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# Is the conflict container full?

## Some financial aspects for the assessment of the situation and the transformation of the system

*It sounds like a cliché, and a fact proven from several aspects[1] to state that the Hungarian system of municipalities that was established in 1990 is characterized by excessive decentralization and the role of the conflict container,[2] as well as the contradiction between the constitutional situation and the financial regulation.[3] What can be concluded from all this is that the advantages[4] of decentralization described in normative economics were not fully realized in practice. Although it cannot be denied that the Hungarian reforms of public finances based on the decentralization of conflicts significantly alleviated the pains caused by the crisis of transition, we also have to see that the reserves of this public policy approach have been exhausted and this does not only jeopardize the utilization of the advantages of EU accession. The condition of the Hungarian system of municipalities does not even allow the implementation of a social policy that is able to prevent the peripherization of the country, nor can it guarantee the minimum level of social cohesion and the competitiveness of the economy. If we narrow our statement exclusively to the direct financial threats, we have to see that the indebtedness of the municipality sector is one of the threats to fiscal stability.*

*In this study, I wish to describe the financial situation of the local government system. In my study, I have strictly examined only the financial aspects, I have not analyzed the deeper reasons leading to the evolution of the situation,[5] I have only tackled the issues of financial risk management in the narrower sense of the word, also in the proposal section. The study is not an audit report, although it has made use of the SAO reports. It is not only so because it does not contain any individual, micro-level analyses and does not deal with the assessment of the individual risks. The situation is that the genre of audit reports is based on evidence gathered by the activities required by strict audit standards, and mainly relies on the completed processes. In the study, the statements are supported by methods, evidence and arguments used in scientific research, in it, I also strove to make forecasts. Scientific methods of research, especially the proposed diagnostic methods can not only serve the analysis of the past but they are also suitable for forecasting risks and modeling the impacts of the expected changes. We hope that this approach does not only help the audit activities performed by the SAO but it also contributes to the substantiation of public policy decisions and the development of the financial self-knowledge of the individual local governments.*

## FINANCIAL RISKS INHERENT IN THE LOCAL GOVERNMENT SYSTEM AND THE INDICATORS OF MEASUREMENT

In our view, the financial risks of the municipalities may present themselves in the forms of the lack of funds, *the lack of liquidity and the lack of creditability.* The *lack of funds* in budget management means that no funds from the relevant budget resource are allocated to the tasks required by law. *The lack of liquidity* means that there is no harmony in timing between the planned incomes and expenses of the player of the economy. Liquidity risks may present themselves in the lack of liquidity, or in excess liquidity as the other extreme. The lack of creditability[6] means that the municipality is not able to meet the financial obligations that it undertook. In the municipality sector, due to the diverse forms of service organization and the high level of freedom in assuming financial commitments, *risks outside the budget* (in the case of the economic associations owned by the municipalities and performing obligatory tasks) and *off-balance sheet* risks also appear besides the risks that are directly reflected in the budget. The off-balance sheet risks are mainly represented in the form of long-term commitments in the PPP contracts, as well as undertaking suretyships and guarantees.

We are aware of that the profitability of the operations of the municipality sector is indicated by the quantity and quality of the public tasks that are performed and the public services that are provided. It is in this comparison that efficiency and profitability can be assessed. Due to the general functions of the public sector, cost efficiency as a goal of financial management is preceded by *profitability*. Thus, we will narrow down the financial approach, we will not examine the cost efficiency and profitability issues.[7] This narrowed approach is justified by that the structural transformation of the municipality system is made difficult by the tensions that have accumulated and continue to accumulate in the system, with which difficulties the new government will also have to reckon. The study confirms our statement made one year ago[8] that the financial situation of the sector is a significant obstacle to the structural reforms within the sector, even if there is corresponding political intention.

As in the case of all financial analyses, it makes sense to start out from the system of financial reporting, also in the case of the municipalities. In the Hungarian public finance system as well, three levels of the information system are distinguished between. These are the *system of financial reporting* applied in public finances and aggregating micro-level information, *the public finance control and information system, as well as the public finance statistics.* These three information system elements are closely related to each other. However, the micro-level (accounting) reporting system used in Hungary, as well as the information control system of public finances are the subjects of numerous critical remarks.[9] The changes in the pecuniary positions of the players of public finances (including the municipalities, which are the subject of this study) are not appropriately reflected by the accounting reports, neither are the financial risks appearing in the sector or its individual units[10] represented by the information and control system of public finances.

We have two ways to go in analyzing the finances of the municipalities. In analyzing the sector as a whole, or its individual groups, we may use the data specified in the forms that are prepared in the framework of the information and control system of public finances as a basis. Supplementary data are provided by financial statistics, the financial invoices of public finances, monetary statistics[11] and the records of the Hungarian Financial Supervisory Authority (Hungarian acronym: PSZÁF), as well as KELER Zrt (the Central Clearing

House and Depository Ltd). When we analyze individual municipalities, we can rely on the financial reports and final accounts decrees of the municipality in question. In the practical analysis, the municipality funds flow and the public budget balance that are prepared annually are usually used. It is common practice that the economic associations "question" these statements by using methods and indicators similar to the reporting system. Besides the routine, the analysts are inspired to do so by the similar reporting systems of the two sectors. *However, the analyzing methods typical of the business sector are unsuitable for the financial analysis of the municipalities.* In the following section, we are going to make a proposal for such a system of indicators which we think can be a starting point for a more suitable, although not perfect, tool for analyzing the financial situation of the municipalities.[12] In developing this system of indicators, *financial capacity*[13] is a key concept. The concept means the amount of credit in the case of taking out of which the charges involved do not jeopardize the ordinary operations of the entity. In applying the concept of financial capacity for municipalities, and in quantifying thereof, we start out from the municipality's budget.[14] In the course of this, we distinguish between the aggregates that describe the *current and investment budgets.* The economic explanation for this distinction is that the total budget deficit[15] that does not exceed the investment (capital) expenses is also permissible in the long run, since in this case, the municipality's property will not decrease. The other important element is the definition of the concept of *gross budget savings.* Budget savings are defined as the difference between the current revenues and the current expenses, where the latter includes interest payments. If we deduce the repayments of the credits taken out earlier from the savings, then we will arrive at the amount of *net budget savings.* This chart indicates the value of the "freely disposable funds" that remains from the current budget of the municipality after performing its obligatory and voluntary tasks and meeting its debt service obligations. This value, more precisely, its dynamics and forecast may be the basis for the calculation of the limit of any prudent borrowing by the municipality.

In establishing the proposed system of indicators, beyond the professional considerations, we kept in mind two practical methodological aspects. One was that they should be calculable on the basis of such primary data whose reliability and comparability are ensured. The other consideration was that the components of the indicators should be clearly definable. These indicators are suitable for the analysis of the municipality sector as a whole, its specific groups of players and its individual entities. Of course, the level of the analysis defines the depth of the accessible reliable information.

*We propose that a financial situation in its narrow sense should be presented according to seven criteria.* These criteria at the same time define the contents of the specific indicators as well. However, we should distinguish between the criterion of the examination and the contents of the specific indicator. The situation is that we regard the seven criteria as permanent,[16] while we are aware of the fact that as the financial architectures of the municipalities change, the contents of the indicators that characterize the criteria will also change, of course. Thus, there are two questions that arise in relation to the structure of the system of indicators, which are partially independent from each other. One is whether the proposed seven criteria are applicable for the overall financial situation, given the specific *financial architecture* of the local governments. The other question is whether the criteria are properly measured by the specific indicators, as long as the criteria are acceptable.

By the *financial architecture of the municipalities,* we mean the combination of the following five criteria:

- the mechanisms of the financial relationships between the government levels, the tools of vertical and horizontal redistribution. This includes the rules of tax sharing, the techniques of allocating state contributions to the obligatory tasks, the procedure for the subsidies' delivery,[17] the tools aimed to moderate the inequalities of the fiscal capacities,
- the right of municipalities to impose local taxes, the system of local taxation,
- the strength of the ownership right of the municipalities,
- the specific rules of the capital market connections, the rules of involving external funds,
- the hardness of the budget constraint, the transferability of the current and capital budgets and the procedures prescribed for financial difficulties.

The proposed three basic and four supplementary criteria are as follows.

❶ *Liquidity indicator*[18] that indicates immediate solvency.

❷ *Financial sustainability indicator* that indicates creditability and is based on the concept of financial capacity. It is an indicator that shows the municipality's financial space to maneuver. This indicator may be applicable for assessing creditability.

❸ Indicators showing *the degree of indebtedness.* This is an indicator that expresses the comparison and burdens of the debt. This may be suitable for assessing creditability (the endogenous component of debt limitation).

❹ Indicator of *fiscal capacity.* This comparable indicator reflects a municipality's own income-generating power.

❺ *Revenue flexibility.* This indicator basically shows the size of a municipality's space to maneuver in generating its incomes.

❻ *Expense flexibility.* This criterion shows the level of a municipality's independence in determining its expense policy.

❼ *Sensitivity indicators* showing the exposure to market risks. Exposure to market risks, which may present themselves on the side of liabilities but also, on the side of receivables or income items.

*Table 1* illustrates the proposed system of indicators. The proposed indicators partly show stock data, partly reflect flow data. In the case of the stock variables, one should pay attention to that these should refer to the same point in time, while the flow variables in fact refer to a certain budgetary year.

One of the most serious methodological difficulties is the distinction between current and cumulative expenses. In our world characterized by financial innovations and structured financing solutions,[19] it is not always easy to tell one type of such expenses from the other.[20]

It is important to carefully think over the budgetary aggregates interpreted as the starting point for the creation of the indicators. In the case of the analysis of the municipalities, *a clear distinction must be made between the current year and what we call GFS system income/expenses/balance.* The former basically reflects the total impact of the financing operations, while the latter only contains the interest expenses and income. The use of current year aggregates may cause considerable optical illusions, since the current year balance contains the utilization of cash reserves and/or the credit income.

The indicators, as long as they are not composite charts, can only reflect certain aspects of the phenomenon that is examined. When describing a financial situation, several types of indicators should be simultaneously applied in order to make the financial situation and the risks tangible enough.

In the creation of the specific indicators, it should be taken into account (and this also leads to compromises) how reliable the data are, and whether there are any such data at all which measure the phenomenon in question.

*Table 1*

**GROUPING OF THE NEW INDICATORS ILLUSTRATING THE FINANCIAL SITUATION OF MUNICIPALITIES**

| Type of financial indicator | Liquidity indicators | Sustainability, financial capacity indicator | Indebtedness indicators | Revenue flexibility index, RFI*** | Expense flexibility index, EFI**** | Indicators characterizing the revenue (fiscal) capacity | Sensitivity indicator |
|---|---|---|---|---|---|---|---|
| **Function of the financial indicator** | Characterizes immediate solvency. The untimeliness of the revenues and expenses, or the structural problems of the budget may cause liquidity problems. | An indicator reflecting the level of freedom of the municipality's financial decisions, as well as the ability to perform its debt service obligation (creditability) | They characterize the weight of the municipality's debts and suspended future liabilities. | It shows the weight of the budget revenues that are freely disposable by the municipality. | The indicator used for characterizing the level of freedom in decision-making on expenses | The indicators reflecting the revenue-generating "power" and the weight of the municipality's own revenues | Illustration of the liabilities exposed to market risks (the risks of revaluation of the interest rates of exchange rates) |
| **Proposed structure** | ❶ deposit +securities for endorsement / debt service + short-term liabilities; ❷ liquid borrowing + sale of securities for endorsement /GFS expenses; | ❶ net operating income/ own revenue*; ❷ net operating income per one inhabitant; | Per capita debt**/own revenue*; annual repayment obligation/operating income; | Δ own income*/ Δ GFS income; | Δ cumulative expenses /Δ total expenses; | ❶ own revenue per inhabitant *; ❷ local business tax income per one enterprise; | ❶ debt exposed to the risk of exchange rates/total debt; ❷ EU subsidies /total revenue; |
| **Interpretation-assessment** | Change in the value of the indicator, and its value as compared to the benchmark value. | Change in the value of the indicator, and its value as compared to the benchmark value. | Change in the value of the indicator as compared to the benchmark value. | Change in the value of the indicator. | Change in the value of the indicator. | Change in the value of the indicator as compared to the benchmark value. | Change in the value of the indicator. |

* own revenue= local tax+duty+motor vehicle tax+ interest income
**The value of the debt includes the present value of leasing and PPP contracts, and the suretyships and guarantees undertaken, with a weight of 50 percent.
***by using the methodology applied in the rating system of Standard & Poors
****by applying the principle proposed by INTOSAI (INTOSAI, 2003)

The indicators can be used for several different purposes of analysis. They can be made suitable for forecasting system-level risks, and examining certain types of municipalities, as well as for analyzing the municipalities. The goals of the analysis determine the technique of analysis, and also, how we evaluate the calculated values. The indicators can be calculated on the individual level, for a group regarded as homogenous, a type of municipality, or the sector as a whole. In the case of the individual indicators, the values that can be interpreted and the benchmarks can be of several types, depending on the type of the indicators. Our proposal on interpretability is contained in the last line of the table.

The proposed indicators start out from the data that can be calculated from the public finance information and control system. However, we have to say that the current system of forms that serves as the basis for the data indicated in today's public finance information system is both redundant and incomplete. *It is probable that the majority of the information specified in the forms is unsuitable for performing such types of analyses, they are not really utilized in financial planning either, so their production and processing incur unnecessary costs.* The lack of data on *off-balance sheet* and *out of the budget* items considerably reduces the transparency of the sector. Still discussing the financial aspects, it would be important to be familiar with the portfolios and composition of suretyships and guarantees, as well as PPP contracts. The *off-balance sheet* data bear significance because they will represent themselves as actual liabilities in a later period with some level of probability. These items mean a kind of "virtual bridge" between the present and the future. In the case of the PPP contracts, these expenses will be incurred with a probability of almost 100 percent, this is why it is possible to define the present value of the liability. In the case of suretyships and guarantees, these should be reckoned with at a proportion weighted by the probability of redemption. The risks *outside the budget* include the range of economic associations that belong to the "quasi-fiscal" scope, which count toward the sector's deficit according to ESA95, as well as the debt.

In the case of some of the proposed indicators, the category of "own income" fulfills an important role. This is highly sensitive to the regulation at any time,[21] as well as to the regulation of funds.[22] In principle, the local public revenues,[23] the institute's own revenue, the utilization fees and the property utilization income all belong here. Shared taxes can also be listed here in a certain regulatory environment. This means that one has to be careful when defining this specific item.

As a result of cashflow-based accounting, there may be such "creative techniques" in recording liabilities by using which, for example, the law on the tax settlement of the municipalities can be evaded. The "concealment" of liabilities overdue by more than sixty or ninety days is established practice.

By way of concluding this methodological section, I would like to mention that, during the testing of the proposed indicators, the fine-tuning of the contents thereof, or the need to generate new indicators will obviously come up as an idea. The development of these indicators, and those that may serve other goals of analysis may play an important role in the modernization of the public finance information system, since they contribute to the specification of the requirements from the data "to be delivered" by the information system.

## THE FINANCIAL SITUATION OF THE MUNICIPALITY SECTOR

The twenty-year-old system of local governments is ridden with a number of internal contradictions. These stem partly from the exaggerated solutions of the Local Government Act adopted in 1990,[24] and partly from the political opportunism of the past twenty years. The point of the latter phenomenon is that the reduction of the state tasks arising from the change of the political regime was usually realized by the governments at any time through the decentralization of the ensuing conflicts. Paradoxically, the reduction of tasks was accompanied by such a legislative process as a result of which such professional laws were adopted which stipulated excessive requirements as compared to the country's level of development. This also means that in the local government system as a conflict container, such contradictions also appear whose treatment is obviously not the responsibility of the governments on the lower levels.[25] It meant a significant further burden that by weakening the mid-level of the municipalities, the financial relations between the government levels became excessively centralized. The tense contradictions could be handled by the fiscal policy of the government at any time, which had an increasingly destructive and erosive effect on the operation of the system. The final outcome of this was that the larger municipalities responded to the situation by getting indebted, while the majority of the smaller local governments can be kept on the verge of operability by interfering individually.[26] Due to these phenomena, the financial situation of the municipalities came to the center of professional and political public speech and in many analyses, alarm bells are sounded.[27] Within the available space, we will deal with two issues. One is how critical the level of indebtedness of the municipality sector can be regarded. The other one is to what extent the local government system jeopardizes the country's fiscal sustainability.

In our opinion, the *critical situation predicted* by the representatives of the more pessimistic approaches *already for the end of 2010[28] will not necessarily develop.* The financial hardships of the small municipalities struggling with financial difficulties mostly in the villages would already be treatable by appropriately working, transparent fund management as early as from 2011. The financial difficulties of the large, highly indebted local governments may become acute after 2013. Until then, there is still some time for stabilization,[29] which would avoid the "rewarding" of the prudent municipalities, which have undertaken moral risks in the past few years. During the transformation of the municipality system of a reform scale, besides the structural, organizational and financial issues, *the definition of state tasks, the sharing thereof between the state and the municipalities, as well as the different types of municipalities are fundamental issues, along with the definition of the minimum scope of necessary local public services.* The municipality reform may turn out to be a process lasting for several years, in which it will (also) depend on the applied financial solutions how painless the development of the new system will be.

## The indebtedness of the local governments and financial stability

As is familiar, since the end of 2006, the municipality sector has seen the beginning of an indebtedness process, which can be regarded as atypical from several aspects. The atypical nature[30] of the process was represented in that it was characterized by a kind of political anticyclicity after the local elections. The other such sign is the instruments of indebtedness and their denomination. The private, mostly Swiss Frank-based placements prove that the lending banks, making use of the then favorable money market situation, similarly to what was experienced in the retail segment, strove to increase their business activity and through this, their profitability in this market segment as well. *It can also be stated that the banks* *extended credits without taking the aspects of prudence into account.* This is shown by Chart 9 in the later part of this text, and also, that the municipality category (county municipalities), which practically has no own income potentials, was granted significant amounts of credits by the banking system. The explosive nature of the process is shown by *Chart 1.*

It is also true that, seeing the processes, the financial government made an absolutely unjustified announcement on the introduction of tightening measures[31] on taking out loans first in April 2007, then in the autumn of the same year. The unjustified nature of the announcement is due to three reasons. In the then political situation, there was no chance at all for this cardinal statutory change. Second, even if there had been any, such information would *necessarily* have resulted in bringing the issuances forward, at the time of the turnaround of the amendments. This is what in fact happened. Third, the regulation elaborated by the Ministry of Finance and submitted in the autumn of 2007 is strongly debatable from a professional aspect, thus the legislator would not have achieved its aim even in the case of potential approval.

*Chart 2* shows the turnaround of the issuances in time. It is noteworthy that the issuance of the highest amount (including the highest proportion of Swiss Frank denomination) took place in 2008, when the financial crisis started to unfold. The other noteworthy information is the 2010 data, which shows that after the strong decline of 2009, new dynamics are expected. This is not to be considered atypical any more, as 2010 is an election year.

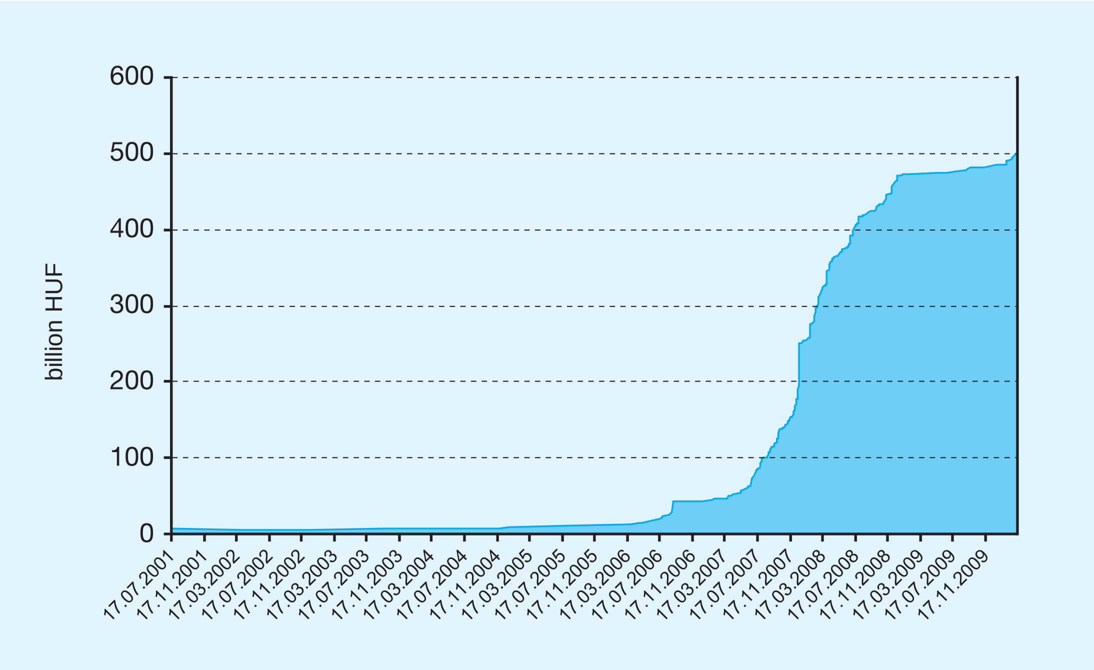
It is obvious from *Chart 3* that these private placements were performed with rather long terms. From the point of view of political economy, such long terms mean the shifting of political responsibility, especially if they involve long grace periods. Responsibility may be shifted to a later generation of the local community in question and/or to a wider range of taxpayers. In the latter case, local borrowing is a typical "stowaway problem" (Balassone et. al., 2004). From a financial aspect, we can also say that, since at the time of the issuances, specific purposes for the loans were very rarely defined, longer terms are bad rather than good news. The situation is that if a capital investment is recovered from, say, fee income, during 20 years, then the term of the external fund will also be around 20 years, expediently. As long as no purpose is defined, then both from the narrow financial and the broader political and regulatory perspectives, longer terms will prove to be a risk rather than an advantage.

*The financial crisis that set in* from the third part of 2008 *created a new situation for the debt of the municipalities as well.* The strong fluctuation of the exchange rates was just the lesser problem. This, though, deteriorated the municipalities' positive balance of the carry trade operations[32] performed with some of the funds that flowed in from the issuances. *Chart 4* shows the effects of revaluations. The real problem was rather due to the fact that the subscribed, long-term forex bonds were covered by the banks from short-term, mostly a few months' money market funds. The volatilization of these funds caused liquidity problems for the banks on the one hand, and made the refinancing costs of the bonds permanently higher. These changing conditions will exert an unfavorable effect on the municipalities for a longer term. The liquidity problems of the lending banks (those subscribing the bonds) were partially resolved by NBH by accepting these bonds for the repo operations, and on the other hand, some of these instruments were bought by some specialized financial institutions from other EU countries from the Hungarian banks that performed primary subscriptions. It should be noted that the market risk of the bond debts denominated in the currency of the municipality does not only arise

*Chart 1*

**TOTAL MUNICIPALITY BOND PORTFOLIO AT THEIR PRICE OF ISSUE**

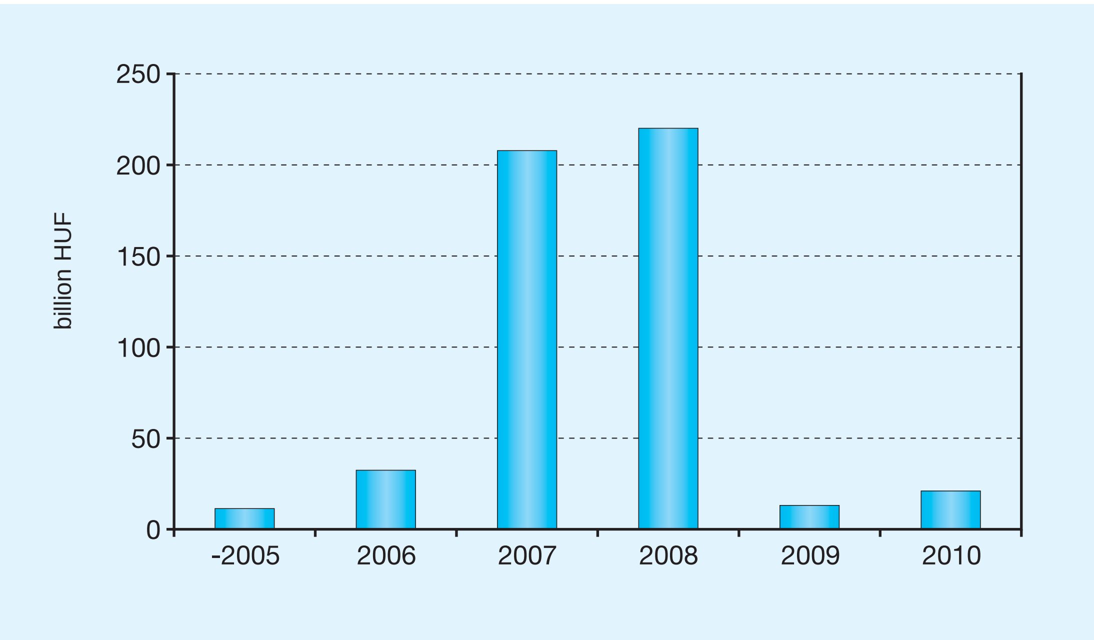
(2001–Q1 2010)




*Source:* KELER Zrt.

*Chart 2*

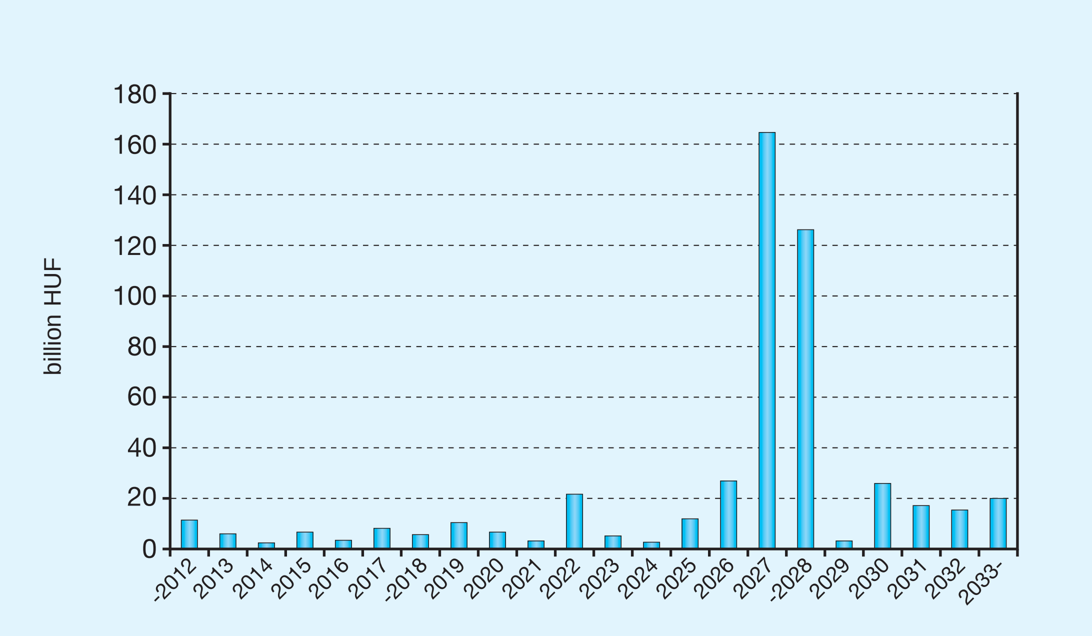
**MUNICIPALITY BOND ISSUANCES BY YEARS**




*Source:* KELER Zrt.

*Chart 3*

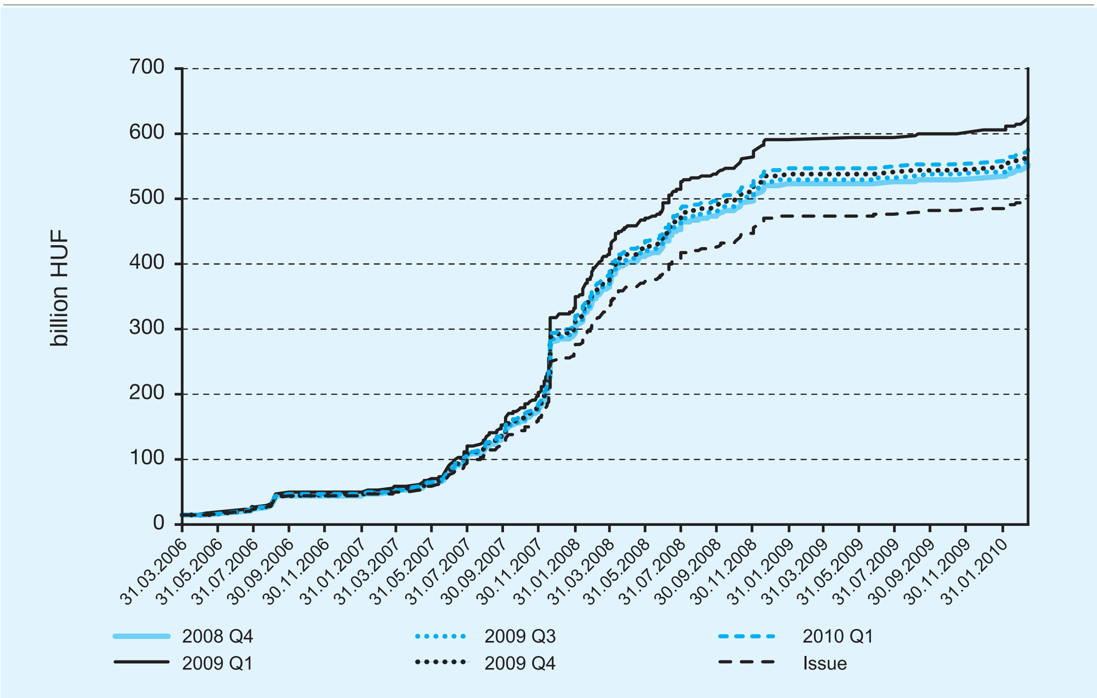
**DISTRIBUTION OF MUNICIPALITY BOND ISSUANCES ACCORDING TO MATURITY STRUCTURE**




*Source:* KELER Zrt.

*Chart 4*

**REVALUATION OF MUNICIPALITY BONDS**



from the exchange risks but also from the interest rate risks. Since these schemes have variable interest rates, the increased refinancing costs of the banks considerably increase the financing burdens of these instruments.

In the financing decisions substantiating the involvement of external funds, the municipalities have to take several viewpoints into account in order to be able to make good decisions on the selection of the instruments of external funds. The two basic instruments are: taking out credits from banks and issuing bonds. In the framework of this study, it is not possible to present the various versions of the two basic instruments. However, from the aspect of the Hungarian developments, two issues should be highlighted[33] related to the issue of credits vs. bonds. On the one hand, in Hungarian law, the issuance of bonds, for reasons not exactly familiar,[34] is not the subject of public procurement, thus competition is less transparent in this market. The other important issue is that while the bank credits are only available to the users on certain conditions, even after the assessment of creditability, a bond issuer that is qualified as creditable more or less freely and immediately disposes over the involved amount. *Thus, an important institutional control is missing[35] from the process of involving funds.* Attention should also be called to that besides the two basic instruments, there are such which can be regarded as "concealed borrowing", which are thus also hidden risks. These are the leasing and PPP schemes. These financing techniques mean financial innovation, and their function is, partially, to appropriately allocate the financing risks related to the complex and long-term projects, and partially, to circumvent the various regulatory frameworks.[36] It is common in both forms of fund involvement that the assets that are financed in such a way are not represented in the balance sheet of the municipality during the term of financing, the burdens of financing are actually the lease fee and the PPP fee that formally count as current expenses. This fact is important because the representation of these items among long-term liabilities[37] is not obvious. From the aspect of contents, PPP is a misleading name, as it is not in every case that genuine risk-sharing is established between the private investor and the budget.

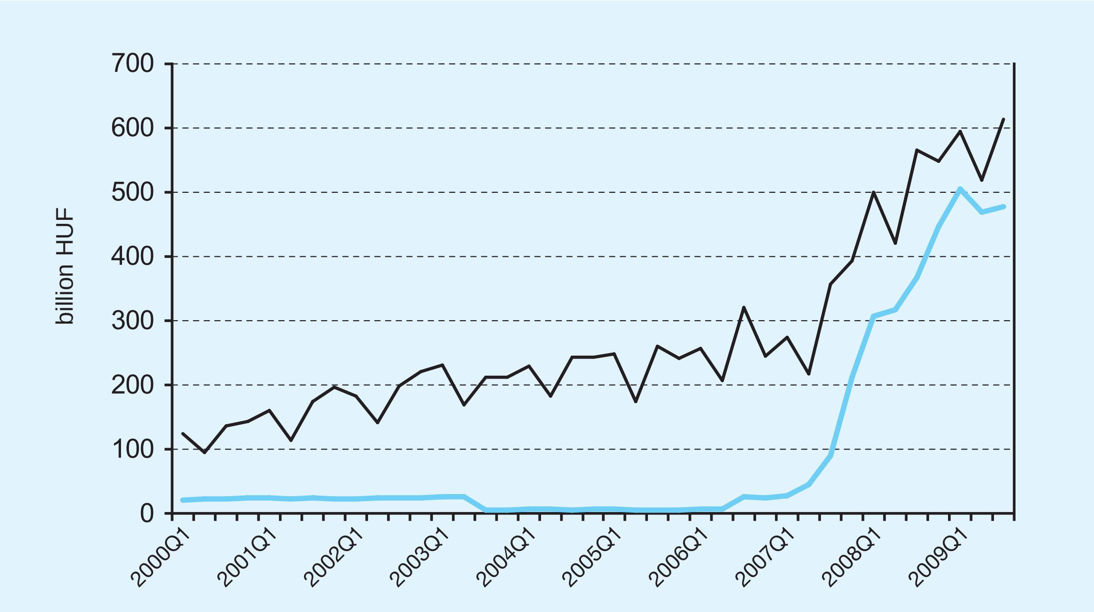
However, the involvement of external funds by the municipality always has such an upper limit both from the side of the creditor and the borrower, the reaching of which gravely jeopardizes the creditability of the municipality in question. This upper limit of indebtedness can be measured and quantified by using the concept of *"financial capacity".*

*Chart 5* shows that the increase of the funds of the municipalities was typically due to the "external funds" coming from the bond issuances. This, however, may appear as "own funds" in everyday financial management, which may lead to serious "optical illusions". It also turns out from the chart that the municipalities reserve a decreasing proportion of the issued bonds as bank deposits.

The credit decisions of the commercial banks that finance the municipalities are driven by several factors at the same time, the motives of which can be seen in the NBH lending survey.[38] The lending decisions and those on the subscription of the issued bonds are of course preceded by a debtor rating procedure but the decisions on the actual allocations are primarily not driven by the conclusions reached in the credit risk proposals. The situation is that the banks regard the municipalities as the clients with the lowest risks. Furthermore, the direct and cross-selling[39] revenues from account management are an important aspect and a competitive advantage[40] in the market. Besides all these, "questions of prestige" and strategic aspects also play an important role, which are caused by the strong competition on the supply side. Our research has shown that the

*Chart 5*

**EVOLUTION OF THE FUNDS OF THE MUNICIPALITES AND THE ISSUED BONDS**




*Source:* NBH

debtor and credit rating systems of the banks are not able to reflect the actual risks involved by the allocations. This is partly explained by the information asymmetries between the banks and the municipalities, which limit the clear sight of the creditors with regard to the financial management of the municipality in question. The main reason for this lies in the current standards of the financial reporting system and the public finance information system.[41] We think that the system of indicators described earlier better supports risk assessment in the current public finance information system as well. A genuine solution would of course be the modernization of the public finance information system.

The behavior of the creditors (the banks subscribing the bonds) is characterized by a certain level of irresponsibility as well. It also turns out from the lending survey that they count on the state to save them if the large local governments face financial difficulties. The municipalities that struggle with payment problems may initiate the launching of a debt settlement procedure, and they are actually obliged to initiate such action against themselves if they have liabilities overdue by more than 90 days. It is not only the municipalities that may exercise this right but any of the creditors or suppliers may initiate the launch of a debt settlement procedure. This statutory possibility means that in the case of a debt settlement procedure, the long-term liabilities will also become the subject of the procedure, which will deteriorate the position of the lending banks. Although it is stipulated by the Act on Debt Settlement Procedure that the state will not be held liable for the obligations undertaken by the municipalities, the banks still think that the funds allocated in this sector are somehow covered by implicit state guarantees. This is a typical case of the moral hazards taken by the municipalities to the detriment of the sovereign state level.

From *Table 2*, you can see that in the banks' allocations, *direct municipality exposures have* almost *tripled*. It is not possible to make statements on the indirect impacts, since we do not know the borrowing data of the companies owned by municipalities.[42] All in all, what we can say is that although the risk level of the municipality client segment is rising, they do not mean a critical factor for financial stability at the moment. It is not to be excluded that in the situation that has evolved, a need for consolidation will present itself with regard to the direct municipality debts (bank credits, bonds) within a few years. What is more, as a result of the size and concentration of the exposure, this also jeopardizes financial stability, due to the deterioration of the banks' credit portfolios. At this point, it should also be noted that long-term indebtedness renders the structural reforms in the municipality system difficult for this reason as well. The significant transformation of the local taxation system (such as the cancellation of the local business tax) *directly affects* the creditability of the municipalities, and through this, the quality of their liabilities. In the case of a major reshuffling of responsibilities and competences and the related changes in fund structure, it is not only the current ownership relations of the municipalities that will cause problems but who will inherit the earlier debts will also be raised as a question. In the case of the transformation of the Budapest municipality system and the reshuffling of responsibilities and funds between the county municipalities and those of the cities with county rights, this will be an important "question of detail".

## The effect of the municipality system on fiscal stability

*The sustainability of the Hungarian public finance system should be jointly ensured by the central and local levels of the budgetary sector.* The local government sector, which accounts for almost one quarter of the expenses of public finances, continues to carry fiscal risks, which have even strengthened since our study prepared in 2009.[43] Some of the fiscal risks aris-

*Table 2*

**THE EXPOSURE OF DOMESTIC BANKS TO THE MUNICIPALITIES***

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| Forint credits (billion HUF) | 91.9 | 115.5 | 135.5 | 167.3 | 263.9 | 267.9 | 239.9 | 276.1 |
| Forex credits (billion HUF) | 19.9 | 25.8 | 37.8 | 62.1 | 67.2 | 74.3 | 92.4 | 98.6 |
| Bonds denominated in Forints (billion HUF) | 1.7 | 2.0 | 1.9 | 1.5 | 2.2 | 25.4 | 47.4 | 79.0 |
| Bonds denominated in foreign currency (billion HUF) | 0 | 0 | 0 | 0 | 21.8 | 166.1 | 349.1 | 425 |
| Total exposure (billion HUF) | 113.5 | 143.3 | 175.2 | 230.9 | 355.1 | 533.7 | 728.8 | 878.6 |
| *Municipality exposure as the percentage of the balance sheet total* | *1.0* | *1.1* | *1.2* | *1.3* | *1.7* | *2.2* | *2.3* | *2.7* |
| *Exposure of the six banks that took part in NBH's lending survey* | – | – | – | – | *2.7* | *3.4* | *3.8* | *4.5* |
| *Proportion of foreign currency financing (%)* | *18* | *18* | *22* | *27* | *25* | *45* | *61* | *59.7* |
| *Proportion of long-term financing (%)* | *77.50* | *79.70* | *78.10* | *76.60* | *80.50* | *87.10* | *91.21* | *90.7* |

*The banking system excludes MFB (the Hungarian Development Bank), KELER (the Central Clearing House and Depository) and EXIM (the Hungarian Export-Import Bank)

*Source*: NBH

ing from the sector include the risks involved by the increased GFS deficit and the unpredictability of the deficit. *Table 3* indicates that it is also reckoned with in fiscal planning.

The aggregated GFS deficit of the sector improved by more than 100 billion Forints from 2006 to 2007. In 2008, the position improved by a further amount of 70 billion Forints. This happened despite decreased central support. We have to mention two such factors which had a one-time effect on the overall balanced budget. One of these was the high amount of interest income in 2008, the other one was the nominal decrease in cumulative expenses. While cumulative expenses amounted to 682 billion Forints in 2006, the respective amount was 583.7 billion Forints in 2007 and 550 billion Forints in 2008.

It turns out from the budgetary data that the contribution of the municipality sector to the consolidated public finance deficit is growing both in the cash-flow and the ESA data.

For 2010, the budget reckons with a municipality deficit that will reach 0.6 percent of the GDP (twice the amount of the previous years), which will very probably be even higher. Two factors that strengthen each other need to be emphasized. One of these is that, due to the bond issuances, a significant part of the liquidity that has accumulated in the municipality system is being spent. The probability of this is strengthened by that 2010 is also the year of local elections, and what is more, as has already been mentioned, the past few years have seen a *nominal reduction* in the municipality cumulative expenses *as well.* These facts signify significant postponed investments, which are in line with the goals of the central government. It is especially important to mention the spending related to EU tenders here. However, it is hard to imagine that this self-restraint will be exercised again, as is explained in the 2010 budget. It may mean a further negative effect, although to a lesser extent, that the improvement of the net interest position that showed a negative value of 12 billion Forints back in 2007 to 15 billion Forints by 2009 is not continuing, and what is even worse, the balance is expected to be deteriorated by the net interest position by 2010. This group of factors means the effects that are hard to control for the central government.

The other group of factors can be controlled by the central government, in principle. It is this group of factors that is usually taken into account by the professional public opinion and the analysts. The National Bank of Hungary counts on that the central budget's expenses on municipalities will exceed 0.3 percent of the GDP. The underplanning of the expenses by the “Way to Work” program (0.1–0.2 percent) and BKV's (the Budapest Public Transport Co.) need for extra support[44] are considered to be the main contributing factors to this.

*Table 3*

**DEFICITS OF THE CENTRAL BUDGET, THE MUNICIPALITY SECTOR AND THE PUBLIC FINANCE SYSTEM EXPRESSED AS A PERCENTAGE OF THE GDP**

| Description | 2008 | | | 2009 | | | 2010 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Cash-flow plan | Cash-flow actual | ESA actual | Cash-flow plan | Cash-flow preliminary actual | ESA preliminary actual | Cash-flow plan | Cash-flow actual | ESA plan |
| Central budget | –4.2 | –3.3 | –3.6 | –2.8 | –2.6 | –3.0 | –3.2 | | – 3.3 |
| Local governments | –0.4 | 0 | 0 | –0.5 | –0.3 | –0.4 | –0.7 | | –0.8 |
| Public finance, total | –4.7 | –3.5 | –3.8 | –3.2 | –3.6 | –3.8 | –4.2 | | –3.8 |

*Source*: own edition on the basis of data from KSH (the Central Statistical Office) and PM (the Ministry of Finance)

The reduction of the *net financial* property of the municipality sector may be considered a sign for concern, which is illustrated by *Table 4*. This value was calculated on the basis of the NBH data but *differently* from the methodology applied in the SNA financial accounts. The difference comes from the fact that from the difference between the financial assets and the liabilities, we deduced the value of other shares and participations. These mean participations in the economic associations owned by the municipalities and performing obligatory local government tasks. We applied the different calculation method based on the consideration that financial property (financial assets) includes an item which is an asset in the formal accounting sense but it is more a liability in the economic sense. This item is the participation of the municipalities in the economic associations that they own. The overwhelming majority of these economic associations perform *obligatory local government tasks.* The marketability of these business shares is limited, the municipalities are obliged to perform these tasks even when the economic associations face financial hardships. These balance sheet items are assets (positive assets) according to the formal accounting approach, still, in the economic sense of the word, they are not assets, they are rather liabilities, since these companies perform such tasks with assets in deteriorating condition whose provision the municipalities cannot terminate. Whether we think of the water utilities network or the city public transport networks, or even the economic associations that run these, we can see material risks in their operations. The potential credits of these companies are usually guaranteed[45] by the owner. This is why we followed the line of thought whereby we deduced the value of other shares and participations from the difference between financial assets and liabilities. Thus, we interpreted these participations in the economic associations owned by the munici-

*Table 4*

**CHANGES OF THE NET FINANCIAL PROPERTY OF THE MUNICIPALITY SECTOR**

(HUF billion)

| Description | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| **Financial assets** | **1 104** | **1 074** | **1 134** | **1 132** | **1 136** | **1 251** | **1 483** | **1 453** |
| *Cash, deposits* | *220.5* | *212.6* | *243.0* | *241.2* | *274.6* | *382.1* | *522.3* | *544.5* |
| *Securities other than shares* | *76.9* | *55.3* | *70.7* | *52.5* | *42.5* | *50.7* | *89.4* | *25.6* |
| *Credits, loans* | *70.6* | *71.3* | *79.4* | *84.2* | *82.8* | *60.8* | *63.9* | *79.3* |
| *Ownership shares* | *697.7* | *692.2* | *697.5* | *705.9* | *710.5* | *700.3* | *754.5* | *746.4* |
| From these, shares on the Stock Exchange | 19.4 | 25.6 | 36.3 | 45.4 | 45.4 | 25.6 | 18.7 | 4.3 |
| Investment units | 15.8 | 14.1 | 16.7 | 15.7 | 11.8 | 16.4 | 13.2 | 9.6 |
| Other shares, participations | 662.5 | 652.5 | 644.5 | 644.7 | 653.3 | 653.3 | 722.5 | 732.5 |
| **Liabilities** | **400** | **426** | **533** | **647** | **822** | **1030** | **1208** | **1.297** |
| *Securities other than shares* | *24.5* | *5.7* | *6.5* | *4.4* | *27.4* | *209.2* | *436.5* | *485* |
| *Credits, loans* | *241.6* | *276.7* | *366.6* | *415.4* | *543.8* | *576.8* | *564.8* | *594* |
| From these, credits from Hungarian credit institutions | 115.1 | 144.0 | 182.4 | 241.5 | 347.3 | 358.5 | 348.4 | 379 |
| Credits taken from abroad | 46.9 | 62.4 | 83.7 | 100.3 | 122.9 | 132.2 | 131.7 | 148 |
| **Net financial property*** | | **–5.0** | **–43.7** | **–160.0** | **–339.7** | **–427.2** | **–447.6** | **–576.5** |

*Value calculated differently from the SNA methodology

*Source*: NBH

palities and performing obligatory local government tasks as "neutral" items, i.e. ones that do not increase or decrease the property.

It causes a problem in itself that *practically no information is available on the quasi-fiscal sector of the local government economy.* In *Table 5*, we have summarized those pieces of information which was available from the public finance information system for this scope of the players of the economy for 2007. Since the role of the economic associations is different for the different types of municipalities, we have shown the data in such a breakdown.

We can only have suspicions on the financial situation and role of the economic associations owned by municipalities in the current public finance information system and on the basis of tax statistics.[46] The *magnitude* of the significance of the public utility companies owned by municipalities is indicated by HVG's TOP 500 statements.[47] What turns out from the situation of the capital is that the public utility companies mean an important part of municipality financial management, as only the number of the employees of the 5 largest companies is around 20,000. In 2008, the budgetary expens-

*Table 5*

**NUMBER OF ECONOMIC ASSOCIATIONS OWNED BY MUNICIPALITIES AND OWNER LOCAL GOVERNMENTS**

| Type of municipality | Majority local government/economic associations owned by multi-purpose small region associations | Municipality-owned in 0–50 percent associations owned by multi-purpose small region associations |
|---|---|---|
| Capital | | |
| Companies | 40 | 4 |
| Owner local government | 1 | 1 |
| Capital district | | |
| Companies | 69 | 40 |
| Owner local government | 20 | 20 |
| Village | | |
| Companies | 509 | 669 |
| Owner local government | 828 | 828 |
| County | | |
| Companies | 28 | 59 |
| Owner local government | 14 | 14 |
| City with county rights | | |
| Companies | 198 | 141 |
| Owner local government | 23 | 23 |
| Town | | |
| Companies | 52 | 54 |
| Owner local government | 61 | 61 |
| City | | |
| Companies | 422 | 431 |
| Owner local government | 201 | 201 |
| **Total** | | |
| **Companies** | **1318** | **1398** |
| **Owner local government** | **1148** | **1148** |

*Source:* Hungarian State Treasury

es of the Municipality of Budapest calculated in the GFS system amounted to 436.5 billion Forints. The annual revenue of the largest public utility companies fully owned by the Municipality of Budapest was 38 percent of the budget of the Municipality of Budapest (by taking all the listed economic associations into account, 51 percent). They also represent considerable weight in the case of the cities with county rights. Debreceni Vagyonkezelő Zrt (Debrecen Asset Management Co.) is at place 375 of the HVG top-list with its annual revenue of 20 billion Forints. This is about 40 percent of the city's budgetary expenses.

## A FEW THOUGHTS ON THE MODERNIZATION OF THE MUNICIPALITY SYSTEM

The overview presented in the previous section also confirms the majority professional opinion that *the 20-year-old system should be paradigmatically reconsidered.* In this section, we have explained our thoughts on this subject in such a way that we have established links with the proposals of some other research programs that took place at ÁSZKUT.[48]

We think that *the key area of the meaningful modernization of the public sector is the system of local governments.* This is so not because this is what most of the money is spent on, and not even because we think that it is here that we have the highest amounts of reserves. The reason is simpler, and at the same time, more complex that that. We refer to the role of conflict container[49] fulfilled by the sector and also, that the realized decentralization does not really support the enforcement of the subsidiarity principle. We firmly believe that the majority of the problems to be faced in the upcoming period (in the area of the protection of the environment, the meeting of the EU requirement on sewage cleaning, the improvement of competitiveness at the local sites, employment, implementation of Roma integration, the treatment of deep poverty, etc.) cannot be resolved without the modernization of the system of local governments either.

It is a further important argument of ours that *the key issue of reconsidering state involvement*[50] *and the reshuffling of priorities is the reshuffling of tasks between the central and local levels*. We think that the elaboration of systems-based reforms may be the result of the cooperation between several professions and politicians. We are also sure that *several possible and viable* solutions exist. In the following part of the article, we meant to show how the birth defect of the current "Hungarian model" can be avoided, namely that a new "mule" is born by using the elements of the various international "models".

The paradigmatic and comprehensive modernization of the municipality sector *should be tackled in a systems-based approach* in two aspects. On the one hand, integration into the Hungarian public policy situation is an important question of consistency, i. e. the coherent system of the distribution of tasks between the individual levels of government, the clear definition of the contents of the undertaken public tasks in a financeable extent.[51] On the other hand, the issue of sub-national governments should also be tacked in a complex manner, *in at least four dimensions*. Based on these dimensions, a high, if not infinite number of good solutions exists. One thing is for sure. Disregarding any of the dimensions in the course of the implementation of the structural reforms will necessarily lead to inconsistencies. When we are talking about complexity, we do not mean that the problem needs to/may be solved "in one rush". However, the individual partial reforms have to be consistent and they should have in mind some kind of vision, which is based on a professional and political consensus. In the next part of the study, we would like to bring up those main issues which have crystallized about the municipality reforms as a result of the various research efforts.[52] We find it important to note that in the course of making decisions, the legislators should endeavor to establish a consistent system.[53]

With regard to *constitutional status and public administrative position,* we will mention three key issues. One is the public administrative position and the allocation of the state administration tasks performed by the municipalities. The other one is the necessity to strengthen the municipality middle level. It would also be an important issue to settle the situation of the privileged and internationally unknown status of the cities with county rights and through this, the situation of the middle levels with "gaps". We should not forget about the critical need to develop a cheaper and viable capital model either. An issue that should be discussed here is the limitation of the boundless owner's authorizations of the municipalities, which is a major "technical" obstacle to all kinds of public policy reforms. My opinion is that withdrawing the right of the settlements to self-government is *not a condition* to creating an effective and efficient performance of local public tasks. The political and public policy costs of such a step would greatly exceed its benefits.

As regards the *allocation of municipality tasks,* it is three issues that should definitely be resolved. The first question to be decided is in what scope the tasks should be decentralized from the central level, and recentralized from the local level. The second question is by what legal technique the differentiated allocation of tasks and competences between the settlements (town, city, big city) and the regional units (sub-region, agglomerate, region) is doable. The third issue is to decide which should be the tasks to be resolved by obligatory cooperation between the settlements and in what framework the obligatory association should be realized in the case of the services with very different "business administration" characteristics (public administration, human services, the operation of the infrastructure). The solution is closely linked to the comprehensive question of what role the state should fulfill in Hungary.

As regards the modernization of *the organizational framework of the performance of municipality tasks,* the scope of task performance and operational rules of the budgetary institutional frameworks and those outside the budgetary sector (economic associations in private ownership, private firms, PPP's, non-profit organizations[54]) should be reviewed. Besides the modernization of the financial management of the budgetary organizations, the special corporate governance rules of the economic associations that perform obligatory local government tasks should especially be introduced,[55] by strengthening the control of the public funds and community property used by the economic organizations that perform public tasks but do not operate in the budgetary system. We assign special significance to the better organization of investment activities by the municipalities.

The question of the *financial system* covers the financing system (fund structure and fund allocation) and the institutional securities of financial discipline. With regard to fund structure and fund allocation, the most important issues include the proportions of funds of the municipality's own right and those received from other levels of government, the dilemmas of tax or fee financing of municipality services, the type of the system of local taxes, as well as the allocation mechanisms of the central operational, balancing and development transfers. Decisions should be made on the new rules of tax sharing and the allocation tools of the state contributions. It is a fundamental question whether the logics of allocation should be adjusted to the free use or earmarked subsidies, and what kind of system for delivery we should apply. An adequate support system adjusted to the broadening sub-national tasks is the subject of sharp international disputes.[56] There are disputes about the proportion of free use or earmarked subsidies just like about the expedient local taxation and tax sharing solutions. In the case of delivery,[57] several solutions seem to be feasible as well. Thus, such is the subsidy system based on the detailed review of tasks (this is valid for some of the earmarked normative grants), just like indicator-based delivery (the normative state subsidies are typical examples for this), or the system of self-appointment. The latter is valid in the distribution of the development funds in tenders, as well as in the case of supplementary operating subsidies such as ÖNHIKI, i.e. the subsidy given to municipalities struggling with problems beyond their control. Selection from the techniques may be based on considering the support objectives and the allocation costs. It should also be taken into account what stimulating effect is exerted by the individual techniques. The invitation of tenders, which is a classic self-appointing technique in many cases, as has been shown by the municipality development financing of the past 20 years, is expressly dysfunctional. The costs of allocation based on a detailed review of tasks are high, so its application obviously needs to be thoroughly considered. Also related to this, the establishment of an information management system that would create the basis for better than today's financial management cannot be escaped, nor can we avoid ensuring the conditions for national economic, local strategic and financial planning.

There are *two key issues* related to the institutional system of financial discipline. One of them is the hardening of the borrowing limit for municipalities. The basis for this is the elimination of the institution of the standard municipality monetary fund. It is a further element of regulation that the total borrowing of the municipality sector for cumulative purposes should not jeopardize the achievement of the national economy level ESA deficit target, or, if you wish, the deficit quota of the municipality sector should be defined. In other words, we can say that the rules-based nature[58] of the budget should be extended to the municipality sector.[59] Last but not least, the extent of borrowing should be adjusted to the financial capacity of the municipality, i.e. insolvency should be avoided.

The other important institutional security for the financial discipline of the municipalities is *the modernization of the auditing system*. The limited and preliminary control authorization of the Hungarian State Treasury, the possibilities of the restoration of compliance audit and the improvement of its genuine role, the roles of special audits, the obligatory municipality audits, as well as the independent audit office controls should all be harmonized.

The reform *should contribute to* task performance that is more effective than today's, *operations that are considerably more transparent* than now *and the reduction of wasting inherent in the system*. Effective reforms may be realized as a result of systems-based changes.

However, one must be aware of that, as a result of the situation described in the earlier sections of the study, there are two issues that cannot be disregarded by any paradigmatic municipality reforms.

One of these is that *the consequence of financial risks must be faced.* The fund structure of the municipalities, which is closely linked to the government ideas on the tax system, should be thought over, just like the handling of the situation of settlements that lack funds, and the management of the accumulated municipality liabilities (debt represented in the balance sheet and those off the balance sheet). The latter is especially important if there is a change in the responsibilities and competences, and thus, in the fund structures of today's types of local governments.

The other factor is that *without the modernization of the current information and planning system of public finances, the intended public policy effects of the changes will not materialize.*[60] Both factors mean that after the relatively quickly realizable symbolic reforms (changes in the numbers of local government representatives), the turnaround time of the steps that will involve meaningful operational changes may even be several years.

Due to the complexity of the area, a big bang kind of reform *is inconceivable.* A kind of "symbolic reform" may be a possible starting point but a paradigmatic transformation partially depends on the distribution of tasks between the state and the municipality, and partially on the public policy solutions related to the public administration system and the welfare systems. The acute fiscal situation, in turn, means further difficulty for the implementation of clear solutions.[61]

*With regard to the financial system, it is justified to answer three questions that are unavoidable as early as when the transformation is started.*

❶ How can the balance between tasks and funds be restored? This question brings up the issue of the fund structure (proportion of local taxes, shared taxes and state contributions) of the municipalities, which is closely linked to the overall question of the taxation system.

❷ The issue of making the conditions of financial management, more precisely, the resource regulation system predictable and transparent. Trust between the two levels of government should be restored, the conditions of cooperative behavior should be created. This includes the enforcement of the offsetting and stimulating effects of resource regulation much better than today.

❸ The settlement of responsibilities for asset management. The regulation of undertaking long-term commitments, the reconsideration of ownership authorizations, ensuring the harmony between the tasks and the assets that is aimed to serve the performance of these tasks, as well as the prevention of the using up of the assets also belong here.

The elaboration of paradigmatic reforms will of course require wide-ranging and harmonized action. I hope that the ÁSZKUT conference will contribute to this process.

## Notes

1 See, for example, Davey (2000), Horváth (2009), Pálné (2008), Vigvári (2008).

2 The concept was introduced by Pálné (1990), based on international literature, more precisely, Offe. See also Ágh (2006) and Vigvári (2009).

3 See Vigvári (2006a).

4 See Szalai (2002).

5 Related to this, see Lóránt (2009), Pálné (2008), Varga (2004) and Vigvári (2008).

6 We do not use the expression 'solvency' that is usually used in the business sector because the municipalities cannot be dissolved without a legal successor.

7 This will happen in the next research program indicated in ÁSZKUT's (Research Institute of the State Audit Office) research plan.

8 See ÁSZKUT (2009a).

9 Without aiming to give all references, I would like to call your attention to the public finance theses of the SAO, published by the State Audit Office (2007) and the studies of Zsuzsa Kassó, Kassó (2006a) and Kassó (2006b).

10 Besides, they are not suitable for supporting performance-based budget planning and cost-sensitive financial management either.

11 The financial statistics are prepared by the National Bank of Hungary.

12 See Béhm's manual (1997) on the financial indicators.

13 The description of the theoretical background of this concept would exceed the scope of the presentation. See László -- Zsámboki (1995).

14 Since the reliability and long-term comparability of the data specified in the funds flows prepared by the municipalities is questionable (see Kassó, 2006a; Kassó, 2006b), starting out from budget data means an advantage.

15 Győrffi – Vigvári – Zsúgyel (2009) analyze the various concepts of the budget deficit in detail.

16 These seem to be crystallizing in international practice as well. See the methodologies applied by the various rating agencies, or INTOSAI's material written by its work group involved in state debts (INTOSAI, 2003)

17 By delivery, we mean whether the central subsidies in fact finance the task to be replaced and/or exert a stimulating effect. On the possible techniques of delivery, see Chapter 6 of Barr (2009).

18 We do not propose that the standard indicators calculated from the funds flow be used, due to the unreliability of the information specified in the funds flow.

19 See, for example, the different types of leases and PPP, and as a unique"wilding", even long-term bills of exchange have appeared.

20 The theoretical significance of this is given by that the "budgetary golden rule" says that credit financing is permissible in the case of cumulative expenses.

21 Such a case is when it is defined by law what items can be taken into account in the calculation of the borrowing limit.

22 The best example here is the continuous changes in the rules of tax sharing.

23 Local taxes, duties and fines

24 The Local Government Act can be regarded as the conclusion of the council reforms that had commenced earlier, with regard to the rules of financial management. Numerous elements of the current financial system had been prepared before the two-third law.

25 The employment problems arising from the deterioration of the economy in the country and the consequential deep poverty are typically such problems.

26 Well-known tools include the ÖNHIKI (subsidy given to municipalities struggling with problems beyond their control) (Appendix 6/1 of the Budget Act) and the supplementary support given to municipalites that are unable to operate (Appendix 6/3 of the Budget Act).

27 See, for example, Price Waterhouse Coopers's study entitled Indebted Municipalities published in May 2010.

28 See PwC (2010).

29 This would be necessary not only for fiscal reasons but also, to see the consequences of imprudent financial management.

30 We do not repeat the analysis and assessment provided in ÁSZKUT (2009a).

31 In April 2007, the then Finance Minister Mr. János Veres projected the introduction of tightening measures in one of his presentations, and in the autumn of the same year, the government submitted its proposed amendment for Section 88 of the Local Government Act.

32 These are special speculative operations that mean the utilization of the different interest levels of the different foreign exchanges for gaining profits.

33 On the involvement of external funds by the municipalities, see El Daher, S. 1997; El Daher, S. 2004; Kopányi – Vigvári (2003)

34 Our public procurement expert does not think that reference to the EU law is right.

35 Of course, you should not take it as a statement of absolute validity.

36 Such regulatory arbitrage may be aimed at evading some budgetary rule, or misleading the affected voters, or even political bodies.

37 See the section on financial indicators.

38 In order to provide a basis for its financial stability reports, NBH has been asking the players of the Hungarian banking system about their credit allocations in a questionnaire-based survey twice a year

since 2003. Besides the corporate and retail credit allocations, municipality lending has also become the subject of the survey since the autumn of 2007.

39 For example, the fact that the banking relationships of the municipality employees and the companies owned by the municipalities are also concentrated at the account-keeping bank

40 If the Treasury proposed in ÁSZKUT's (2009a) analysis was realized, the municipalities would probably mean a less attractive financing target, and/or the banks would increase the risk margin of the funding that they provide.

41 This is partly why the earlier described new indicator system is important.

42 The already mentioned out of the budget risks are not reflected.

43 ÁSZKUT (Research Institute of the SAO) (2009a)

44 NBH (2010b), p. 78

45 It is important because of these characteristics to have more in-depth knowledge of this sector. We have started this analysis in Section 4 of the study.

46 There is an ongoing research program at ÁSZKUT, which tries to "get closer" to this segment by processing the Tax Authority data gained from the corporate income tax returns.

47 In the first issue of each year, the weekly Heti Világgazdaság (HVG) shows the key charts of the 500 biggest companies based on the corporate income tax returns.

48 We first of all mean the research programs substantiating the study entitled The Regulatory Theses of Public Finances published by SAO (Báger – Vigvári, (2007)), the research program on state involvement (ÁSZKUT, (2009b)) and the one related to the modernization of the planning system. From the analyses of this subject in other workshops, Stumpf (2009) and Századvég (2009) deserve mentioning.

49 See on this, ÁSZKUT (2009a) and Vigvári (2010).

50 See on this, ÁSZKUT (2009b).

51 See, for example, the Financial Research Institute (2007).

52 Without aiming to give a full list of references, Davey (2000), Horváth (2009), Pálné (2008), Vigvári (ed.) (2007)

53 By using a simile: if in a Rubik cube game, we only concentrate on completing the colors of one side, we may face a situation where trying to turn the other sides will destroy the completed side.

54 Including the actual non-profit and church-sponsored institutions as well

55 This proposal is not new, see Vigvári (ed.) (2007b) but the scandals of the past few months have indicated the absurdity of the situation.

56 See the Council of Europe (2009).

57 The behavior of the affected players largely depends on the allocation techniques of the subsidies.

58 See on this, Kopits (20004) (ed.).

59 This was implemented on the central level of public finances, at least on the level of statutory regulation.

60 In other words, we are stating that the contents of the document entitled Theses of the Regulation of Public Finances submitted by earlier President of SAO Mr. Árpád Kovács are still valid (State Audit Office, 2007).

61 For instance, meeting the sensible requirement of the management of depreciation costs is hindered by the fact that in the current situation, there are no funds for the replenishment of the property.

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