The Hungarian Experience of Decentralization

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The 1990. Hungarian Act on Local Governments was created on the basis of the major values and principles of the Council of Europe's European Charter of Local Self-Governments. The locally elected governments have their own assets and their own revenues that are supplemented by revenues from the central government. They are basically public service entities who were assigned wide range of tasks. They have considerable decision-making power. Decisions of local governments can be overridden only by the decision of the Constitutional Court or a court in the case of violation of law.

The establishment of autonomous local governments transformed the system of public administration in Hungary. The monolithic, hierarchical system of the communist era was transformed into a system consisting of two frameworks: one structure is the central government and its territorial and local organs subordinated to the state administration, the other structure is the system of local self-governments, based on the principle of autonomy and decentralization. The two structures share the function of public administration and the responsibility for public policies. Beside the obvious cooperation and sharing of tasks and revenues, competition and conflict of interest is also inherent between the local governments and the organs of the state administration.

In Hungary of the local governments organized by settlements have the general responsibility for the basic local public services. Beside this, as a weak middle tier, county governments are also elected for subsidiary functions. I.e. for services that the settlements are not capable to perform or are of regional character. Local governments have mandatory services and can overtake by choice any optional services as long as they do not endanger the supply of mandatory services. The parliament defines the mandatory services and it has to allocate the necessary financial resources for their fulfillment. As local government sizes and capabilities strongly differ, there is a sub-group of mandatory services that must be supplied by all local governments, and there are some other services that are assigned to governments with greater capacities.

Table 1: Comparison of local services in different European regions

	"Nordics"	"Southern Europe"1	Hungary
Kindergartens	X		X*
Primary Education	X		X*
Secondary Education	X		X
Daily Child Care	X		X*
Health	X		X*
Social Welfare	X		X*
Public Safety	X		X
Public Lighting	X	X	X*
Roads	X	X	X*
Water	X	X	X*
Sewerage	X	X	X
Garbage Collection	X	X	X
Fire Protection	X		X
Parks & Recreation	X		X
Cemeteries	X	X	X*
Housing	X	X	X
Minority rights			X*

1) *For municipalities below 5,000 2) * Indicates compulsory*

Source: Hungary – Modernizing the Subnational Government System, World Bank, 2000

Operation of local governments is financed by own revenues, shared revenues (PIT and vehicle tax) and normative grants. Own revenues are the local tax revenues, user charges and fees collected by the local governments. Municipal governments can levy taxes on property, tourism and turnover of businesses. They can set tax and other revenue rates within the limits given by the central government.

Other own revenues of local governments are from profits, dividend yield, leasing fees and sale of assets. For capital investments aimed and targeted subsidies can also be tendered from the central government.

The Act on Local Governments includes the right of borrowing and bond issuing, but at the same time sets the limit of annual commitment of debt service. The borrowing limit is pegged to a specific portion of own-source revenues.

Table 2: Local Government Accounts, 1993-98 (in % of GDP)

	1993	1994	1995	1996	1997	1998
Total Revenues	16.1	15.9	13.6	13.0	12.8	12.0
Own Current Revenues	3.0	2.8	2.6	3.0	3.3	2.9
Revenue Sharing with Central Govt.	1.4	1.5	1.7	1.6	1.7	1.9
Transfers from Central Govt.	7.7	7.3	5.7	5.0	4.3	4.2
Transfers from Other Public Sector	2.8	2.9	2.4	2.4	2.4	2.2
Capital Revenues	0.7	0.9	0.8	0.6	0.6	0.5
Other Revenues	0.5	0.5	0.4	0.4	0.5	0.3
Total Expenditures	17.2	17.4	13.9	13.0	13.1	12.7
Current Expenditures	13.5	13.7	11.5	10.9	10.5	10.2
Capital Expenditures	3.1	3.3	2.4	2.1	2.6	2.4
Other Expenditures	0.6	0.4	0.0	0.0	0.0	0.1
Balance	-1.1	-1.5	-0.3	0.0	-0.3	-0.7
Net Financing	0.5	1.0	0.2	0.3	0.3	0.4
Privatization Revenues	0.2	0.3	0.5	0.7	1.0	0.5
Net Borrowing	0.3	0.7	-0.2	-0.4	-0.7	-0.1
Residual Balance	-0.6	-0.5	-0.1	0.3	0.0	-0.3
Memo Item :						
Borrowing/Borrowing Cap (in %)	117	167	81	27	19	30

Source: Ministry of finance, 1999

The table below summarizes the characteristic features of Hungarian local government system. It also lists the major problems of the system. The paragraphs below give explanation and possible answers for the policy problems. They are numbered according to the list of problems.

MANDATES	RIGHTS	PROBLEMS OF THE SYSTEM
Development planning, Master Planning and urban regulation Protection of the natural and built environment Transport and Public works Cemeteries, fire brigades and public security Management of housing Education and Culture Social and Health Care Others	Political independence Property transferred Annual revenue transfer Shared revenues Normative grants Targeted- and aimed revenues Own-source revenues: Local tax and user charges Other incomes Loans and bond issuing	General problems: 1. Yearly decisions on central transfers 2. Macro economic risk caused by local financial independence 3. Difficulties and inconsistencies caused by the Public Sector Reform 4. Fragmentation Differences of capabilities Externalia and economy of scale problems

(1.) Relation of transfers and own revenues

During the 1990s public expenditure had to be decreased. It was an understandable strategy of the central government to decrease its own public expenditure by the decrease of the transfers to local governments. In consequence transfers have drastically declined each year. At the same time local governments made great efforts to raise own revenues. In larger cities the central transfer dominance of the budget has reversed to larger percent of own revenues. This situation theoretically increases the independence of local governments through the independence of their finances. The process would be clearly positive, if parallel to the decrease of central transfers, the central tax burden on local constituencies would be eased and room would be made for local revenue collection. This has not happened in Hungary. Central government budgets each year – except of 1998 –overtook larger and larger share of public expenditure, which phenomenon demonstrates a re-centralizing tendency. The interest of local governments and the stability of the system would require that the amount of intergovernmental transfers should be pegged to a relatively foreseeable macro economic indicator (GDP, central government budget share, total tax revenues, etc) and the right of central government on discretion over drastic changes and larger subsidies should be limited.

(2.) 1996 Municipal Bankruptcy Law and Debt Settlement Procedure

The other element of stability is, that the wide financial independence of local governments can create a risk factor to the macro economic stability. Financial procedures and restrictions on borrowing of local governments are defined in the law on local governments. Still municipalities overtaking projects not corresponding to financial capacities can arrive to an insolvent financial situation. Municipalities cannot practically go bankrupt, as "insolvency" cannot be continuous because of the existence of recurrent revenues. When insolvency happens, it is true only in relation to a group of creditors. (i.e. suppliers of capital investment projects and loans). In the unique Hungarian law on local government bankruptcy conditions were defined when difficult financial situations should be solved by a debt settlement procedure initiated by creditors and assisted by nominated commissioners.

The law was introduced in1996, since then nine procedures were initiated, the last in 1998. All cases go back to 1994-95 cases of irresponsible borrowing by small settlements for nonobligatory activities. (Settlements of 600-1000 inhabitants borrowing cca 150 million HUF for gas constructions and resort area projects.)

(3.a.) Tasks of local governments

Mandatory and optional tasks of local governments were defined in the 1990 Act on Local Governments, still they are being continuously modified by the new sector laws and regulations. At the same time an elongated process of public finance reform is also taking place. The two processes together create uncertainty and a fiscal pressure as they often increase local mandates while decreasing funds to fulfil them. This is a natural process of the transition whose impact is often not mediated at the best possible level by careful preparation and participation of all actors.

(3.b.) Sectoral Policies and Inter-sectoral Bargains

Local government independence means the decision over the mix of services supplied. The possible efficiency gain from decentralization can also be realized only through local aggregation of policies. New sector laws bring stronger output, quality standard and financing regulations restricting of the scope of movement of local governments. The trade off is clear: uniform quality standards are utterly important for public services supplied by different local governments for equity considerations, while local decisions can increase efficiency. For positive sum outcome new quality standard should acknowledge financing capacities or increase funds to keep decision-making independence.

The other element of the sector policies is the allocation policy of investment subsidies. Line ministries want to keep decision over investment funds whose allocation often distorts local government investment decisions and limit coordination of national level policies and synergy of local level policies. The adequate strategic planning on the national and local level to solve these dis-functions will probably require a long time.

(3.) Fragmentation / Size of Jurisdictions

In 1990 local governments were formed in all settlements. Out of the 3168 local authorities more than half has populations below 1000 and 300 are below 200. As all authorities have been assigned nearly the same tasks, many is not capable to meet minimal standards of services. Fragmented service delivery also raises the problem of externalia and decreased economy of scale. As the goal of such decentralization was to best strengthen citizen-control, amalgamation is not considered appropriate even if it could clearly have economic merits. The direction chosen in Hungary to deal with the problem of fragmentation is threefold: (1) certain functions were shifted to the weak middle level of the counties and the developmental function to the regions, (2) government incentives were introduced for intergovernmental cooperation and micro region formation (3) the privatisation in local service delivery has been encouraged.

Further reading / References:

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