ANDRÁS VIGVÁRI:

LOST ILLUSIONS: FISCAL DECENTRALIZATION IN HUNGARY

This paper describes the fundamental inconsistency of the Hungarian local government system, which is manifested in a constellation of legal autonomy that is comprehensive even in international comparison and in fiscal centralization that is becoming ever stricter.

Originally, the funding system of the Hungarian local governments fitted into this legal framework. The paper shows the deformations of the funding system and the reasons leading to them – including how the conditions of tax sharing became more rigorous and how the role of non-earmarked (or block) grants weakened, and, simultaneously, how t earmarked grants played an increasingly larger role as time went on. Finally, the article outlines possible solutions.

The international literature contains quite different assessments[1] of the role of equalization and transfers in fiscal relations across levels of government. The source of the different approaches is partly value selection (equalization), partly the empirical difficulties of establishing the goals and thirdly, diverging views on the motivations behind the behaviour of subcentral governments.

Relevant international literature gives two basic explanations of the decentralization of government functions [Boadway (2006)]. The first, which we can call Tiebout-Oates paradigm, says that the purpose of decentralization is the adequate provision of local public goods. What decentralization adds to this is making sure that the composition of local taxes and expenses are adjusted to the different preferences of local communities. The consumers of local public services can express their preferences through migration between different towns and cities. The issue of grant design is not raised within the boundaries of this paradigm.

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[1] See Boadway 2006. and Kim– Lotz (ed.) (2008

The second view sees the advantages of decentralization mainly in organizing public services within an optimal framework, in making sizes more economical, in improving services with better targeting, in reducing transaction costs and in information advantages. In this view, the structure of funding of local governments and within this the central grant design and the types of grants play a significant role.

The system of grants has to achieve two basic goals: vertical and horizontal distribution of funds within the government sector. The former ensures the general sustainability of the budget, while the goal of the latter is to provide incentives for the local governments to perform their functions effectively and economically and also to ensure the fair distribution of funds between the different jurisdictions at the subcentral level. Achieving these goals requires the right measurement of local government expenditures needs. These issues are discussed and the practices of different countries are shown in Kim, J – Lotz, J. (ed.) (2008).

According to a third explanation of fiscal decentralization, an important motive for the distribution of functions between the different levels of government is the decentralization of tensions resulting from the mismatch of the demand for public services and the budgetary funds available. This interpretation describes the subcentral government level as a buffer zone (Offe, 1975), or as the Hungarian literature [Ágh(2004), Pálné(1990), Vigvári] puts it, a conflict container. The decentralization of conflicts can be an effective tool in restricting the role the government plays. The 20 year history of the Hungarian local government system shows that in this case the third factor plays an important role among the motives for decentralization. This results in a special Hungarian characteristic, namely that grant design takes mainly the requirements of vertical distribution into consideration. It means that the governments have tried to deal with the pressure on the budget as a whole and the pressure to make adjustments partly through the decentralization of further government functions and partly through making the grant design based on individual decisions in each case. This situation makes decentralization counter-productive, since it does not allow the advantages that the normative economic approach applies to prevail.

A few characteristic features of the Hungarian local government system

The formation and the operation of the Hungarian local government system is closely related to the political and economic changes that took place twenty years ago and to the difficult processes of the transition from centrally planned economy to market economy. When the Hungarian system was formed it complied with the requirements of the European Charter of Local Governments[2]. The political forces that created the system had high hopes about how the frameworks of democratic operation will be able to balance the problems resulting from the economic difficulties and the lack of funds. The Constitution and the Act on Local Governments contained the criteria required by the Charter.

The legal foundations of the present framework are the Constitution and the 1990 Act on Local Governments. Both legal instruments have *organic* law status, meaning that they can only be amended by a qualified parliamentary majority of two-thirds, rather than a simple majority. Both the Constitution and Act on Local Governments define the economic basis of the independence of local governments. These include municipal own-source revenues, their assets and the grants from the central government. They have considerable autonomy in local decision making processes, while some restrictions that exist in other countries are absent. These are the following:

- The requirement of the balance of operational budget. The Hungarian local governments can finance their operational deficit with the sale of assets or with credit.
- The obligation to create associations to perform functions in order to secure economy of scale.
- Central approval for some part of the budget, e.g. for the major capital programmes, or borrowing is not required in Hungary ;
- Central provision for a compulsory number of local staff; however there are some regulations in the legislation of the given sector that require minimum standards for the provision of local public services;
- A requirement for keeping the local current account at the Treasury, or the National Bank, or for a treasury counter-signature. Local governments are free to choose their bank to keep their accounts or for other financial services.

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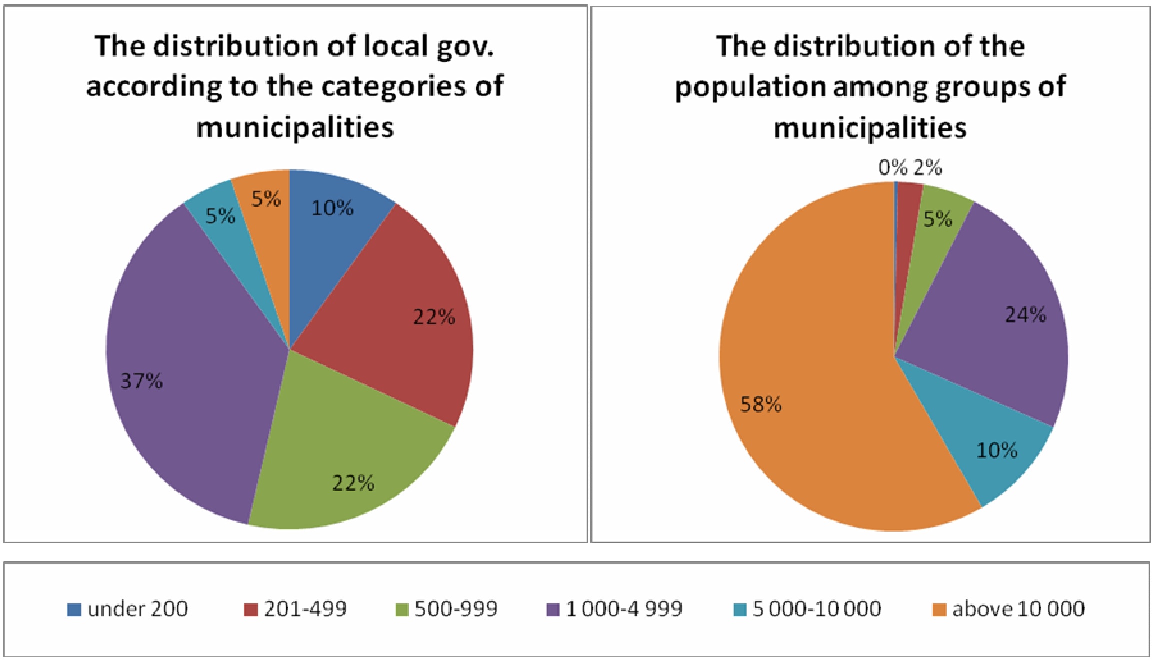
[2] For the summary of these requirements see: Lotz 2009.

Hungary is a unitary (centralized) state, with three levels of elected public administration. However, local governments that are in full harmony with European norms can be found at the levels of central government and of municipalities. The situation on the third level, the level of the counties, is transitional: although they have a directly elected assembly, their autonomy is limited and they do not have their own real resources. In Hungary there are 3,194 local or municipal governments. The capital city has a special, dual structure: it consists of the level of the capital city and 23 district (municipal) governments not subordinated to the capital city. The Hungarian local government system also consists of 19 counties, 23 towns with a county status, 274 towns, 146 so-called "major villages" and 2,708 villages.

The diagram shows how the Hungarian system is broken up into small units. This does not go together with the hierarchic distribution of functions between municipalities of different sizes.

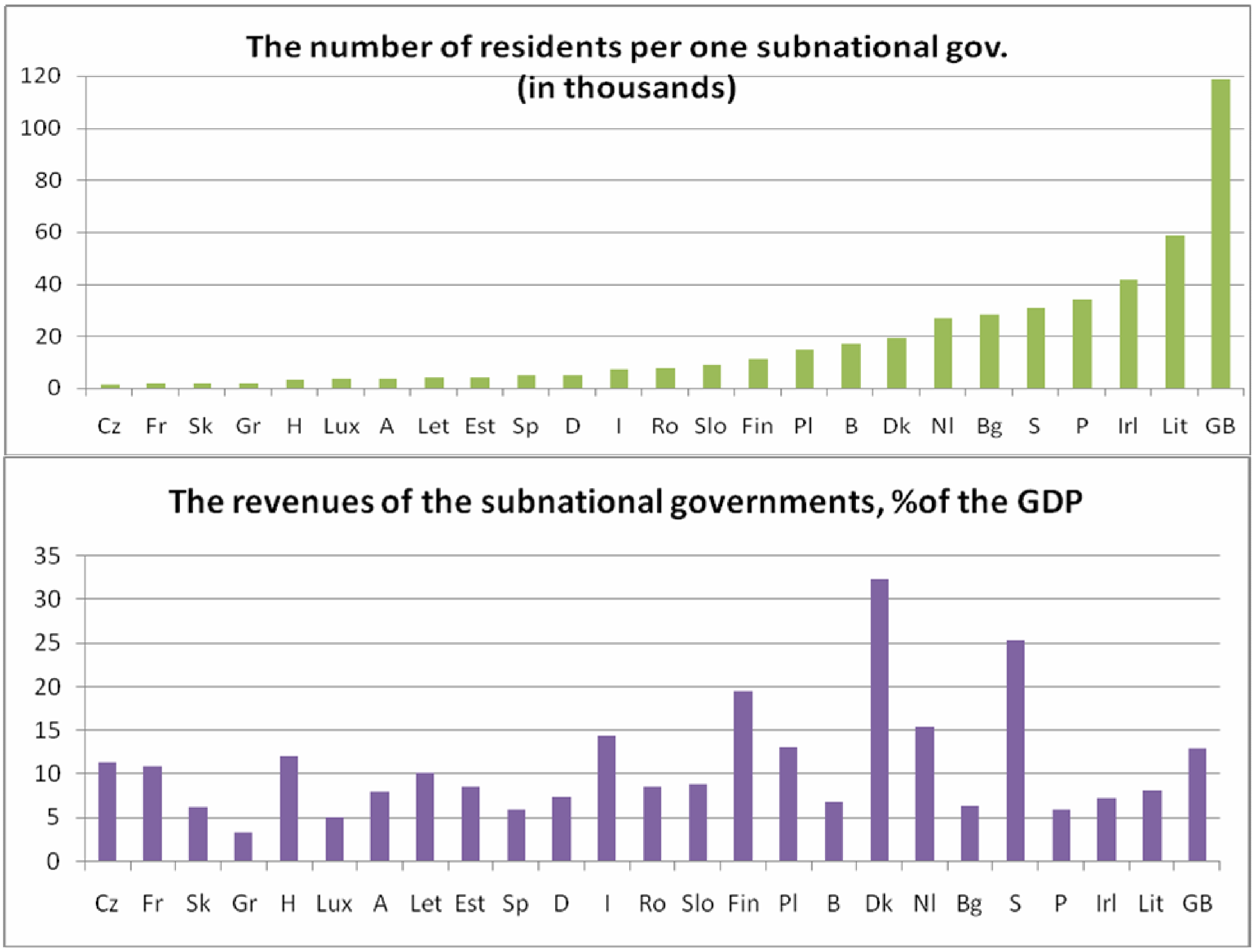
Figure 1.



Source: Ministry of Finance.

The budget of local governments amounts to between 12 and 13% of the GDP, which can be regarded as average in international comparison (see figure 2). Of course, this comparison does not show what fundamental differences exist between the local government systems of the different countries concerning the functions.

Figure 2.

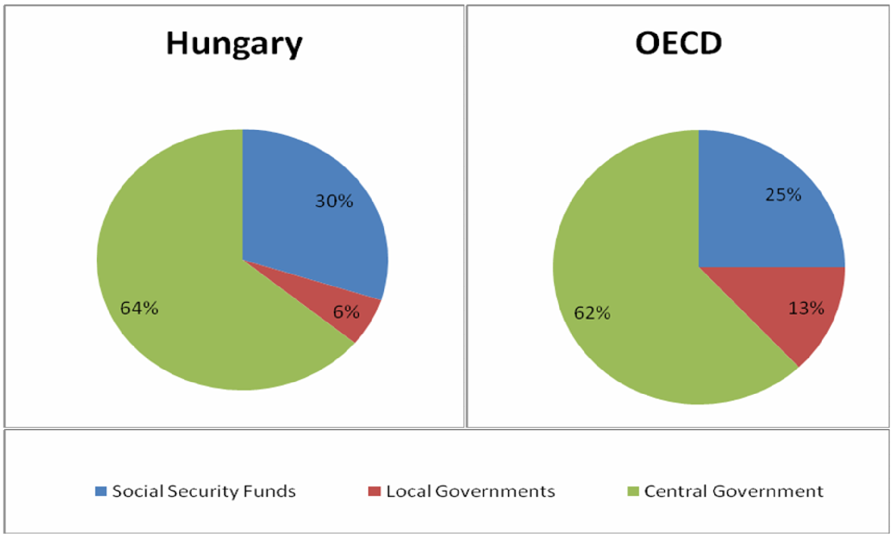


Source: Own compilation based on OECD and Eurostat figures.

Hungarian local governments are relatively small, at the same time, they have to cope with a significant amount of tasks. Concerning their size in European comparison (see Figure 2.) they are 21st among 25 member states, that is, they are in the lower third of the list, at the same time, they are 8th based on their position in the redistribution of GDP, that is, they are in the upper third. This shows what a wide spectrum their activities cover from education through health care to social tasks and from culture and sports to cleanliness of public areas and waste collection.

Beside the heavy decentralization of functions, legislation concerning the performance of functions and the funding structure of the general government sector is highly decentralized. This is shown by Figure 3.

Figure 3.



Source: OECD (2006), Revenue Statistics 1965-2005.

The Hungarian local governments have considerable financial freedom. The operational and capital investment funds constituting their budget are freely accessible and there are no regulations limiting a position of deficit and they can take out loans within certain limits. The central government can provide surety for local government debt only in the Act on the Budget. In the case of insolvency, the act on the procedure of settling of debts accepted in 1995 has to be applied. This procedure aims to create an agreement of creditors through court proceedings with the help of a trustee in bankruptcy. If this attempt fails, the trustee in bankruptcy takes over the financial competences of the assembly and satisfies the creditors by selling assets, in a defined order. However, this financial freedom is only apparent. First, because 60-70% of their funds actually depend on the annual decision on the central budget. Second, the government grants paid to finance their compulsory functions cover the costs of these services to a decreasing extent only. An increasingly higher proportion of the local governments' own revenues are used to finance the centrally ordained functions. It is increasingly more difficult for local governments to raise their own funds necessary to perform the compulsory functions. This is true mainly of village local governments. If the local governments do not have enough own revenues to perform these compulsory functions they can apply for two types of supplementary grants (normative deficit grant, discretionary grant). Table 2 shows that an increasing number of local governments are forced to use these supplementary forms of grants because they lack adequate funds. The inner disproportionality of the system is also shown by the fact that although there are a high number of these grants, their amount is not significant.

The design of intergovernmental financial relations

The Hungarian local governments can levy local taxes. The types of local taxes that can be levied and the rules for levying these taxes are regulated through separate laws that are accepted and can be changed by a single majority. The regulation is in conformity with the requirements of the Charter of European Local Governments. Parliament has recently decided on the centralization of the most important local tax, the local business tax. Also, the new tax on property to be introduced raises constitutional problems owing to the possibility of multiple taxation.

Tax sharing and the system of central government contributions and grants are part of the regulation of resources. The system is theoretically based on central government contributions, which are adjusted to the compulsory tasks as inalienable rights but do not pay for the total cost of the compulsory tasks and on tax sharing, which creates an interest in increasing local fiscal capacity. In practice, the regulation of resources is increasingly directed centrally.

Tax sharing	The system of grants
➢ Motor vehicle tax, shared tax, 100% of it belongs to the local government collecting it ➢ - In the sharing of Personal Income Tax vertical and horizontal sharing are mixed. This is a rather complicated and incomprehensible tax sharing mechanism.	➢ Mandatory, unconditional ➢ Mandatory, conditional ➢ Normative deficit grant ➢ Discretionary grants, inc. discretionary deficit grant. ➢ Vis major grants

The regulation of resources is characterized by a high degree of volatility, which makes it difficult for local governments to have financial management with a strategic approach considering medium term factors. Another characteristic feature is the rapid multiplication of the number of grants and the increase in the number of earmarked grants and in their proportion in the total of revenues. This is shown by Table 1. The reason for this is clearly that the governments, and more specifically the line ministries, prescribe perfectionist standards, which are therefore impossible to finance, in the special legislation for certain sectors created and formed by them. Consequently, through the vertical distribution the central funds, the real value of which is decreasing, have to be distributed among an increasing number of functions. This was manifested in the growth of normative grant titles and the earmarked grants[3].

Table 1.

Year	**The number of operational grants**	**Non-earmarked block grant**	**Earmarked block grant**	**The number of capital grants**
1991	36	26	0	1
1998	95	46	5	9
2002	98	56	20	10
2008	170	76	33	15

Source: Ministry of Finance

The distortion in the financial system corresponding to the European Charter is shown not only in the spreading of earmarked grants but in the increasing role of mandatory deficit grants, which were originally intended as buffers. The seriousness of the situation is shown by

[3] The selection of years shown in Table 1 is not arbitrary, since these can be considered as the main stages in this process.

the fact that beside mandatory deficit grants, discretionary deficit grants also appeared from the year 2000 on.

Table 2.

Year	The number of of local governments receiving mandatory deficit grant	The number of local governments receiving discretionary deficit grant	The share of two deficit grants in local revenues (%)
1991	165*	-	n.a.
1998	888	-	0,6
2002	1 279	558	0,8
2008	1 050	1.364	1,2

Source: Ministry of Finance

The situation of county local governments poses a special problem. Essentially, they do not have their own revenues but in their significant institutional network they perform various compulsory functions. These local governments compensate for the lack of adequate sources by issuing bonds, which foreshadows the possibility of insolvency among them.

Conclusion

The example of Hungary shows that if the engine of fiscal decentralization is the decentralization of conflicts resulting from the reduction of government functions, grant design proves to be an appropriate vessel to achieve this political preference.

Hungarian local governments are allowed a relatively free hand in a legal-constitutional sense, and the scope of their compulsory functions is becoming wider every year. At the same time, their fiscal independence and, as a result, their freedom in making economic choices is shrinking. In other words, legal frameworks and financing, revenues from local taxes and the proportion of non-earmarked grants are not in line with the constitutional status and the wide range of functions they are responsible for. Responsible and transparent local economic management is hindered by the constant and unpredictable changing of central grants and the non-transparent mechanism of allocating resources. Due to the bad financial situation of the local governments debts have quickly been incurred in the sector after 2006 mainly in the form of foreign currency-denominated bonds. The weak solvency of county governments and certain cities and the use of liquid assets available from the issuing of bonds may threaten compliance with the Maastricht Criteria on fiscal matters.

In the present crisis, the pendulum of Hungarian politics seems to be swinging in the direction of strengthening fiscal centralization. This is underlined by the latest developments regarding the local tax system and by the fact that the present state of grant design makes direct central control of affairs possible. In such circumstances, it is less and less possible for the advantages of fiscal decentralization described in normative theories to dominate.

The majority of Hungarian experts (Kopányi et al. 2004 and Vigvári 2006b) agree that the model established in 1990 has to be thoroughly revised. However, concerning the possible directions of change significant technical and political disagreement can be observed (Vigvári 2006a). I believe that the restructuring of intergovernmental finance is inevitable regardless of the direction of any structural change and reorganization of functions. Restructuring should ensure fiscal sustainability, financial discipline of the local governments and that the grant design may be an incentive for local governments to be effective, efficient and economical in service delivery. Therefore, grant design should be significantly simplified: the number of grant entitlements, and within these, the number of earmarked grants should be reduced. It is necessary to equalize the different fiscal capacities resulting from fragmentation and the regional disparities in salaries, which is typical of Hungary.

The payment of the small number of grants should be conditional on service contracts. Payment should be based on formulas. The rules of grant design – contrary to present Hungarian practice – should be stipulated by special legislation and it would be worth considering whether certain fixing techniques can be used regarding tax sharing and the ESA deficit of the sector.

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