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Encouraging sub-national government efficiency in Hungary

Hungarian sub-national governments are facing difficult challenges. Many of the cost-cutting structural reforms to public services being initiated by central government involve the municipal and county governments through their responsibilities in providing services. In addition, these governments face ongoing investment challenges in raising the quality of local infrastructures to address social and economic issues. There are wide regional disparities in GDP per capita across Hungary, reflecting an uneven pace of economic development. Local governments in poorer areas in particular need to be successful in accessing EU-funds aimed at narrowing gaps in development through infrastructure investment.

This paper looks at how meeting these challenges can be helped by changes to budgeting systems, financing arrangements and spending responsibilities in the municipal and county governments.

THE SUB-NATIONAL GOVERNMENT SYSTEM

Hungary, a unitary state, has three layers of elected governments – central government, counties and municipalities. There are 3,167 municipalities, 19 counties and 20 city-counties (including Budapest) which have a special dual status as a municipality and a county *(Table 1, left column)*. Elections to the respective assemblies are held every four years and always (at least so far) in the same year as the general elections. Established in 1990, this structure replaced a centrally controlled system comprising three levels: communities, districts and counties.[1]

Unlike under the previous system, which granted significant powers on spending rights and funding allocations to the counties, the municipalities today benefit from a considerable degree of autonomy. Municipal governments are no longer subordinated to county governments; notably, a county cannot overrule the decisions of a municipality. The institutional foundations of the present framework are the Constitution and the 1990 Act on Local Governments. Both legal instruments have

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organic law status, meaning that they can only be amended by a qualified parliamentary majority of two-thirds, rather than a simple majority.

Understandably, the qualified majority requirement is intended as a safeguard against the risk of excessively frequent and possibly disruptive changes. As in other countries, however, it may occasionally generate tensions and even hold back opportunities to introduce changes with a potential to raise the effectiveness of service delivery. This is particularly the case in Hungary at present, where following the recent local elections the opposition has a majority in most local governments.

Many local activities, particularly in infrastructure development, education and healthcare, are initiated and co-ordinated via a system of local Councils and micro-regions *(Table 1, right column)*. A National Development Council and 19 County Development Councils were created in 1996, along with seven Regional Development Councils for the 'NUTS II' regions which provide the interface with the EU's regional funding mechanism. However, the regions not only play a policymaking role in development but also other areas of spending. For example, there are Regional Healthcare Councils that include representatives from counties and municipalities.

Since 2004, there are also 166 "NUTS IV" micro-regions, comprising groups of municipalities that plan and implement various local activities, mainly with an aim to expand the provision of joint services. Most changes at the regional and micro-regional levels were initiated as part of Hungary's process towards joining the European Union (Temesi, 2000).

BUDGETING ISSUES

There are several mechanisms that aim to make local governments deliver balanced budgets and these include the requirement for balanced budget submission and a "deficit grant". By law

Table 1

THE STRUCTURE OF PUBLIC ADMINISTRATION IN HUNGARY

Elected bodies	Appointed Councils, notably on development, education and health
Parliament	*Councils in the national and regional level.* *There are three National Councils covering Development, Education and Healthcare, respectively.* Most of their members are appointed by the central government. For example, the Development Council includes representatives from 9 Ministries, the presidents of the Regional Development Councils (see below) and the Mayor of Budapest. *There are also 7 Regional Development Councils (NUTS II regions) and 7 Regional Healthcare Councils.* Most of their members are appointed by the central government.
19 County governments	*19 County Development Councils.* These Councils include members appointed by the central government and county governments.
3167 Municipalities plus 20 cities with county status (including Budapest)	*Development Councils of micro-regions* (166 in total) *and other forms of local government associations.* These Councils are appointed by the municipalities.

Source: OECD, based on M. Kopányi and D. Wetzel (2004) sub-national governments have to submit a balanced budget. In addition, there is a "deficit grant", that provides immediate relief to municipalities experiencing temporary financial pressures because of unforeseeable developments.

Moreover, there are strict regulations limiting the amount of debt sub-national governments can carry. Annual debt service is limited to "corrected own revenues", namely 70% of own source revenues (defined to exclude revenue sharing) after subtracting the amount of short-term liabilities. The legal framework imposes limitations on the assets and revenue sources that can be used as collaterals and loan guarantees. The government has proposed to modify regulations of local governments' debt. Vigvári discusses the proposal and debates on financial rules for sub national governments (2007).

Municipal bankruptcy is subject to special legislation under which the creditor or the local government can initiate a bankruptcy proceeding each time a debt is 60 or more days overdue (World Bank, 2006). Cases are examined by a court which can:

- Order the start of debt settlement procedures and designate a financial trustee; or alternatively,
- Determine that the local government can meet its obligations from existing cash flows and assets and establish the conditions for the reimbursement.

The legislation mainly works as a deterrent and has been used relatively sparingly so far. Since the end of the 1990s, there have been eleven municipal bankruptcy cases approved by court decision. Nine cases resulted in a voluntary debt settlement agreement between the parties. In two cases the court followed the recommendation of the trustee and ordered the liquidation of the assets. Interestingly, procedures have never been initiated by the creditors. All were launched by the local governments themselves, most of which were small municipalities with a population below 5000 inhabitants.

As a result, the combined budget of sub-national governments has typically been close to balance or even in a slight surplus. Also, Hungary's local governments have not accumulated much debt *(see Table 2)*.

However, it is hard to draw a firm conclusion about the quality of financial management from this. Given the strong reliance of the local system on central government transfers, these positive budgetary outcomes could reflect a tendency for central government to respond to local budgetary slippages with increased funding. The following sections look in more depth at various aspects of budgetary management.

Table 2

GROSS PUBLIC DEBT END OF YEAR PER CENT OF GDP

	2000	2001	2002	2003	2004	2005	2006	2007
Central government	54.3	52.0	55.0	57.1	58.4	60.3	65.0	64.3
Social security funds	0.9	0.4	0.8	2.0	2.1	2.2	0.6	0.0
Local governments' gross debt	1.0	1.1	1.5	1.5	1.6	1.9	2.4	3.1
Consolidation within general government	*1.9*	*1.4*	*1.6*	*2.7*	*2.8*	*2.7*	*1.2*	*0.0*
General government consolidated gross debt	*54.2*	*52.1*	*55.6*	*58.0*	*59.4*	*61.7*	*66.8*	*67.4*

Source: National Bank of Hungary

Making use of stronger budgeting rules

Strategic prioritisation in sub-national government budgeting is rather weak. Indeed, local governments focus almost exclusively on ensuring that the budget meets legal and procedural obligations, and medium- and long-term policy goals tend to take a back seat. Most municipalities only fulfil minimum presentation requirements which just require classification by spending units (salaries, goods and services, capital expenses). Only a few municipalities specify their spending objectives by services or programmes (education, child care, water, garbage collection and so on). The basic objectives of public spending are therefore not transparent in most municipalities' accounts. Various steps could be taken to rectify this:

◗ Specification of separate budget balance rules for current and capital items.[2] Local governments must present budget proposals that differentiate between capital and operating items, but there is only one budget balance requirement (which applies to the aggregate budget). The city of Budapest has taken a welcome lead with a self-imposed rule that any surplus on current spending can only be used to finance infrastructure investment.[3]

◗ Introduction of multi-year budgeting at the local level, in parallel with developments in central-government practice *(see OECD, 2007, Chapter 2).* Several OECD countries (including Finland, Norway and Spain) have introduced multi-annual budgeting to both central and local government either simultaneously or following a defined timetable, rather than targeting the central budget alone.

A need to widen the coverage of budgets

Several OECD countries (Austria, some Canadian provinces, Poland and Spain) have recently made local governments move "off-budget" items into their accounts and Hungary could follow this example. The financial flows associated with certain important activities are not fully reflected in local-government accounts. The accounts of local public utility holdings (notably in transport) and non-profit foundations created to run housing and welfare assistance services are off-budget. In addition, the motivation for outsourcing some activities is questionable as this also can take accounts off-budget. Off-budget status makes it difficult to find out the amount being spent in these areas and obscures the true status of local-government debt given the likelihood of implicit guarantees. Both local holdings and non-profit foundations are governed by commercial law and are therefore free to finance themselves in the capital market. In addition, off-budget accounts widen the scope for circumventing fiscal rules through accountancy gimmickry. Reportedly, more than one third of the non-profit organisations receiving local financial support do not report the full extent of financial assistance (State Audit Office, 2006).

Better monitoring during the budget year is required

Municipalities must submit annual and semi-annual budget updates to the Ministry of Finance but there are problems in the format of the reports. According to the State Audit Office (SAO), more than two thirds of the local governments implement registration systems that are unsuited to allowing precise assessment of liabilities (State Audit Office, 2006). Efforts should therefore be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards.

In addition, the sanctions against municipalities that break budget rules are rather soft. At present the Ministry of Finance can only send out signals or make recommendations when it sees that a sub-central government is in breach of fiscal rules. One way of giving more teeth to sanctions would be to introduce provisions that require local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures to rectify the situation.

At the same time, in some respects too much budgetary information is demanded and a review of the budgetary information that municipalities have to provide to the central government should be carried out. A frequent complaint of municipal officers is that a great amount of unnecessary information must be attached to the budget documentation. Several hundreds of expenditure and revenue variables are collected annually by the central government. The level of detail is such that the Ministry of Finance lacks enough means to scrutinise that such expenditures cater effectively to their objectives. Not surprisingly, much of the information sent is incomplete or unreliable and is kept confidential at the national level.

The deficit grant is unsuited to deal with cyclical pressures

The deficit grant aims to provide relief to municipalities due to unforeseeable financial developments. In 2007 the eligibility criteria of the deficit grant have been tightened. However, improving local budget management would probably require abolishing it. This grant has to date amounted to about three quarters of a percentage point of GDP per year and it has adverse incentive effects for local governments.

The introduction of multi-year budgeting at the local level, as suggested above, could be used as a vehicle for removing the deficit grant. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance. In the Netherlands, where a similar mechanism is in place, if a municipality is unable to show a balance budget over the official multi-year budgetary period of three years it has to submit the budget to the higher level of government for approval.

Enhancing the effectiveness of the auditing system

The auditing system was reformed in 2003 and included a requirement that over each parliamentary cycle the SAO must audit each local government at least once. Though the new auditing framework also included changes intended to raise the visibility of the link between the budget and the quality of service delivery, little progress on this front has been achieved so far. Reportedly, this reflects the problem that many of the municipalities surveyed by the SAO have yet to implement internal audit systems or, when in place, the internal auditors are not independent of the local governments.

Spending assignment issues

Decentralisation of spending responsibilities to the municipalities and the counties in the early 1990s was significant. The municipalities were made responsible for several core services, most prominently primary education, water supply and various areas of healthcare including general practices, non-specialist hospitals and ambulatory services. The counties are notably responsible for secondary education, research hospitals and other specialised healthcare services. All in all, 20 key tasks are allocated to sub-national governments *(see Table 3)*, a fairly large number in the OECD context. Indeed, Hungary's municipalities perform broadly the same range of tasks as in the European Nordic countries, even though local systems are much less dispersed in these countries, based on the overall number of municipalities.[4] In terms of the share of total public spending, Hungary's sub-national governments are not exceptional. The counties and municipalities combined account for about a quarter of general government spending, a similar level to Poland, the Czech Republic and the UK *(see Chart 1)*.

The devolution of responsibilities for public services has been a broadly positive step but has also generated some challenges. The following sections look at problems in co-ordination, challenges in overcoming economies of scale and issues in wage setting for public-sector workers.

Costly co-ordination failures

Getting the "middle level" of government right: counties or regions?

The middle level of government and administration (i.e. the level between the municipalities and the central government) has become rather complicated. Entry to the EU required the formation of the regions based on Eurostat NUTS II criteria as an administrative tool in EU funding. As mentioned above, the resulting system of seven regions has been used by central government to set up regional councils, which are made up of representatives from the counties and municipalities and which cover issues in development, health and education. This has further narrowed the role of the counties which, as noted, was already significantly reduced by decentralisation in 1990.[5]

The co-existence of decision-making bodies at the regional level via the councils with county and municipal governments has generated overlapping responsibilities, especially between the councils and the large urban municipalities which also have county status. This is slowing decision making considerably, particularly in infrastructure development where it is difficult to agree upon the boundaries of a given project (e.g. road projects, water services and energy supply).

Co-ordination failures between central government and sub-national government

Hungary's constitutional law provides a large degree of autonomy to municipalities, but freedom in policymaking is affected by several other factors. A key role is played by the provision regulations laid down in sector specific laws, on which line ministries have strong influence. These laws have come under increasing criticism for going beyond the core mission of enforcing or supporting nationwide standards and priorities.[6] Compared with local government laws, sector-specific laws can be passed relatively quickly, namely by means of a simple parliamentary majority.

The Act on Public Education, for example, imposes overly restrictive rules on closing, or modifying the use of education facilities that restrain the room for adjusting the provision of services to local conditions. In particular, the Act confers special veto power to both providers and users of the service on any proposal to dissolve a public education institution.[7] The impact of the mechanisms encouraging joint provision in education (see below) is likely to be weakened in these circumstances.

In healthcare, most hospital workers are public-sector employees and have to be paid using central funding.[8] This framework considerably limits the scope for introducing performance management and performance-based compensation in the hospitals. Also, it exacerbates the problem of so called "gratitude

Table 3

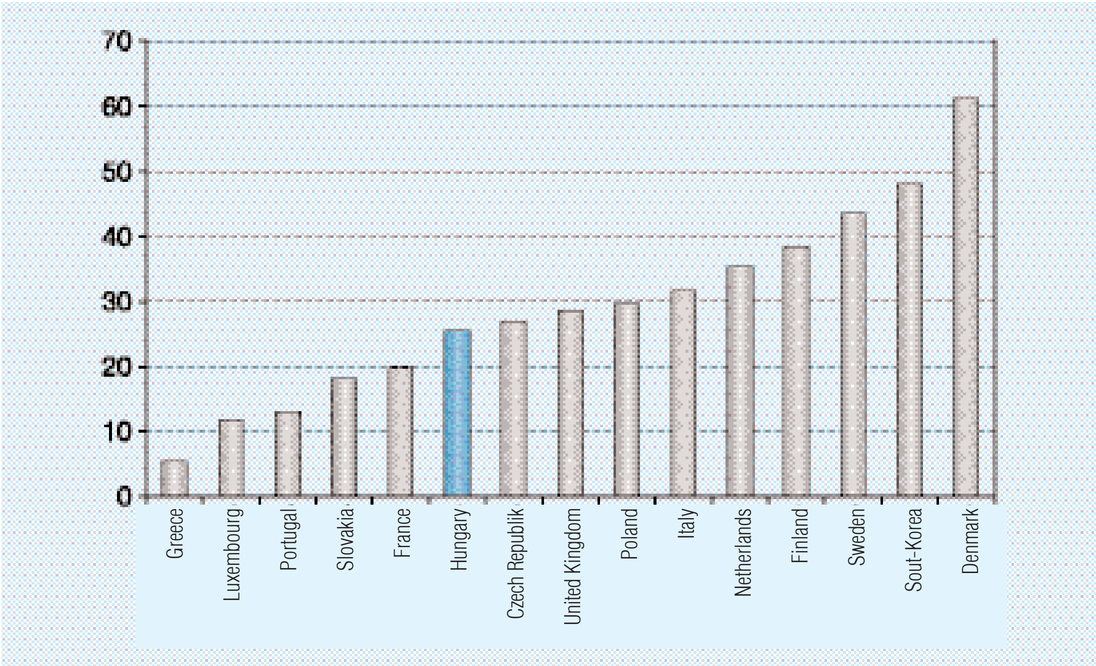
THE ASSIGNMENT OF COMPETENCES TO THE LOCAL GOVERNMENTS

Fuctions	Municipalities	Counties/Urban governments	Local administrative units of the central state
Education			
Pre school and primary	X		
Secondary		X	
Social welfare			
Nurseries, kindergartens and welfare homes	X		
Social care services (elderly, disabled, special services for homeless and families in crisis)	X		
Social housing		X	
Healthcare			
Primary healthcare	X		
General hospitals		X	
Preventive care			X
Leisure			
Culture, leisure and sport		X	
Parks and cultural centres	X		
Water and energy			
Water supply and waste water treatment	X		
Gas supply and heating			X
Electricity supply			X
Environment and public sanitation			
Refuse collection and disposal	X		
Street cleaning		X	
Cemeteries	X		
Environmental protection	X		
Roads and transports			
Local roads and public lighting	X		
Secondary and national roads			X
Public transport services		X	X
Urban planning and development			
Town planning	X		
Regional planning		X	
Local economic development	X	X	
Tourism	X		X
Administration and emergency services			
Licences and administrative services	X		X
Law enforcement and emergency services (police, fire brigades, etc.)	X		X
Consumer protection			X

Source: OECD, Temesi (2003)

Chart 1

LOCAL GOVERNMENTS' SHARES IN GENERAL GOVERNMENT EXPENDITURE[9]



Source: OECD, National Accounts Database

money" (under-the-table compensation payments), which is widespread, though illegal. Other aspects of the legislation are also overly prescriptive on issues which should be at the discretion of local decision makers. For example, the sector-specific act in healthcare states that patients must be able to access hospitals using regular public transport.

Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper, rather than encourage improvements in public services by sub-national governments. Over-regulation generates inefficiencies in the sector they apply. It also creates a more general problem of weak incentives in local governments to initiate reform because they feel they are merely the executors of central-government policy, tightly bound by the provision rules and detailed formula-based grants (so called "normative subsidies").

Economies of scale

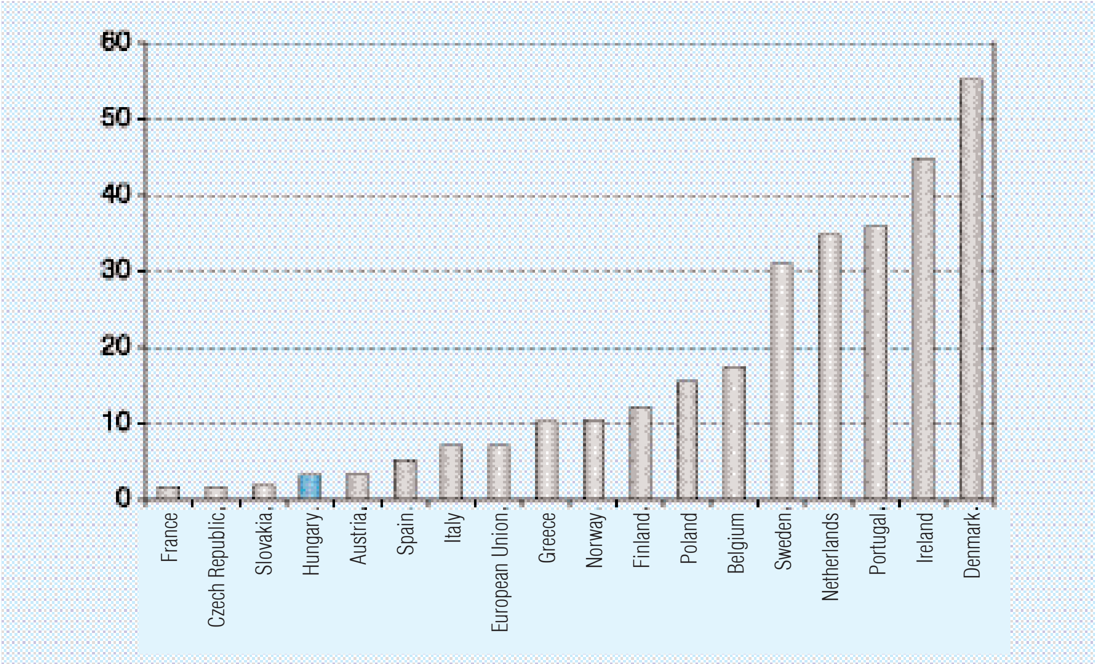
The average size of Hungarian municipalities is one of the lowest of the European Union *(see Chart 2)*. The small size of many municipalities, especially given the wide range of responsibilities they have to cover, raises the question as to whether the scale of operation in administrative overheads and public services is efficient.

Though a precise picture of the relationship between size and efficiency in local government is difficult to establish, it seems that many Hungarian municipalities are relatively inefficient reflecting the small scale of their administrative capacities and client populations. Empirical studies broadly agree that efficiency begins to drop off significantly below 5 000 inhabitants.[10] Among them, *Solé-Ollé* and *Bosch* (2003) estimate that spending needs

Chart 2

INTERNATIONAL COMPARISON OF THE AVERAGE NUMBER OF INHABITANTS PER MUNICIPALITY

(thousands)



Source: Denmark, Ministry of the Interior and Health website; Dexia Bank

per head in Spain's municipalities with 1,000 inhabitants are 23% higher than in municipalities with 5,000 inhabitants. Research on small local governments in Swiss cantons (a system often held up as a case where small-scale government works well) suggests that costs and quality are severely compromised below a population of 500 (Ladner and Steiner, 2003). Evaluated against these benchmarks, the number of municipalities below critical minimum sizes in terms of efficiency is relatively large in Hungary *(see Table 4)*.[11]

The most obvious solution to the Hungarian problem of economies of scale would be through mergers. However, this is easier said than done. Many argue that mergers will never get political support because the setting up of local democracy is one of the main achievements of transition.[12] Local democracy is indeed strongly protected; the constitution prohibits the central government from decreeing the merger of municipalities. Given this, policy has to work more indirectly so that joint provision is encouraged through persuasion and incentive mechanisms.

A good feature of the local-government system is that it allows municipalities to transfer their service responsibilities to the county level on the grounds that they are unable to meet the related operating costs.[13] While this helps avoid costly duplications of specialised services, some regulatory fine tuning is required. At present, the ownership of the asset is not transferred along with the transfer of the utilisation rights. Transfer of ownership requires approval by the municipality following a request from the recipient county but this is rarely carried out. The municipalities are often reluctant to

Table 4

THE SIZE DISTRIBUTION OF MUNICIPALITIES

Population range	Number of municipalities	Number of minicipalities (cumulative)	Percentage of total municipalities (cumulative)	Total population	Total population (cumulative)	Percentage of total population (cumulative)
Below 200	312	312	9,9	38,030	38,030	0,4
201–499	705	1,017	32,1	241,942	279,972	2,7
500–999	682	1,699	53,6	497,662	777,634	7,6
1 000–4 999	1,157	2,856	90,2	2,445,773	3,223,407	31,6
5 000–10 000	146	3,002	94,8	1,012,533	4,235,940	41,6
Above 10 000	165	3,167	100,0	5,957,446	10,193,386	100,0

Source: Ministry of Finance

introduce changes in the use of their infrastructures and this limits the counties room for manoeuvre in reform. The regulations on passing over responsibility for services would be more effective if municipalities were prevented from imposing rules on how the county' uses the infrastructure.

In addition, the joint provision of services by municipalities is common.[14] There exist various legally recognised forms of associations. These allow for the joint delivery of services, the delivery of services by one of the member municipalities and the formation of joint administrative districts (e.g. covering local tax offices and internal audit).

The system of 166 "micro-regions" (based on Eurostat's NUTS IV criteria) set up in 2004 has been used to bring more structured joint provision in key areas of public spending, including development projects. Central government is encouraging municipalities to use the micro-regions as a basis for joint provision. The broad aim is to encourage co-operation between small villages and larger settlements, something the former have often been reluctant to accept for fear of losing autonomy. Several incentive mechanisms have been introduced.

PROGRESSIVELY INCREASING GRANTS Grants for some services are progressively increased with the population coverage of the associations of municipalities. For example, for sewage networks serving between 2,000 and 15,000 residents, the central-government grant covers 40% of total costs, this is increased to 50% if population exceeds 15,000.

THRESHOLD REQUIREMENTS IN INVESTMENT GRANTS Access to special investment grants is sometimes contingent upon meeting a minimum population or consumption threshold.

ONE-OFF AND FORMULA BASED COMPENSATIONS These are provided when associations are formed and later on to help cover operating and development costs. This compensation represents only about 2% of total central-government transfers to municipalities but the experience so far suggests that even this modest compensation can be enough to motivate small settlements to co-operate.

DETERRENTS From 2007 some penalties have been introduced. For example, the "deficit grant" will no longer be available to those municipalities that are not in an association for the joint provision of education services.

There is welcome flexibility in the micro-region system. Borders can be altered through legislation that allows municipalities to switch to an adjacent micro-region.[15] In addition, central government is taking a flexible approach in its application of the incentive mechanisms described above. Associations do not have to comprise all municipalities in a micro-region to be eligible for the incentives and the joint provision of public services can even span the boundaries of the micro-regions.

The general perception is that these mechanisms are indeed encouraging a more efficient scale of operations. Virtually all the micro-regions are now being used for joint provision and are running at least three services. The most common joint provision is in education *(see Table 5)*.

Though the micro-region system seems to be running well, there is some scope for improving governance. The micro-regions are typically run by the association councils comprising only the mayors from the participating municipalities. Reportedly, in some instances this is leading to excessive marginalisation of the municipal assemblies. The law allows the establishment of a separate organisation a joint municipal authority – to oversee joint services. However, very few have been created because their powers are vaguely defined. Oversight of the association councils could be strengthened by provisions allowing for comment on preliminary council decisions from all stakeholders. This however would also require allowing local stakeholders access to the relevant details of the councils' work.

Additional mechanisms for encouraging joint provision should be explored. Adjustment of tax allocation formula is one candidate. For example, the Czech Republic is considering adjustment of its tax allocation formula to reward joint provision (OECD, 2006c). However, the returns to both existing and new schemes need to be carefully evaluated. It can prove tricky to ensure that co-operation agreements result in concrete economies in service provision and not just superficial organisational changes to fulfil eligibility criteria. Also, the returns from a fiscal perspective may be limited if efficiency gains emerge in improved service quality rather than cost savings.

FUNDING ARRANGEMENTS FOR LOCAL GOVERNMENTS

Aside from the structure of spending assignments, *de facto* levels of self-determination in the municipalities and the counties are influ-

Table 5

DISTRIBUTION OF MICRO-REGIONS BY TYPE OF ACTIVITY END OF 2007

Purposes	Number of micro-regions with joint provisions
Educational	164
Social institutional	33
Social basic service	128
Children-protection service	3
Children-welfare basic service	145
Moving library	85
Inner audit	154
Total number of micro regions with joint provision subsidised by central government	164
Total number of micro regions with joint provision	173

Source: Ministry of Finance.

enced by the system of intergovernmental financing. Most sub-national government funding goes to the municipalities, reflecting the much wider range of responsibilities compared with the counties. The key features of the system are as follows *(see Chart 3):*

GRANTS FROM CENTRAL GOVERNMENT Grants are by far the most important source of revenues for sub-national governments. These are the sole source of revenue for counties and account for a large share of municipal funding. Grants account for roughly 45% of the aggregate revenues of municipalities, equivalent to about 6% of GDP.

TAX SHARING About 40% of revenues from personal income tax (PIT) are distributed to the municipalities. These account for 15% of total sub-national government revenues (some 2% of GDP).

LOCAL TAXES Local taxes make for roughly another 15% of total revenues, though there is considerable variation across sub-national governments. Particularly important is a tax on business turnover which totals approximately 80% of overall local tax revenues at the sub national level (this is discussed further below).

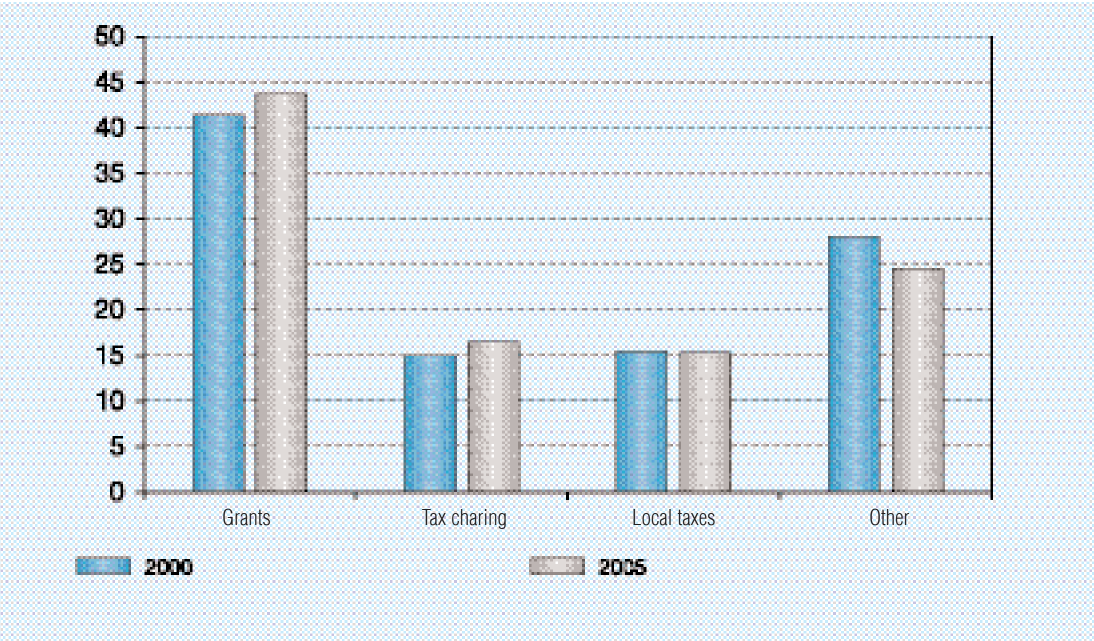
OTHER REVENUE SOURCES The remainder (roughly 25% of total revenue) comes from various items, in particular asset sales, revenues from local fees and fines, and the reimbursement of value added taxes (for instance that those paid on the purchase of inputs used for services).[16]

In broad terms, the system of financing is overly complex. This problem has been recognised by the government, particularly regarding the grant system (see, for example, Government of Hungary, 2006b). This is discussed in detail below along with the use of performance indicators in financing, the PIT tax allocation, local business taxes and the funding of investment.

Chart 3

REVENUES OF LOCAL GOVERNMENTS BY TYPE

(% of total revenue)



Source: Ministry of Finance

An administratively costly grant system

The largest grant transfers are so-called normative subsidies, i.e. they are formula based grants. Around 40% of these transfers are for primary education. A large share of grants are not-earmarked (i.e. they go into general sub-national government revenues). Recent OECD work (Blöchliger and King, 2006) calculates that 43% of total grant transfers are non-earmarked, a share roughly in line with the OECD countries' average (45%).

Some important grants are however earmarked (i.e. the local authority must spend the allocation on the designated activity) and stipulate matching funding (i.e. the local authority has to make a contribution to the funding of the activity). The largest earmarked grant is the social security transfer for healthcare which is paid directly to the healthcare institutions. Supplementary funding allotted to education (e.g. special programmes for Roma children) and grants for large infrastructure projects are also earmarked. This is the case, at present, with the Budapest's fourth Metro line.

A major source of concern in the grant system is with the large number of detailed financial normatives applied. It is usual for grant systems to be complex because of the need to tailor the grants to suit the services being funded. However, excessive complexity and administrative costs are added to the Hungarian system due to the large number of specific characteristics and sector requirements. This is exemplified by the numerous formula based grants, of which there are over 200.[17] The education grant alone results from the aggregation of some 30 normatives, each one associated to a mandatory service.

The government is taking some steps to cut back on the number of formula based grants. The Convergence Programme of Hungary (Government of Hungary, 2006b), contains a commitment to reforms, beginning with education. From September 2007 (the beginning of the school year), kindergartens and primary schools will be financed using a single normative subsidy instead of the ten normatives used to date. Unlike the present system, where the normative is calculated on a per-child basis, the new formula will be based on organisational parameters with the objective of increasing the number of classes taught per-teacher and the number of pupils per class. The government expects that, once fully implemented, the uniform grant will replace 70% of all state grants in public education.

Further to these measures, the current OECD assessment of good practices with grant management (Bergvall et al., 2006) suggests that other options should be considered.

- Further reducing the number of earmarked grants as part of a broad re-assessment of the structure of the "basic package" of services covered by these grants. Switzerland, for instance, has had some success in removing perverse incentives by replacing earmarked grants with non-earmarked general purpose grants. In the Netherlands a more selective approach has been taken: switches from earmarked to non-earmarked grants are only made in areas where municipalities are unlikely to cut back services drastically.
- Simplifying the system of obligations and minimum standards. Reducing the number of normative subsidies can be facilitated if detailed and superfluous standard requirements are eliminated. It also facilitates the calculation of the aggregate non-earmarked grant.

The need for more performance-based funding

Progress in introducing measures of output in funding formulae has been modest so far. Indeed, the largest subsidies put a very strong emphasis on the *per capita* component and items reflecting outcomes or quality carry little, or no, weight. For example, grants for secondary education remain largely based on the number of students in the classroom with no penalties or rewards based, for example, on student performance in national tests or on the number of successful students who have access to higher education. In addition, central government authorities like the Ministry of Finance or the Ministry of the Local Governments do not verify outcomes. As a result, quality standards are not enforceable, even when they are set in the sector-specific laws.

The government sees the fiscal adjustment programme as providing opportunity to make grant transfers more conditional on performance. For example, since 2007 funding of local social welfare services has made half of the grant dependent on the fulfilment of provision standards. Similar quality-focussed incentives have been introduced in education, notably affecting the numerous secondary art schools.

The ongoing efforts to increase the role of quality and output in determining funding for mandatory services are welcome. This is a positive feature because these are services that contribute to established central government objectives. However, the use of quality indicators remains limited and more work is needed to widen this approach.

Fine tuning the allocation of personal income tax

The share of PIT revenues allocated to the municipalities has declined and is now roughly 40% of total PIT revenue. The allocation mechanism is complex. The calculation is based on total PIT revenue collected two years previously and has several components:

OWN-BASED COMPONENT The "cessation level", i.e. the share allocated according to the PIT collected within the municipality (own-based revenues), will equal 8% of overall PIT revenues in 2008.

EQUALISATION COMPONENT Another part of PIT is spent on an equalisation mechanism. In this process, the annual state budget law sets averages of per capita tax revenues according to several size-classes of municipality (the calculations factor in revenues from PIT as well as the local business tax). Municipalities with per capita revenues below the average for their size-class receive a supplement that fully covers the shortfall. Those with per capita revenues above the average have to contribute to the equalisation scheme according to a schedule in which the share of the difference with the average that is retained increases with the size of the gap. For 2008, the equalisation will cost the equivalent of 8.3% of total PIT revenue.

FORMULA BASED (NORMATIVE) COMPONENT The remainder of the municipalities' share of the PIT is used to fully fund a range of administrative services and to top-up funding in some other areas (e.g. welfare services). The allocation uses formulae similar to those used in the grant system. This component is relatively important; for the 2008 budget it will amount to 23.7% of total PIT revenues and for the past fifteen years it has never been below 20%.

The formula based component of the PIT allocation should be reconsidered. First, the link between the funding of a range of services to PIT revenue runs against the principles of efficiency and flexibility in financing and should be severed. For instance, the link to PIT means strong exposure in funding for these activities to fluctuations that are unlikely to relate to cost or output variation. One way forward would be to drop this indirect allocation of PIT to municipalities and to fund these services from general government revenues (as is the case for other formula based funding for municipalities). Another approach would be to re-direct the allocation into the own-based and equalisation components and to drop the specific funding for these activities. The need for simplification in this area of municipality financing is echoed in a recent World Bank report on local-government financing in Central and Eastern Europe (World Bank, 2006).[18] Indeed, of the eight countries surveyed, only Hungary has a two-tier system in which revenue redistribution on an origin basis and general purpose grant transfers are combined together.

Second, if formula based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services. For example, under the 2007 budget each municipality with less than 500 inhabitants is entitled to receive a PIT-related normative for "administrative, communal, and sport-related tasks" that is twice the value of larger municipalities, which weakens the objective of municipal co-operation. Similar adverse signalling mechanisms are contained in the grants allocated for the issuance of official documents (passports, identity cards, car plates, birth certificates, etc.).[19]

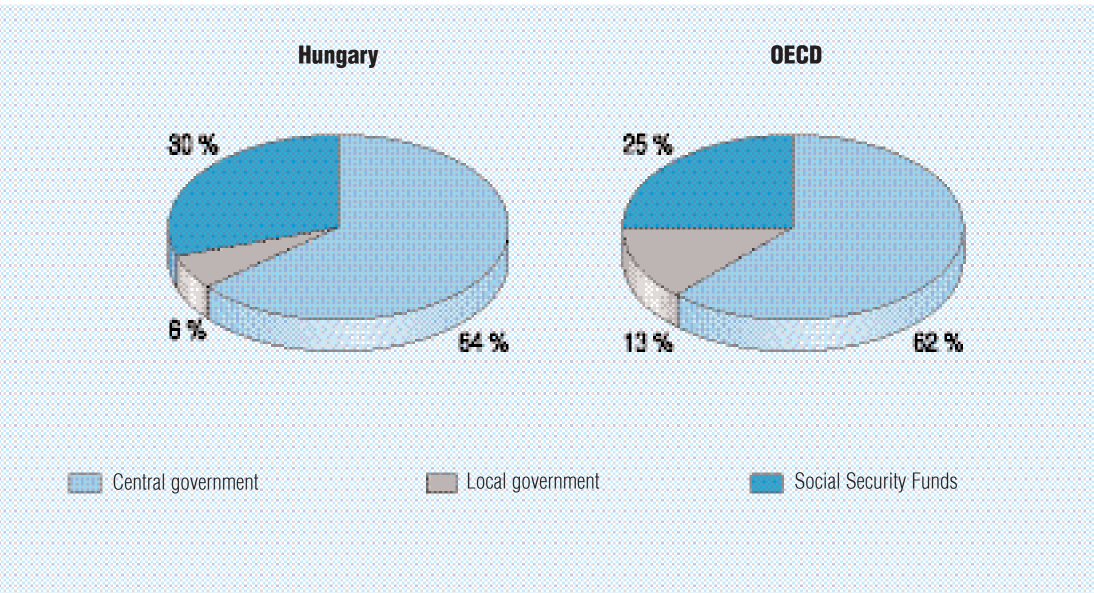
Problems with local tax-raising capacity

Local government own tax revenues are well below the average of the sample of unitary OECD countries *(see Chart 4)*. In addition, the most important local tax is a local business tax, rather than a property tax *(see Table 6)*. Hungary has a local property tax, based on the size of plots or buildings, but its contribution is negligible, as is the case with the tourist tax. Under the current legal framework the local authorities have a relatively wide margin of discretion about how to shape their local taxes.[20]

There are a number of problems with the business tax:

Chart 4

TAXES BY LEVEL OF GOVERNMENTS % OF TOTAL TAX REVENUE[21]



Source: OECD (2006), Revenue Statistics, 1965–2005

Table 6

LOCAL TAXES AS OF 2007

Type of tax	Number of municipalities levying the tax	Number of municipalities levying the tax as a percentage of total number of municipalitie levying at least one tax	Amount of revenues reised as a percentage of total local revenues
Building tax	743	23.8	10.1
Land tax	422	13.5	1.4
Communal tax for private individuals	2233	71.6	2.5
Communal tax for business	700	22.4	0.2
Tourism tax	717	23.0	1.3
Local business tax	2676	85.8	84.5
Total number of municipalities having at least one tax	3119	100.0	100.0

Source: Ministry of Finance

◗ It erodes the local tax base as it is imposed on mobile assets and increases pressure on tax competition. This is visible in the trend increase in the number of local municipalities that choose to set the level of the local business tax rate below the statutory maximum ceiling of 2%.

◗ Since it applies to business operations that can last for short periods – such as construction – the basis of the tax is subject to variability.

◗ To the extent that the regional disparity in the local business tax basis broadly matches that of wealth, the strong reliance on local business taxation aggravates regional income disparities. At present Budapest and surrounding municipalities collect most of the local business tax and, Budapest alone account for 30% of total business tax revenues.

◗ The base is questionable. Because the tax is based on turnover it runs counter to the principle of taxing incomes or profits.

Acknowledging these problems, the government announced in 2005 that firms would be able to fully deduct the local business tax in the calculation of corporate income tax.

A system more focussed on the local property tax would ultimately be better. Property taxes have low avoidance and relatively stable and predictable revenues. In addition, the "benefit principle" is more strongly adhered to since the local property tax is imposed directly on the local taxpayers and is difficult to avoid. A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. The following issues should be considered in the proposals.

◗ Development of up-to-date local "value maps" to ensure that the new property tax is levied on values that reflect market developments. At present, properties are valued using arbitrary point values, such as per square metre and location in the case of land, or in the case of buildings, per square metre and according to use (whether office or residential). Such values were deliberately set low in the early 1990s when Hungary lacked a properly functioning property market and have never been re-evaluated since.

◗ Broaden the tax to include home owners. A broader tax base would more closely align the tax with the local electorate, thus bringing it more in accordance with the benefit principle.

It would entail corresponding widening of valuation to include residential premises. Much of the framework necessary to do this is already in place. The cadastral mapping and the legal property registry are unified and all land and real estate properties in the country have been registered. One source of possible problems is that while the information technology systems in the land offices are operational, the national network of registries is yet to be connected. An ongoing programme to produce digital cadastral maps is expected to be finalised by 2008, though putting digital maps in a fully harmonised format should take longer.

Issues in investment funding

Hungary's sub-national governments initiate a lot of investments and local development is one of the main pillars of the new government strategy to use EU funding. Assessments by the government and the World Bank conclude however that the system is highly fragmented and somewhat un-coordinated (Government of Hungary, 2006a; World Bank, 2000). While the allocation process stimulates competition among municipalities, engaging in local investment funding requires substantial administrative costs and local priorities are not always well identified.

In response to these issues, the latest Development Plan of Hungary (Government of Hungary, 2006a) sets out clearer local objectives and brings in new approaches to manage funding. Investment activities will not only focus on traditional "hard" infrastructures (e.g. roads and railways), but also on boosting local human resources and skills (e.g. education and training). In transport, there is the intention to widen the scope beyond motorways and to invest more in local roads, the expectation being that, by helping local labour mobility, this will support employability. Local policy-makers will have to submit development strategies that involve more co-operation and close ties between local governments, the business community and local institutions, such as universities. According to the Development Plan, several large municipalities will act as "hubs" for development.[22]

To improve co-ordination, the allocation of EU funding will become more centralised. So far, programmes have been divided up between line Ministries. Under the new approach, the Ministries' role will be more that of intermediary bodies, both during the planning stage and as executors of programmes. Otherwise, any funding decisions will be taken centrally.

CONCLUSION AND POLICY RECOMMENDATIONS FOR LOCAL GOVERNMENT REFORMS

Budgeting issues

- The authorities should consider reinforcing budgetary rules: separate budget balance rules for current and capital items should be specified and, in parallel with developments in central-government practice, multi-year budgeting at the local level should be introduced.
- Hungary could follow the example of several OECD countries (Austria, some Canadian provinces, Poland and Spain) which have recently made local governments move "off-budget" items into their accounts.
- On budgetary transparency, efforts should be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards. One way of giving more teeth to sanctions would be via provisions requiring local governments to provide an explanation for breaching

the budget rules and to submit a plan describing the measures they intend to implement in order to rectify the situation.

- The deficit grant is unfitted to deal with cyclical pressures. A good opportunity to remove it appears to be offered by the ongoing shift to the multi-year budgeting framework in central government. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance.

Spending assignment issues

- Efforts to find consensus on the issue of replacing the county-level of government with elected assemblies in the seven NUTS II Regions should continue. The replacement would help overcome problems of overlapping responsibilities and allow for savings in administrative overheads.
- Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper rather than encourage improvements in public services by sub-national governments.
- The regulations on passing over responsibilities for services from municipalities to counties would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure. Support from the municipalities for joint provision *via* the system of "micro-regions" would be helped by stronger mechanisms for public comment on the decisions taken by the councils of mayors that run these services.
- On benchmarking, much faster progress is required in the development of comparable cost, output and performance indicators.
- Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better.

Funding arrangements for local governments

- The number of formula based earmarked grants should be further reduced as part of a broad re-assessment of the structure of the "basic package" of services covered by these grants.
- Steps are needed to eliminate problems in the PIT allocation. First, the link between the funding of a range of services to PIT revenue runs against the principles of efficiency and flexibility in financing and should be severed. Second, if formula-based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services.
- Ongoing efforts to increase the role of service quality in funding represent good progress. However, the use of quality indicators remains limited and more work is needed to widen this approach.
- A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. Local "value maps" ought to be developed to ensure that the new property tax is levied on values that reflect market developments. The tax base should be broadened to include home owners.

Notes

1 For earlier discussions of Hungary's structure of governance see Wetzel and Papp (2003), OECD (2001a), OECD (2001b) and World Bank (2000).

2 Sutherland et al. (2005). Drawing mainly on questionnaire responses, this paper gives a detailed picture of fiscal rules for sub-central governments in a number of OECD countries.

3 The City of Budapest's self-imposed rule on use of the current surplus has been in place since 1995 and surpluses on current spending have been recorded since then. For 2006, Budapest's gap between current revenue income and spending was 13%, with the plan being to widen the gap further to 20% before 2010.

4 In Finland, for example, a system of grants has provoked some mergers. In Denmark, the number of municipalities was cut quite dramatically from January 2007 from 271 to 98, with an average population of 55,000 compared with 20,000 previously. The 14 counties have been merged to five regions responsible for healthcare (OECD, 2006a). It should be noted, however, that compared with Hungary municipalities enjoy much less constitutional protection in Denmark.

5 For further discussion about the role of counties, Vigvari (2006), Fekete, et al. (2002) and Pálné Kovács (2005)

6 The issue was originally raised in World Bank (2000). Peteri (2006) suggests that the power of line ministries may have lead to less "objective" local grants, basically reflecting strong ministries' control of sector laws.

7 For example, the dissolution of a public education institution is conditional upon a consultation involving the staff of the institution, the school board, the parents and the school's student council, with all these players having veto rights.

8 The law allows local governments to contract out the operations of their hospitals but this does not happen very often. In this case, the hospital becomes a private company and the healthcare workers are no longer public employees.

9 Secretariat estimates based on the latest available national accounts figures (2005 for most countries) and excluding the transfers paid to other levels of government.

10 These estimates should be considered with caution, since larger municipalities tend to offer more services, resulting in higher average spending per capita. For recent surveys of economies of scale issues, see Fox and Gurley (2006) and Lotz (2006).

11 Excluding Budapest and the largest cities, Hungary's municipalities average only 1 258 inhabitants. There are 1 020 municipalities with populations of less than 500 and 1 700 of less than 1 000. A number of papers have argued that although mergers and joint provision may allow scale economies to be exploited, such solutions are not without drawbacks. In France, for example, where joint provision is very common, concerns have been raised that they could lead to a failure of democratic control because joint bodies are not elected by the population and are often perceived as lacking transparency (Le Saout, 1998). Citizens may therefore be left with little influence over local services. However, these views apply only weakly to countries, such as Hungary, where citizens from small municipalities do not exert a strong voice with regard to local affairs (see below).

12 Before the transition there were 1,500 municipalities and Budapest, which counts as many as 23 districts, was considerably more centralised than at present.

13 The municipalities can only transfer duties that were passed on to them in 1990 as part of decentralisation. Over the past fifteen years many secondary schools as well as a number of hospitals were transferred from the municipalities to the counties by this means. Also, municipal governments have the right to take over the control of any county service as long as it can be proved that over at least the previous four years it has been mostly used by local residents.

14 Joint provision is covered by Act on Local Governments which permits the establishment of inter-communal partnerships on a voluntary basis. Adherence to a joint association requires approval by a qualified majority of the local council and the law does not impose any specific requirement with regard to the sectors the association is going to cover.

15 Notably, boundaries can be adjusted with a four year frequency, within 6 months from the general local government elections. During this period, local governments can opt to join an adjacent micro-region if this is seen as leading to better public services for their inhabitants.

16 These VAT revenues are to be initially paid to the State Tax Authority, implying that also the expenditure-side of the sub-national government balance sheet contains this item.

17 "Only" 50 normatives are presented in a special annex attached to the draft budget. See Fox (2004) for more details on this issue.

18 Notably the World Bank report concludes that Hungary has the most complex system among the eight countries surveyed (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). Lithuania, for example, which has the simplest system in the region according to the World Bank study, targets a fixed level of equalisation using a single parameter. Specifically, the PIT is distributed entirely on an origin basis, with the richer jurisdictions then being required to share part of their revenues with the poorer ones. See World Bank (2006, p. 68)

19 In this case, the 2007 budget law states that the grant is evaluated at 513 HUF per document processed (roughly equivalent to 2 euros), but at the same time it requires that the total grant value cannot be less than HUF 6 million which implies funding for processing 12 000 documents. It seems unlikely that municipalities with only a few hundred inhabitants require processing on this scale.

20 The institutional setting is defined by the Act on Local Taxes under which the central government defines the ceiling but not the floor of local taxes. As a result, the local governments have the right but not the obligation to introduce certain taxes (OECD, 2006e).

21 Estimates for 2004. Central government includes supranational taxes (attribution less than 0.5%) collected on behalf of the European Union by its member states. OECD is an unweighted average of unitary countries. The figures do not take into account the transfer of revenue from central to local government which in Hungary's case is partly derived from the local government's tax base.

22 For example, Győr and its surroundings, which make for the automotive centre of Hungary, will focus on the engineering industry and renewable energies. Miskolc, where many chemical companies are already located, will act as an R&D pole in the area of nano-technologies and alternative energies.

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