Financial Management Reform in Budapest

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The Act on Local Governments in 1990, created a clear legal basis for democratic and fully autonomous local management, meanwhile it suddenly became a local task to fulfil assigned responsibilities by exploiting local opportunities. Municipalities were facing with a key challenge to transform their financial and administrative system inherited from the socialist local councils into an efficient, prudent, and accountable management of an autonomous local government.

Budapest as the biggest city, the strongest economic region (see Case 18), and the most professional local government plays a unique role in Hungary's municipal development. The positive experiences of the Budapest financial management reform has been used not only by secondary cities in the country, but could become also a model for the largest cities in the neighbor transition economies.

This paper discusses the financial management reform of Budapest accomplished during the 1990s. This reform has been a gradual process, since reform steps had to be introduced and matched with inherited and new obligations to maintain a continuos balance of the municipality in fast changing circumstances. After the overview of the reform process, its tools and procedures we also summarize the cornerstones of the city's current financial strategy.[1]

Financial Management in Transition

The first elected government of Budapest clearly knew that political independence, fiscal stability, and sound municipal finances reinforce each other and jointly constitute a real sovereignty. It was understood also early on that financial autonomy required increased own revenues; stability and sustainable financing required clearly defined tasks, competencies, and responsibilities; and the planning, decision making, and managing processes had to be restructured in order to fit the responsibilities and exploit the opportunities of the autonomy.

The Objectives and Tasks of the Financial Management Reform

The financial reforms had two strategic objectives: (i) to obtain a sustainable balanced budget in order to secure the city's operation and service delivery, and (ii) to enhance creditworthiness in order to enable optimal and equitable financing of city development. In order to achieve these objectives: municipal functions and services had to be rationalized, user charges had to be adjusted, a task financing scheme and a multi-year planning and forecasting system had to be introduced, borrowing and privatization had to be integrated into the management and financing strategy of the municipality[2]. These have been carried out in tandem with a fiscal squeeze and steadily reduced inter-governmental transfers between 1990 and 2000.

For the sustainability of the operation, the key transition challenges were the reconsideration of municipal functions plus rationalization and reorganization of service delivery. With limited resources available, the city had to concentrate on what functions could be reinforced and which one to be depraved from the inherited group of tasks. Decisions on tasks had to be made in conformity with the conceptually desirable role of the local government and the predictable

[1] This paper is based on [Pallai 2000b]

[2] Budapest has a two-tier system in management, financing, and delivery of local services. These tasks are divided between local governments of the 23 districts and the municipal government (see Case 6). This paper focuses on the issues relevant at municipal level.

financial constraints of the municipality. This rationalization consisted of both change in scale of services and functions and of privatization or concessionaire arrangement of service delivery.

For the long term-security of service delivery two additional tasks had to be accomplished: to increase own revenues for strengthening financial independence and to establish a sustainable balanced budget through financial forecasting and multi-year planning. Balanced budget in this sense means not only preventing deficit, but also generating an operational surplus for renovations and new investments (for the future security of operation). A 20 percent surplus of operational revenues over operational expenditures was targeted to have a secure budget for capital expenses even after the drying out of the privatization revenues.

The forecasting and planning system was a crucial tool not only in creating a sound financial management but also to improve transparency and accountability. The sustainable task structure, the sustainable balanced budget, and the reorganization of the financial management enhanced creditworthiness and allowed a shift to an active borrowing policy to facilitate future project financing.

The Process of the Financial Reform

It is worthwhile to summarize first "how was the reform made in Budapest" in focusing on the sequence and challenges of implementation. A clear and consistent strategy and readiness for implementation were the driving forces of the changes in Budapest. At the same time the success required adequate timing and coalition building for the reform steps, as well. . The vision and the adaptability together could make the municipality capable to achieve gradual reform even among changing and often unfriendly circumstances.

Table 1: The Reform of Financial Management in Budapest

1990 – 1994	1994 – 1998	1998+
Situation		
Fiscal pressure Fiscal uncertainty Biased relation with central government	macroeconomic problems improving fiscal certainty improving relation with central government	starting economic growth public finance reform "fend for yourself"
Policy goals		
Maintenance of financial balance and operational capacity	strategy for balanced budget and liquidity management	Sustainable financial management and balance
Reform goals		
Renewal of decision processes and procedures	Strengthening fiscal independence Implementation of medium term planning	Strategic development plan Reform the institutional structure and operation
New tools		
New decision procedure for new projects A formula based model for shared funds elaborated	Increase of own revenues (Tax, user charge and privatization) Forecasting model Four-years planning of capital budget Reform of operation elaborated and started	Rationalization of operation Task financing of operation Seven-years forecasting and planning Active borrowing policy
Results		
Coexistence of old and new elements of financial management: Fight for regaining central revenues A formula-based model for shared funds A "base financing" of institutions New decision procedure	operation surplus increase better fiscal balance till the end of term enhancing creditworthiness bond issuance	system of sustainable financial balance flexible/optimal project financing sound base for strategic planning

For achieving a sustainable fiscal balance not only the increase of service revenues and the reduction of expenditures were necessary, but various policies had to be integrated into a broader frame of urban management in order to increase competitiveness, improve quality of

life, and secure long term revenue flows for local public services (see Case 8, 12, 18 and 20).

The chronology of the events is focussed on the strategically important steps and features listed by election periods (see Table 1). The reform process can be best followed by the changing goals. In the three periods discussed, the municipality had three different targets. The first election term (1990-1994) targeted only first simple steps in reforming and consolidation of local functions. The second election term (1994-1998) was focussed on elaboration and initiation of the major reforms of financial management. By the end of the second election term and in the first years of the third one sustainable balance was achieved and a robust economic growth started. The third government period and the future development will be guided by increasingly complex strategic development plans, (see Case 18).

Progress in the 1990-1994 Period

The start of the life of the new local government system was very promising in 1990. First municipalities received 100 percent of the personal income tax, some other central transfers, and virtually all local public assets to fulfill the wide range of tasks assigned to them.

One major weakness of the Hungarian system, however, could already be seen in the early years. The intergovernmental finance rules and budget envelope were (and are) determined by the annual national budget, hence the central transfers could be significantly modified from one year to the other, while the own revenue capacity could be built up only slowly by the local governments. These caused growing fiscal uncertainty. A profound tendency of the 1990s was that the central government passed more and more service responsibilities while cut the transfers to local governments in order to decrease overall public expenditures and ease the pressure on the central budget. The two processes together caused a considerable fiscal pressure on localities.

During the first election term (1990-1994) the fiscal pressure was so much pressing that the leadership of Budapest made great efforts to maintain its financial balance and the operational capacity, and struggled for regaining at least a part of the resources withdrawn by the central government. At the same time the elaboration of a strategy to reform the fiscal and operational management has also started. As a result, new elements were introduced into the system, which for the time being were coexisting with surviving old elements and practices.

Box 1. Electoral Cycles do Matter

In Budapest the situation was further aggravated by the fact that in the first and the third electoral periods the city leadership belonged to the opposition parties of the Parliament. This resulted in various tensions between the city and the central government. Beyond the general fiscal restrictions in intergovernmental transfers, Budapest was dis-preferred in central investment grants in two electoral periods. As a result, central government transfers in the Budapest budget dropped from 71 percent of the total revenues in 1990 to 57 percent in 1994 and to 27 percent in 2000. As the own revenues could not increase enough to counterbalance the missing transfers, the real value of total revenues decreased, while local tasks increased.

Financing operation tasks remained within the frame of the traditional "base financing system" since a new task financing system was premature so far. Capital budgets were accepted only for a given year, and projects could be approved at any time of the year as in the old system. From 1993 on — as a first step towards stricter budget constraints — the consequences of new projects on the capital budget of the following years were also calculated and adjusted to total financing projections. The decision rules were also reformed towards a bit more transparent and accountable system. This first improvement of financial planning was obviously effective only on the capital side of the budget, but could not adequately handle the operational consequences yet.

Progress in the 1994-1998 Period

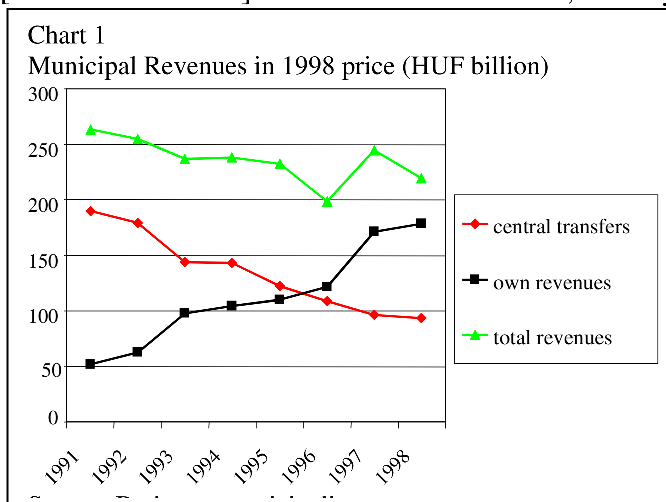
During the second election period (1994-1998) there were good and bad news for Budapest. The country faced serious macro-economic distresses, but intergovernmental relations did not only improve, but became more predictable, which significantly helped the proceeding of the reforms in Budapest. The strategy changed from survival to development. Important reform steps became effective and the goals to obtain a balanced budget and introduce liquidity management became achievable.

It was clear since the beginning that the central government had its serious fiscal problems and that Budapest had a structural deficit [Ebel-Simon: 1995] as well. In this situation, the key element of the city's strategy was to increase own revenues and target a real fiscal autonomy through increase of local taxes, charges, and capital revenues - instead of fruitless fight for regaining the earlier central transfers.

Firm reform steps became plausible and unavoidable in 1995 when a large amount (HUF8.5 billion) of central grant was pending for months. This short instability helped the city's financial leadership to gain broad political acceptance for the first privatization, dynamic revenue raising, and introduction of a seriously restrictive expenditure policy foreseen in the new financial strategy.

Chart 1

Municipal Revenues in 1998 price (HUF billion)



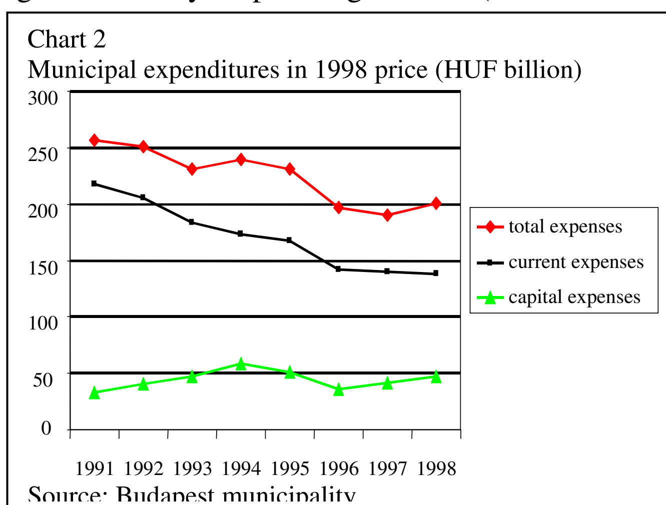
Local taxes increased from HUF9.9 billion to HUF29.4 billion from 1995 to 1998, other own revenues also increased dynamically (see Chart 1) The privatization breakthrough was the sale of shareholdings in three major public utility companies that in itself provided for a USD300 million municipal revenues. Further increase of own revenues was a crucial element of the institutional and fiscal restructuring strategy adopted in 1996.

The cornerstones of the new financial strategy had to be defined by an analysis of tasks and resources. A seven year financing projection model was developed for Budapest with the assistance of the French Credit Local International Council. The obvious consequence of the seven year forecasting was that a multi year could be established. In 1997, the municipality introduced a seven year revenue forecasting and a four year planning scheme (then in 1999 a seven year planning of capital budgets was implemented).

The Credit Local model besides helping to establish a multi year planning highlighted the need for structural changes. Projections of any set of plausible hypothesis in the model proved that, without important changes in service delivery, the structural deficit could not be eliminated in any other way, but by an increase of own revenues and decrease of operational expenditures (see Chart 2).

Chart 2

Municipal expenditures in 1998 price (HUF billion)



Source: Budapest municipality

The financial projection model seemed to be a simple tool, but it became a decisive element in the political process. It helped many politicians who previously opposed financial reforms, to capture the notion of the

structural deficit. Hence, the model helped the emergence of a common support for the reform and willingness to accept its political costs.

The local government had to face with the fact that the increase of current revenues and revenue from asset divestiture had serious limits. Under such circumstances, maintaining the operating expenses in real term would result in dry out investment resources, and eventually even financing the operations would become impossible.

The strategy to decrease operational expenditures had three pillars. First, developing concepts for each service sector to define core functions while to set up a strategy to get rid of superfluous functions whose expenses could not be covered in long term. Second, the reduction of unit operating costs by the introduction of a task financing system. Third, rationalization of the service institutions financed from asset revenues through a rationalization fund.

Due to this decrease the municipality could change the expenditure side of its budget considerably. The operational expenditures decreased from 85% to 47% in 1998. Parallel to this, capital expenditures were increased from 13% to 24 %. The rest of the budget, i.e. the remaining 29 percent in 1998 was debt service, financial investments and reserves.

Targets and Progress in 1998 and Beyond

It was clear already at the beginning of the financial reform that these huge changes required several years. The capital budgeting reform was easy and complete, but earlier only the first introductory steps were taken towards the operating budget reform. In the third election term the shift to task financing of operation was targeted. In 1999 and 2000, beside the traditional type operational budget so-called shadow budgets based on the new task financing scheme were also prepared with the aim that after necessary refinements they would be ready for exclusive use. The extended budget reform aimed to establish a predictable and transparent fiscal planning system, to build creditworthiness, to create incentives for efficiency, and discourage institutional slack.

Enhanced creditworthiness was a precondition to shift to an active borrowing policy, enter the capital market as a fully autonomous entity, and to be able to build a loan portfolio in which financing risk is dispersed. For adopting an active borrowing policy, the municipality had to increase its financial reserves assessed to be equivalent to at least one year’s debt service obligations. After positive experiences with EBRD and IBRD transport loans, the Municipality issued debt at the value of DEM150 million on the international bond market.

Financing infrastructure investments partly from borrowing ensured that the amount of annual investment outlays remained roughly equal. Had this practice not been pursued by the City, investments would have been implemented with delays, on the one hand, and great fluctuations would have characterized development activities on the other hand.

The strategy of prudent financial management became a key objective of this period. Every autumn, when the concept for the next year budget is prepared a seven year forecasting model is updated. Based on the financial forecast and analysis, the targeted annual proportion of the operating and capital budgets are set. The operating surplus is a crucial element of the budgeting.Each year there is an effort to obtain or approach a 20 percent surplus even if current expenditures ought to be decreased for the sake of long-term sustainability. The most heated debates are often around this issue among the members of the local government from November, when the Concept for the Budget is accepted till March, when the budget of the actual year is approved.

In the yearly budget debate the financial management fights for the operating surplus, i.e. to peg operating expenditures to operating revenues. This approach resists the short-term political temptation to avoid both cutbacks on expenses and increase own revenues to enable continuing capital investments and strategic development. For the advocates of the “operational needs” the operational surplus is a big target, as a 20 percent surplus seems to be an arbitrary number with

the arguments to improve services instead. Until 2000, the financial leadership proved to be strong enough to accept the short-term political costs of restrictions and after serious conflicts in the leading coalition the proposed financial strategy was kept. So the operating and capital expenditure items defined on the basis of the pre-set proportions of the budget, the multiyear planning of capital budgets, and financial reserves for active borrowing policy are maintained.

Table 2 Major budget figures in the year 2000

Revenues	2000 Planned		Expenditures	2000 Planned	
	HUF bn.	%		HUF bn	%
Central Transfers	75.3	27.3	**Operating expenses**	**125.4**	**45.5**
a) for operations	69.2	25.1	**Investments, transfer of funds**	**61.8**	**22.4**
b) capital	6.0	2.2	**Cost of refurbishment**	**9.0**	**3.3**
Own revenues in the reporting year	112.8	40.9	**Debt service**	**2.4**	**0.9**
a.) Current revenues	88.4	32.0	**Government securities bought**	**36.0**	**13.1**
b.) Accumulation and capital-type revenues	24.5	8.8	**a) maturity within one year**	**18.5**	**6.7**
			b) maturing over one year	**17.5**	**6.3**
Residual funds	0.1	0.1	**Specified reserves**	**39.0**	**14.2**
Redemption of Government securities purchased in preceding years	68.5	24.8	**a) for operations**	**2 .4**	**0.8**
a) maturity within one year	43.4	15.7	**b) for accumulations**	**36.2**	**13.1**
b) maturing over one year (municipality)	25.1	9.1	**c) for refurbishment**	**0.5**	**0.2**
Loans	18.8	6.8	**d) for local minority governments**	**0.0**	**0.0**
			General reserve	**1.7**	**0.6**
Grand total of revenues and loans	**275.5**	**100.0**	**Total expenses**	275.5	100.0

The key achievement of the reforms is that even after two years of serious decrease in intergovernmental transfers the budget figures of the municipality demonstrate financial health and balance in 2000. Debt service is fairly low and the proportions of expenditures are good: 47 percent operating expenses and 42 percent capital expenditures.

Tools and Procedures in Financial Reform

In this section we shortly summarize key instruments and procedures applied in the ten year reform program in the city of Budapest namely: the Rationalization Fund, the task financing procedure, the major privatization actions, the new borrowing policy, and the change in user charges.

Rationalization Fund

The Rationalization Fund was set up within the 1997 municipal budget, to facilitate the institutional restructuring process by providing resources for one time investments aiming at cost saving and efficiency increase in the local budgetary institutions. The underlying considerations were that: (i) an institution often did not have resources for a large one time investment or for compensations needed to realize continuous cost savings later; (ii) because of information asymmetry, the management of the institutions had to be motivated in exploring and disclosing possibilities for reducing operational expenditure and in cooperating with the financial department in the cost saving process.

All local budgetary institutions can bid for resources from the Rationalization Fund by submitting a calculation on cost savings achievable by a rationalization investment. The calculations are not revised, but the offered annual cost savings are automatically deducted from the operational budget envelope of the institution. This rule encourages accountable decisions.

The financial department sets financial conditions, the rules, and the amount of resources to fill up the Fund each year. The sectoral departments of the local government makes the actual decisions on the bids keeping the given financial framework and using their professional standards.

This Fund has resulted in, on the one hand, prevents the municipal budget process from long debates on small refurbishing and rationalizing interventions with relatively small amounts. On the other hand, it has broken the old routine of lobbying for capital investments without considerations on operational cost consequences. Directors of the institutions now have to take a responsibily on cost savings. The Fund secures positive steps towards more efficient institutions, and optimally allocates decision making roles. The needs assessment is made by the institution, the financial conditions are defined by the financial leadership, while professional priorities are set and decisions are made by sector departments and professional committees. The merits of the fund has gained wide acceptance and resulted in increasing resources.

Task Financing

The so-called base financing method in financing budgetary institution was a heritage in Hungary and in Budapest alike. This means first that the institution rather than the delivered task is financed. Second, the actual expenditures of the "base year" are considered as the relevant basis of the budget plan of the following year, wile line items are increased or decreased in accordance with various benchmarks like inflation, overall change in resources or without any normative arguments. This old and simple method can result in serious disparities across institutions because it gives no information about the financing level of each activities, efficiency, and possible cost reductions or obstacles of reducing costs without risking service delivery.

For the reduction of operational expenditure of the municipality as targeted in the financial strategy, it was necessary to introduce a more effective and transparent system of financing service delivery. Resources had to be scaled to tasks rather than financial positions gained over years. Hence, probably in the whole financial management reform the most complicated systemic change was the shift to a zero based task financing.

The task-financing program started in 1997 when a concept of comprehensive assessment of the budgetary institutions and task performance was prepared. The primary items of every accounts were recorded at least throughout one year in order to measure the attainment of material expenditures. On the basis of these data the legal framework of a normative task financing was prepared and normatives were set. Soon after these the preparation of a zero-base budget proposal started, which was linked to physical benchmarks and task normatives. In the first phase of the zero-base budgeting procedure new labor and material expenditure plans were calculated for each institutions.

It was clear at the beginning that an all-embracing change to the zero-base budgeting procedure required at least 3 to 4 years. In the first, experimental years (1998-2000), so called shadow budgets were prepared beside the traditional type budgets, which remained in use. On the basis of assessing the results of the two budgeting schemes, the benchmarks and the normatives of the zero-based budgeting would be refined before shifting the system to the exclusive use of the task-financing scheme. The complete shift to task financing of material and labor expenses is expected to happen only in 2001 or 2002.

When the system will be fully introduced, the municipality will annually update the normatives and benchmarks if necessary and set financing (current transfer) conditions accordingly. The receiver institution, however, will then have freedom in actual utilization of resources received, i.e. reallocation of funds between tasks preformed.

Privatization

The basic principles of privatization are service security and the involvement of professional investors with adequate financial strength and operating experiences. The privatization concept scoped privatization of a very large circle of companies, set guidelines and procedure, while left room for exclusive decisions [Privatization Concept, 1994]. By 1996, all of the service enterprises were transformed into commercial companies to prepare them for privatization. Out of the 15 public utility companies, eight essentially were natural monopolies, while seven providers worked in a competitive market already prior to the privatization. Four companies retained their natural monopoly after privatization, the privatization decisions and other regulations will determine the market position of the other companies.

Privatization of the Three Big Utility Companies

The most important transactions in Budapest have been the privatization of the Gas Supply company, the Water Works, and Waste-Water Works. There are two common features in the privatization of the three major utility companies. First, each of them were tendered in two round open international competitive bidding process. Second, the municipality has retained its majority ownership stake in each of these companies. Third, the privatization involved the companies' core assets (the physical network and structures) in order to maintain the unity of the assets and operation. An exception from the latter principle will be the new sewage treatment facilities those ruled to remain in 100 percent municipal ownership because they were financed from earmarked state grants (see Case 3 and 5). These new components of the municipal infrastructure will also be operated by the privatized company on the basis of a lease or an operation agreement.

Table 3 Privatization of Utilities

	Gas Works	**Waterworks**	**Wastewater Works**
Conditions to be fulfilled	operation &maintenance	operation &maintenance +reconstruction	operation + maintenance + reconstruction + development
Market position	monopoly	monopoly	monopoly
User charge set by	central government	municipality	municipality
User charge formula	none	cash-flow basis	cash-flow basis
Subsidy	none	none	Development subsidies
Privatization method	50 % in preference shares +dominant management rights	27 % of voting shares + dominant management rights + responsibility of operation	25 % of priority shares + dominant management rights + responsibility of operation
Privatization revenue	HUF13.5 bill. (1995) HUF4.3 bill. (1995) Combined USD142 million	HUF 16.5 billion (1997) USD88 million	HUF16.9 billion HUF (1997) USD88 million
Period of contract	indefinite	25 years	25 years
Investors' benefit	dividend	management fee	dividend priority
Local govt. benefit	dividend	Cost savings	dividend earnings

Source: Budapest Municipality

Besides similarities, the differences between the utility companies justified the application of differing privatization models. The Gas Company was essentially in an good condition at the time of privatization, so investors were called to submit two bids each: one for a majority, and

one for a minority ownership. The decision whereby a minority shareholdings was sold with majority management rights was essentially political. A professional investor (VeW Ruhrgas consortium) was awarded the contract, which assured the enhancement of the company's efficiency. Privatization, nonetheless, should be regarded as a financial investment, whereas the market price of the shares sold depend on the gas price. Since the gas price is regulated by the central government; the Budapest local government could not offer a rate of return guarantee to the investor. The investor receives dividends only if this company is profitable under these conditions.

Although divestiture to a minority municipal ownership is still not on the agenda, it is in principle an alternative. For this reason, the local government changed the statute of the company prior privatization, and created a so cold "golden share", which will be retained even if virtually all the shares sold, because the golden share enables to retain key ownership rights (e.g. vote against closure, spin off, merger, change in the company's core activities or capital).

The Waterworks had a current and a forecasted future deficit at the time of its privatization. Therefore, the investor was not interested in acquiring a majority ownership stake, instead sought after another way of earning its profit. The investor (Suez Lyonnaise des Euax & RWE-Acqua GmbH consortium) acquired 27 percent of voting shares and a 25 year concession to be the operator of the company under a management fee agreement. The investor were enabled to obtain its profit from 75 percent of the cost saved. Cost savings is calculated on the basis of the 1996 costs according to a formula set in the contract.

Privatization of the Wastewater Works likewise did not ensure adequate return on the shares acquired. This company was a profitable sufficient to enable reinvestment for needed development. Therefore, the profit on investor's return on equity was projected to remain very low for years. As a result, the investor (CGE/Berliner Wasserbetriebe) received a priority dividend right, which means that all profits up to 18 percent of the face value of the shares purchased must be paid exclusively to the investor; and additional payments if any can only be made above this amount in proportion to the share ownership.

The Privatization Benefits for the Municipality

In the privatization contracts of these three major utility companies, the municipality remained responsible for control, monitor, and regulate the service delivery in accordance with the Act on Local Government, and retained its ownership rights. Ownership rights are exercised through delegated members in the board of directors, in the supervisory boards, and at the companies' general assembly.

Between 1995 and 1997, privatization revenues amounted nearly USD320 million that represented on average 7 to 20 percent of municipal annual revenues. Since 1990, the municipality uses amortization and capital revenues strictly for capital expenditures, thereby avoids living up its wealth. Privatization revenues though constitutes one-time resources, their availability was a cardinal element of infrastructure development. They played a crucial role in Budapest, because central transfers were seriously decreasing in a period when the fast reconstruction of the degraded and underdeveloped infrastructure was a major strategic task of the city.

Since in the case of the Water and the Wastewater Works the municipality is not only the owner and user, but it is also the price authority, a trade-off situation occurred between the one time revenue from the share price and the water and wastewater charge efficiency. The long term price policy received higher priority than the revenue goal in Budapest. Besides these considerations, efficiency was supported by making a distinction between the share ownership and the management rights. The strategic investors received proportionately higher management rights than their share ownership, because a rational private like management was assumed to increase operational efficiency.

In both cases a complicated cash flow type price formula was introduced to secure incentives for short and long term investments alike. Looking back at the past 3-4 years of the Budapest privatization it can clearly be seen that while the Gas and Waste Water privatization has proven to be rather successful, some calculation and contractual problems are causing enduring conflicts between the ownership partners of the Waterworks.

In Budapest, the joint sale of assets and management rights to strategic investors was not only a revenue source for the local government, but it also meant a strong commitment for the restructuring of the entities and creation of market conform efficient companies. In transition especially the symbolic content of these changes have also particular importance.

Borrowing Policy

Since the infrastructure investments of the municipality could not be exclusively financed from capital revenues and operational surplus external resources has also been used since the early 1990s. For timely financing of long-term development projects, the local government aimed at establishing a loan portfolio in which financing risk could be spread.

The borrowing strategy of the local government has been based on conservative assessment of resources, selection of quality partners, use of negative pledge, and creation of a continuously optimized and versatile loan portfolio. The one time capital revenues were used to upgrade assets and improve operation that has lead to improving budget figures and creditworthiness, eventually to a gradual improvement of borrowing position. These enabled first to shift from access to domestic to international markets and from money to bond and equity markets.

Till 1996, the municipality borrowed from two sources: domestic bank loans and local currency denominated loans form the international financing institutions. In 1996-1997 the city was already able to enter the international money market because it had a small debt portfolio and a relatively large investment portfolio, meanwhile investments required sound financing, the privatization progress was good, and the foreign confidence in the country was increasing.

The decision for the first bond issuing was the Eurobond market targeting personal investors. As the city could not get higher rating than the country, and the Euro bond issuance of the Hungarian National Bank had only a slightly a lower interest rate than the city was projected to obtain, a decision was made to issue a bond without rating.

Table 4 Terms of the Budapest Municipal General Obligation Bond 1998

Issuer	Municipality of Budapest	**Status**	Direct, unconditional
Amount	150 million D EM	**Security**	Unsecured
Type	Fix rate	**Rating**	None
Maturity	5 years	**Negative pledge**	Yes
Amortization	None; bullet payment	**Purpose**	General funding
Interest rate	4,75 %	**Use of proceeds**	Infrastructure development
Interest payment	Annual	**Performance**	punctual
Issue price	101,55		

Source: Budapest Local Government

In 1996 the municipality already conducted a two round tender to select the lead manager of a bond issuance, which finally was postponed because of the change of taxation rules. Following the amendment of the tax rules 1998, the decision was made to launch the bond issuance. Meanwhile the rating of Hungary has improved from the speculative to the investment category (Moody’s Baa2) and the city’s financial status has also strengthened. In the absence of a rating an Information Memorandum was complied by the local government, and the issuance took place in Frankfurt with the Deutsche Genossenschaftsbank as lead manager in July 1998.

The trading price of the bond was 99.35 percent and its offer price 101.55 percent. The interest rate of the bond was 4.75 percent fix rate, which represented a 57 basis point risk premium over the yield of the reference German government bond. On LIBOR 35 basis point

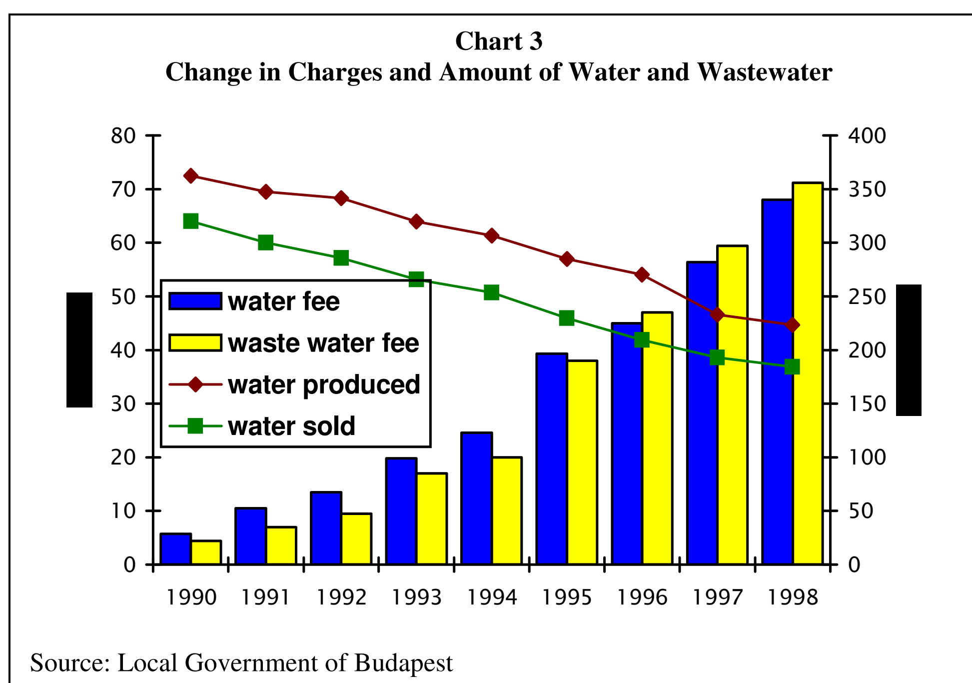
premium was obtained. A bond issuance of the Hungarian National Bank obtained a 33 basis point risk premium over LIBOR in February 1998, so the market assessed the risk of the municipal bond very similar to the country risk. Twenty percent of the bond was subscribed by institutional and 80 percent by personal investors, mainly on the German and Austrian money market.

User Charges

During the socialist period a clear supply side planning with its all consequent weaknesses in developing utilities resulted in inefficient networks, huge subsidies, and financial losses. Utility charges remained still symbolic in the early 1990s. The gradual increase of charges modified consumption patterns and enabled nearly cost recovery, hence furnished the conditions for improving service delivery. These made possible to start a process to separate the service delivery and social assistance functions of the municipality.

For instance, the inherited symbolic charge for waste containers were replaced by a volumetric charge for households waste in Budapest in 1996. The inflexibility of the container based volumetric charges scheme was attacked by lively criticism in the course of a few month after its introduction. Later – as the users got familiar with the new system – some 20 percent of containers were returned, and both the collected volume and charges reached a balanced level in the course of one year. The major fear before the introduction was that illegal dumping would increase, but similarly to other countries' experiences, no evidence has occurred on this matter. Since 1997, in consequence of the charging policy, only the development expenses of waste management have debited the budget of the Municipality.

Chart 3
Change in Charges and Amount of Water and Wastewater



Source: Local Government of Budapest

On the field of water services the socialist heritage was a relatively well-developed, but poorly maintained network of both water supply (with 97.5 percent coverage) and sewage collection network (with 90.2 percent coverage). The rate of waste water treatment, however, was very low (25 percent in 1999). At the same time, in consequence of symbolic prices, water consumption well surpassed Western European standards.

The gradual increase of user charges not only decreased consumption to 140 liter per day per household about the EU average, but allowed a nearly full cost recovery. So charges became a tool to improve efficiency and conformity with market and made privatization possible. In the wastewater system some investment subsidy is still needed. The wastewater figures, however,

can not be used as comparative data as it contains only the costs of the existing 28 percent capacity in full treatment.

The pricing system has further changed with the privatization. Water charges now consist of two parts: there is a connection fee, and there is a use related charge which covers an access fee and a water price both calculated on a volumetric basis. The volumetric charge is based on average accounted costs determined by a cash flow based formula that is set in the privatization contract[3].

Though the pricing is based on an average cost rather than marginal cost type charge, it still affected users' behavior as it can be seen in Chart 3. The present system provides for an adequate information about the demand which help introducing further rationalization steps in service delivery. The plan of the city for waste water treatment capacity development was 1.5 million cubic meter in 1993, it was cut back to 600 thousand cubic meter per year in 1999 and the process of adjustment of plans to demand continues. This process enables to save huge development costs on wastewater services and operating costs both on water and wastewater services.

Conclusions

The case of Budapest clearly demonstrates that a successful reform requires not only clear and consistent vision, but also adequate external and internal conditions for implementation. The strong strategy and adequate timing of the introduction of the reform elements are equally important factors of the success. A decisive issue is to recognize when the system is mature enough for the implementation of more sophisticated tools, and to see whether the political arena is suitable for building a supportive coalition for the reforms.

The stability and transparency of the financial management made the local government a reliable partner for banks, investors, and other private partners. The financial management reform of Budapest has been used as a model in other Hungarian municipalities. It is widely cited and used as a best practice case in training of municipal staff in transition countries.

The recent re-centralizing fiscal strategy of the central government that endangers the emerging prudent local financial management influences the development agenda in Budapest too. One of the most important achievements of the Hungarian transition, the existence of a multi-layer public sector with strong and independent local governments is jeopardized for the sake of a power concentration that historically has already been proven to be ineffective.

For the time being the financial system of Budapest could keep its balance with further reduction of operational expenses. Most local governments, however, have to seriously restrict their development programs to prevent sober financial difficulties. Still the situation calls for the reconsideration of the entire system of intergovernmental transfers (see Part 1 and Case 4 and 7). The overall amount of transfers to municipal sector that was subject of annual changes over the 1990s, now ought to be pegged to macroeconomic indicators (e.g. GDP, national budget) to maintain present achievements and support further local improvements. "To date the Hungarian transition has been not only gradual and systematic, but also bold and creative. There is no doubt, that this will continue." (Ebel-Várfalvi-Varga: 1998)

References:

Ebel – Simon (1995): *Financing a large municipality: Budapest,* in: Decentralization of the Socialist State, ed: Bird - Ebel – Wallich, The World Bank

[3] Before the privatization the charge was decided yearly by the municipal assembly on the basis of direct accounting cost estimates prepared by the companies.

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