect to the EU accession. However, local governments had to make up for deferment in capital investment. Local government investments have remained quite stable in the last years, between 15-20 % of the total expenditures.[5] But because the local government share in the GDP has decreased, their investment share decreased as a percentage of GDP, as well.

We have to note that "off-budget" local government investments have not been shown in Table 13. While local governments have spent 2.2-2.5 % of GDP annually on infrastructure investments, municipal public service enterprises have carried out investments of an additional 1.5 percent of GDP. With respect to their sectoral contribution, in the basic activities municipal companies' investments accounted for 30 percent of the total sectoral investment. In the Supplementary service sectors this proportion equalled 20 percent. Companies in which municipalities have shares carried out investments in an amount of more than HUF 400 billion (nearly 5 percent of GDP). Out of these investments 31 percent was undertaken by gas and electricity companies and 38 percent by companies operating in other business services. Basic and supplementary public service companies invested nearly HUF 130 billion in 1997 (1.5 percent of GDP). Within supplementary services, telecommunication accounts for more than half of the investments. In the case of basic service companies, the distribution of investments is more even within the various sectors. District heating, sewage and waste treatment take up on average 12-13 percent respectively, water management and local transport account for 25-29 percent of the total basic service investment. (Hertelendy and Kopányi, 2000)

[5] In year 1996 the lower level of investments can be explained by the "Bokros pack" (austerity program, and the higher figure for year 1998 is explained by the election.



- **Table 13 Local government investments as a percentage of total expenditure in 1995-2000**

The main source of financing local government investments is revenues from property (sale of assets), the grant from central government, loans and “operating surplus”. Table 14 shows how the role of different financing sources has changed[6]. The revenue from local government asset sales was the main source in the year of 1995-1997, when it accounted for 60-80 % of the total investments. From 1997 its share has decreased. The second most important source is the capital grant, which accounts for 16-25 % of the total investment. The data show some of the distortion in local government investments. First of all, the property sales can not be a long-term source, and as it was distributed unevenly among the local governments, it contributed to the growing disparity among the different settlement types. Loan had a very limited role, which shows that the municipal credit market has not played the role expected.

- **Table 14 The financial source of the local government capital investment in 1995-2000**

	1995		1996		1997		1998		1999		2000	
	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %
Capital investment	136,1	100,0	143,7	100,0	216,9	100,0	279,7	100,0	237,0	100,0	314,4	100,0
Revenue from property	80,3	59,0	107,1	74,6	175,2	80,7	105,1	37,6	50,7	21,4	94,9	30,2
Loan	19,7	14,5	14,3	10,0	17,6	8,1	43,4	15,5	12,0	5,1	21,3	6,8
Capital grant	24,2	17,8	24,0	16,7	38,1	17,6	50,6	18,1	55,6	23,4	70,1	22,3
"Operating surplus"	11,9	8,8	-1,7	-	-13,9	-	80,7	28,8	118,7	50,1	128,2	40,8

Sources: own calculation based on budget tables

5.2. Local government and the capital market

According to the LG Law of 1990 local governments are in principle free to finance their budget deficit through capital market. Evolution of the municipal credit framework

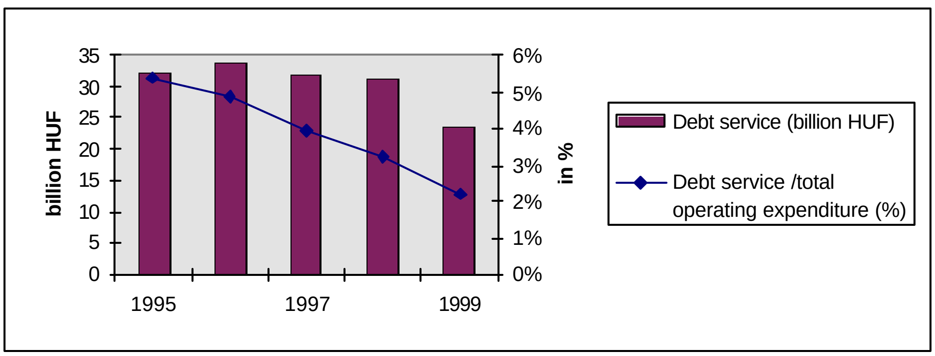
[6] The data do not show exactly the financing source for investment because some part of the revenues could be used for operating expenditures. But it shows the main trends.

in Hungary may be divided into two general phases. In the first phase, from 1990 to 1995, there were no formal central rules which constrained local government borrowing - no debt service limits, no reporting requirements, no separate specifications for the issuance of municipal bonds. The controls on subnational borrowing essentially operated (or did not) based on market discipline.

The possibility of credit sector has not been utilized by the local government, the main reason for which is not the supply side regulation, but much more constraints on the demand side. Local government financing choices for investments were determined by two other factors. The first is the availability of a large number and amount of central government grants, targeted by sector and type of equipment. This has led most municipalities to engage in "grant-maximization" behavior. The second factor was the large share of revenues generated from the sale and privatization of municipal assets.

The outstanding loan to the LG sector have not increased, the local government sector is is a net depositor. In 2000 (January 1) total mfinancial liabilities was 142 billion HUF, and financial assets was 417 billion HUF.

To measure the role of the credit market in terms of the debt service, the conclusion is the same. The debt service was 5 % of the total expenditure in 1995, but it decreased to 2 %. One of the reasons was that the revenue from asset sales was used for repaying the outstanding loans.



- **Table 15 Local government debt service in 1995 -1999**

Regulation of local government borrowing and the eventual consequences of municipal default were implemented through three measures: (1) a debt service limit for local governments was introduced in 1996; (2) the Municipal Debt Adjustment Act (1997) and (3) the Securities Act includes rules on issuance of municipal bonds (1997).

a. Debt service limit

Debt of the local government is defined to include loans, bonds, guarantees issued on behalf of third parties and lease agreements. The annual debt service is limited to 70 percent of corrected own current revenues. Own current revenues are defined to include local taxes, duties, interest revenues, environmental fines and other own revenues. This definition excludes revenue of institutions (rent, user fees) although these are also included in local government budget tables as part of "own local revenues". Own local revenues are "corrected" by subtracting the amount of short-term liabilities, (not including cash flow credits which are used to ensure funding of local government operations). Data on the current status of local government debt service indicate that for 1997 local governments reached over 20 percent of their available debt service limit and close to 30 percent in 1998. This data does not include guarantees and leases, so the level of available borrowing capacity is even lower than can be directly estimated. (Pigey, 1999)

The centerpiece of the new municipal borrowing framework is the Municipal Debt Adjustment Act, Law XXV of 1996, in effect from about mid-1996. The law defines a debt adjustment process, whose objective is to allow local governments to regain their financial health while at the same time protecting the rights of creditors. The provisions of the Municipal Debt Adjustment act are quite sophisticated and impose a definite financial and moral cost on local governments who default on debt or other payments.

Impact of the decentralization: Conflict and solutions

Decentralization is a process where the changes take place as consequences of the negotiations and conflicts of the stakeholder institutions. In the next part of the paper the most important areas of the conflicts will be described.

1. Privatization game: assets of the local governments

Municipalities received considerable equity through municipal and related acts, so that they could perform their tasks, primarily public services. The question how much is this equity and what is the most effective way of making use of it is of key importance. [7]The assets could be a dynamic source of new revenue for local governments. But there is no useful information about the distribution of the local assets, which means that this became an important factor for regional inequality. (The book value information is not proper for basing the equalizing grant system on it)

The most important assets were housing and non-residential properties (offices, land) and public works. There was a debate whether these are liabilities for the local government or they are real assets. In the beginning, most of the municipal companies (public works) were loss-making organizations because their fee structure did not make cost recovery possible, but in the long run – as a result of the adjustment process -- increased user charges changed the situation. However, the arrears issue (contingent liability) is an issue even today.

The conflicts between the two levels (central and local) of government was particularly sharpened by the political cleavage in 1990-94. But even after the 1994 election when this cleavage disappeared the fight over the privatization revenue became an

[7] The "windfall" gain through the asset revenue is very important. One example is Gyor, the fourth largest city in Hungary, which realized a 3,5 billion revenue from selling its cable television company, which is 20 % of its budget in year 2000. Budapest estimated the wealth of the Municipal Government to 1,000 billion HUF, which is around 4 times of the budget (500 billion shares in public works, and 400 billion in budgetary institutions)

important political issue. According to the Property Transfer Law (1990), the land the state companies own belong to the local government, which they were to receive as shares in the privatization process. The SPA (State Property Agency) has been blamed for systematically undervaluing the real estate part of the companies they had sold. The Law was not very specific and offered a wide room for interpretation. (1) The SPA deducts from the land market value the value of infrastructure (network of the pipes), which is highly criticized by the local governments. (2) The debt of the company should be deducted from the value of the company's assets including land value. One of the most significant political scandals of 1996 was connected to this dispute. Both LGs and SPA gave a substantial fee for private consultant companies to make a compromise. The fee was 10-15 %, which made a “fortune” for selected companies. According to some estimates the unpaid share for LGs is around 60 billion HUF.

The privatization revenue from the Public Gas Companies and Electric Companies had to be shared between the local government sector and the central governments. In 1996 the LG will be given shares from Public Gas Company with the book value of 18,6 billion. Local governments sued the SPA in 1996, and the Court of Constitution made a decision in 1998 September for the LG sector. As a consequence, SPA has to pay net 50-60 billion HUF to the sector in year 2000. This is equal to 20 % of the sector’s one-year investments. According to an estimate, the total value of assets sued by local governments accounted for 700 billion HUF, which is 3,5 times the investment made by LG in 1998.

2. *Accountability and the role of the own revenues*

The standard criticism against the Hungarian intergovernmental fiscal system is the low share of own revenues. However, in Hungary the education, social welfare, health etc., have a dominant role in local government tasks, which explains the importance of the transfers providing horizontal equity. Access to these services should not depend on the revenues capacity of the local governments. Therefore it seems to be an illusion to increase the share of own revenues radically.

The *inner structure of the own revenues is much more problematic*. The role of the revenue from asset sales raises some concerns. First of all, this is not a long-term source as it was shown above. Secondly, assets have been distributed very unevenly among localities, which forced the CG to increase the effect of equalization grant, and intervene into the transfers system. The problem was not just the inequality, but much more that no information was available about the size of the distortion caused by this element. The third problem with this revenue source is the lack of accountability to the voters. The LG managers consider this revenue as their own success, which does not need public control in the same way as the tax revenues.

Increase in own local revenues implies encouraging municipalities to levy local taxes. The most frequently implemented local tax is the business tax, which is very unevenly distributed among municipalities. Encouraging greater local revenue raising could work against another objective, that of equalization. Equalization concerns have come to the fore in Hungary due to the unequal distribution of the personal income tax (discussed earlier). Two-thirds of the revenue from this tax is raised in Budapest .

The *business tax* comprises 85 percent of total local taxes, which although not a long-term solution to municipal revenue requirements, has increased the accountability of local governments to the taxpayer, and has thus begun involving them in the decision-making process. However, this has been limited to a narrow group of potential taxpayers, i.e., entrepreneurs, businesses, and industry. Another disadvantage of the business tax is that taxing business too heavily may discourage investors. Therefore there is pressure to increase exemptions, which, in turn, leads to inequity across the tax base. It must also be noted that while the business tax is often portrayed as being a way of avoiding taxing households directly, in fact, the cost is ultimately borne by the consumer. Hence, it is usually a regressive tax. (Garzon, 1999)

The central government tries to centralize the local business tax revenues or a part of it. According to the proposal the local business tax (which is 202 billion HUF in year 2000) would be collected by the state tax administration and would be redistributed to local governments partly on the origin bases. There are strong counter arguments against this attempt as it punishes local government which used this tax as a part of long term development strategies giving exemption for new business development. Furthermore, it is really a "badly designed" tax causing a lot of distortions.

Also, it is also evident that there is a need for modernization of local taxes. For instance, the property tax (PT) is based on the physical *size* of the properties rather than their *market value.* In addition, the property tax is primarily levied (if at all) on non-residential property. Clearly, there is a need to expand the PT tax base to residential property, among other things, through the elimination of tax exemptions, particularly those that refer to "living-space" and newly built flats. Furthermore, the vehicle tax, which is a national tax shared with local governments, is based on the weight of the vehicles rather than their market value.

However, the uneven distribution is further compounded by the choice of municipality to levy the business tax as the preferred local tax source. Business tax capacity is likewise concentrated in the same municipalities and regions with above average PIT payments. As the business tax is not mandatory, using this revenue in an equalizing mechanism could discourage municipalities from levying the tax.

3. Service delivery: local structural adjustment

In response to a fiscal squeeze, local governments adopted **three main cost reduction approaches**. First, in reaction to the changes in the grant allocation system, they increased the provision of services where the grant-to-cost ratios were high and cut on both quantity and quality of services where they were low. Second, they restructured and rationalized services by introducing more efficient management and institutional structures. Finally, they took full advantage of different contracting out techniques and privatization opportunities as well.

3.1. Grant structure and service provision

While the 1990 Local Government Act and the subsequent legislation on decentralization gave local governments ample flexibility to adjust their expenditures, they also imposed hard budgetary constraints. The majority of local governments prefer to rely on central resources and pursue a policy of minimum local taxation and not borrowing. The main objective of these municipalities is to obtain necessary resources to finance the provision of local services without overburdening local taxpayers and taking unjustified political risks. In many respects, complying with the eligibility criteria for central grants became an important local financial strategy. Many municipalities design their financial plans around grant allocation process and have special staff responsible for tracking available grants and submitting the applications.

In the current intergovernmental transfer system, the grants are negotiated annually. The grant structure, depending on the type of grant, in one way or another, affects the economic behavior of local governments. As local governments try to maximize the amount of grants they receive from the central government, the grant allocation process may distort their financial decisions resulting in a situation where local user preferences have no or little effect on the provision of services. The response of local governments to the grant allocation system can be described as optimal when they discontinue or minimize the provision of services with low grant-to-cost ratios and of low local priority. The grant-to-cost ratios can be low not because of insufficient grant financing but due to high costs related to over-capacity or bad management. An example of a type of behavior like this was the closing of nursery schools in the early 1990s due to the lack of grant financing and partly because of decreased number of eligible kids.

Only in cases when municipalities discontinued the provision of services which were badly needed by the community but received insufficient grant financing, their economic behavior can be considered distorted. An extension of this type of distorted behavior is when municipalities reduce the scale or quality of important local services, typically by neglecting adequate maintenance or renovation work, or by scaling back on the level of services. Another form of municipal response to low grant-to-cost ratios for certain local services has been to transfer the responsibility for their delivery to the county level.

Nevertheless, while sectoral transfers are generally earmarked for certain services, the pressure on local governments to provide services differs across the sectors owing to the rigidity of sectoral regulations and their enforcement. As a result, in practice local governments frequently draw resources from less rigidly regulated sectors such as social services or housing to cross-subsidize the provision of politically more important and more tightly regulated services such as education.

As part of cost cutting measures, local governments were involved in active privatization of municipal assets that was made possible by the Privatization Law. Between 1991-1995, more than 500,000 apartments were sold resulting in substantial savings on housing maintenance for municipal budgets. Housing privatization resulted in savings around 25-30 billion HUF (calculated for 1998), which account for 2,5-3 % of total local government expenditures.

3.2. Reorganizations

The 1990 Law gave local governments an opportunity to choose the set of local services and the organizational forms of service delivery that are most suitable for the local conditions. However, the inertia of the existing tasks and responsibilities embedded in institutional structure frequently prevailed resulting in little or no changes in the traditional organizational structure of municipal service providers. Nevertheless, in the mid 1990s, the changes in the organizational forms of local service provision started taking place under the influence of (a) sectoral laws which introduced new local service responsibilities; (b) tax incentives for private service providers; and (c) local lobbies advocating the alternative forms of service delivery.

The Hungarian local governments were quite innovative in introducing alternative ways of service delivery, and a spectrum developed from the direct provision of services by municipalities to full service privatization. A wide range of institutional arrangements is used to provide local services. Most frequently, however, the service delivery responsibilities are vested either with (1) Mayor's office, (2) municipally owned organizations or foundations; (3) joint ventures, or (4) privately owned service providers.

While the improved cost efficiency and better quality of services are usually the main rationale for experimenting with different institutional vehicles, in some cases other objectives are no less important. Usually local governments try to avoid the compliance with certain government regulations, which can be achieved by changing the institutional structure of the service provider. For instance, while municipally owned service providers are subject to government cash-accounting rules and cannot obtain refunds of the VAT, a service provider structured as an independent company can refund the VAT and in general can receive a more favorable tax treatment.

The provision of services through the local government institutions is also quite common. It has become standard practice for cities to create one or more municipally owned companies which are responsible for park, road maintenance, snow clearing, refuse collection, and cemetery services. In turn, some of these services are subcontracted out to private firms. Operating as internal units of the local government, such entities usually enjoy a significant degree of independence in terms of planning and budgeting procedures.

The local government institutions have their own personnel policy, have the right to subcontract and the right to use municipal assets under their management the way they see fit. They can also seek external funding and can even start some entrepreneurial activities. While the director for such institutions is appointed by the elected body, the operational control is in the hands of local administration. In general, local government institutions account for 60-70 percent of total local government spending, which means that the efficiency of local governments very much depends upon the right incentives given to these institutions.

3.3. Contracting out and Privatization.

In their efforts to reduce the costs of local service provision local governments also took full advantage of various contracting out opportunities presented by the new Hungarian legislation on procurement standards, modelled after the standards set forth in EU procurement directives. The general experience is that contracting out results in a more cost efficient delivery of local services as private firms can employ labor far more cheaply than public entities. In addition, private companies may obtain refunds of their VAT payments, while government entities cannot. This tax adds about 25 percent to the cost of local public service providers.

The contracting out strategy led to more efficient provision of services. In addition, as municipally owned service providers were aware of the contracting out arrangements, the efficiency of their operations has improved too. In 1997 alone, the Hungarian municipalities awarded 135 billion HUF in contracts through tenders, which amounts to almost 15 percent of their gross expenditures. In addition to that there were tenders awarded by public service providers in the amount of HUF 81 billion. (Baar, 1998).

4. *Local financial management*

The Treasury began functioning in Hungary on January 1 1996 with the intention to have more effective cash management and further structural budget reform. It was expected to save the GOH, at 1996 prices, 35-40 billion HUF annually, or over one half percent of GDP. Among others, the treasury provided a net salary payment system whereby state employees receive only their net pay (i.e., after taxes and social security contributions have been deducted). The plan was that the accounts of local governments and budgetary institutions would be handled by the treasury from 1998. It was not approved because of the resistance of the local government interest groups, and the National Savings Bank, which has financial interest in servicing local government accounts.

The creation of independent financial treasuries in Hungary has been a product of economic pressure rather than public demand. Following a change in the government fiscal policies, large cost reductions had to be made at the local level to meet the increasing service requirements with only modest financial resources available. The local treasury aimed to control the budgetary institutions.

Improvements in financial management at the local level were achieved through rationalization of the budget execution process. The ability of municipalities to organize efficient cash management, introduce cost controls, monitor expenditures, and generate adequate financial reporting were key to a successful fiscal adjustment at the local level. To perform these functions, many municipal governments created local treasuries.

Historically, the main reason for setting up local treasury operations was to increase local interest revenues through consolidation of cash balances in municipal institutions. Closer monitoring of the accounts of local budgetary institutions resulted in a better financial discipline and improved their financial management. In contrast, earlier the local institutions paid little or no attention to whether their revenues had been collected as it was the local government which financed all their expenses. Though institutions recognize the benefits of a municipal treasury, there is a widely spread perception that this represents an encroachment on their institutional autonomy.

Conclusion and recommendation

The Hungarian reform of public finance was one of the most radical moves toward decentralization. In a ten-year perspective, we can conclude that the early start had some drawbacks on the intergovernmental fiscal relations, especially the grant types, local taxes proved to be less efficient in the system. It is far from us to idealize the system, but it has not lost its three basic features: 1. elected councils accountable for their constituency 2. “hard budget constraints”, which set limits to the moral hazard behavior, and 3. substantial expenditure responsibility and autonomy.

The comparative analyses of the intergovernmental fiscal systems overemphasize the technical issues and neglect the fact that the transition from the centrally planned socialist economy to a democratic market economy require continuous structural changes which modify the position of the different tiers of the government. For example, the expectation of a predictable revenues structure is an illusion in the time of radical changes, while the hard budget constraints and the autonomy are the key elements of the efficient adjustment.

In Hungary the case of the hospitals is a good example how the lack of incentive has led to a series of bankruptcy. As we discussed earlier, local governments do not have substantial expenditure and revenue control over the health services. As the management of the hospitals realized that the budget constraints had been "softened" by the central level on the basis of the political pressures, almost each of them went into deficit. There is no final solution to this problem, but one suggestion was to give more responsibility to the local government or re-centralise the task.

The rule of the law is one of the key questions in the region. Countries under the "pressure" of the donor agencies are willing to adopt laws (as a condition of support programs), which they do not want or can not implement. Hungary does not belong to this circle of countries, but the rule of the law is a problematic area. Hungary established a system where local governments are no longer agents of the central governments. The power of central government and the parliament are exercised through different laws. The ministries have no direct control over the local governments, and the enforcement of the laws and guidelines given to the local government is critical. The lack of "co-ordination" among the ministries has led to situations where the sectoral law transfers tasks and responsibilities to local governments without sufficient financial support (unfounded mandates). It is not rare that local governments are not able to provide services prescribed by the law.

Although Hungarian local governments are not agents of the central politics, politics has always tried to intervene into the local issues. The centralist tendencies exist in the government based on the view that "local governments have more freedom than is necessary". In the intergovernmental fiscal system, the grant allocation based on discretionary decisions gives room for political interventions. There is always room for intervention, but the key issue is that these interventions should be marginal, and should not dominate the behaviour of the central and local government. The hard budget constraints mean exactly that ultimately the transfers are not entirely negotiable. There are elements in the intergovernmental system which are negotiable *among certain limits,* not just for political, but sometimes for technical reasons. The deficit grant in Hungary is a good example for that, which has been misunderstood by several experts. Another example is the capital city, which is in almost every country a special, politically dominated issue.

The Hungarian intergovernmental finance system has gone through a series of continuous reforms and it has been over-regulated with the partial, uncoordinated modifications. The reform steps attempted to solve the most urgent short-term problems with the aim of optimizing the position of the central government. It was basically successful, but started to ruin the framework of the efficient adjustment process. There is a need for a coherent reform program in the area of intergovernmental finance.

The Hungarian experiences of decentralization showed that one of the weakest points in the system is the **low level of local taxes, in a real sense.** In the case of local taxes the local governments should have a reasonable discretion over tax revenue, and they should have the political responsibility to introduce the tax putting burden on the constituency. The reason for this is that the political "cost" of the local tax has not been compensated by the political benefits. This needs a cooperation between the central and local government to give additional incentives to the introduction local taxes.

One of the most important elements in the reform is the grant structure. The **grant structure** for the expenditure for the service delivery should be radically restructured. More simple -- formula-based – grants should be introduced, where the interest of the sectors will be provided through a block grant design. (This was proposed by Davey-Péteri, 1999) The grant design should be based on the local own revenue capacity (not just local tax) and the expenditure needs. In this system the role of deficit grant will be more important, as it is the only way to compensate the special cases. The disincentives should be built in to avoid moral hazard behavior.

The reform should include the **revision of sector strategies**. The government has to revise sectoral strategies in view of the decentralization, making clear task assignment and estimate the real investment need and its financial sources. Parallel with these steps, it is very important to make decisions about the nature of the second tier.

Local governments, despite the fiscal squeeze, managed to maintain acceptable local service delivery, but localities had to adjust to the changing financial environment. One of the most important factors in the efficient adjustment process was the *wide scope of expenditure decisions* transferred to local governments It is true that there were several cases when this freedom led to mismanagement of public resources but the overall effect was a more efficient public sector. The other factor which explains why the net decrease of LG sector revenue did not lead to a more critical situation was the "reserves" the old system accumulated in inefficiency. (See Six city report, MRI/UI 1999).

Bibliography

Baar, Kenneth K., 1998. Contracting Out Municipal Public Services: Transparency, Procurement, and Price Setting Issues. The Case of Hungary.

Balás G., -J. Hegedüs: Equalization grant in Budapest 1992-1999, manuscript, 2000

Balogh M.: Financing education at local governments, Know How Program, 2000, manuscript

Bird - Ebel – Wallich, ed (1995): *Decentralization of the Socialist State,* The World Bank

Booth, Martyn, *et .all.*, 1998. Development of an Industrial Park in Nyiregyhaza, Consultant's Report, Local Government Know-How Programme.

Borkos – Dethier, ed (1998): Public Finance Reform During The Transition: The Experience of Hungary, The World Bank

Davey, Kenneth and Gábor Péteri, 1998. Local Government Finances: Options for Reform, Nagykovácsi, Hungary.

Ebel, Robert D. - Simon, Peter: Financing a large municipality: Budapest (1995) [in. Decentraliztaion of the Socialist State, ed.: Bird - Ebel - Wallich, World Bank, 1995.]

Financial Management in Hungarian Cities: Six Case Studies, 1999. Urban Institute/MRI research papers (Katalin Mitró, Robert, Kovács, Zsolt Pataki, Orsolya Sebõk, Andrea Tönkõ) USAID, Hungary.

Fiscal Design Across Levels of Government, The OECD 1999 Survey on Fiscal Design Across Levels of Government, Country Report: Hungary

Fox, William, 1995. Intergovernmental Finance in Hungary: Background Paper and Recommendations for the Public Sector Adjustment Loan, Consultant's Report, World Bank.

Gábor Péteri, 1999 Institutional Component of SNDP: City Management. Background Paper for the World Bank City Management Policy Note. Budapest.

Garzon, Hernando, 1998. Local Revenues and Policy Implications, The Urban Institute, USAID, Budapest.

Hegedüs József: Municipal Finnmace and Governance in Hungary, MRI, 2000

Hegedüs, J. :Hungarian Local Governments. in Emil J. Kirchner, editor, Decentralization and Transition: The Visegrad Countries, Macmillan Publishers, 1999,

Hegedüs, József (with Sorin Ionita and Ciprian Fartusnic (Romania) , Yuri Navruzov (Ukraine), Orsolya Sebõk (Hungary) Non-Tax and Off-Budget Revenues in Three CEE Local Governments, Prepared by the Metropolitan Research Institute, for consideration by the Local Government Initiative (an affiliate of the Open Society Institute), 1999

Hegedüs, József and Gábor Péteri, 1996. Local finance and municipal services in Hungary (Country report and reform proposals) FDI, 1996

Hegedüs, József, et all, 1996. József Hegedüs, Judit Kálmán, Katherine Mark, Ritu Nayyar-Stone, Juliana Pigey, Steve Swanson, Andrea Tönkõ: The Subsidy System of Municipal Inrfastructure Developments, MRI - The Urban Institute, March 1996.

Hegedüs, József, et all., 1998. A hazai támogatási rendszer csatlakozási kérdései, koordinációja az EU strukturális Alapokkal (Issues of Hungarian subsidy system in respect of EU accession and coordination with EU's Structural Funds), MRI, Budapest (Városkutatás Kft)

Hegedus, Jozsef, Katherine Mark, and Juliana H. Pigey. 1994. "Municipal Lending in Hungary." Prepared for International City/County Management Association, Local Government and Housing Privatization, United States Agency for International Development Project 180-0034. Contract EURO00340 C-00-2034-00, RFS 69. Urban Institute, Washington, D.C. and Metropolitan Research Institute, Hungary (Project 6283-69).

Hungary – Statistical Appendix, 1997. IMF, Wahsington, DC

József Hegedüs, Judit Kálmán, Katherine Mar, Ritu Nayyar-Stone, Juliana Pigey, Steve Swanson, Andrea Tönkõ: The Subsidy System of Municipal Inrfastructure Developments, MRI - The Urban Institute, March 1996.

Juliana H. Pigey with assistance from Judit Kálmán: Fiscal Decentralization and Local Government Finance In Hungary, 1989 – 1999 August 1999

Károly Jókay, Judit Kálmán, Mihály Kopányi: Municipal Infrastructure Financing in Hungary, Four Cases Hungary – Subnational Development Program ,The World Bank, October, 1998

König, Éva, 1998. What for Is the Social Transfer Enough? Mire elegendõ a szociális normatíva?) In. Esély: 1998/6., 44-59 pp

Kopányi-Wetzel, ed (2000): Sub-national Modernization Challenges: The Experience of Hungary, The World Bank, (in proceedings)

Kusztosné, Nyitrai E. (Editor),1998: Helyi önkormányzatok és pénzügyeik (Local governments and their finances) Consulting Rt., Budapest

Lutz, M. Ruggiero E., Spahn P. and Sunley E.: Hungary in: Fiscal Federalism in Theory and Practice (ed.: Teresa Ter-Minassian)IMF 1997.

OECD, 2001 Fiscal Design Across Levels of Government, Year 2000 Surveys, Country Report: Hungary, FINAL. 3rd May, 2001

Puskás Ildikó: Mít jelent az "Önhiki"? (What is the deficit grant?) in: Pénzügyi Szemle 2000/2, 117-135.

SAO, 1997: Jelentés a helyi önkormányzatok ellenõrzési funkciója érvényesülésének tapasztalatairól (Report on the auditing activities of local governments). Sate Audit Office, Budapest

Shah, A.,1998: Fiscal Federalism and Macroeconomic Governance: For Better of for Worse. The World Bank conference, Santander, Spain

Süveges, Zsuzsa: Local government finance in 1998 in County Jász-Nagykun-Szolnok, in Pénzügyi Szemle, 1999/10.

Temesi (2000): *Local Government in Hungary,* in: Decentralization: Experiments and Reforms, ed: T. M. Horvath, LGI, OSI

World Bank SNDP report, 2000

Zsófia Hertelendy and Mihály Kopányi: Municipal Enterprises:World Bank, Background study for the SNDP March 2000