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Risks in the local government system from the stakeholders' point of view

The words 'risk' and 'stakeholder' are business terms often used nowadays when presenting the problems of a system. In the past fifteen years or more, the local government system, put on a new foundation at the time of the political change, has undergone several changes that can be clearly termed as unfavourable today and which are easiest to grasp in the light of the complexity of the suggested reforms.[1] The aim of this study is to contribute to the discussions on the direction of the local government system reform by an analysis of a different nature, which has worked in other fields.

Taking the national economic significance of the local government sector as a basis, the study undertakes to present the problems of the changing regulation, the development of the respective risks and the stakeholder behaviour patterns closely related.

THE ROLE OF THE LOCAL GOVERNMENT SECTOR IN THE NATIONAL ECONOMY

After the collapse of the council system, the local government system established in Hungary seemed to meet the challenges of the time. With the right of self-government and the relatively large freedom in local affairs granted, some had the temporary feeling, while others even the lasting impression, that a significant problem had been successfully solved. For such a value judgement to be made, events have to be viewed from several years' perspective, however.

The local government sector has become one of the basic pillars of the Hungarian economy. Evidence for the latter includes the expenditure rate of the sector to GDP as well as its role in employment. The reason why public sector reforms should be started from the side of local governments[2] is not only that it is here where the problems are most serious. The opinion that local governments have become far too important in the judgement and improvement of the competitiveness of Hungary also deserves consideration, we believe. *(see Table 1)*

The sector manages some one third of the national wealth, the total value of which was HUF 9 860.9 billion as of December 31, 2005. It implies its significance furthermore that the decisive rate of basic and public education- as well as social services-related expenditure is realised through the sector. Good evidence for the latter is that about 90 per cent of local expenditure is related to these welfare services rather than to town operational costs. It is thus justifiable to view the sector as the “engine” of competitiveness, which is not something specific to Hungary, however; the same has been formulated in several court judgements in Germany, for example.[3]

Table 1

BASIC CHARACTERISTICS OF THE SIZE OF THE LOCAL GOVERNMENT SECTOR

	1991	1993	1995	1997	1999	2001	2002	2003
Number of employees of local governments and their institutions (thousand people)[4]	ND	ND	561.3	544.0[5]	520.5	506.0	496.4	501.4
Number of local government institutions (on December 31)[6]	ND	ND	ND	ND	20 705	ND	ND	21 154
Number of built-up real estates (pcs)	ND	ND	ND	ND	243 573	ND	ND	240 815
Number of Associations (pcs)	ND	ND	ND	ND	1 646	ND	ND	2 142

Source: Dobos–Szelényi (1996–2006), local government balance 1998, 2003

The fact that local governments constitute parts of the state budget is a source of risks, at the same time – through regulating duties and sources, the central government predetermines the situation of local governments. Considering the increasingly frequent borrowings and bond issuings by local governments, however, a certain benchmark-phenomenon can also be observed, i.e. that a creditor or an investor compares the local government concerned to the state as a debtor. This may have both positive effects (improvement in the judgement of the state at the international level, for example) as well as negative consequences (e.g. underfinancing for obligatory duties, inconsistencies in regulations, etc.).

Considering the above we believe that the regulation on the operation of the sector must always be given special attention in economic policy.

THE SOURCE OF CONFLICTS

According to *Ágh* (2005), in the 1990's, the central government treated local governments as conflict containers, due to other prevailing problems. The phrase refers to the phenomenon that the sector was assigned a growing list of duties which, in retrospect, can be claimed non-local ones, without the necessary financing provided. Hungary was no champion in this, either, as it had been a custom also in other countries in the 1970's to solve central budget deficit problems by means of financially unsupported decentralisation (Pálné, 2001). The conflict container-situation can be interpreted along the following regulation problems.

❶ The Act on Local Governments does not differentiate between the rights and responsibilities of settlements of different sizes.[7] Settlements with a population of under 500 inhabitants thus have basically the same duties as towns or cities with thousands of inhabitants.

❷The legislator has left the situation of county local governments unclear. The exclusive source of income for county local governments may be subsidies, which is especially problematic considering that public duties potentially delegated by settlement level local governments to county local governments are thus to be performed under worse economies of scale.

❸The law does not draw a clear line between obligatory and voluntary duties. While guaranteeing secondary-level education is a duty obligatory for county local governments, settlement local governments also have the right to perform this duty.

The consequences of these contradictions in the regulations can be quite precisely established today. Considering the deteriorating quality of management, the May 2006 report of the State Auditing Office (SAO) already mentioned exhausting local government core assets as a development of serious likelihood. Data of *Table 2* seem to support the prediction of SAO.

Data draw attention to several facts. On the one hand, privatisation incomes had a determinative role in the GFS-balance in the 1990's; after the absence of these there was considerable deficit in the budget balance. On the other hand, local government expenditure within general government expenditure rose in 1996–2005, which rise was, however, covered, to some extent, by using money reserves. It seems thus that other sources, too, had a role in ensuring the operation of the underfinanced system.

Sources were nevertheless insufficient for meeting public duties. This is also well indicated by the fall of expenditure in real terms *(see Table 3)*.

Even more serious financing problems appeared at the micro level. Although there is no comprehensive analysis available on the operation of the almost 3,200 local governments, three important phenomena reflecting the appearance of problems can be pointed out.

❶ A drastic rise in the legal titles of normative subsidies: while in 1996 there were still 52 legal titles, in 2005, there were 143 already.

❷ The appearance of supplementary subsidies for underfinanced local governments in the annual budget acts: there are currently three such legal titles, the most significant of which are supplementary subsidies for local governments underfinanced for reasons beyond their control.

❸ The appearance and growth of operational indebtedness: in the year 2000, 13.9 per cent of local governments while, in 2005, 20.3 per cent of them already were obliged to take up operational loans (SAO, 2006, p 21). While the rate of operational indebtedness within total debt constitutes a stable 15 per cent, total debt made up only 1.4 per cent of public debt in the year 2000 but amounted to as high as 2.3 per cent in 2005.

Considering the above it can be established, we believe, that there are serious risks inherent in the inner contradictions of the local government system. The exploration of these requires the survey of literature on risk evaluation.

THE RISKS INHERENT IN THE HUNGARIAN LOCAL GOVERNMENT SYSTEM

So as to be able to establish the presence of actual risks, it is necessary to discuss some theoretical issues first. When describing the risks of a system, it is important to emphasise the aspect of observation and the subjective-objective nature thereof. The same local government is certainly given various evaluations of by taxpaying small enterprises, capital investing big enterprises, financing credit institutions, rating agencies, the Auditing Office and, last but not

Table 2

MAJOR FINANCIAL DATA OF THE LOCAL GOVERNMENT SECTOR

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GFS-balance	48.0	66.5	–8.8	23.0	5.0	1.3	–105.0	–31.7	–16.5	–81.4
Privatisation revenues[8]	47.4	90.5	19.3	21.9	37.1	11.2	11.6	9.0	8.7	15.6
Operational balance[9]/GDP (%)	+0.69	+0.77	–0.0	+0.20	+0.0	+0.0	–0.62	–0.17	+1.9	+1.8
Local government expenditure/general government expenditure (%)	25.2	25.6	25.8	25.0	ND	27.0	25.2	25.4	27.8	ND
Growth in GFS-expenditure, compared to previous year (HUF bn)	74.9	212.4	206.8	127.0	175.6	251.3	383.5	271.1	156.7	282.4
Growth in spending reserves (HUF bn)	23.6	ND	ND	2.2	14.2	44.5	5.3	12.6	34.8	17.1

Source: Own calculations based on data by Dobos – Szelényi (1996–2006), Illés (2005) and the Ministry of Finance

Table 3

CHANGES IN THE LOCAL GOVERNMENT SECTOR EXPENDITURE

Year	Nominal change in expenditure (%)	Consumer price-index (%)	Change in real value (%)
1991	118.5	135.0	87.8
1992	133.3	123.0	108.4
1993	120.4	122.5	98.3
1994	125.2	118.8	105.4
1995	106.7	128.2	83.2
1996	114.1	123.6	92.4
1997	124.3	118.3	105.1
1998	118.8	114.3	103.9
1999	109.5	110.0	99.5
2000	111.9	109.8	101.9
2001	115.2	109.2	105.5
2002	120.2	105.3	114.1
2003	110.8	104.7	105.8
2004	106.0	106.8	99.0
2005	110.5	103.6	106.7

Source: Vigvári (2006b)

least, the local government concerned itself. As regards the objective-subjective approach, we believe that, even though it is economic organisations that are examined, it is insufficient to apply an objective approach due to their embeddedness in the state budget. The most important reason for the latter is that the regulatory environment may change unexpectedly from year to year. Following the methodological practice of North-American rating agencies, it is therefore advisable instead to familiarise with the situation of the local government observed as closely as possible and to compare it with local governments of settlements in a similar situation.[10] Adding dimensions like space and time to the observations may be of help.

Space, as a dimension, is of double significance. On the one hand, it provides important data on the area of authority of the local government concerned, i.e. geographically, regarding the microeconomic development level, (e.g. the number of enterprises, their capital strength, etc.), the state of infrastructure, etc. On the other hand, the dimension of space reflects the size of the duties of the local government (the number of obligatory and voluntary duties, the depth of duties, the number of beneficiaries, etc.) and the relation thereof to the micro economy. This thus covers a survey related to the size of the local government itself as well as that of the settlement concerned, which can be carried out in the case of local authorities of a similar size only.

The survey along the time dimension takes the utilisation of the decision alternatives offered by the laws and regulations, and the "room for action" of the organisation concerned as the bases, which, by altering the phrase "expectable control" of *Vigvári* (2002), can be referred to as the "expectable behaviour". During the surveys along the time dimension, the emphasis moves from the short-term to the medium-term, because of which a failure to meet the indicators observed or to perform the "expectable behaviour" does not make it necessary to implement an immediate revaluation of the riskiness of the organisation observed.

So as to get a precise picture of the organisation examined, it is often necessary to further refine the picture acquired through the space and time surveys, one way of which is connecting the dimensions, thereby making the exploration of individual traits possible. The above is based on the realisation that, beyond the relative geographical location of the settlement concerned, its stage of development, to be evaluated, also contributes to its uniqueness. In their reports, international rating agencies differentiate between what are referred to as mature settlements, the population of which does not grow significantly, and developing settlements, in the case of which there is significant population growth annually. Local governments in the latter category must be prepared for a future growth in the demand for public duties, too, i.e. for the need to widen capacity. Therefore, in the case of developing settlements, diversion from the expected data, to serve as the basis of evaluation, and from the requirements of "expectable behaviour" is to be greater than in the case of mature settlements (Fitchratings, 2004, p 8).

The above theoretical foundation probably raises doubts in the reader as regards our knowledge of the risks of the Hungarian local government sector on the basis of the information available. There is a reason for doubt indeed since the analyses presented are missing in one aspect or the other even at the macro level, let alone those according to the types of settlement. Since the Hungarian local government system covers a relatively high number of local governments, however, from the data and indicators calculated on the system as a whole, it is easy to make conclusions on the presence of risks. On the basis of the data and expert opinions on the operation of the local government system in the past one and the half decades, the following risk categories can be specified:

- state budget risks,
- risks in the decentralisation of duties,
- financial risks,
- asset risks,
- management risks.

In the presentation of the performance of the sector above, references were made to the risks related to the state budget and to the decentralisation of duties, while financial, assets-related and management risks still require some explanation. As a significant consequence of the conflict container situation, there has been little information available on these risks until today.

It is related to the obscurity of financial risks that, due to the borrowing limit set by the local government act, banks present some of the deficit financing as if it was liquidity borrowing, which latter is unlimited (Vigvári, 2006a). The rise in debt as compared to own revenue is higher than the debt rate compared to total expenditure, thus resulting in worsening borrowing ability. The amount of borrowing rises nevertheless, which raises the need to determine the level of borrowings that still allows a local government to meet its public duty-related expenditure.[11]

The presence of assets-related risks is only apparent from the SAO reports. The problem is that most local governments do not keep a statement on the assets available for the respective public duties or on whether the condition of these assets makes meeting the public duty concerned possible. It is certainly important to note that in the case of certain local public duties – like basic and public education, social services – it is probably only the quality of services that we can make conclusions on based on the current methodology. There is thus no information on the suitability of the assets themselves.

Since local government managements also share the responsibility for the current situation, we believe, it should be examined to what extent they met the requirements of "expectable behaviour" when making financial management decisions. The priority of operational activities to investment activities at settlements resulted in efforts to achieve budget balance by any means. Whether a local government achieved this by borrowings, local taxes or by selling tradable assets, depended on how and to what extent they were, while keeping their own position, able to involve local taxpayers in burden sharing. As theoretical research has revealed for almost 50 years, the interests of settlements are pushed into the background during efforts to win over electors. The situation in Hungary is most likely to be the same. In view of this, analysing stakeholders' interests is probably of even higher significance.

LOCAL GOVERNMENT STAKEHOLDERS

In the beginning of this study we noted that basically the whole national economy is interested in the operation of local governments. The following can be established as regards the behaviour of the respective interest groups.

Electors

Electors are taxpayers and the beneficiaries of local services at the same time. Theoretical research reveals that taxpayers tend to move from settlements with what they find non-optimal public goods tax combination.[12] The Hungarian population is characterised by low mobility, however, because of which changes in (i.e. the deterioration of) local taxation and the standard of local services have little influence on changing residence.[13]

For the operation of the local government, it can be regarded as expectable behaviour of electors to be actively interested in the election of local leaders and to check accountability for public moneys as well as to control the adequate treatment of the assets owned by the local government, i.e. the public assets of the local community. In the past few years, partly due to the political dividedness of voters, these issues have been very much in focus, but rumours have often lacked economic considerations. There is low probability for electors' clear-sightedness.

Off-budget organisations performing duties[14]

The performance of public duties by off-budget organisations is also closely related with the conflict container situation. Due to the lack of independent decision making opportunity in financial management and the real fall in revenue, local governments have viewed market solutions as the omnipotent solutions. The contents of the contracts made with organisa-

Table 4

THE VOLUME OF LOCAL GOVERNMENT ASSETS TRANSFERRED FOR OPERATION AND MANAGEMENT CONSIDERING THE SECTOR AS A WHOLE IN 1999–2005

(as of December 31, HUF bn)

	1999	2000	2001	2002	2003	2004	2005
Assets transferred for operation and management	174.6	399.3	489.5	858.4	1 214.0	1 396.5	1 465.8
Value of local government property assets	2 313.2	3 089.9	3 504.8	6 423.3	9 234.6	9 617.9	9 860.9
Rate of transferred assets compared to local government property (%)	7.54	12.92	13.96	13.36	13.14	4.52	14.86

Source: Dobos – Szelényi (2000–2004 and 2006) as well as data of the Ministry of Finance tions performing public duties or the risks involved therein have been ignored by the central government.

It can be expected of off-budget organisations to use the transferred local government property assets and funds in a transparent way. The importance of this can be appreciated considering the volume of property assets transferred for use *(see Table 4)*.

Yet, for every company, it is profitability that is of primary importance. Although the market attitude and the base of distribution of administrational costs are wider, local government decisions on public services fees as well as the potential demands for supplementary subsidies because of the former do not serve the responsible management of transferred moneys and property assets.

The state

In addition to the aspect of improving the competitiveness of Hungary, the state interest in the development of the situation of the state budget is also significant considering the requirement to meet the Maastricht criteria. The deterioration of the GFS-balance of the local government sector indicates that reforms must not be put off for long since borrowings of growing significance, with no regard to financing ability, have appeared as a social risk in the background already.

So as to guarantee the performance of public duties, the state must ultimately bear the burden of the local indebtedness related to the operation of local governments. Apparently, indebtedness does not always appear explicitly: the situation caused by the increase in the financial obligations outside the budget (exchange rate risks involved in leasing contracts and foreign currency loans) and the assumed deterioration of the transferred property – due to the lack of local control – cannot be sustained for long. In the case of investments – the decisive majority of which is likely to be financed from EU sources in future – it is an extra problem that, under the current regulations, it is the state that is responsible for the potential repayment of sources.[15]

The treatment of local governments as conflict containers thus concealed the real situation apart from the problems on the one hand and eased control on the other hand, which, in some cases, could lead to free rider behaviour.

Creditors

For the Hungarian bank sector, local governments count as major clients. In the 1980's, local governments issued bonds for the first time as an experiment, through the National Savings Bank OTP. The credit institution that developed into a bank later on faced serious competitors at the local government market in the 1990's already. Since, until 1996, creditors believed there was state guarantee behind local government borrowings, in the competition of banks, OTP often lost current account and loan contracts to other banks. Another aspect of moral hazard was that, although excessively indebted local governments were not allowed to take up loans under the law, OTP accepted a simple local government statement as verification.

The local government bankruptcy cases after Act 25 of 1996 took effect, made creditors, too, more careful. The return on claims, sometimes as high as 1–10 per cent, had its effect: the local government sector became a net financer of the bank sector until 2004 *(see Table 5)*.

After 1996, it is what is referred to as the “rule of thumb” under which credit institutions judged applications for loans,[16] which were made by local governments for liquidity purposes basically, as well as in relation with actual investments. It can be formulated as criticism of the credit institutions that they failed to develop standardised products for local governments.[17]

The suspicion occurs that there is "cross-financing" between the various financial products offered to local governments. Current account management is basically guaranteed revenue of low risk for banks, because of which they often set irrealistically low conditions to local government clients in the case of potential applications for loans.[18]

So as to meet Basel II regulations, commercial banks will assumingly show greater interest in buying local government bonds, which fall into a lower risk category compared to classic loans. Once they are made interested thus, credit institutions will probably also be interested in sharing their experience as well as in evaluating their local government clients under new aspects, which has not become general practice as yet, however.

Investors

As a result of the expected rise in local government investments, investors are to be assigned an important role. The criticism raised against the new solutions – like PPP, BOT – which also make it possible to circumvent the Maastricht criteria, includes the lack of an adequate legal regulation or local experience on the management of such contractual relations on the one hand, and the consequence of putting the burden of the investments on later generations on the other hand.[20] Since it is the return on their investments that investors primarily keep in mind, with no adequate contracts available, it is not to be predicted in what condition property assets in permanent private management will be returned to state ownership later on. Considering the state orders or subsidies guaranteed during the contracts, such constructions can be justified only if, after the expiration of the contract, the property assets concerned are suitable for performing the purpose for which they were produced and their further operation does not involve unjustified extra burden on the state.

Under paragraph 80/A of the Local Government Act which entered into force on January 1, 2007, the core property may be assigned to property management. If a local government assigns its property assets to property management by appointment, the transfer involves no VAT payment obligation. Investigations by the State Auditing Office into the transfer of water public utility property have revealed unlawfulness in several cases

Table 5

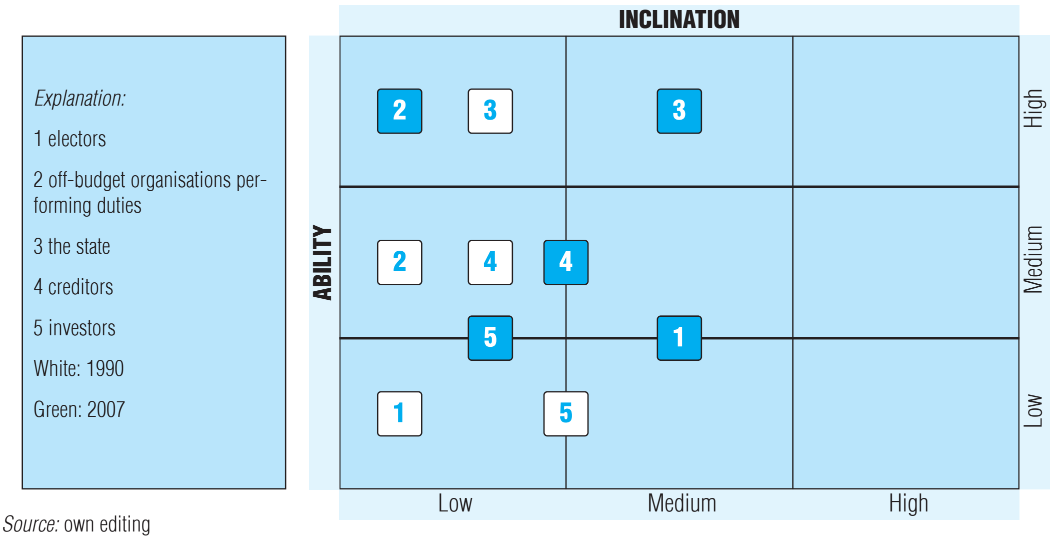
THE RELATION BETWEEN THE LOCAL GOVERNMENT SECTOR AND THE BANK SECTOR

	1996 Dec	1997 Dec	1998 Dec	1999 Dec	2000 Dec	2001 Dec	2002 Dec	2003 Dec	2004 Dec	2005 Dec	2006 March	2006 Jun
Bank loan	49.9	38.5	30.3	44.4	57.6	73.1	115.1	44.0	182.8	241.5	260.1	293.0
Bank deposit	80.7	86.8	115.8	123.5	148.3	197.5	219.3	211.3	251.9	249.9	256.0	210.7
Net position against the Hungarian bank system	30.8	48.3	85.5	79.1	90.7	124.4	104.2	67.3	69.1	–8.4	–4.1	–82.3
Liabilities total[19]	ND	ND	ND	ND	224.4	231.6	405.4	419.8	533.8	647.6	589.6	ND
70 per cent limit of own current revenue	136.0	199.9	246.3	292.4	335.0	335.2	438.9	461.9	523.6	556.4	ND	ND

Source: Vigvári (2002), Kopányi – Vigvári (2003), Vigvári (2005) and Hungarian National Bank (MNB, 2006)

Chart 1

THE INTEREST OF STAKEHOLDERS OF THE HUNGARIAN LOCAL GOVERNMENT SECTOR IN CLEARING THE SITUATION OF THE SECTOR



Source: own editing

and ordered the restoration of the original state. As made possible by the widened law, local governments will probably prefer to have property assets of mostly limited tradability, assigned to use by cultural, educational, sports, health and social, etc. institutions, restored or renovated by private companies, without making the necessary steps to avoid risks.

CONCLUSION

The behaviour of local government stakeholders is the result of the regulatory environment determining the operation of the sector basically. During the economic transition, the national economic significance of the sector increased. Since the reforms are likely to have a catalyst effect on the other subsystems of the state budget and on the Hungarian economy as a whole, the irresponsible stakeholder behaviour should be stopped as soon as possible.

As a conclusion of the stakeholder-analysis, stakeholders' interest in clearing the situation of local governments is summarised in *Chart 1* (ability-inclination-time).

As revealed by the chart – which reflects high subjectivity, just like in the case of risk awareness – inclination for improving the situation of the sector has improved in the case of several stakeholders in the past one and a half decades or more, but further steps are required for an overall effect. There has been a positive shift in the inclination of the state, we believe, which will hopefully influence the inclination of other stakeholders as well.

Notes

1 Cf. Péteri (2005), Pitti (2003), Vigvári (2005), etc.

2 Cf. Vigvári (2006)

3 Public servants, civil servants and other employees (e.g. firefighters, elected officials, not including local government representatives)

4 Data of December 31, 1996

5 Year-end closing data; instead of December 31, 1997, data of December 31, 1998 are presented.

6 For further detail cf. Albers (2004)

7 The only differentiation that exists is between county- and settlement-level local governments.

8 In 2004 and 2005, this constituted revenues from the sale of shares that local governments had acquired through privatisation primarily.

9 In 2004 and 2005, instead of operational revenues, data reflect total revenues minus accumulation revenues, earmarked- and target subsidies.

10 From the relevant Hungarian literature, it is works of Kozma (2006) and Vigvári (2004) that should be noted.

11 The term used for this in the literature is financial capacity, which was first used by Gurley and Shaw. The problem is that financial capacity is not easy to determine even in individual cases. Under a court judgement made in Rheinland-Pfalz province, Germany, (Rheinland-Pfalz GemO 103. §, Thüringen KO 63. §), local governments should be banned from further borrowings if their ability to meet public duties permanently fails. The piquancy of the problem is that the above is determined by the per capita indebtedness indicator.

12 Cf. Tiebout (1956)

13 In further research, it would be interesting to examine population behaviour patterns related to the tax-public services rate, in the view of low mobility.

14 Since the activities are carried out outside the local government budget, such companies as a whole are referred to as the off-budget sector.

15 Hungary is not alone with the problem. The issue is currently dealt with by Germany and Austria, where the GDP proportionate deficit framework – and thereby the risk of repayment – is divided up between the federal and the province levels.

16 The rates and conditions of loans continued to be decided on without comprehensive analyses, on the basis of the rate of local industrial tax revenues and changes therein basically.

17 Local governments are to start repaying loan capital during the term of the loans already, in contrast to the state, which usually starts repaying at the end of the term, using revenues from new loans.

18 Source: a discussion with Péter Kígyós, sales manager of Dexia Kredit Hungary.

19 The deadline composition of these is unknown but the dominance of long-term deadlines can be assumed.

20 It was Katalin Botos who called attention to the fact that such constructions may be the bases of future state subsidies or orders, the sustainability of which should be examined.

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