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Right and wrong paths – facts and data about local government management

The significance played by the local governments' economy within the national economy and public finance is reflected not merely by the total value of its assets worth more than HUF 11 thousand billion or by its expenditure and revenue totalling HUF 3600 billion, rather its significance is primarily represented by the total volume of public services provided by them. Let us only focus our attention on the most important human services: in the 12 thousand budgetary organisations (half of which have independent economic management), local governments provide care for 330 thousand children in 4 thousand kindergartens, for 790 thousand pupils in three thousand primary schools, for half a million students attending two thousand grammar schools, specialised secondary schools and vocational training schools, they must safeguard the management of 45 thousand hospital beds, 30 thousand places in social welfare homes. In addition to the above, it is the local governments' responsibility to maintain a road network of 166 thousand km (out of which 31 thousand km represent roads in built-up areas), 25 thousand hectares of green area, 3300 public cemeteries, it is also their responsibility to maintain a drinking water pipeline network of 65 thousand km with several million cubic metres

of water together with the indirect service of waste water disposal and treatment and also to operate dump sites for the disposal of several hundred million communal waste together with other communal services. The average citizen has a regular contact with the local governments that act on behalf of the service state when managing official affairs in various offices (office of government issued documents, office for housing and construction, tax administration, public guardianship authority). We can say that the economic management activity of the local governments is part and parcel of our everyday life "from cradle to the grave".

In this article I intend to analyse the present state of the local governments' economic management – based on the experience of the State Audit Office (SAO) – with a focus on the following three questions:

- the characteristic features of the local government system,
- regulations on the tasks and resources of local governments,
- the asset management of local governments.

Finally – instead of a detailed summary – I intend to describe why it is necessary to launch and to consistently carry out the structural reform of local governments.

SOME MAJOR FEATURES OF THE HUNGARIAN LOCAL GOVERNMENT SYSTEM

The idea to transform the system of local councils into local governments already surfaced in the 1980s. After the change of the political system, the Constitution declared that local governments exercise the community rights of the electors, emphasising democracy and autonomy as its focal points. The legal regulations, however, failed to specify the detailed conditions and procedural framework of exercising the powers of local governments. The Act on Local Governments belongs to the so-called “two-thirds” parliamentary majority laws representing a norm of constitutional character. It does not only represent stability but also reflects the difficulties and obstacles of amending the law. This difficulty is still palpable because *the system of local governments*, which replaced the former local councils in all settlements, *still carries the initial contradictions, which have not yet been corrected* (for example, the contradiction between the fragmented settlement pattern and a broad set of undifferentiated tasks, and between decision-making autonomy and limited economic and financial conditions), *contradictions which have lead to future operational disorders*. There is a separate law regulating the local governments of the capital city with the city districts operating side by side as independent units. In addition to the

district local governments, the Municipality of Budapest was also set up by the same law generating debates over competence. In 1994 the clout of the capital city was reinforced, but the main character of the system remained unchanged.

As indicated in *Table 1*, the system of Hungarian local governments has a fragmented pattern. I believe the crucial question is not whether the number of local governments is too high or too low. The principle underlying local governments suggests that the municipalities themselves should decide when and under what conditions they wish to exercise local executive power, including the employment of the mayor in line with the labour law. Accordingly, they should also decide what remuneration and cost compensation they want to offer to local government members (whether or not the central government “from above” provides financial assistance for them is a separate question). From the aspect of economic management, *less than 10 per cent of local governments represent genuine financial risk for the public finance* as far as budgetary and financial factors are concerned: in actual practice, this applies to the Municipality of Budapest, to the local governments of capital districts, counties, and towns with or without county rank. It is this group of local governments that manage 75–85 per cent of the local governments' assets and that of the annual budget allocated for the

Table 1
THE DISTRIBUTION OF LOCAL GOVERNMENTS ACCORDING TO ADMINISTRATIVE RANK

Capital/counties	Capital districts	Towns with county rank	Towns	Large villages, villages	Total
20	23	23	282*	2 846**	3 194
* of which: above 10 000 inhabitants		118		** of which: above 10 000 inhabitants	2
between 5 000–10 000 inh.		103		between 5 000–10 000 inh.	42
below 5 000 inhabitants		61		between 2 000–5 000 inh.	625
				between 1 000–2 000 inh.	477
				between 500–1 000 inh.	668
				between 200–500 inh.	698
				below 200 inhabitants	334

Source: Hungarian State Treasury (HST), Central Statistical Office (CSO)

whole system. It also means that the great majority of local governments operate only one or two institutions, and their tasks are limited to providing the basic public services only.

The Act on Local Governments created new forms of exercising local power with a broad autonomy to replace the previous system of local councils by focusing on the settlements. It created new problems vis-a-vis the territorial levels of the local government system, the performance of local tasks, financing as well as the territorial structure of central public administration. If we compare the Hungarian model with other European local government systems, we find – with some simplification – that we can consider its particular features reflecting a mixture of the Scandinavian system (wide-ranging tasks and powers with territorial concentration) and the Southern European system (relatively large number of local governments with varying tasks and powers at the different levels, mandatory associations). There are significant differences in the local government systems of the EU Member States, they have different resources for revenues in the public finance system and the weight and proportions of individual solutions for financing their tasks also show considerable differences.

CONTRADICTIONS IN TASKS AND COMPETENCES

According to the broad autonomy granted to settlements, in the new system following 1990, *local governments were charged with operating local public services or making provisions for their operations*. The Local Government Act stipulated the general framework for mandatory local government tasks, whereas the details are regulated by sectoral, professional and other legal provisions. The local governments may fulfil these tasks directly in their offices, through local government institutions and

local government-owned enterprises i.e. independently, alternatively they may sign association agreements with other local governments or they may conclude service contracts with civil organisations, churches or private enterprises. *The central professional requirements are usually laid down in the form of qualitative and quantitative criteria defined by legal provisions.* These legal provisions have a significant impact on the costs of providing these services. The above conditions may be regarded as the national minimum of fulfilling local government tasks. Having said that, the question remains: what should be the level of central government contribution. The relevant laws often include high professional requirements reflecting sectoral lobby interests with the intention to generate future investment demands. Even in the case of successful projects, the additional operational and maintenance costs put added burden on the local governments in which they trigger financial tensions.

Efforts aimed at eliminating the disadvantages arising from by the fragmented settlement pattern, *from the institution of voluntary association formed to counterbalance the contradictions that exist between the performance capacity of settlements and their wide-ranging tasks and competences failed to bring about thorough-going changes* despite the constantly available legal possibilities. District-notary offices that represent an interest for the joint performance of tasks and for the improvement of efficiency have received central financial support since 1990. The total amount of the above support has gradually grew and in 2009 it amounted to more than HUF 6 billion. Despite an increase in the number of district-notary offices, *almost one-third of the local governments with a population of less than 1000 people functions outside such offices.* The very concept of the district-notary office remains unclear even today! The professional set of criteria is yet to be elaborated which could ensure that central

financial support should be granted only to the district-notary offices that comply with the conditions specified in the relevant legal provisions. Under such condition, it is not surprising that there is not much readiness for cooperation, and the associations among local governments have remained a marginal phenomenon. The total number of associations remained considerably low even among villages and towns and their action areas in which the performance of institutional tasks usually requires significant financial resources.

The *Act on Regional Development and Physical Planning* came into force in 1996, and established two "new" levels: the regional and micro-regional levels, at the same time, it introduced the separation of regional development and settlement development and territorial administration. The amendment in 1999 of the cited act further reinforced the regional and micro-regional levels, as well as the county level, because the offices of the county governments were charged with new tasks in regional development. With the establishment of a system of micro-regional managers, representatives, distributional and control bodies of the central government were set up also at this level. To a certain extent, these new measures and legal provisions were introduced to prepare a new system of territorial administration in which, in accordance with Hungary's accession to the EU, the central government delegated a number of tasks to the regional level and in which service provision is organised on micro-regional level rather than on settlement level. This last phenomenon may have brought about a reduction of settlement autonomy, but in the given political climate no fundamental shift in this direction was visible.

As part of Hungary's pre-accession preparatory activity, a new territorial division was to be set up, which in its structure could satisfy the requirements of the NUTS system laid down in community regulations on the Nomenclature

of Territorial Statistical Units. The second level of this represents the seven planning and statistical regions, which are of outstanding importance from the aspect of development funds. The new division has not been fully put into practice.

In the first half of 2003, the documents on the reform of the public administration were presented for public debate. These documents reflected the requirements set for Hungary's future approaching accession to the European Union (such as, the establishment of public administration levels suitable for support and the provision of own resources). They also included the integrity of municipal autonomy and the need for an efficient public administration together with associated set of tasks (the endeavour to develop an optimum level for performing tasks). The documents in practice were in harmony with the spirit in which work had started based on earlier government decrees and aimed at furthering the tasks specified in those decrees. Despite the gravity of the problem and despite the recognition that the reform is necessary, the programme failed to be completed, because open opposition by politicians prevented the adoption of laws that required two-thirds majority in Parliament.

The two preferential levels, the regions and micro-regions, acquired a crucial role in development policies. In the past few years, increasing funds were allocated by the central government to facilitate the micro-regional integration of local authorities. These efforts were also supported by changing some legal provisions. The provision of public services on a modern, European level is not feasible if public duties by more than three thousand local governments are organised separately. Reservations and doubts were raised especially about how broad and deep the integration of local governments should be, particularly concerning the operational size. *By 2005, as a result of financial incentives and resource allocation, a system of*

functioning micro-regions has developed. At the early stage of this development, a large number of local governments refused to join the associations, but later under financial pressure and pressed by legal regulations, a national network of multi-functional micro-regional associations evolved.

The newly built micro-regional system adjusted itself to the central government objectives both in public administration and organisation, the question however remained whether or not the existing structure is sustainable to serve regional development and to fulfil public duties, because the existing system is excessively heterogeneous (due to the diversity of Hungary's settlement pattern, there are some micro-regions which include only a few settlements, whereas in Southern Transdanubia a micro-region may be made up of 30-50 settlements). Consequently – contrary to the objectives and endeavours of the central government – it is difficult to draft a uniform regulation. At the same time, the interests of local governments can be better represented in a form of cooperation in which only a few settlements form an association to fulfil public duties efficiently. In this way, cooperation also seems to be easier. These micro-regional co-operations indeed represent the future road to the integration of local governments and to their genuine cooperation based on real partnership. *Micro-regional co-operations*, as a matter of fact, *can much better take into account the actual demands*, in view of the local economic and social conditions and possibilities for action than a micro-regional structure developed "top down".

The issue of local competences remains an urgent question, its regulation is yet to be finalised. The major problem is that *the funds allocated in the annual budget serve the purpose of maintaining municipal services in small settlements while also reflecting the interests associated with the efficient fulfilment of duties.* These two

are in opposition with each other and reflect contradictory intentions.

From 2002 on, a public debate was conducted about the reform of public administration and its financing. The *reform plan drafted in 2003* (Ministry of Interior, IDEA Working Group) suggested that services should be provided on a new, more efficient level and organised through (a compulsory) integration of local governments. Small settlements are understandably unable to operate and maintain investment projects of large volume without subsidy, and if such investments are nevertheless carried out by small settlements with central subsidies, they are likely to give rise to lavish spending. The solution offered by the present system means that investments are accomplished in associations formed by settlements and the system of services is operated jointly.

THE FINANCIAL AND LEGAL RELATIONSHIP OF THE LOCAL LEVEL OF PUBLIC FINANCES

Local governments operate as a sub-system of public finances, their budget is part of public finances with which they are linked with their total cash-flow. Local government budgets are separated from the central state budget, however, they are connected with it by state subsidies and by other budgetary links.

The revenues of local governments are connected with the public finance balance in gross amounts, in other words, the revenue side of the public finance balance contains all the resources of local government revenues, whereas all expenditures of the local governments are incorporated in the expenditure side of public finance balance. Naturally, altogether it represents an accumulated (gross) balance, the consolidated public finance balance eliminates the cash movement among the individual sub-systems.

The important role played by *local governments* in the national economy and in society in general (in public finances) is underlined by the fact that their share of the GDP amounts to between 11–13 per cent and *their share in the total expenditure of public finances reached 25 per cent in the recent years.*

The ratio of local government expenditures in the current year compared to GDP is presented in *Chart 1*.

In 2009 the local level of public finance, the local government sub-system incorporated 3194 local governments, 173 micro-regional associations and approximately 12 500 budgetary institutions. Between 2001 and 2009, the total assets shown in the accounting balance sheet of local governments grew from HUF 3257 billion to HUF 11 269 billion. In 2009 the local governments were managing a total revenue of HUF 3600 billion. In performing local government tasks, altogether 40 thousand public officers and 360 thousand full-time public employees were employed. (*See Chart 2*)

State subsidies from the central budget, central contribution and allocations from personal income tax continue to represent the decisive proportion of revenues for local governments. In the past 20 years, the relative proportion and total value of central budgetary contributions continuously decreased, while the so-called operational and own revenues were on the rise.

The structural problems of the local government system are not attributable to the large number of local governments, rather it is caused by the allocation of undifferentiated tasks and competencies as well as by the uncoordinated individual components of the system.

As the network of micro-regions failed to be assigned with mandatory tasks, *a further development of the present incentives seems to be justified.* Central subsidies and financial incentives have been on the rise since 2004. In 2009 the normative, targeted subsidies allocated for micro-regions amounted to HUF 31 billion. In the course of tender evaluations, the develop-

Chart 1

LOCAL GOVERNMENT EXPENDITURES IN % OF GDP BETWEEN 2001 AND 2010

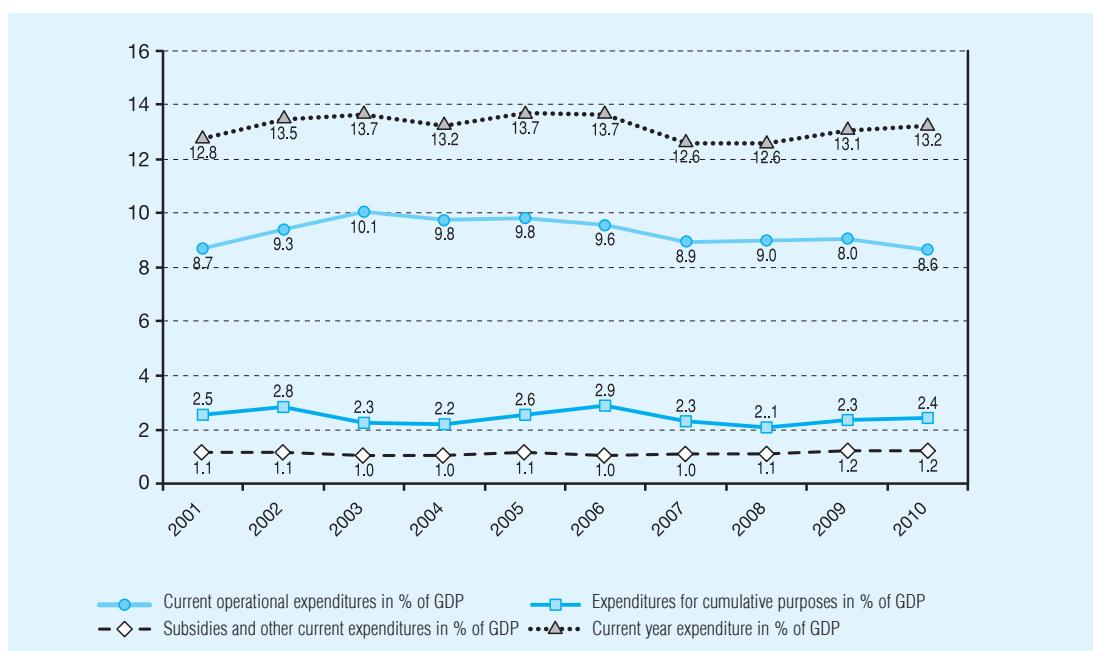
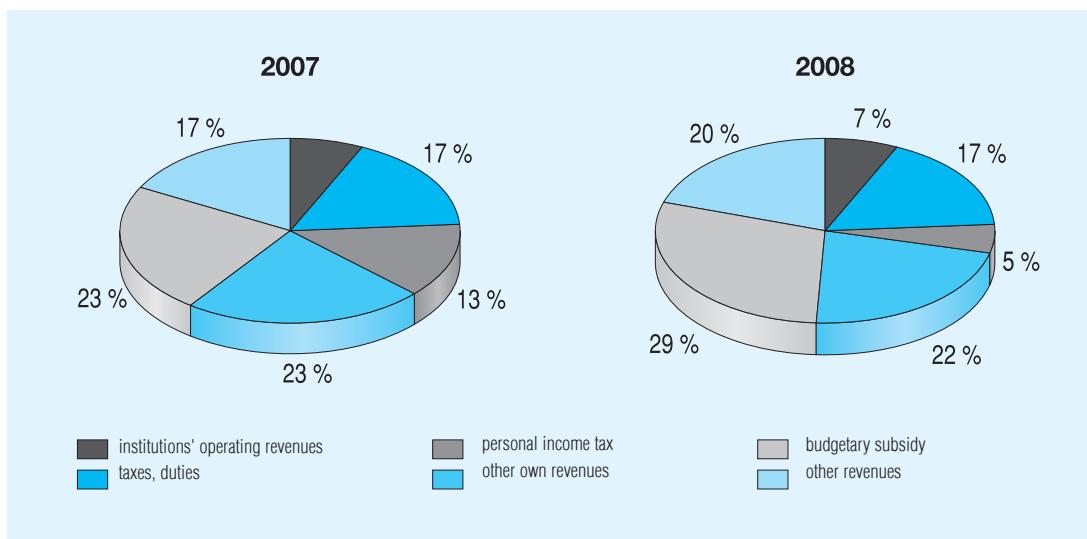


Chart 2

DISTRIBUTION OF LOCAL GOVERNMENT REVENUES

ment ideas of associations increasingly enjoy a preference both in EU funds and also in the case of state subsidy for domestic development. In addition to government subsidies applied as incentives, there is also positive discrimination recognising local government cooperations.

REGULATIONS CONCERNING THE LOCAL GOVERNMENT TASKS AND RESOURCES

There have been no substantial changes in the organisational structure of local governments since the adoption of the Act on Local Governments. The tasks of local governments, which have accomplished considerable results in organising public services and in developing their municipal infrastructure, were assigned with numerous new tasks in the past decade based on the provisions laid down in various sectoral laws, whereas these local governments received only partial or no financial support for shouldering these additional duties.

In the recent years, there have been no major changes in the laws regulating local govern-

ment resources. There has been no change in the standard practice that *the central budget does not provide appropriate funds for the additional new tasks assigned to local governments*. The abolition or joint treatment of titles to individual state subsidies or normative contributions -which are aimed at extending room for manoeuvre for local governments – are primarily of technical nature. *In the absence of any comprehensive review of the present system in which the local government tasks, competences and finances are defined, the budgetary risks of the different local government levels remain unchanged.*

Approximately the budget of about one-third of the local governments has faced with a shortage of resources for years. Local governments are expected to make a manifold good use of significant amounts of public funds and public assets without the necessary comprehensive tasks, competences and resources re-regulated.

The different sectoral authorities have issued *professional standards and requirements* (such as minimum requirements and provisions for operational licenses) in order to guarantee the

provision of public services at an expected quality, the *financial conditions*, however, are not granted directly and comprehensively within the framework of regulating resources of local governments, a practice which is certainly not substantiated by concrete data. In close relation with the above, the sectoral regulations continuously raised the number of titles based on which normative contributions can be applied for from the central budget for performing mandatory local government duties. Additional resources for the total, nominal amount of normative state contributions were provided only subject to the general conditions of the central budget, i.e. the funds available at macro level were distributed among an increasing number of titles. As a result of the introduction of numerous new conditions attached to the utilisation of supports, conditions which were aimed at protecting sectoral interests, the number of titles based on which applications can be submitted by local governments for subsidies from the central budget reached more than 200, and due to the constantly changing rules the procedures have become more beurocratic, while their application and control incurred additional expenses. (See Table 2)

Let us see an example. From 2007 on, new regulations were introduced for the financing of public education duties of local governments. Accordingly, the conditions of application for normative subsidies together with specific values attached to them are allocated for a school-year rather than a budgetary year. After 2007, in the application and settlement of public education subsidies and contributions, the provisions of budgetary laws applicable for two years must be taken into account, a new system which resulted in a further rise in accounting code numbers. The funds serving as an incentive for multi-functional micro-regional associations are accessible from the central budget under conditions of quite complicated regulations. Multi-functional micro-regional associations could satisfy the criteria of their joint fulfilment of tasks simply by organisational activity, because the regulations did not specify its concrete content. Application and settlement of subsidy was done in the database developed by the Ministry of Local Government, a system which was too excessive and hardly transparent. Its method of calculation concerning the rules on the indicators' rounding off was not in line with the provisions of the Budgetary Act for 2008.

Table 2

NORMATIVE CONTRIBUTIONS AND SUBSIDIES OF LOCAL GOVERNMENTS

Year	Normative contributions		Normative earmarked subsidies	
	Number of titles	Processing code	Number of titles	Processing code
2003	28	105	14	25
2004	29	143	14	29
2005	31	131	10	14*
2006	24	158	9	11**
2007	17	228	8	10
2008	13	244	8	10
2009	13	278	8	10

* from 2005 on, the support of local government fire brigades must be accounted with one code, but the application can still be submitted by using several codes (~10-15)

** from 2005 on, the support for multi-functional micro-regional associations must be accounted with one cod , but the application can still be submitted by using several codes (~70)

Source: HST

A more extensive set of norms was also attributable to the fact that the ministries and sectoral representative bodies had reservations concerning the use by the local governments with full-scale autonomy of normative contributions provided for the various institutions performing public duties. This concept shifted the direction of regulations from a resources-oriented policy to a new policy which now rather focused on financing duties and institutions. *The system which regulates the local government resources and subsidies has not substantially changed since it was introduced.* This system is characterised by a massive concentration of revenues and a decentralisation of tasks, competences and responsibilities. In the recent years, *there has been no review of the local governments' tasks and competences regulated in government resolutions.*

The local governments' financial scope for action is further limited by professional requirements. The local government system does not distinguish between municipal duties based on the size or status of the individual settlements. *Legislators eventually leave it up to the given local community to decide whether they wish to perform certain duties, or whether they are capable of doing so.* This is a very clear example of applying the principle of subsidiarity. Another aspect, however, should also be taken into account: namely, that due to the specific features of the local governments' financing system (due to sizeable government subsidies), these communities undertake the relatively higher financial burdens at the expense of a larger community, i.e. it is not the local communities' money that the local decision-makers are managing. *Only incentives built into the central financing system can facilitate the development of performing duties more efficiently.* Under circumstances in which certain institutions (local governments) are permanently underfinanced they are often under pressure to compete for the favours of the community.

They are under pressure to provide better and more diverse services (e.g. special forms of education in schools), with which they can offer more attractive and more efficient services. As a matter of fact, the local governments' own contributions, which may in its proportions amount to as much as 50 per cent of the expenses, are often too much for a lot of small local governments to shoulder. Because of the declining number of children at primary schools and also because of the growing technical needs, small municipalities find it very difficult to perform educational tasks.

Resources are regulated for the local governments – to an extent specified in the annual Budgetary Act – in two different ways: through state subsidies and contributions and through transferred personal income tax (PIT). These resources represent approximately one-third of the total revenues on the local level of public finances. The majority of revenues originating from the central budget are allocated to local governments as subsidies by subjective right, and contributions and normative subsidies provided for performing mandatory duties. Other operational and development supports also represent significant funds: most of them today come from EU funds. Since the establishment of local governments, within the scope of state subsidies and contributions, *normative subsidies* – which, at first were referred to as so-called general contributions – *are of defining nature.* These so-called general contributions were very soon replaced by normative subsidies closely linked to specific duties defined in the Local Government Act. The increasing number of titles to subsidies is attributable to provisions in the Local Government Act and also to sectoral regulations.

When the Act on Social Welfare was adopted in 1993, the set of norms became broader and the number of centralised appropriations with social

objectives was also on the rise. After the adoption of the acts on public education and on culture in 1997, the regulations became even more complicated. Since 1995 the set of norms has also contained the norms financed by personal income tax. The proportions of PIT transfer has not changed since 2000 (it is 40 per cent), but the proportion of the amount of money retained at the point where the tax arises did change. This means a cut of 5 per cent between 2000 and 2002, then a further 10 per cent between 2003 and 2007, and 8 per cent in 2008 and 2009, whereas in the case of county governments it means a one-time HUF 8 billion in 2010.

DEVELOPMENTS OF OWN REVENUES AND LOANS IN LOCAL GOVERNMENTS

In the past two decades, own revenues have been calculated in an increasing proportion in the financing of local government tasks. The proportion of the local government revenues coming from the central budget (state subsidies and contributions, transferred taxes, and other monies re-allocated for operational purposes from other sub-systems of public finances) fell from 72.7 per cent in 1993 to less than two-thirds in 2009, while the proportion of own current revenues grew from 18 per cent to almost one-third, within which local taxes and duties represent a dominant percentage, which may show significant differences in the different types of settlements.

The increasing role of own revenues to finance mandatory tasks, together with a changing set of tasks resulted in, first, the suspension and then the abolishment of financing guaranteed incorporated in the sectoral laws (public education law, etc.). On macro level, the real value of subsidies from the central budget has dropped in the recent years, whereas the real value of own revenues, especially local enterprise tax has risen. As a result of the above developments,

the financial position of the local governments represented a more diverse picture and brought about the deterioration of their liquidity. Despite the mechanism introduced to moderate the differences in revenues, additional subsidies provided to local governments, which are in a disadvantageous financial position beyond their own control, play an increasingly important role.

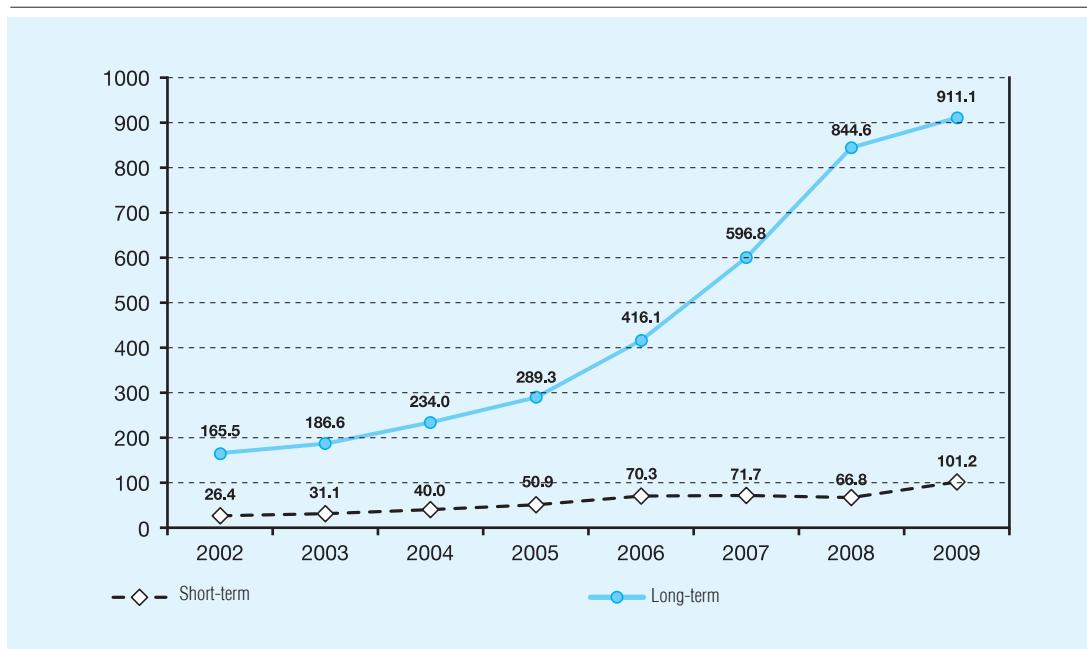
As indicated by Chart 3, efforts by the local governments to improve the balance were not successful, because despite such efforts, the total amount of the local governments' credit and bond portfolios showed a drastic rise. At the same time, most local governments generated own revenues exceeding the original plans while implementing their budgets: additional revenues originated from the sale of various assets and local governments also made good use of various support schemes and additional revenues accessible through tenders. On top of the above, local governments also introduced a number of austerity measures. We agree with the general statement that these measures resulted in a lower level of performing duties and the renewal of tangible assets also suffered a setback.

The financial and legal consequences of bond issues carried both economic and political risks as both bond issues were made with a maturity of 15–25 years and with a period of grace of 1–10 years specified for the repayment of the principal amount. The budget reports between 2005 and 2008 indicate that a growing number of local governments used the issuance of bonds for generating additional revenues.

Bond issues in 2005 were of marginal values, whereas between 2006 and 2008 bonds were mainly issued by county governments, town governments with county rank, the capital district governments of Budapest and towns governments either with the purpose of financing development projects or for the purpose of repaying debts. The

Chart 3

LONG-TERM CREDIT AND BOND PORTFOLIOS AND SHORT-TERM CREDIT PORTFOLIOS



Source: HST

smallest amount of bond issue was HUF 0.2 billion, while the highest was HUF 12 billion. Between 2006 and 2008, 6.9 per cent of all local governments generated own revenues by bond issues: in the county this proportion is 95 per cent, in towns with county rank and in the capital district governments of Budapest the figure was 56 per cent respectively and in town governments it reached only 46 per cent. In 2007 and in 2008 the majority of audited local governments issued foreign currency-based, floating rate bonds.

As a result of this practice, borrowers are likely to put pressure on the financial scope of action for the next generations as (bonds issued in foreign currency) carry exchange rate risks and floating rate risks.

The extension of – i.e. more stringent – professional minimum criteria also represented a significant area of additional duties for local governments. In the absence of appropriate studies,

the financial consequences of these increasingly stringent conditions cannot be quantified. In public services the increasingly strict requirements made it difficult for the local governments to satisfy the human and material conditions (for instance, a lot of hospital wards operate only with a temporary license issued by the health authorities to safeguard such services). The fulfilment of the professional criteria – depending on budgetary conditions – was also facilitated by various central subsidies, tender competitions and – following Hungary's EU accession – by certain EU funds. These resources, however, can only be used for development objectives, operational expenses, and the replacement of assets (amortisation) cannot be financed within this system.

It has been a general practice in the recent years that the increase of salaries in the public sector (e.g. the salaries of civil servants) was only partly financed from the central budget or it

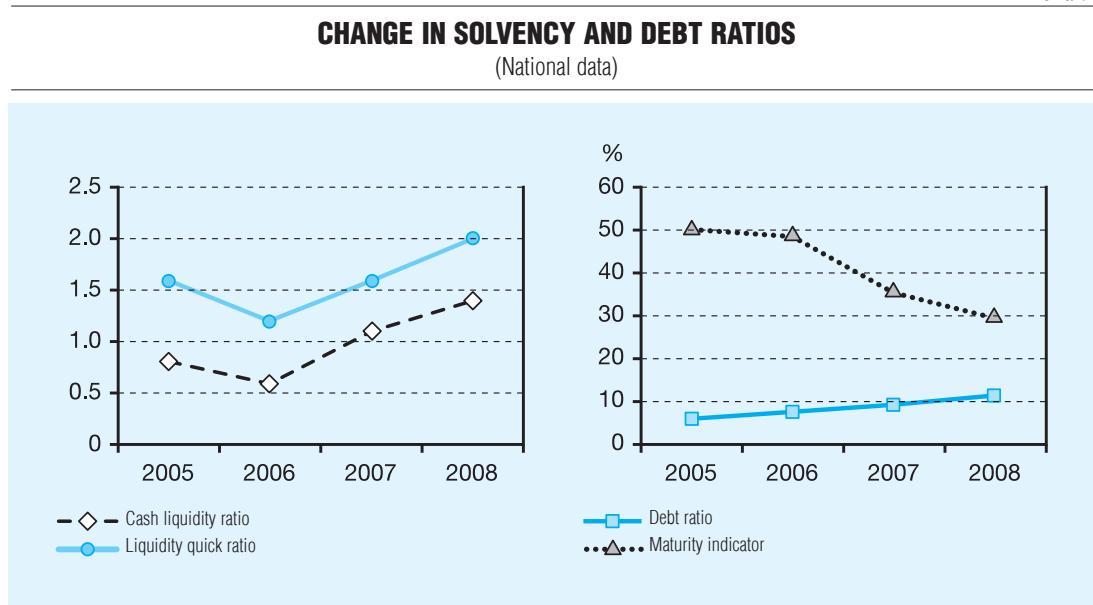
was not financed at all. The salary hikes were supposed to be covered from so-called organisational measures at local level (which practically means staff reductions). In 2003 and 2004, only 50 per cent of the central wage policy measures (affecting the salaries of civil servants and public employees) were covered by the state budget (the other 50 per cent was expected to be raised by local governments with a long-lasting consequence for the budget of local governments in the years to come). The central salary increase of one per cent put altogether approximately HUF 10 billion additional expenses to shoulder by the local governments. Central state contributions also failed to offer coverage for either the price rise in fuels (no automatic indexation) or for compensating the VAT rate increase. *The total amount of central subsidies provided for the local governments were reduced by the impact of changing duties (reduction of duties)* (for example, by raising the number of teachers' weekly hours and by reducing the central health contribution and by suspending the 13th month salary in 2009), whereas in the mixed financing scheme only 50–70 per cent of

the expenses incurred by the mandatory tasks are covered by the central budget.

The above developments have inevitably resulted in liquidity problems – of varying degree – in the local government system and in a growing indebtedness of this sector as indicated by Chart 4.

Based on the aggregate data of local governments, the debt ratio¹ showed a gradual rise between 2005 and 2008, and the joint ratio of long and short-term liabilities was also on the rise within total liabilities and equity. Within the same period, out of the total payment obligations the proportion of short-term liabilities went down as a result of the increasing proportion of long-term liabilities. Indebtedness is expected to exert an adverse impact on the financial position of local governments in the long run. The cash liquidity ratio and liquidity quick ratio showed a declining pattern between 2005 and 2006, but at the end of the period between 2007 and 2008 both ratios were on the rise, which is attributable to the developments in which the monies raised by bond issues in the last months of the year were deposited in banks and the movement among financial

Chart 4



assets was recorded. The increase in liquidity ratios at the end of years 2007 and 2008 by no means represents a permanent and favourable direction in the future development of solvency. When the grace period of 1 to 10 years expires, the repayment obligation of revenues originating from bond issues will surface as short-term liabilities as a result of which the solvency in the current year will considerably deteriorate compared to previous years. The financial indicators as a whole point to the growing indebtedness of local governments and to their worsening financial position.

There is considerable uncertainty in the local governments concerning the planning of revenues and expenditures. Unpredictable and conditional commitments on the expenditure side in local governments, which provide large-scale public services, aggravate the risks caused by the inability to forecast revenues. As a result of these unpredictable conditions, *local decision-makers are obliged to avoid conflict, to transfer expenses into the future or to accept risks without due considerations*, instead of introducing the necessary structural changes. Budgetary rules are far from being helpful to keep risks within sensible and justifiable limits (loans can be used also for purposes other than development projects, and the only stumbling block to prevent debts from growing is the limited supply of credit from banks, etc.). Under the present economic environment, local governments find it difficult to plan their revenues from personal income tax and local enterprise tax!

Every year the revenues of local governments depend on the central budget to a large extent, which has a serious impact on their economic management activity. According to the calculations made by the experts of the SAO, the balance showed a “gap” of about HUF 100 billion when the draft budget bill of 2010 was elaborated. The different types of local governments are considerably affected by the above gap and also by the impacts listed below:

- cuts in the central budgetary subsidies (reduction of duties without reallocation of resources);
- the absence of any measures to counterbalance inflation caused by VAT increase;
- the expected decline of own revenues, especially the decline of local enterprise tax and duties and – in some cases – the operating revenues caused by the economic crisis;
- “operational” costs for development projects of both previous years and for 2010 as well as the need to finance additional costs originating from PPP schemes.

The local governments' asset management

I believe that in a broad interpretation of asset management, we must consider not only fixed assets (e.g. property, plant, equipment and vehicles), which ensure the performance of local government duties, but also decisions that exert an impact on local government assets, such as bond issues, purchase of short-term securities as well as cash management linked to any assets. With an experience of two decades of SAO audits, I focus on tangible assets. (See Table 3)

In the course of SAO audits, we focused on the following subjects: !!!pötyök!!!

- the implementation of investments necessary for performing local government duties and the management of tender procedures,
- the transfer of certain state assets into local government ownership,
- the asset management of local governments, including the utilisation of assets and entrepreneurial activity,
- the asset structure of local governments with an attention to the causes of changes in it as well as its documentation,
- the utilisation of local governments' primary assets which are only partly or not at all tradable.

Table 3

THE ASSETS OF LOCAL GOVERNMENTS ACCORDING TO THE BALANCE SHEET

(HUF billion)

Assets	2002	2003	2004	2005	2006	2007	2008
Intangible assets	9	11	16	21	25	26	25
Tangible assets	4 350	6 833	7 021	7 238	7 576	7 688	7 803
Financial investments	564	566	575	556	558	557	592
Assets transferred for operation, management	930	1 254	1 369	1 482	1 587	1 721	1 824
CURRENT ASSETS	570	571	610	564	554	632	855
ASSETS TOTAL	6 423	9 235	9 618	9 861	10 300	10 624	11 099
LIABILITIES	490	518	589	697	925	1 088	1 395
EQUITY	5 933	8 717	9 029	9 164	9 375	9 536	9 704

Source: HST

During the site audits conducted at the local governments, we controlled the accounting documents and the land registry of various organisations (budgetary institutions, business enterprises), which are direct cooperating partners in the fulfilment of asset management tasks assigned to mayor's offices and local governments. In addition to the above, the audits also examined budget reports, decrees on asset management as well as submissions, resolutions and decrees issued by the general assemblies or representative bodies of local governments on assets.

Local government rights – including ownership rights – belong to the community of the local people eligible to vote. Electors exercise their local government community rights both by proxy of representatives elected to the local government's representative body and by participating in referenda. It is the community of a given settlement that is the subject of local government property, a community which can directly exercise its ownership rights only exceptionally in the case of referenda. A local referendum is organised when the local government issues a decree in which the decision to sell or mortgage a certain asset or part of an asset or any other utilisation is subject to the outcome of a local referendum. The represen-

tative body or the general assembly of the county or the municipality of the capital city may issue orders concerning the exercising of ownership rights.

According to the Local Government Act, ownership rights may be exercised by proxy of the representative body and the general assembly. Certain competences of the local government bodies – for instance, the owner's right of disposition – can be delegated to the mayor, to local government committees or to the representative body of a partial local government, to the representative body of minority local government and to a local government, association. It cannot be delegated to a business enterprise.

According to the general management liabilities set out in the Local Government Act, *the representative body (general assembly) is liable for the security of asset management, whereas the mayor (the chairman of the general assembly) is liable for its regularity. Documentation and data provision, which are integral part of regularity, fall under the liabilities of the local government's notary public.*

The consequences of a loss-making asset management must be borne by the local government. The central budget cannot be held responsible for the duties assigned to local governments even though the central government

– as we have often seen in the course of our SAO audits – is prepared to mitigate or take over such consequences.

According to accounting records, *the total wealth (total assets minus liabilities) of the local governments as a whole reached HUF 11,000 billion at the end of 2009* from HUF 369.5 billion in 1991. Within the total wealth of local governments, the proportion of tangible assets and financial investments represents the decisive share.

In the past 20 years, changes – to a different degree – in the various groups of assets contributed to a changing set up and structure in the local governments' aggregated own assets. This period is also characterised by the increasing proportion of assets transferred into local government ownership for operation and management due to large-scale infrastructural development projects.

The SAO audits have also highlighted the most significant shortcomings in the statement of the amount of assets, as a consequence of which the asset value shown in the balance sheet cannot be accepted a realistic value at the end of 2009. The above-mentioned shortcomings are the following:

- ▶ Since 1969 the gross values of tangible assets, including property, plant, equipment and vehicles recorded in the books have failed to be adjusted to the changes in the market value.

- ▶ According to a legal regulation, local governments were required to appraise all of their real properties by the end of 2003 the latest, and include these values in their records. Marketable real properties and all land properties (also land properties next to a road) are to be appraised with the market-based appraisal approach, whereas real properties with limited marketability or non-marketable real properties – based on the issued guidelines – by using the cost approach to value. This has also affected the accounting records.

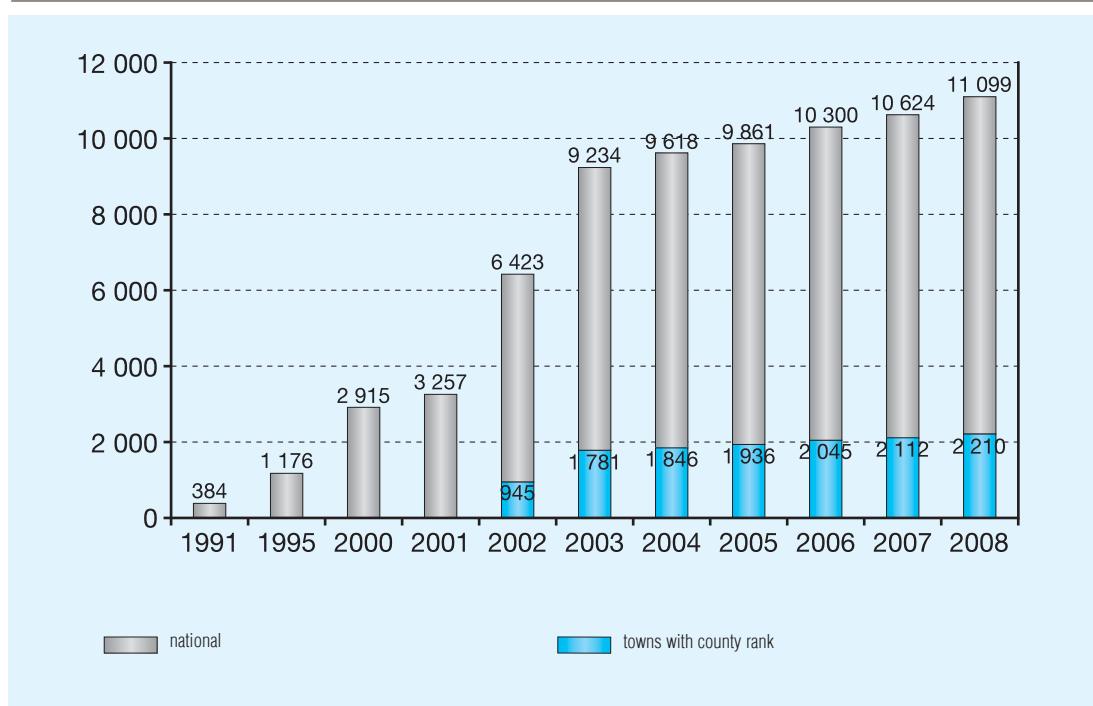
Chart 5 describes the growth of the assets mentioned earlier clearly indicating that approximately 20 per cent of the total local government assets belong to towns with county rank.

The above chart shows that the asset evaluation prescribed by law from 2001 on brought about almost a threefold growth in the total value of assets. This growth is attributable to a past practice according to which a number of real properties owned by the local governments had no registered value or were alternatively registered at an intangible value of HUF 100. (In the balance sheet of 2004 more than 50 per cent of the one million odd items of property belonged to this category!) On the other hand, 95 per cent of local roads and bridges and structures, open spaces, parks, woods, other types of land, waterways and related public water facilities were not recorded at value, and the same is true for 80 per cent of the land areas of built-in real properties and undeveloped residential and recreational land areas. The value appraisal of most of the above assets was done in an unprofessional manner, causing a significant distortion in the value of local government assets and their structure.

- ▶ A certain proportion of the infrastructure facilities (gas, electricity, water and sewerage networks) financed by local government resources between 1992 and 1999 was not capitalised by the local governments, i.e. was not registered in their accounting system, the facilities were not taken into local government ownership, consequently, there is no value attached to them among the local governments' balance sheets. Some assets jointly owned by some local governments are not entered in the balance sheet in harmony with the relevant regulations.

- ▶ The amendment in 1994 of Act LXXXIX of 1992 on Targeted and Labelled Subsidies made it possible for local governments to use their capitalised assets in public utilities as non-

Chart 5

GROWTH OF LOCAL GOVERNMENT ASSETS

cash capital contributions even in business enterprises in which they had a majority ownership. According to the law, business enterprises established by organisations other than local governments were authorised to operate public water facilities only under concession contracts. However, Act LVII of 1995 on Water Management no longer made it possible for local governments to transform their public water facility assets from the category of limited marketability assets into the category of marketable assets, and thus use them as non-cash capital contribution in business enterprises. Under point b) para, (2) of Article 79 of the Local Government Act, local governments are not authorised to reduce their primary assets, a prohibition which has been repeatedly reiterated in some resolutions of the Constitutional Court.

► In their accounting records local governments often fail to indicate their share in business enterprises. Changes in the value of busi-

ness shares included in the balance sheet were not always accounted for, and in certain cases there is no accounting for various guarantee agreements and surety agreements, which promote the borrowing of local government associations.

► In 2008 the total value represented by the local governments' surety agreements in majority-owned business enterprises reached close to HUF 10 billion, while liabilities vis-a-vis business enterprises with local governments' minority ownership exceeded HUF 1.6 billion. The total value of liabilities originating from local government investments implemented in PPP schemes will be first available in the 2009 reports.

► The financial position, bond issue and closing cash-in-hand are unevenly distributed in the per centage of current expenditures. Expenditures on investments were on the rise, and the year-end amount of liabilities continued to grow, while the ratio of current assets

that can help financial balance showed a decline, developments which are all viewed as unfavourable tendencies. As a result of the above trends, *the financial position of the individual local governments is quite different* both concerning the types of local government and the individual local government. *Their debt stock in 2009 amounted to more than HUF 1000 billion* mainly originating from borrowing for investment and development purposes and from bond issues. *The future risks associated with the debt servicing of foreign currency-based bond issues were significantly up* because of exchange rate exposure and fluctuating interest rates. The total value of bond issues by the local governments at the end of 2009 reached HUF 469.5 billion. (*See Table 4*)

Counties and towns with county rank have the highest proportion of bond loans compared to their budget. Some of the money raised from bond issues was used primarily for accumulation and to a smaller extent for operational purposes, and considerable sums were also spent on the repayment of loans received earlier. Most of the money is currently used to "replace old money with new" within the sector of financial institutions. For county governments the highest risk is represented in financial risks, because in this category of local government typically there are no or hardly any own resources – except for revenue generated

by operating institutions – and only marketable assets can be used for mortgage, county governments cannot use their primary assets for covering loans.

► Some of the local governments do not have the necessary professional expertise and the necessary financial resources to conduct the case-by-case assessment required by the legal provisions, consequently, the current value of assets indicated does not correspond to their market value. In the years to come, local governments will need to pay more attention to the year-end consolidation of data both in the balance sheet and the land register.

With a few exceptions, changes in the asset structure of local governments are not the result of deliberate and long-term planning by the local governments and are often not in line with the economic programmes adopted by the local governments' representative bodies.

In the analysis of local government asset management it is also justified to dwell on the new bankruptcy position of local governments which is becoming a reality of today. In the recent years, approximately 30 local governments were submitted to procedures under the act on debt management.

When local governments or their budgetary organisations enter the business sector in order to perform their activities, they are obliged to abide by market rules and meet their contrac-

THE DEBT STOCK OF LOCAL GOVERNMENTS IN 2009

(preliminary data, HUF billion)

Description	Capital	Capital Towns with districts	Towns with country rank	Other towns	Large villages	Village	Country	Multifunctional regional associations	Country micro- total
Total debts,	161.5	74.8	273.1	302.3	23.8	52.9	123.7	0.2	1 012.3
of which debts originating from bond issue	0.0	38.3	111.8	194.4	19.2	10.5	98.3	0.0	469.5

tual obligations. Local governments and their institutions cannot cite the performance of public duties and insolvency as an excuse for causing damage to contracted creditors. *Act XXV of 1996 on the Procedure of Settlement of Local Government Debts* sets out a procedure which can guarantee that creditors are paid their receivables and ensures that the mandatory duties are performed by local governments under the procedure of debt settlement as well. Resolution No. 38/2000 (X. 31.) of the Constitutional Court also reiterated this dual function. It also reinforced the rules which limit the scope of assets that can be subject to debt management. Only assets outside the non-marketable primary assets specified in the relevant laws and those outside the assets necessary for carrying out statutory duties and basic community services can be subject to debt management. Consequently, obligations relating to the local governments' performance of public duties based on public law remain of primary importance even in the case of "bankruptcy", and the law excludes any possibility for the liquidation of legal entities under public law without legal succession.

Local government reform is inevitable

One of the most important characteristic features of local government management is that although, from legal point of view, it enjoys an almost unlimited autonomy, its financial conditions are far from being guaranteed. Local government management covers a decisively large proportion of public finances, handles large amount of public funds and public assets, whereas decisions on spending the funds and using the assets are excessively decentralised in a system which requires the operation of many institutions.

Despite repeated modifications, some components of the present local government sys-

tem have not been fully developed. Characteristic shortcomings include the following: the weakness of regional self-governments to organise regional duties and public services, the absence of public services performed according to professional requirements in small settlements. There is a conflict of interest between local and regional duties. As much as half to two-thirds of public services are used by people living in other settlements, whereas mid-level organisations, which are responsible for organising regional tasks do not possess the necessary means and tools to do so (the counties are obliged to be limited to running various institutions under constantly worsening financial conditions). *With the upsurge of regional institutions and with the extension of micro-regional tasks, the role of counties shows a decline. Another principle problem is that there is no harmony between the county system and the tools available for regional development*, because there is no clear division of work and no political consensus to establish one.

The following internal contradictions represent further burden on the local government system: overlaps between towns with county rank and county governments, contradictory competences which cause tensions between the capital and its districts (for example, every year there are heated financial and political debates between the capital and its districts about the allocation of resources, an amount which totals more than HUF 200 billion).

Following the establishment of the local government system, each and every general government made efforts to reform local governments and public administration. Quite a few government resolutions were issued to this effect,² but changing political values and interests always had a crucial impact on the fate of such efforts and measures. *There are three levels of regionalisation: regional development, local government and territorial state administration.*

The absence of a local government reform – based on a consensus – brought about the uncoordinated transformation of the above three levels. The current tasks and competences of the local government levels lack a clear definition (no clear separation) and as a result – as it is demonstrated by SAO audits – none of these levels is capable of performing a comprehensive integrating role, a role which is missing from the system.

According to a multi-annual practice, the strategic directions of the development of regions were translated into delegating again state administration tasks to regional level and in regional development into operating the level of regional development. The measures aimed at delegating county administration offices to regional level were found unconstitutional by the Constitutional Court, with the unfortunate consequence that there is no legal control over local governments for two years. In addition to plans concerning structural changes, proposals were also made to establish a “minimum programme” which would modify and effectively reduce the number of local representatives and their remuneration.

For years now, there has also been a tension between local government tasks and the available resources for implementing them. Quite a few SAO reports have already highlighted this tension. Since 2005, SAO audits have focused on the various causes jeopardising the financial balance of the local government system, highlighting the need to fully coordinate tasks and the financing of resources, the need to create financial stability and the long-term risks arising from the indebtedness in the local government sub-system. Based on SAO experience, we can state that rising tensions in local government management were also caused by shortcomings in the governance: its internal control mechanism failed to guarantee the profitable performance of their tasks and activities as a result of which, among others, the utilisation of institutional capacities remained

low, voluntary tasks often exceeded local governments' abilities, various planning mistakes were also committed and – last but not the least – expenditures with accumulation purposes were also undertaken beyond the local governments' means.

As I mentioned above, there has been no review of tasks and competences based on relevant government resolutions. There has been no review on the local governments' mandatory task, there has been no reflection on or precise definition of state tasks, and the differentiated delegation and comprehensive modification of local government tasks and competences also failed to be accomplished. The debate on mid-level self-government (region, county, mandatory micro-region) is yet to be closed. The further development of regulating resources was also put off. The present system is still characterised by the fact that *there is no full allocation of financial cover by the central budget for local governments to perform the prescribed new*. There has been no major shift in the regulatory principles and means of local governments. Annual changes in the state subsidies make it impossible for local governments to predict revenues originating from the central budget. One of the most important conditions of transparency is a reliable and relevant financial information system, the absence of this important condition in practically each and every area is a stumbling block to accountability and to the development and implementation of performance requirements.

The local government system remains a fragmented one. The only change was brought about by local government associations – which are set up already on micro-regional level – they are the only sign of concentration serving the purpose of professional and financial efficiency and the purpose of performing tasks in a sensible rational way. Financial incentives played a key role, but decision-makers were often strongly influenced by local economic

pressures. A slow transformation – with contradictions and often with wasteful spending – is likely to bring about a sensible improvement in the provision of quality public services only in the long run.

There is no denying that *a reform-type transformation of the local government system already in place for two decades is inevitable*. The renewal of the financial system of local governments (up-to-date financing solutions, the prevalence of object-oriented resource structures and the

rationalisation of resource allocation as well as the elaboration of guarantees concerning budgetary liabilities) is interlinked with the legal status and tasks of the different levels of local governments (delegation of tasks as well as regulatory and organisational solutions to support them). The sensible reorganisation of the above system into an up-to-date system of public administration should be based on the reconsideration of their relevant constitutional status.

NOTES

- ¹ Debt ratio = (total liabilities – other accruals) / total liabilities and equity
Maturity indicator = short-term liabilities/ (total liabilities – other accruals)
Cash liquidity ratio = cash/short-term liabilities
Liquity quick ratio = (receivables + securities held for trading + financial assets) / short-term liabilities
- ² Government Resolution No. 1105/1995. (XI. 1.) on the Main Directions of the Reform of Territorial State Administration Bodies
Government Resolution No. 1052/1999. (V. 21.) on the Plan of Governmental Tasks Concerning the Continued Development of the Public Administration System in 1999-2000
Government Resolution No. 1057/2001. (VI. 21.) on the Plan of Governmental Tasks Concerning the Continued Development of the Public Administration System in 2001 and 2002

- Government Resolution No. 2198/2003. (IX. 1.) on the Task Concerning the Modernisation of the Public Administration System
Government Resolution No. 1113/2003. (XI. 11.) on the Modernisation Programme of Public Administration Services
Government Resolution 1075/2004 (VII. 21.) on public administration tasks and competences requiring regional and micro-regional organisation, as well as on measures concerning the transformation of territorial state administration bodies
Government Resolution No. 1054/2006. (V. 26.) on Tasks Related to the Preparation of the Transformation of Public Administration
Government Resolution No. 2118/2006. (VI. 30.) on Organisational Changes Promoting the Efficient Operation of Public Finances as well as on Supporting Measures
Government Resolution No. 2229/2006. (XII. 20.) on the Supervision of Public Tasks