

Gábor Péteri

Is the conflict container full, or which way is the container trailer going?

Issues of the transformation of the system of local governments

In this article of his, *András Vigvári* undertook to evaluate the public service system of the local governments in a completely new light. In his thorough analysis built on detailed financial data, he first of all discusses the indebtedness of the local governments. His starting hypothesis, and at the same time, his approach, rests on the measurement of financial risks: he thinks that the credit portfolio is too high as compared to the budget of the local governments, besides which the conditional commitments of uncertain extents can also jeopardize the operability of the local public service system.

In my comment, I will examine three issues.

① Are the municipality financing problems in fact so grave and can the solution of the problems of the local government structure and financing model be achieved by applying a financial risk analysis for them?

② At which points is intervention necessary in order to be able to improve the allocation of local government tasks, their structure and the financing position?

③ Finally, I will briefly discuss what the actual conditions of organizing a higher scale program of local government restructuring are, what we have been missing in this respect in the recent years.

A PROBLEM, OR NEW PHENOMENA?

Taking out credits, indebtedness, undertaking conditional commitments

If we look at the budgetary figures of the past few years, we can see that the credit portfolio of the municipalities has significantly increased and by now, its value exceeds even a thousand billion Forints. This taking out of credits, which has grown rapidly since 2005, was realized almost exclusively from the issuance of bonds. Now as much as 63 percent of the credit portfolio is foreign currency-based. This is definitely a new phenomenon but the question is whether the high volume of credits is in fact such a big problem.

It used to be an often voiced criticism of the city municipalities that the financial managers in charge of managing the budgets of several billion Forints do not utilize the modern market and financial management tools to the full and as a result of this, they miss potential revenues. It was also criticized that in the area of infrastructural developments, the fundamental principle that the investments that pay off in a longer period of time can be implemented from credit financing much more rapidly, was not

followed. Now that changes are at last in their forming in both areas, this process cannot be regarded as harmful.

The larger municipalities only used the opportunities of the pre-crisis period when they accepted the funds offered by the monetary market. These were obviously needed for the financing of the EU subsidies and the pre-financing of the projects. The issuance of bonds was encouraged by that the mostly private issuance was supported by the banks, they could be performed without a public procurement process and repayment was also put off by the grace period. The majority of the funds obtained in such a way were reserved by the municipalities as deposits in the banks at the beginning and in the middle of the election cycle. By the way, the Polish municipalities acted in a similar way in this period.

All this is well reflected by the “net operating profits” indicator applied in the study as well. In 2006–2007, this indicator got into a slightly negative range in the case of each type of the municipalities under review. However, there is no clear process of indebtedness of a dangerous extent, the trend seems to be reversing by now. The level of the debt portfolio of the municipalities is between 35–45 percent in the country as compared to the revenues of the current year. (This is only 11 percent in the case of villages.). The debt portfolio is compared to the municipalities' own revenues in the study but a genuinely accurate indicator would be the comparison of the burdens of credit repayment and the expected evolution of the municipalities' own revenues, of which, however, we do not have any data. However, according to the available data, the comparison of the portfolios also indicates that the level of indebtedness of the municipalities is not alarmingly high if we take the system as a whole and look at the national averages.

New public management in the crisis period

The subject of the financial risk analysis applied in the study also covers the review of the guarantees undertaken by the municipalities as owners. According to the study, the amount of guarantees undertaken out of the budget is 11,4 billion Forints in the case of the 2,730 majority- or minority-owned economic associations, which amount almost fully appears in the cities outside Budapest. This amount may seem to be high but if we create other indicators in the course of risk analysis as well, we can see that the situation is not that bad: the amount of conditional commitments is 9–10 million Forints if projected on one economic association, only 134 million Forints in the average of a city with county rights, while in the case of other cities, it is 26 million Forints.

It is exactly because of this that it would not be right to make far-reaching conclusions from this single fact, and question the organization system of public utilities services in the past decade. The form of the economic association, the professional investors, as well as the diverse service organization and financing techniques (concessions and other public/private partnership solutions) brought capital, know-how and improved efficiency into local water and waste management, distant heat supply and other settlement operational services. The integration of services was realized by the market (for example, the number of waste repositories decreased from 2,600 to some 140). The settlement operational holdings of the big cities are built on economic rationality, although of course the large organizations carry their own operating risks due to the more indirect nature of owner's influence in the large organizations.

The phenomenon seen in the recent period, i.e. that the operator companies of mixed ownership have been bought back by the municipalities, has always had unique reasons charac-



teristic of the city in question. For instance, in the case of Pécs, the spectacular “reoccupation” of the waterworks was, among others, necessary because the foreign minority owner had a majority vote in the Board of Directors, and they started to pursue a business policy of buying up smaller service providers and spreading by getting indebted, which arose from the market logics. This process could not be controlled and prevented by the owner municipality but it does not mean that the structure is wrong, it only indicates that the influence and regulatory competence of the majority owner were weak.

Thus, in the current period of budgetary restrictions, it is not the organizational and financing solutions developed in the system of new public management that should be fully disregarded but the proportion within the model should be changed. This is a natural part of the learning process, during which the regulatory system should be strengthened now. And there is a lot to be done here. We do not know the answer to even such basic questions as, for example, exactly how many water supply organizations there are in the country, what kind of pricing policy is applied by the municipalities responsible for determining the prices in the public utilities sector, how the central water charge support of 4.5–5 billion Forints is allocated. All these would mean relevant information for the local governments. The participants of the decentralized service system can learn best from each other, so a benchmarking built on publicly available data would be important for the local decision-makers, the owners, the consumers and the managers of the companies alike.

BALANCE OF TASKS AND RESOURCES

So, all the problems discussed in the study are important and are burdened by considerable conflicts on the municipality level. But in order

to be able to introduce solutions that affect the local public services as a whole, it is some other elements of the system that should be transformed. As consequence of the significant level of decentralization that was accomplished in Hungary, the “conflict container” of the municipalities is in fact full, as many problems were delegated to the local level by the budgetary restrictions and certain steps of the transformation of the public sector. But for the development of the reforms, the following issues should be examined: what the most relevant problems are, what changes have taken place in the past few decades of the municipality system, i. e. what the processes that determined the development of the “container” are characterized by.

Political independence – rational approach to service organization

The institutional system of local governments that had developed by 1990 was built on local autonomy and the political independence of settlements. In the process of transformation, these were unquestionable values, which, along with the multi-party system and private property, became the fundamental elements of the new system. The municipalities with wide authorities and significant own revenues helped manage the problems involved by transformation, reduce the losses and utilize the development opportunities to a great extent.

This basic political value, however, was partially in conflict with the rationality involved by the organization of services. The local independence in selecting the forms of service organization promoted the efficient performance of tasks and the giving of effective responses to the diverse consumer needs. This, in turn, took the system to the direction of smaller decision-making units and stronger local influence. The prevention of population

flow to the cities and the utilization of the opportunities still available in village agriculture were promoted by the development of a system consisting of small-size settlement-based municipalities. Of course, by building on the principle of economies of scale, it was necessary to establish larger-size supply systems as well. The establishment of a rational operational size both in planning and in the area of human resource and public administration services was made possible by the municipality associations. On the other hand, this process was driven by the market liberalization of services in the public utilities-communal sector.

So, if we are looking for harmony between the political logics and the practices of service organization, it is the new balance of the two systems that should be created. This does not mean that we should weaken one of the elements (political autonomy) to the benefit of the other (the service system) but much rather, it means that we should transform the internal operational rules of the two system elements. This, in turn, requires the further development of the sub-regional and mid-level forms of municipality in the current system of local governments.

Multi-purpose sub-regional associations control 2.2 percent of the local government budgets. Half of the state subsidies that they receive are used for public education tasks (16 billion), besides which they get considerable state support (4.2 billion) for performing the basic social support tasks. By now, these associations of an average headcount of 47 thousand have become stable elements of the local public service system, as a result of the subsidy system and the public administration-political constraints. It would mean a great stride forward here to expand the range of tasks to be performed in the sub-regional association by making the professional requirements and standards of the settlement services stricter. Also, own revenues should be allocated to the

regional forms of government, for which purpose the local business tax could also be appropriate.

The other elements of the system that are ready for structural change are the county municipalities. In the development of the earlier regional government ideas, the goal was to strengthen the performance of tasks on the mid-level, extending to several counties and to moderate the isolation of the cities with county rights. For this, the dependence of county municipalities on state subsidies should be reduced. This can be achieved through ensuring own funds and increasing participation from the local, allocated revenues, or the assignment of new kinds of tax revenues to the regional municipalities.

Own resources and budgetary offsetting

It is obvious from the above that the future of task allocation and that of the financing system are inseparable from each other. The answer to the question what resources will be necessary for the new tasks in a different kind of structure should be jointly sought. Several different financing technical solutions can be applied in the same public service-public administration model. Anyway, today's municipality financial system can be further developed in basically two directions: the interests in the municipalities' own, local revenues should be increased and the methods of offsetting should be improved.

Currently, 43 percent of the municipality resources are made up by their own current and cumulative revenues, which is a rather significant proportion. Within these, the local taxes and especially, the local business tax (15 percent of the total revenues) are the key items. Surprisingly, these own resources were not even considerably decreased by the economic

crisis, even if we take the delaying mechanism of the regulatory system into account. However, from a theoretical aspect, the local business tax cannot be regarded as a good type of tax. The taxpaying enterprise is usually not entitled to take part in the elections, so it does not even have an indirect effect on the purposes or operation of the municipality that determines the taxes. As compared to the village average, the per capita local business tax revenue is 2.7 times of it in the average of the cities in the country, and 3.7 times of this in the average of the cities with county rights. However, it was exactly because of the significant weight of the local business tax (472 billion Forints in 2009) that this own source of revenue could not be transformed.

One of the potential alternatives would be the introduction of the property tax based on local values. However, despite several attempts, it seems like it is not possible to spread it widely in Hungary. Thus, the dependence on local revenues could only be strengthened by modifying the extent of the assignment of taxes. The new allocated tax, primarily on the level of the regional municipalities, could be a stable and foreseeably increasing VAT. On the other hand, at the local municipalities in general, the increase of the locally remaining Personal Income Tax participation could create a stronger interest in the revenues.

This, however, would require a different kind of offsetting policy. In the current fragmented municipality system of the settlements, there is a considerable but not unmanageable difference between the average per capita Personal Income Tax revenue of the villages and the average of the cities: the city average is 43 percent higher, while the average of the cities with county rights is 94 percent higher than that of the villages. The subsidy that offsets the local revenue capacity well handles this problem by its resource offsetting mechanism.

Changes are needed more in order to realize

a better offsetting policy aimed at the expenses and to encourage more efficient operations. This can be attained by modifying the internal proportions of the subsidy system and transforming the techniques of the central allocation of resources. From both the ÖNHIKI (subsidy given to municipalities struggling with problems beyond their control) and the system of allocating per capita state subsidies, a general purpose state contribution that supports the achievement of an average, estimated level of expenses and not the actual, existing service capacity, is missing.

Today, ÖNHIKI is received by the individual calculation of expenses and revenues by settlements. Per capita support (and the Personal Income Tax allocated on a normative basis), on the other hand, reach the local budget either simply in proportion to the population, or projected to the capacity of the institution run by the municipality. The latter form of support makes the municipality interested in maintaining the institution at all costs, rather than in the sensible organization of services. The allocation of resources simply in proportion to the population, on the other hand, disregards the differences between the individual settlements, in its system of unit costs.

These logics can only be changed by refining the indicators measuring the service needs of the settlements. This means that the subsidy amounts are calculated on the basis of the factors determining the costs of the individual tasks such as the population by age groups, the area, the level of urbanization, the length of the roads within the settlement, etc. By applying this method, the freedom of choice between the institutional forms will grow, and thus, the efficiency of the service system may also increase. If this system is further refined, the average, standard expense level could be calculated and the amount of the subsidies could be derived from this, after deducing the calculated revenue capacity.

However, a local government subsidy system is supposed to fulfill several objectives: guaranteeing a minimum service level, regional offsetting, ensuring interests in pursuing business activities. In order to reach these goals, the various state contribution and assigned tax revenue allocation methods should complement each other. The changes can only be implemented gradually, by modifying the internal proportions of the resources.

HOW TO REALIZE A REFORM?

The past few years have seen quite a number of proposals for the modernization of the municipality system, which has basically been unchanged for two decades. These professional and political ideas, however, did not tackle the methods of implementing the reforms, or the program of preparing and introducing the proposals of sectoral policy at all. Perhaps this is exactly why they were not successful, since several problems can be identified here.

First of all, those state research institutes which used to be involved in applied research and the preparation of decisions which could deal with either public finances or the further development of public administration, ceased to exist. Of course, some other organizations partially fill this gap but perhaps it is not the background institution of the State Audit Office that should develop the public finance reforms of the government, or it is not the academic institutions of regional research that should primarily undertake to perform the

tasks of modernizing public administration. Earlier, both areas had research and development institutes that supplemented the capacities of the relevant ministries. The consulting firms in the market can help a great deal in these efforts but they do not ensure the institutional continuity of the reforms and thus, they probably do not represent the most efficient solution.

It is partially related to the lack of professional workshops that the system of public budgetary information has not been established. Today, the data necessary for municipality financial modeling can only be accessed in possession of individual permits, and one has to pay for the information, while these are data of public interest, which should be disclosed in a manageable (electronic) form. The various professional proposals can only be tested in this way, and this would mean a great deal of help in the elaboration of government policies.

Finally, besides research capacities and access to information, the third key element of the preparation of reforms is the existence of a client that places orders. This, of course primarily depends on the political intentions but the formulation of government intentions is rendered difficult by the uncertainties about institutional responsibility. Earlier, responsibility for the modernization of the local governments and the local public service system was shared, and frequently changed, by both among the ministries (PM (the Ministry of Finance)-ÖM (the Ministry of Regional Municipalities)-sectors) and within the government (programs and ministries).