

Central European University
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**The Budapest Budgeting Reform Strategy
between 1995 and 1999**

Analysis of a Post-socialist Local Government Reform through
System Paradigms

By

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Abstract

The dissertation is a case study. Its subject is the Budapest Budgeting Reform Strategy (BBRS) and its implementation experience between 1995 and 1999. I demonstrate that the Budapest strategy aimed for a managerial type reform. I examine a proposition of Western public management theory: that post-socialist reforms, before launching managerial reforms, as precondition, must first strengthen traditional (Western) administrative and control mechanisms and establish a Performance Measurement System (PMS).

The hypothesis is that an alternative trajectory of (municipal reform) is possible. In the dissertation I demonstrate that in Budapest, managerial reforms did not strengthen traditional control, but through a new performance related accountability framework, linked macro-level control over goals with decentralized micro-level management. The BBRS, as one case experience, is enough to demonstrate that the proposition is not generally true, i.e. falsification. In the conclusion I propose a revision for the proposition.

To examine the proposition I raise two questions: (1) is the absence of a PMS a sign of inconsistency in the BBRS? (2) Is an alternative trajectory, a leap to the managerial model, possible? I introduce a conceptual framework based on three system paradigms – traditional, socialist and managerial – in order to explore the internal logic of different public management models. In the dissertation, the paradigms support the explanation for the absence of a PMS in Budapest and show that the falsified proposition represents a bias resulting from the use of a Western angle to judge post-socialist reform.

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Abbreviations

1996 Budget Concept	Proposal for the 1996 Budget Conception of the Municipality of Budapest (Office of the Mayor of Budapest 1995)
1997 Budget Concept	Proposal for the 1997 Budget Conception of the Municipality of Budapest (Office of the Mayor of Budapest 1996)
1998 Budget Concept	Proposal for the 1998 Budget Conception of the Municipality of Budapest (Office of the Mayor of Budapest 1997)
ALG	Act on Local Governments (Act No. LXV of 1990)
APF	Act on Public Finance (Act No. XXXVIII. of 1992)
BBRS	Budapest Budgeting Reform Strategy
CEE	Central and Eastern Europe
CIP	Capital Investment Program
CLI model	the financial forecasting and planning model developed by Credit Local International Conseil and adapted for Budapest in 1995
Draft Concept	Deputy-Mayor of Budapest. 1995a. "Konceptió-vázlat az 1996. évi költségvetéshez." [Draft concept for the Budget of 1996]. Policy paper prepared for the Mayor's Cabinet, Budapest.
EXPO	World Exhibition planned for 1994 in Budapest
Final Strategy	The formulation of BBRS as published in 1998 Budget Concept
MTEF	Medium Term Expenditure Framework
NPM	New Public Management
PMS	Performance Measurement System
PPB	Program and Performance Budgeting
PPBS	Planning, Programming, Budgeting System
ZBB	Zero Based Budgeting

Glossary of Terms

Accountability framework: the sum of information and rules that are used to hold a unit or individual to account in how they discharge their responsibilities.

Budapest Budgeting Reform Strategy (BBRS): refers to the evolving conception of the strategy and its implementation. Thus, it refers to the actual form of it at the given point in time. That is: it means the strategy whose preliminary formulation was the Draft Concept (1995); its revised form published as part of the 1997 Budget Concept (1996); and final formulation in the 1998 Budget Concept (1997) document.

Budgeting: is part of financial management (beside accounting and auditing). Budgeting includes the planning and decision making related to incoming and outgoing money flows.

De-concentration: delegation of implementation functions to lower level governments without the devolution of policy decision making.

Decentralization: devolution of power. Decentralization of government means the devolution of decision making power to lower levels of government or further. Decentralization implies political, administrative and fiscal decentralization. In the dissertation the term is often used for the decentralization of decision making or management within the local government. Here it means the devolution of management from the level of top decision makers to departments or to the heads of service units.

Decentralized management: when the given unit – government unit, service unit, or any other organizational unit – can make decisions on planning, financing and implementing its functions within the frame of broad rules pertinent to certain indicators of expected output, outcome or process.

Macro-level budgeting: deals with budget aggregates and with the maintenance of fiscal discipline.

Macro-level management: in our case it refers to the management of the issues pertinent to the local government as a whole, as one agency.

Managerial paradigm: in public management, it means that strategic planning and policy making keeps a strong grip on setting goals; specifies expected performance; decentralizes and decontrols management in order to increase its efficiency and effectiveness; encourages

performance through personal accountability; and in service delivery introduces market type and market based solutions.

Managerial public management: public management based mostly on mechanisms following the logic of the managerial paradigm.

Managerial model: the paradigmatic form of managerial public management. That is: public management based on macro-level control of goals, decentralized management and performance based accountability framework.

Managerial reform: reform in the direction of the managerial paradigm.

Mechanism: a specific solution designed for (or as part of) the implementation of an objective.

Micro-level budgeting: is concerned with the operation of departments, service units, programs and activities.

Micro-level management: in our case refers to the management of activities at the level of departments and service units.

Models: typical ways of achieving certain goals or objectives. I use traditional or managerial model when I refer to the organizational model or functioning that is the typical product of the given paradigm.

Paradigm: paradigm is a system that, based on specific values and principles, creates its own specific institutions and modes of coordination and culture. The system paradigm approach is a method of comparing the essential features of systems and inherent logic of the relations among its parts. I use the word 'paradigm' when I refer to the system logic.

Performance indicators: On the basis of operational objectives and targets, various performance indicators can be computed that refer to relevance, productivity efficiency, utility, effectiveness, or any other characteristic of a given policy, activity or strategy.

Performance link: any linkage established between any performance indicator of an activity and its financing or assessment.

Performance Measurement System (PMS): a coherent system of performance measures and their regular collection and evaluation. Such PMS assume integration into the decision and management system in order to establish systematic performance management.

Performance measurement: a process of assessing progress towards a predetermined goal.

Performance measures: includes input, activity, output and outcome measures.

Public management: An applied discipline, the subject of which is the exploration of methods and processes that can be applied in the public sector to improve the implementation of public goals.

Reform goal: the long term, key aim of the reform process.

Reform objectives: the specific aims that the reforms intends to achieve. They support the implementation of the goal, are usually shorter term than goals and clearly define the expected output or outcome.

Reform strategy: a broad definition of what and how something should be achieved.

Reform trajectory: the content of changes and sequence of steps from an initial stage to the accomplishment of the reform process.

Service delivery unit (or service unit): economically independent or quasi independent budget units that were established to supply specific predetermined public services. In Budapest according to the 1990 Act on Local Governments and 1992 Act on Public Finance, municipal institutions (e.g. schools, elderly homes, hospitals, etc.) were reorganized in such legal and economic entities. Though the terminology used in budgeting is still institution, I use service unit as it is more revealing of the role and functioning.

Socialist paradigm: mostly used in this short form for the ideal-type public management within the socialist system paradigm. That is, the system of centralized bureaucratic coordination based on the ideology and undivided power of the communist party. The characteristic features of the system are the centralization information and planning; discretionary decisions; vertical dependence; vertical bargaining; soft constraints and the absence of valid information.

Traditional model of public administration: the typical organizational and functioning features of public administration under the traditional paradigm.

Traditional paradigm: mostly used in this short form for the ideal-type public management in classical public administration, i.e., the system developed on the basis of theories of Weber, Wilson and scientific management.

West or Western model: refers to the West European and North American tradition of democracy and public administration. This meaning for the term West and Western model is

used to distinguish the system that is paradigmatically different from the system developed under socialism in Central and Eastern Europe.

Chapter 1. Introduction

Since the 1980s, the traditional model of public administration (developed according to theories of Weber and Wilson), became widely criticized for its weaknesses. It was demonstrated that bureaucratic organizations may be effective vehicles for the execution of instructions, but they are rigid and inflexible. Bureaucracies do not necessarily represent the most effective and efficient organizational model for implementing public goals.

In the late 1970s and 1980s, increasing budget deficits put strong political pressure on governments of developed countries to achieve cost savings and reforms that promised such results. This urged the development of new practices along lines propagated by economic and public choice theory. Consequently, public roles were reconsidered. There was a turn towards market-based solutions to increase the productive and allocative efficiency of government services, and a shift of focus from process to results and from administration to management.

The managerial reforms were intended to create a lean and efficient public sector that would be responsible to citizen needs. To implement this goal, three main tactics were used: (1) market expansion (2) introduction of market-based solutions to delivery public services and (3) the adaptation of new management techniques from the private sector. Many authors term this modernization agenda – managerial reform or managerial paradigm (Bovaird and Löffler 2003 and Hughes 2003).

Traditional public administration – the traditional paradigm – was criticized not only from the angle of public choice theory. Parallel to the emergence of the managerial paradigm,

traditional public administration was also criticized as bureaucratic, lacking citizen-focus and legitimacy. This alternative modernization agenda, evolved into the governance paradigm. The term governance paradigm attempts to distinguish a managerial as opposed to a political response to the problems confronting public service bureaucracies. The modernization agenda of the emerging governance paradigm evolved from the necessity for government to partner with other actors. Governance refers to government plus the horizontal web of its active relations that lay outside government¹. Additionally, it refers to the “looser processes of influencing and negotiating with a range of public and private sector agencies to achieve desired outcomes.” These relationships beyond traditional government are equally exploited for negotiating and implementing policy goals (Hambleton 2002, 150-5).

“The paradigms of public policy making have changed significantly during the past decades – the ‘old public administration’ was replaced partly by the ‘new public management’, which in turn has been supplanted partly by the ‘public governance’ movement. However, current public policy making in most countries still has strong elements of all three paradigms” (Bovaird and Löffler 2003, 22).

Various country experiences present multiple trajectories of public sector reforms. The starting points differ as well as the envisioned future conditions. Depending on the initial politico-administrative system and the different political visions, components of the traditional, managerial and governance type reforms gain prominence and public sector transformation goes in different directions. “While it is clear that each country or jurisdiction exhibits its own unique features, there are also many reform concepts, techniques, and

¹ Governance is a term that is widely used in various disciplines connected to policy making. Different disciplines use the term with different meanings. In public management texts it often refers to the relations with private agencies involved in public service delivery, while in political science literature it refers to a wider network of participation possibly including all stakeholders, and actors concerned. In the dissertation I use the term with the wider meaning according to the “democracy agenda”.

practices that are items of international trade...that has been greatly facilitated by international and supranational bodies” (Pollit-Boukaert 2004, 1).

After the dramatic changes of 1990, the post-socialist countries also entered into international trade of reform concepts. The transition countries were selected as target region for the export of government reform ideas from the West. This was part of a democratization effort and, at the same time, a response to the demands from the transition region. International agencies, donor programs and foreign experts brought public management and governance concepts from their country of origin without serious reflection on adaptability. Local leaders, who were unprepared for the enormous challenge of post-socialist transformation, often eagerly borrowed the modernization models, and both sides only realized adaptation problems during the implementation process. The socialist heritage was a different starting point than traditional Western public administration systems and demanded different strategies and sequencing of reforms. This led to many failed attempts and later to the realization that the post-socialist trajectory of reforms is not necessarily the same as reforms in developed countries (Schick 1998, Sutch 1999, Guess 2001).

Hungary was among the countries that implemented the most rapid and systematic changes after the political transition. The legislative reforms implemented during the first half of the 1990s resulted in considerable structural changes and a high degree of decentralization. Local reforms to adjust local government operation to the new context were necessary in the Municipality of Budapest. At the first local elections in 1990, a Mayor was elected who was a former dissident. He was elected on a ‘liberal’ program and collected around him a circle of like-minded advisors. That is, they were supporters of individual freedom, convinced of the value of competition and social responsibility as last resort. The municipal leadership

followed a different approach. Its leadership chose to gradually develop its own ideas on reform, and, on its own reading of theory and international practices, develop its own tools.

At the start they knew less about the new managerial and governance paradigms than the visiting experts, but had an intimate knowledge and understanding of the heritage they intended to change - the socialist paradigm. They knew that socialism as a system became intrusive, inefficient, corrupt and fiscally burdensome. They developed a principled approach to overcome obstacles and difficulties of the socialist heritage. They believed in competition and free choice, devolved power, decentralized information and action; and that change could be brought by applying market type incentives to internal management and the provision of services and financial resources. Their principles and goals aligned with the principles of the managerial paradigm. Nevertheless, the results built on the post-socialist starting point did not replicate the Western practices.

The Political Transition and Decentralization in Hungary

The socialist state was built on the basis of monopolistic power concentration, one party system and an official ideology that kept all property in the possession of the state. These conditions engendered a system of over-centralized bureaucratic coordination. Bureaucracies play a prominent role in Western democracies as well, but they are partial and localized to specific functions and institutions. “Classical socialism, however, is the first system in history to merge these partial bureaucracies into a single entity embracing the whole society” (Kornai 1992, 97).

The power monopoly resulted not only in the all-embracing bureaucracy, but a tendency towards micro management exercised by frequent, *ad hoc* interventions by government officials. Thus, paradoxically, the socialist system combined a command based, monumental bureaucracy with arbitrary vertical interventions. This system of societal coordination was very different from the tradition of the West². Kornai, in his seminal work, *The Socialist System* (Kornai 1992), described the historical formation that evolved during the socialist era and the relations that developed among its parts in the spirit of a system paradigm. He named the model of coordination under socialism “direct bureaucratic control” and characterized it as centralization of decision making and information, dominance of hierarchical dependence, paternalism, ideological and imperative planning, vertical bargaining³, and soft budget constraints⁴ (Kornai 1992, 363).

Within the monumental bureaucracy of the socialist state, local councils were deconcentrated units of the public administration and had little or no autonomy. Their role was to administer key local functions and services. In principle, service delivery and financing was coordinated by the central planning system, leaving the role of local councils to supply information to the

² The word and phrase “West” or “Western model” refers to the West European and North American tradition of democracy and public administration. This meaning for the term West and Western model is used for distinguishing the system that is paradigmatically different from the system developed under socialism in Central and Eastern Europe.

³ Kornai calls the specific negotiating system that developed in socialism “vertical bargaining” in order to distinguish it from horizontal bargaining that happens in market capitalism on markets. (Kornai 1992, 122)

⁴ Soft Budget constraint is a concept introduced by János Kornai in works analyzing the socialist system. (Kornai 1979, 1980) It was first used by Kornai to describe the situation in which state-owned enterprises managed to survive even though they made persistent losses. (Kornai, 1979, 1980) Later the same term was also applied to explain why government bureaucracies could always obtain additional resources to avoid service closures and failures. (Kornai 1992)

central planners, and to implement plans that were ordered from above, with due diligence. Policy making was controlled and centralized, and local government had little independence in planning and implementing its own local policies.

However, the pseudo-scientific central planning was only the official coordination mechanism. In practice, direct vertical interventions and orders from above created conflicting incentives and stress for local leaders. Conflicting orders could be easily exploited as excuses for defaults and inefficiencies. The resulting stress was contained through vertical bargaining of plans and finances. The vertical bargain created an incentive for local leaders to maximize demand for resources and distort planning information supplied to the center, leading to the softening of central budget constraints. All this led to an ineffective and inefficient system that worked on very different mechanisms than the traditional model of bureaucracy in the West. Discretion prevailed instead of the rule of law, and paternalism and loyalty were the expected behavioral patterns, instead of a professional and neutral bureaucracy.

During the 1990s, after the fall of the socialist system and the break of the power monopoly of the socialist party, the whole organizational model of society had to be remodeled, including the organization and relations of the public and private sectors and civil society.

The transition was a paradigmatic system change⁵ (Kornai 1999a). When the values, principles and the fundamental rules of the game were dramatically changed, the societal institutions were greatly transformed.

⁵ Here I use paradigm in two ways. Kornai (1999a) writes about the “system paradigm” in the meaning of a long-lasting, common way of thinking and inquiry by a scientific community. The other use of the term paradigm is a

“The socialist system, especially in its most pronounced classical form, went to extremes in limiting the rights of the individuals, so that the state became omnipotent. To expand the range of individual sovereignty, with the complementary change of narrowing the range controlled by the state was among the basic achievements of the change of system. What occurred was not a minor border adjustment, but a massive change of dramatic importance, resulting in a new borderline that lies far from the old” (Kornai 1998, 25-26).

The public sector had to be substantially reformed. The task was to rethink the role of the public sector, restructure it and create a sustainable system of public sector management that could deliver efficient and high quality public services according to the new expectations. “It is not simply a question of the state, as a whole, becoming smaller. Far more, it is a question of it becoming different” (Kornai 1998, 29).

One key element of this change was decentralization. The new Hungarian Constitution, adopted in 1989, guaranteed the autonomy of local governments. The 1990 Act on Local Governments and subsequent regulation of intergovernmental relations and local affairs resulted in a substantial devolution of fiscal and decision making power. System designers and decision makers made a huge effort to make the new system rule-based and predictable. Further, efforts were made to transition the soft budget constraints of the socialist system to hard constraints in both private sector relations and intergovernmental fiscal relations (Bokros and Dethier 1998). Thus, the new intergovernmental system coupled considerable local autonomy with local accountability.

system that, based on specific values and principles, creates its own specific, institutions and modes of coordination and culture. In this sense we can speak about the socialist system as the socialist paradigm, and as a paradigm compared to the capitalist paradigm. These paradigms and the great transformations of these paradigms are the subject of system paradigm inquiry. Sources in the study of Public Administration and Public Management also use the term paradigm when comparing various systems of administration, like the bureaucratic, managerial and governance paradigms. (Hughes 2003, Bovaird and Löffler 2003) I use the term paradigm in the dissertation in this meaning.

The decentralized institutional framework allowed for autonomous operation and decisions, but local reforms had to be undertaken against a background of national fiscal reform and a developing national fiscal crisis. This fact obliged the newly established local governments to implement reforms under strong fiscal pressure. Considerable changes had to be implemented within local governments in order to develop a system of sustainable local planning and service delivery.

Freshly elected local leaders faced multiple challenges in the early 1990s. Local public services had to be reconsidered according to a new context and philosophy. The earlier ideology of a physical planning driven local planning system, to support the vertical bargaining for subsidy maximization, had to be abandoned. A new system had to be developed that was adapted to the new realities. All this happened during the 1990s, under increasing fiscal squeeze on local governments (Horvath and Peteri 2003, 376). Hungarian local governments reacted to the challenges with different local reform strategies. Some focused on planning and administrative reforms as leitmotiv for restructuring, some built their strategy on sector reforms, or around development strategies, and others initiated local reform through the reconsideration of local financial mechanisms (Peteri 2004, 362-7).

The Strategy of the Budapest Municipality

As a result of the structural and intergovernmental changes which created the conditions for innovative local reforms, the Budapest municipal leadership made various attempts from 1990 to develop a comprehensive local policy reform strategy. However, concepts and documents

developed in the early 1990s could barely impact the course of events. World Bank and local analysts equally noted in 1994 that in just four years of self-government, the Budapest Municipality had made “remarkable progress” in identifying the financial and administrative problems it must address to effect its transition from an instrument of the state to an autonomous government (Ebel and Simon 1995, 119). However, much of it had been *ad hoc*. An effective strategy for implementing fiscal autonomy was yet to be initiated (Hegedüs, Pallai and Tosics 1994). Local officials were thus able to redirect efforts away from activities such as negotiating the structure of central transfers and toward the task of strengthening their own fiscal system.

The strategy that could finally make a decisive impact on the course of local reforms was the Local Budgeting Reform Strategy (BBRS), elaborated in its first form in 1995. This budgeting reform strategy initiated not only a comprehensive reform of local financing, but also accelerated institutional restructuring and planning and service delivery reforms.

The BBRS was first laid out in a policy paper Draft Concept for the Budget of 1996 (Draft Concept) that was produced for review by the Mayor’s Cabinet (Deputy-Mayor of Budapest 1995). The policy paper presented a comprehensive draft concept on how to reform the budgeting process (translated text is in Annex 1). Its purpose was to initiate a long term political agreement amongst the city leaders to support a multi-year strategy of comprehensive reforms.

The declared strategic goal⁶ of the BBRS was to leave old budgeting practices behind and establish strategic budget planning designed to achieve a sustainable, balanced municipal budget. As such, it was a budgeting reform strategy. Its components (objectives) are the following: (1) introduction of realistic multi-year planning⁷, (2) increase revenues from taxes, user fees and asset related revenues⁸, (3) leveling the earlier fluctuation of capital investments and (4) expenditure decreases through financial incentives. All these objectives were to be achieved through improved financial information and analysis, better planning coordination and financial incentives – typical components of modernizing local public finance reforms around the World⁹.

At the time the Municipality was “facing enormous structural fiscal pressures stemming from a deconcentration of expenditure responsibilities unaccompanied by a capacity to receive or finance these functions” (Ebel and Simon 1995, 120). Therefore, the document also states in the introduction that a sustainable balanced budget cannot be achieved through incremental

⁶ The Budapest documents often use terminology that is not in harmony with the terminology of mainstream literature. Moreover, the terminology changes through the years. For the clarity of my discussion I use the same terms for the same content. The declared aim of the Draft Concept is to introduce strategic budgeting. In the final version of the strategy in 1997, the central statement (aim of balanced budget) is called “strategic goal”. Therefore, I use strategic goal from here on to define the main intention behind the strategy. Under strategic goal, key components are listed, in following strategies, the supporting conditions. I will consistently call this level of the strategy “objectives”. Under the objectives, specific tools are introduced in each version of the strategy.

⁷ Mechanisms used to achieve this objective were: (1) the introduction of a multi-year financial forecasting and planning model, (2) a rolling planning mechanism and (3) better coordination of strategic and medium term budget planning.

⁸ Operational objectives and mechanisms under this objective were: (1) better asset management in order to produce positive asset value, (2) asset conversion and (3) privatization.

⁹ I use the word “modernizing” instead of connecting the mechanisms to a given paradigm because they can be used in various paradigms. At the same time, it also has to be noted that the idea behind these innovations points towards a managerial approach.

changes and over-the-board-cuts. Instead, the strategy must be “based on a multi-year outlook ... establish clear priorities and accomplish institutional restructuring through financial incentives” (Deputy-Mayor of Budapest 1995, 1). This statement is very important as it clearly acknowledges that, as in most post-socialist cases, the disequilibrium is structural. Therefore, a sustainable balanced budget can only be established through institutional change (Kornai 1998, 37).

Under each objective, mechanisms are listed with weighty references to the targeted institutional and organizational restructuring (e.g. own revenues must be increased for strengthening autonomy; new user charge policy is a key incentive both on the user and the provider side; privatization will target efficient increase of provision; new institution finance mechanism will compel rationalization and restructuring without interfering in technical/professional decisions of sectors).

The policy paper became a key internal document that established the direction for reforms. It was a document that was not only comprehensive but also emanated coherence, complete with cross references between objectives and mechanisms that allow the effort to establish synergic impact among reform components. It was both concise (7 pages long), but at the same time clearly defined, and for the first time in forty years, pertinent to local intentions. Although it defined only the goals and objectives and lacked a precise strategy, it was of strategic importance for the future, as it sought agreement on direction and general process.

In the course of the following two years the Draft Strategy was slightly reformulated. A clear long-term strategy was also designed to implement the agreed goals. This long term strategy was published and publicly discussed in 1997 and, from the date of the approval by the

Municipal Assembly in November 1997, set the new rules for the budgeting process.(Office of the Mayor, 1997).

Its comprehensiveness and attempt to be consistent makes the BBRS a unique case of post-socialist budgeting reform. A clear, coherent and comprehensive strategy was elaborated prior to initiating the reforms and then, during the following years, an attempt was made to implement it through a carefully sequenced process, in a manner adjusted to the changing conditions and opportunities (Pallai 2004, Pallai 2003c). Though the planned reforms could not be fully implemented, the successful components still resulted in a substantial change of local management.

The experience is also unique in that no international organization or ‘guest star’ was involved in the elaboration. It was entirely ‘home grown’, the product of local experts and decision makers. This is important because when Budapest started its budgeting reform it was still struggling with the culture, routines and methods inherited from the socialist past. This is a very different starting point for managerial reforms than the practices and systematic discipline of the traditional bureaucracy in developed Western countries. The local team involved in the process had an intimate understanding of this context – an asset that foreign experts rarely possess.

The research explores the question whether the different starting point and the insight of the local team can explain the differences between the Budapest strategy of budgeting reform and the concepts propagated in mainstream public finance and management theories.

Relevance of Concepts of Mainstream Public Finance

When discussing budget reforms, Western scholars of public finance commonly make reference to better informed budget decisions as a key target and result of the reforms. Thus, Axelrod wrote that “among the measures prized by reformers are ... above all, the impact of reforms on budget decisions” (Axelrod 1995, 315). Schick asked whether the innovation altered the basis for making budget decisions and argued that “only if the answer is ‘yes’ can an innovation be considered successful” (Schick 1990, 91).

Better information for decision making was a key element of the BBRS as well. Key objectives included: improving financial planning through medium term financial forecasting and analysis; connecting budget planning to planning in general; and initiating strategic changes that met policy goals on the expenditure and revenue side of the budget. The objectives towards better planning, and all the other objectives neatly fit into the budgeting ‘modernization’ and reform concepts of Western public finance.

The agenda, at the level of the strategic goal and objectives of the BBRS, looked similar to goals of Western budgeting reforms that implemented the shift from the traditional, bureaucratic, input based, line-item executive budget to a modernized, managerial concept of budgeting. Only one key component was missing – the integration of a Performance Measurement System (PMS) into the budgeting process. This was not a minor difference, as performance information had been a cornerstone of public finance reforms since the mid-twentieth century. The goal was to supplant the input orientation of the traditional executive budget by an objective- or results-orientation. It was necessary to include performance measuring and systematic collection of performance information to support decision making.

The absence of a performance measurement component makes the BBRS look incomplete and inconsistent from the perspective of mainstream public finance.

This inconsistency, revealed within the framework of mainstream public finance, seems to contradict the serious effort of strategy drafters to establish consistency and synergy among reform goals. From another perspective, it is less surprising. It has already been frequently mentioned by analysts that traditional analysis of mainstream public finance “does not fully address the legacies of a command economy that transition economies share and must address” (Bird, Ebel and Wallich 1995, 6).

What Kornai wrote in 1998 about the Hungarian Public Finance Reform is also relevant to local finance reform and might lead us further.

“Well-known analyses of several stabilization episodes have reached the conclusions that the way to avoid persistent disequilibrium is to try to curtail the expenditure side, rather than expand the revenue side. Hungarian experience and the experience of post-socialist transition in general, suggest a different classification of measures. Lasting equilibrium is far less likely to result from the adjusting of quantitative macro economic parameters than from carrying out institutional changes. If, during times of trouble, it is possible to shift a quantitative indicator in one direction, it will be possible to shift it back to the opposite direction once the trouble has passed. Since the situation usually improves after the threatened or actual crisis has been overcome, politicians are tempted to become overconfident again, and spoil what they have improved. So changes in the numerical value of some macro-parameters are not enough to bring lasting results. There have to be changes in the institutions that ultimately generate the numerical values of those parameters” (Kornai 1998, 37).

In order to include the institutional change aspect of reforms we make an attempt to assess the BBRS from the perspective of public management reform.

Relevance of Concepts of Mainstream Public Management

According to the definition of the two leading scholars of the field, “public management reform consists of deliberate changes to the structures and processes of public sector organizations with the objective of getting them (in some sense) to run better” (Pollit-Boukaert 2004, 8). As it has been noted earlier, the intention of institutional reform is discernible on the level of objectives in the BBR. Most of the planned mechanisms connect objectives to institutional reform. Thus, the public management angle certainly looks more adequate (than that of public finance) to analyze the BBR. In general, the emphasis on financial incentives and the interconnectedness of the financing and institutional reform objectives in the BBR are consistent with the conceptual framework applied in managerial type public management reform. However, if we turn to the same, or other¹⁰, authors for a definition of financial management reform within the discipline of public management, we find out that PMS is an equally central component as it was in public finance:

“Pressures have led to what in effect has been an expansion in the scope of budgeting. Instead of a situation where budgets were mainly a process by which annual financial allocations were incrementally adjusted, legalized, and made available to legislatures, budgeting has become more intimately linked with other processes – planning, operation management and performance measurement. Greater integration of these systems has been a common objective” (Pollit and Boukaert 2004, 67).

PMS is logically a crucial aspect of managerial reforms. Managerial reforms decentralize operational management to increase efficiency. Decentralizing implementation decisions

¹⁰ e.g. “Financial management is now closely related to personnel and performance management.” (Hughes, 2003, 165) In budgeting, “performance and results – not inputs – are stressed” (Chan, 2003, 103) Techniques for improvements include “increased control by means of economic and financial information ...performance

offers flexibility to managers to choose the best solutions. At the same time, as decentralization of decisions necessarily softens traditional input controls, a performance control has to be established to secure prudent implementation of public goals. PMS gives security that public goals will be duly implemented through decentralized management.

In managerial public finance reforms PMS is really the mortar among system elements. It links macro and micro-budgeting and plays a crucial role in strengthening accountability. In the new managerial paradigm of public finance decision makers can focus on policy goals and macro-budgeting, and micro (management) decisions can be safely decentralized because the performance information connects goals and implementation (Cothran 1993, 449-450).

Thus, our earlier concern about the BBRS is still valid – we do not find any reference to PMS. The Draft Strategy uses the term financial incentives, but incentives are not specified and not connected to performance measurement. Later versions introduce mechanisms that attempt to link resource allocation to tasks, but PMS has been never part of the management system in Budapest. Even performance related tools appear in Budapest only in later years, in detailed implementation concepts of various reform components¹¹. Therefore, an explanation for the absence of PMS, a centerpiece of managerial reforms, is still missing.

This leads us to the next question. Are Western managerial reforms and post-socialist restructuring similar enough that Western models are directly applicable? Can the solution for

evaluation techniques and incentives both to reward achievements and sanction under-performance or error” (Keraudren and van Mierlo, 1998, 43)

¹¹ E.g. Rationalization Fund, 1996 and Task-based operating finance scheme, 1997

our puzzle and the explanation for the absence of PMS in the BBRS arise from the difference between the challenge of Western modernization and post-socialist reform?

Are the Western Models Applicable?

During the last decade, countless attempts were made to transplant public finance and management theory and applications, developed in stable Western democracies, to the post-socialist transition region of Central and South East Europe (CEE and SEE). Many Western experts came, but “the short time available left them unable to step out of the paradigm that had defined their way of thinking hitherto” (Kornai, 1999a, 13). In most cases models of financing and budgeting were transferred without serious reflection or adaptation. Analysis and debate started only after many disappointing experiments were already completed.

Axelrod, discussing developing country experiences, notes in 1995 that the history of performance budgeting was of high hopes and disappointing achievements, and that performance measures were “incomplete and inadequate” with few links existing between performance budgets and medium-term development plans (Axelrod, 1995, 288).

Nevertheless, most scholars still argue for the necessity of modernized public finance methods and the introduction of performance measurement before embarking on managerial reforms. In his famous article, *Why Most Developing Countries Should not Try New Zealand's Reforms*, Allen Schick argues for the importance of gradual change: diminishing informality, strengthening rule-based systems, separating political and administrative power and

establishing effective input control should occur before starting to managerial reforms. “They must be able to control inputs before they are called upon to control outputs; they must be able to account for cash before they are asked to account for cost; they must abide by uniform rules before they are authorized to make their own rules; they must operate in integrated, centralized departments before being authorized to go alone in autonomous agencies” (Schick, 1998, 130).

Whereas Schick speaks about developing and transition countries in general, some others, who focused solely on the transition countries and the fiscal decentralization of the socialist state, adopted a similar argument. Thus Sutch argues that in absence of a “long tradition of public service characterized by high standards of integrity, well-developed accountability mechanisms and – at least of relative – openness of information” it is hazardous to shift to managerialism (Sutch, 1999, 3). She writes “when they have good accounting systems so that they define and measure performance and can remunerate it fairly and transparently, they will be able to make informed choice” (Sutch 1999, 5).

Thus both Schick (1998) and Sutch (1999) have as a starting point the development of the pre-conditions to change. I label this train of thought the necessary condition argument. They formulate a general proposition that post-socialist managerial reform should proceed in a sequence whereby policy makers first establish the traditional (Western) administrative

framework and PMS before proceeding to managerial decentralization. This is a valid option, but it is the only one?¹²

Kornai (1992), Bird, Ebel and Wallich (1995), and Guess (1997) build their argument on a different starting point. As we will later discuss, Kornai (1992) identified the lack of reliable information in the socialist planning mechanism as a systemic problem. Guess observes the absence of valid information in socialist budgeting (Guess 1997, 638). Demand for information can be generated only if functional responsibilities replace the old physical planning system that was cost blind (Guess 1997, 638).

On the basis of these views, conclusions can be made that are very different from that of Schick (1998) and Sutch (1999). According to this alternative, performance measurement can hardly be the initial phase in post-socialist reform. Institutional reform has to first create the context where valid information is generated on the basis of systemic demand. This second argument can be labeled the systemic weakness argument. According to this train of thought, institutions and incentives have to be first changed to have a realistic chance of generating valid information.

In sum, one can accept that performance measurement is logically necessary in managerial reform. It is a systemic element in the managerial paradigm. In Western reform trajectories, as a necessary condition of safe decentralization of operational management, it was developed

¹² It is fair to note that in the sources I could locate, Schick has not changed his view on transition, but in 2001, analyzing performance management in American Government, he noted: “The great mistake of the performance measurement industry is the notion that an organization can be transformed by measuring its performance” (Schick, 2001a, 43)

before the devolution of managerial discretion. At the same time, we know that the absence of valid information is a systemic problem in socialism. Only institutional reform can create the conditions for reliable information to be generated. The question is whether institutional reform should first follow the traditional paradigm, establish PMS, and then implement managerial reforms, or, whether there is a way to 'leap' to the managerial reforms right away? This is a crucial dilemma of all practitioners advising reforms.

Chapter 2. Research Goal, Hypothesis and Questions

Relevance of the System Paradigm

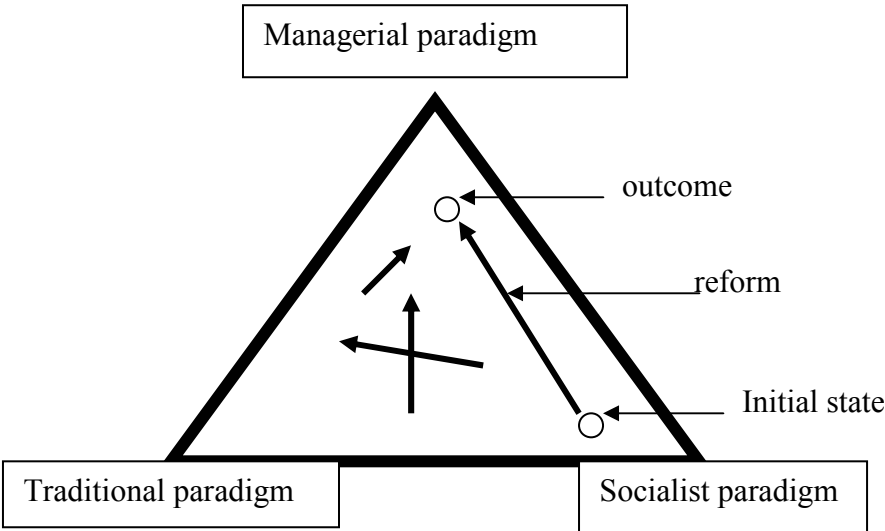
In the introduction I demonstrated that the Budapest reform is not consistent with the mainstream angle. Maybe the better question is the following: Is the Budapest strategy consistent if viewed from the angle of post-socialist problems? Is it consistent within an environment that attempts transformation from the socialist to managerial paradigm? Is it as consistent as are the integrated three pillars¹³ of public management reforms that lead the transformation from classical bureaucracy to public management?

Kornai, in his short paper ‘The System Paradigm’ (1999a), argues that only intimate knowledge of the given system paradigm can lead to adequate choices about reform trajectories. This view of Kornai is the starting point for my inquiry. The dissertation explores the difference between the initial conditions for local public management reforms in East and West. It compares the socialist and the traditional Western bureaucratic public sector paradigm and the managerial paradigm. The paradigm descriptions focus attention to systemic features pertinent to local government organization and planning.

¹³ By the integrated three pillars I mean here the earlier mentioned three common features: strengthening control over goal-setting, decentralizing management and linking to performance measurement.

The assessment of the BBRS is imbedded in this conceptual framework. The paradigm frame describes ideal-types. That is, perfect conditions that are never achieved. They are logically consistent functioning within the given frame. It supplies static reference points that can help determine directions of moves along the paradigms. Paradigms can be depicted as corners of a triangle. The three paradigms create a triangular space where the corners are the paradigms, and all existing systems are inside, representing a certain combination of the three elements. Reforms can be depicted as moves in the triangular space cornered by the three paradigms. (see Figure 1 below) Statements related to the moves do not entail quality judgments on decisions, they only qualify the logic of the move.

Figure 1: The system paradigms and reforms



Goal of Research

The dissertation is a case study. Its subject is the BBRS and its implementation between 1995 and 1999.

I intend to use the case to examine a general proposition in Western literature that post-socialist managerial reform should first establish the traditional (Western) administrative framework and PMS before management decentralization (Schick 1998 and Sutch 1999). That this (primarily Western) view of public sector reform is the right model for transition governments such as Budapest has huge policy implications for a sustainable post-socialist society. In this case, a municipality in transition from socialism to pluralism, that faced an urgency to become viable. As the literature review attests, this sequence has not only been largely unchallenged, but also never been tested *vis-à-vis* an actual case implementation.

The goal of this dissertation is to test the relevance of the Western view and demonstrate that it shows a Western bias.

The Hypothesis

The counter-proposition to the Western view – and thus the hypothesis here - is that a different trajectory can make the leap towards the managerial paradigm. It is possible to introduce decentralized management and design a new accountability framework without prior emphasis on control and PMS. The accountability framework can be based on the

establishing various performance links and not necessarily on an integrated PMS.

The hypothesis is that an alternative trajectory of municipal reform is not only possible, but, in a post-socialist context, appropriate. If this can be demonstrated for the case of Budapest in a manner that lays out an alternative approach, then this one case, Budapest, is enough to demonstrate that the proposition is not generally true: that is the falsification of the proposition.

The Method

To examine this matter, I pose two research questions: (1) Is the absence of PMS an inconsistent strategy? (2) Is a leap to the managerial paradigm possible?

The framework for the examination is laid out by identifying alternative system paradigms, which allows one to explore the system logic of each paradigm and establish causal links among components. I distinguish between causes and end result phenomena, as I am convinced that lasting reform requires that causes be solved, not simply attacking end result phenomenon.

On the basis of the system paradigms I explain why the absence of PMS is not an inconsistency at the start of post-socialist reform.

I equally use the system paradigms to demonstrate that the criticized proposition represents a Western bias because it views the problem of post-socialist reform exclusively from Western

frames - the traditional and managerial paradigms. The proposition builds only on the starting point, and what happened in the West. It fails to factor in the initial post-socialist situation.

But what identifies this leap? Or lack of one? That is what the case study addresses. Based on the evidence — the empirical case of Budapest (with several strategies and tools discussed in the case), I am able to conclude that an alternative trajectory is possible and, indeed, occurred. Falsification is successful. I reject the trajectory proposed by Western scholars, as it intends to change results without treating the causes, and propose a revision.

This is an important finding, not only for Budapest but for other municipalities in transition as well because it demonstrates an alternative strategy for municipal public sector reform. This finding does not imply that the Budapest experience is necessarily applicable to any transition municipality, but that it is an alternative that worked elsewhere.

Structure of the Dissertation

The dissertation is organized in eight chapters. The next, third chapter provides an overview of the relevant literature and the concepts that will later be applied. It discusses the evolution of public sector concepts and identifies the key paradigms. It then reviews the concepts used in the discussion of public management reform and local financial management found in public management literature and introduces the categories used by mainstream public finance

professionals in the discussion of budget reforms. It also reviews what has been written on post-socialist public management and budgeting reform.

The fourth chapter develops the conceptual framework by connecting public sector paradigms and specific approaches to planning and financial management, allowing one to argue for logical approaches to planning and financial management within each of the paradigms.

In chapter five I discuss the methodology of the case research. The sixth and seventh chapters develop the case study. They include the empirical material. That is, they examine in detail how a large CEE municipality carried out its managerial reforms and the mechanisms, some successful, others unsuccessful, that were employed.

The concluding eighth chapter summarizes the findings and draws conclusions. First I demonstrate the explanatory power of the conceptual framework based on system paradigms by showing that the earlier identified inconsistency - that could not be explained within mainstream concepts - can be explained through the paradigms. Then I conclude the falsification and propose a revision of the general proposition in a form that the possibility of the alternative trajectory, demonstrated in the case of Budapest, is not excluded.

Chapter 3. Literature Review

The subject of the dissertation is the analysis of the BBRS. In the 1990s, at the time of the discussed reforms, a liberal leadership led the city whose modernization goals were in full accordance with the earlier mentioned managerial paradigm. Under a sustainable budgeting reform strategy, managerial reforms of local public finance and service delivery mechanisms were initiated. Public finance and public management reform are closely linked in this strategy. In this literature review, I will explore both of these fields in order to aid the construction of the conceptual framework for the case analysis.

In Budapest, the goal was to implement a managerial reform. Mainstream theory focuses on managerial reforms in developed countries. The starting points of post-socialist reforms are fundamentally different, causing the reform trajectory to also differ. Thus, the first part of the literature review, that explores public sector concepts and reform trends, describes both worlds: the trajectory of change in the developed West and the socialist system paradigm. The goal is to provide the theoretical underpinnings of the conceptual framework that is based on the comparison of public sector paradigms and is used for the case analysis.

The systematic connection between public sector paradigms and public finance and management approaches and practices will be established in the next chapter (Chapter 4: The Conceptual Framework).

Public Sector Concepts and Paradigms

Since the 1980s, in developed countries, the traditional model of public administration¹⁴ became widely criticized for its weaknesses. Following this criticism, public sector management and related studies have been in flux. First, a managerial paradigm emerged then, more recently, a new governance paradigm has started to take shape.

Some authors see this process as a logical sequence of evolution that moves from the legal tradition of the traditional paradigm, through the managerial innovations targeted to service delivery efficiency, towards the more recent citizen focus of the emerging governance paradigm (Bovaird-Löffler 2003, 19). Some others discuss the managerial and governance changes as attacks on the traditional model from two angles that result in parallel processes “of managerial as opposed to a political response to the problems confronting public service bureaucracies” (Hambleton 2002, 155). In practice, approaches and techniques originating from all three paradigms are coexisting in the public administration system of each country and their uses are interconnected (Bovaird-Löffler 2003, 22). As I will focus on the managerial reforms as treated separately in both concepts, it is not important for me to distinguish whether the two reform directions emerged in a consecutive or parallel way. Therefore, it is

¹⁴ I discuss three paradigms of public administration: the traditional, managerial and socialist. I use the word ‘paradigm’ when I refer to the logic of the system.. I use ‘model’ when I refer to the organizational model that is the typical product of the given paradigm. For example, the traditional administrative paradigm describes the logic of organizing the classical state bureaucracy in Western European nation states (the Weberian bureaucracy), the relations among its parts and its functioning, while the traditional model is the typical form of organization within this system. Equally, the socialist administrative paradigm describes the logic of organizing the administration in the socialist system, the relations among its parts and its functioning, while the socialist model is the typical form of organization within this system. Thus, the meanings of paradigms and model are close, but not fully interchangeable.

not important to choose one of the competing definitions of governance¹⁵, as the distinction is not directly relevant to my case.

Countries undergoing a post-socialist transformation attempt to establish a democratic market economy based on the same key principles as the systems of developed countries. Marketization and managerial reforms play a crucial role in the transformation. Still, public sector reform during a post-socialist transformation necessarily follows a different trajectory than managerial reform in the West. To begin with, the organizational model was very different from its Western parallel, the traditional model of public administration (Kornai 1992, 109).

My focus is on managerial reform – the term is mostly used in mainstream literature to describe the path from the traditional paradigm of bureaucracy towards the managerial paradigm. Post-socialist countries initiate reforms from a specific starting point, the socialist paradigm. To understand post-socialist reforms, it is not enough to understand Western paradigms and transformations, the socialist paradigm must also be factored into the analysis.

¹⁵ Authors in the literature of public management and political science use the term ‘governance’ with conflicting meanings. A few sources define governance in its original meaning, not connected to the new developments. “Governance is just another way of saying public administration.” (Starling, 2002 1-2) In most sources, governance refers to the importance of links between governments and non-governmental actors. Governance refers to government plus the horizontal web of its active relations that lies outside government. Authors discussing the managerial paradigm use ‘governance’ mostly to refer to the private service providers and the mechanisms of coordinating public services. Governance refers to this wider framework of service provision. (Matheson and Kwon 2003, 43) Other authors use the word ‘governance’ with a much wider meaning, shifting focus beyond service delivery. Governance in this framework stresses the limits of representative democracy. (Klausen and Sweeting 2005, 217-220)

I present the evolution and essence of the three paradigms: traditional, managerial and socialist. First I discuss the Western managerial reforms, then the socialist paradigm and the resulting key challenges of post-socialist transformation.

The Western trajectory

Until the birth of the national states, public affairs were handled by amateurs bound by loyalty to leaders. Government administration was personal, “in effect, a private business in which government decisions, money and votes were negotiable commodities” (Mosher 1982, 65). Once the national state became the reigning model of administrative organization, states needed professional civil servants to implement law and order. The evolution of administrative organization was a long process.

The 1854 Northcote-Trevelyan Report in the United Kingdom and the 1883 Civil Service Act in the United States were milestones in the process of forming professional public administrations. Both called for recruitment to civil service by open competitive examination and merit-based promotion. Woodrow Wilson’s 1886 article arguing for strict separation of politics from administration was another milestone. He argued that “administration lies outside the proper sphere of politics” and its role is “detailed and systematic execution of public law” (Wilson 1941, 197). Wilson defined the concept of the dichotomy between politics and administration as:

“a distinct sphere for administrative development and discretion – often rather wide – free from meddling and interference of politics. The dichotomy that became an important instrument for progressive reforms, allowed room for a new criterion for public action, based on the insertion of professionalization, expertise, and merit values into the active direction of government affairs” (Stillman 1991, 107).

The practice dictated by the traditional model of public administration was already widely applied when Max Weber formulated his theory of bureaucracy. To compare large organizations, historical and contemporary, Weber developed the main features of the ideal bureaucracy: hierarchy of authority, impersonality, written rules of conduct, promotion based on achievement, specialized division of labor, and efficiency.

“Precision, speed, unambiguity, knowledge of the files, continuity, discretion, unity, strict subordination, reduction of friction and of material and personal costs — these are raised to the optimum point in the strictly bureaucratic organization” (Weber 1946, 1959, 214).

Weber’s theory formed the logic behind actual practices and codified it into principles and norms of expected bureaucratic behavior. With these theoretical underpinnings, he greatly advanced this form of organization, aiming to bring certainty, impersonality and efficiency to public administration. Weber and Wilson laid down the foundations of the theory of public administration (Horváth 2005, 26).

At this point “all that was needed for a complete theory was a way of working and organizing, to be added to the bureaucratic model of Weber, the political control of Wilson and the merit appointments and political neutrality of Northcote-Trevelyan” (Hughes 2003, 26-7). This component emerged from the public sector adaptation of Frederick Taylor’s Scientific Management theory. Taylor’s theory had two pillars that contributed to the operationalization of the bureaucratic form: defining the “one best way” and its standardization and controlling implementation. Scientific management “gave a form and purpose, a self confidence to both the practice and the study of administration in the 1920s and 1930s” (Dunsire 1973, 94).

“The ideas of the ‘one best way’ and systematic control were a perfect fit with the rigid hierarchy, process and precedent” (Hughes 2003, 28) from Weber’s theory. The contributions

of Wilson, Weber and Taylor “all fit neatly together: a strong, effective administrative system could flourish if politics was restricted to its proper sphere, if scientific methods were applied, and if economy and efficiency were societal goals” (Stillman 1991, 110). This is the paradigm of classical bureaucracy – I refer to it as the ‘traditional paradigm.’

The public administration model based on the traditional paradigm has some undisputed strengths. Its focus on law, defined authority and procedural clarity secured the legitimacy of the system and the decisions it produced. The rigidly regulated, hierarchical system, and the neutrality and professionalism expected from bureaucrats created certainty. Systematic coordination and control supplied operational efficiency and effectiveness. The static order of the traditional model of administration, which was preoccupied with legality, structure and process, was in perfect harmony with the stability of the context and citizens’ desire for certainty.

At the same time, the model has its obvious limits. Already Weber acknowledged that:

“The decisive reason for the advance of bureaucratic organization has always been its purely technical superiority over any other kind of organization. The fully developed bureaucratic mechanism compares with other organizations exactly as does the machine with the non-mechanical modes of organization” (Weber 1946,1958, 214).

Weber’s statement is systemic, not judgmental. However, the same line of thought engendered serious criticism of the bureaucratic paradigm by the 1970s: the bureaucratic mechanism brings certainty but may be slow. Its preoccupation with process, standardization and control surely contributes to certainty, but can kill flexibility and creativity. Moreover, the preoccupation with process transforms bureaucrats into little automatons and diverts attention from results and outcomes that is the *raison d’être* of government. All these features work

against the efficiency that had been the key goal of the bureaucratic model of organization.

It also became obvious that the dichotomy of politics and administration was a myth. As

Peters argues:

“Administration does make policy, although these policies are not always written and promulgated in the same manner as the rules made by the legislature and executives. Moreover, the operational rules developed by administrators can be more telling for the actual outcomes for individuals than are the formally promulgated rules” (Peters 1989, 4).

The last and most systemic attack on the bureaucratic form of organization was developed by economic and public choice theory. Economists and public choice theorists claim that the market is the most efficient form of organization, and bureaucracy brings sub-optimal results while unnecessarily restricting freedom of choice and competition – the best incentives for efficiency. (Features of the traditional paradigm are summarized in table form and compared to the other two paradigms in Annex 5).

The public choice critique of the traditional model of public administration has two main components. One raises concerns about the scope of government and argues for a more restricted domain of government action and for the introduction of private provision of public services. The other component attacks the myth that civil servants are led by the higher value of serving the state. Assuming rational actors, the public choice theory argues that bureaucrats follow lower level goals, maximize their discretionary budget and their own welfare leading to office politics and the displacement of organizational goals (Niskanen 1973, 23 and 1994, 281).

In sum, by the 1980s it was demonstrated that bureaucratic organizations may be effective at

executing instructions, but were not necessarily the most effective and efficient organizational model for implementing public goals. At the same time that these concerns were raised, increasing national budget deficits caused strong political pressure for cost savings and reforms that promised such results.

Behind the pressure was the ideological transformation of public sector. Neo-liberals like Hayek and Friedman argued that public sector crowded out the private sector, and reducing government intervention would actually work in the public interest. On this basis, by the 1980s, neo-conservative governments in Western countries initiated a radical reorganization of the public sector.

Neo-conservatives urged the development of new practices following economic and public choice theory. Consequently, public roles were reconsidered, market-based solutions were adopted to increase efficiency in government services and a shift from process to results and from administration to management occurred. Hence, the market-based and managerial approaches to public sector management emerged which constitute the 'managerial paradigm'.

Public choice criticism of the traditional model called for two main reforms: (1) expansion of the market and the introduction of market-based solutions in the delivery of public services and (2) the adoption of new management techniques from the private sector.

The first generation of managerial reforms intended to create a lean and efficient public sector responsible to citizen needs. They conceptualized the citizen as a rational consumer of public services and attempted to enlarge his freedom of choice. The focus was on better management of services. Instead of a bureaucrat that duly carries out instructions, the central figure was the

manager, who has personal responsibility, takes risks by making decisions and has the resulting accountability. Devolution, marketization and privatization were the key tools of this manager who had professional management training. Instead of simply exercising control, the manager was tasked to manage performance. (Features of the managerial paradigm are summarized in a table form and compared to the other two paradigms in Annex 5).

This first generation of managerial reforms was labeled by Hood (1991) 'New Public Management' (NPM). Early enthusiasts of this rational new approach propagated its universal applicability and encouraged governments to adopt its 'best practices.' A closer look at public management experiences negated this naive universalism and showed that applications and results were highly varied among countries (Pollitt-Bouckaert 2004). It was also demonstrated that the strong incentives to produce outputs could lead to insufficient attention on outcomes. Moreover it was revealed that the instrumentalist approach, focused on technical and operational efficiency mostly pertinent to the micro-level, often "produced some negative effects at a systemic level" (Matheson and Kwon 2003, 43).

Analysts identify three conceptual problems that contributed to the insufficient attention to the systemic and governance effects during the first generation of managerial reforms: (1) formalized, rational planning and management with tight specification and measurement has limited capacity to address complexity and bounded rationality; (2) as government, "despite its size and complexity,... remains a single enterprise,... any reform aiming to systemic changes cannot hope to do so by concentrating on one lever; (3) "public management is not only about delivering public services, but it also 'institutionalizes' deeper governance values and therefore in some respect it is inseparable from the governance arrangements in which it is embedded" (Matheson and Kwon 2003, 45).

It was realized that “as important as it is, efficiency in producing outputs is not the whole of public management. It also is essential that government has the capacity to achieve its larger political and strategic objectives... fostering outcomes” (Schick 1996, 87). The new agenda shifted towards a more systemic understanding of reform, bringing an end to enthusiastic propagation of ‘best practices.’ The focus should instead be on the systemic impact of management tools.

“In the next phase of public sector reforms, the fostering of innovation should be underpinned by more attention to the capacity of governments to diagnose the deeper characteristics of their public sectors; to understand the political-economy of reform in that environment; to assess the risks and priorities within that context; to develop ways of deciding the point of intervention and sequence of action; and to pay active attention to their public service leadership and culture, especially in respect of governance values” (Matheson and Kwon 2003, 49).

The mechanisms planned and implemented in the course of the BBRS are in line with the managerial tools that were experimented with and introduced to public management during the first generation of public management reforms. At the same time, the BBRS as a reform strategy is in the framework of the second generation agenda. I raise similar concerns about the direct applicability of Western models to post-socialist transformation challenges, as the critiques of the first generation managerial reforms raised. Thus, the aim of the research and the arguments developed here is to make a contribution to the emerging new agenda of the public management discipline.

The socialist administrative system paradigm and transformation challenges

Kornai, in his seminal book, *The Socialist State*, described the system paradigm of socialism (Kornai 1992). In the dissertation I call Kornai’s paradigm ‘the socialist system’ in order to distinguish it from my own use of the word ‘socialist paradigm.’ I will use the ‘socialist

paradigm' not for the whole system of socialism, but for its administrative system. 'Socialist paradigm' here is the short reference to the socialist administrative system paradigm.

Kornai describes the classical socialist system by identifying a “clearly perceptible main line of causal connections” (Kornai 1992, 360). For him, the key to explaining the socialist system is an understanding of its one-party political structure that secures undivided power for the Communist party. The preponderance of state property and the control of the commanding positions of the economy are consequences of the ideology. Political structure, ideology and the dominant role of state ownership combine to account for the bureaucratic control that embraces the whole society. The bureaucratic coordination of classical socialism eliminates free enterprise and market competition, centralizes information and decision making and creates a system structured exclusively on vertical dependence¹⁶. Bureaucracy taking over the other forms of coordination leads to behavioral patterns like plan bargaining, paternalistic superiors and soft budget controls. These factors together lead to the typical economic and social phenomena experienced in command economies (Kornai 1992, 360-3). (Kornai's causality line is reproduced in the Annex 4).

Kornai developed his model to analyze macro-economic functioning. My focus is on administrative coordination in the socialist system. This subject forms only part of Kornai's system paradigm, but all its characteristics can be logically deduced by continuing Kornai's line of causality.

¹⁶ “Structured on vertical dependence” means this is the official and dominant link. It does not imply that horizontal relations do not work, but that their role is restricted and mostly unofficial.

In the dissertation I use the term ‘socialist paradigm’ to describe: the organization, the functioning of its administrative system and the working of its local units. Kornai named this organizational system a ‘centralized, bureaucratic coordination system’ in order to distinguish it from the classical bureaucratic coordination discussed above, under the term ‘traditional paradigm.’ (Kornai 1992, 109)

Administrative coordination under socialism was based on an imperative planning system that attempted to centralize the collection and processing of information, and produced all comprehensive plans to directly control allocations. Plans defined goals and programs for one, five and sometimes twenty years, and were underpinned by legal force. They were meant to guide the behavior of all actors.

In the socialist planning system, the plan was ‘officially’ the mechanism of direct control. The idea that an all embracing plan could define the best way to bring about progress and order was a naïve, arch-positivist extreme of the comprehensive planning concept. As such, it shared the usual weakness of formalized planning systems applied to the public sector: information problems and inability to deal with complexity. However, these problematic features of the formal planning system were aggravated by the specific attributes of socialist planning that I discuss in the following paragraphs as components of the informal noise in the system (i.e. the culture of direct intervention by leaders and vertical bargains, the interest of actors to distort planning information and soft budget constraints).

While officially the wisdom of the centralized, scientific (i.e. ideological) planning system was supposed to coordinate the activities of actors, in reality, the systemic problems of the informal noise negated this utopia.

The first component of this noise was party-controlled nominations for key positions. Such nominations created vertical dependence and led to top-down, paternalistic behavior¹⁷ and personal loyalty in relations throughout the system. This was a fundamentally different dynamic than the clearly regulated and merit-based role of bureaucrats under either the traditional or the managerial paradigm.

The second component of the noise was that party and higher level leaders frequently made arbitrary interventions by giving orders to subordinates that diverged from the plan. It was difficult not to obey the intervening orders as nominations for positions were directly controlled by the same party or superior. At the same time, the ad hoc orders created conflicting objectives and stress in the system. They also supplied an excellent excuse for weak performance or running over budget allocations. This stress was contained by the system of vertical bargaining¹⁸ (Kornai 1992, 121-4).

Vertical bargaining was the third component of the noise that directly leads us to the fourth and fifth components. The fourth was soft budget constraints¹⁹. As interventions in the plan created the excuse for overspending, additional transfers could be gained through vertical

¹⁷ Kornai captures the paternalism of the socialist leader beautifully, it “binds him to traditional socialistic values: he feels obliged to aid a firm in trouble; he certainly cannot throw workers out on the street; he has responsibility to level off the firm’s earnings. Paternalism is his bounden duty.” (Kornai 1992, 493)

¹⁸ Kornai uses the term ‘vertical bargaining’ to distinguish this process of negotiating within bureaucracies from the ‘horizontal bargaining’ that takes place between seller and buyer in the market place.

¹⁹ The term soft budget constraint was introduced by Kornai to describe the situation in which state-owned enterprises managed to survive even though they made persistent losses. Their constraint was soft as the state, in order to avoid social costs, rushed to their aid when they were in deficit. (Kornai 1979, 1980) A similar logic applies to state bureaucracy under socialism and the term has been used for this as well.

bargaining. This was the meaning of soft constraints (Kornai 1999b). Soft constraint was systemic, not solely caused by the vertical bargain. It resulted from all the components mentioned above. At the core was the strength of the party. Directly or indirectly, all nominees were appointed by the top. According to the ideology, they worked hard and were committed to the same cause, hence, embedded in the system of paternalism. Their aid and help could not be refused. Moreover, the vertical bargain could not allow for hard constraint. The bargain always ran on friendly terms, avoiding harsh conflict as vertical interventions and compliance created complicity between superior and subordinate at each level.

The fifth component of the noise was unreliable information. In the central planning system, there were two vertical channels. Information traveled from the bottom-up, got processed in the center as input to the plans, while orders traveled from top-down through multiple layers of plans. “Whatever the case, the processes of information and incentive have parted ways, which is one of the gravest problems inherent in the bureaucratic coordination” (Kornai 1992, 130).

When subordinates prepared the information for planning they were fully aware that they could influence the plan through the information they supplied. If their wish was a comfortable life, and they did not have incentives to produce more by higher pay or other means, their interest was to distort performance information in order to lower performance expectations. If they were committed to their mission, they could distort figures on demand. As superiors were fully aware of this tendency, however, they simply deflated or inflated expectations. This practice in turn made it impossible for subordinates to start the bargaining on real information and established a culture of distortions, guessing and use of thumb rules, instead of one based on information. This completely undermined the reliability of the

information system and its potential to support plans and decisions, while simultaneously undermining the accountability of each actor involved in this chain of bargaining.

It was impossible to construct a reliable system on the basis of unreliable information. The solution was multiplication. This was the sixth component of the noise. “Redundancy within the system allows damage caused by any random unit malfunctioning to be prevented or rectified by another that chances to be functioning properly at that time²⁰” (Kornai 1992, 99). The multiplication of regulation, parts, reserves and control could, to a certain extent, stabilize functioning, but at the same time led to immense inefficiency.

Aware of the consequences of all this noise, socialist leaders realized that the plan could not work. “It is like wanting to change the channel or volume of a television set by a remote controller when no sensor has been built into the set” (Kornai 1992, 497). Through circular logic they legitimized their continuing direct interventions and micro management of subordinates’ activities. This peculiar mix of loyalty and complacency reigned in the socialist system. (Features of the Socialist paradigm are summarized in a table form and compared to the other two paradigms in Annex 5).

Centralized bureaucratic coordination was a centerpiece of socialism, embracing the whole society and economy. It developed as a consequence of the ideology and was also the main source of its weakness and inefficiency, finally leading to its collapse:

²⁰ Kornai, in his explanation, refers to Neumann’s theory of constructing a reliable automaton from unreliable parts. (Neuman 1956)

“It is unique in history for a central power to have intervened from above artificially by means of legal regulations in the development of society to decide that a particular main type, market coordination, should vanish, or at least be confined to insignificant position, and replaced by centralized bureaucratic coordination. This was a fundamental change that did not occur spontaneously....[and led to] a spontaneous self generation, self-propagation, and excessive expansion of bureaucratic mechanisms that went beyond the expectations even of those who initiated and directed the epoch-making change” (Kornai 1992, 109).

The last years of Hungarian socialism represented a peculiar condition - market socialism. Market socialism changed certain elements of the regulation of the economy and administration. The regulatory changes brought perceptible differences in certain economic activities and in citizens' lives. At the same time, they did not change the essential features of the system, and thus the root of the casual line.²¹ Thus, market socialism did not represent a different system paradigm for Kornai, as the fundamental causes and the internal logic of the system remained unchanged. Looking at the administrative system, the difference is even smaller.

For my inquiry, post-socialist transformation can be conceptualized as the conscious dismantling of the centralized bureaucratic coordination, underpinned by the refusal of the socialist ideology and implemented after the break of the political power monopoly. Thus, it is the time when the deepest elements of the causal chain were dismantled.

Political liberalization is the starting point for the post-socialist era. It is labeled post-socialist, as the imprint of the previous forty-five years of socialist legacy is still discernible. During

²¹ “Nor can be a comprehensive and consistently radical transformation in the other spheres while the key feature of the old classical structure, the Communist Party's power, remains. Although the monopoly of power is shaken and the official ideology begins to break down, they remain strong enough to obstruct any consistent, full change in the system's other elements..” (Kornai 1992, 566)

this time period, efforts are made to erase this imprint and develop an organizational structure and mode of functioning adapted to the evolving new political and administrative framework. The BBRS is a case of a local government's effort to navigate through the post-socialist transformation. In my terminology, it is an effort to shift from the socialist to the managerial paradigm.

I concentrated on system specific constellations in public administration under classical socialism. Centralized bureaucratic planning is in the center of the socialist paradigm of public management. Officially, central planning is the mechanism for commanding the production of the entire supply of goods and services. However, the effectiveness of central planning is debilitated by the systemic problem of unreliable and often consciously distorted information. Implementation is also immobilized by frequent intervention from leaders at various levels, a system of vertical bargaining and soft budget control. The result is an over-centralized and bureaucratized command and control mechanism that is rigid, untransparent, inefficient and ineffective.

Correcting these weaknesses was impossible under a system where the omnipotent party controlled the whole chain of nominations, and paternalism and personal loyalty was the glue among the actors. Political transition opened the way for transformation. The task was immense: individual rights and markets had to be restored and a new boundary established between the public and private domains. State control over assets, information and redistribution had to be abolished, giving way to freedom of choice, decentralization, privatization and tax collections. At the same time the culture of secrecy, bargaining and intervention had to be changed so that procedure, transparency and hard constraints could emerge (Kornai 1998).

Substantial changes had to be implemented within the organizational structure and operations of the state. The system, in principle liberated from a direct party link, had to become efficient and professional, better coordinated and less redundant than the earlier system. The shift towards a rule-based system promised to work against the old habits of interference and bargaining to strengthen accountability at all levels. For this, a different kind of planning, coordination, policy process and policy making capacity had to be developed.

This is an agenda that takes decades. Analysts still noted at the end of the first decade of reforms in CEE the lack of coordination, coherence, stability, continuity, and policy making capacities. Weakness of managerial capacities and weakness of accountability systems were still typical shortcomings of governments at each level (Verhejinen 1998a, 208).

My case will consider only a small component of the transformation. Through the lens of the BBRS, I will analyze the attempt of a local government to change the inherited institutional structure and culture to establish sustainable independent functioning within the new context.

Public Finance on Budgeting Reform

At the very start of the analysis a note has to be made. Most key sources on public finance and budgeting reform discuss the totality of public finance and make only occasional reference to local finance. The focus is on central government level mechanisms and reforms. In his seminal work on budgeting, Axelrod (1995) did not discuss local budgeting at all, and Bailey, in his *Strategic Public Finance* (2004), devoted less than eight percent of the text to local

financial management. Högye and McFerren (2002) in their analysis of local budgeting reform literature stated “within the field of public finance, material concerning local government budgeting is lacking. Thus, the current state-of-the art provides little theoretical guidance for local government employees charged with satisfying the wants of their constituents” (Högye and Mc Ferren 2002, 47).

In this situation, my analysis of the literature is also mostly based on general sources of public finance, but I select those elements that are pertinent to local budgeting practices. I will also make an attempt to include the few sources in the analysis that discuss the specificities of local budgeting.

Axelrod, in his seminal book on modern government budgeting, identifies fifteen major budget reforms (Axelrod 1995, 274-319). Here I discuss only those reforms that brought a different logic and represented specific models relevant to my public sector paradigms. I discuss these models to develop a vocabulary for categorizing budgeting approaches within the three paradigms and to relate the Budapest budget reform components and results to mainstream concepts.

‘Executive budgeting’ was the earliest and most enduring form of budgeting. Executive referred to the process when budget offices and staff drafted a proposed budget to submit to the legislature. As a rule, executive budget proposals were comprehensive—they included all sources of funding and expenditures, with the possible exception of enterprises that generate their own revenue. In many cases the executive budget was the only comprehensive policy document that set the government’s agenda for policy debate. Especially at the local level where balancing the budget was an obligation, the executive budget proposal framed and

dominated the budget debate. The balancing requirement and the volume of information in the document made it very difficult for the legislature to make considerable changes (Schell 2005).

The executive budget was the typical form of budgeting in traditional public administration. In the executive budget resource management was focused on controlling the inputs, i.e. on the objects of expense, that were listed in line-items. The usual method of budgeting was to start from the 'base,' i.e. the allocations made in the previous year, and to make proportional increases or decreases according to available resources. During the budgeting process only those allocations where the suggested proportional change was different than the general rule were discussed. This process resulted in focused debate and marginal changes in line-items.

This model had obvious strengths that secured the long history of its use. First, it was a potent instrument of expenditure control. Second, it was in harmony with incremental policymaking. Third it was a routine that all actors knew and had learned to cope with. At the same time, since the 1920s, serious criticism was frequently leveled at executive budgeting. Paradoxically, the same characteristics that make up the key strengths were also the focus of attacks: line-item control diverted attention from outputs and performance; incremental changes may not be enough to implement new policies; the lack of performance analysis did not support efficient allocation of funds; and actors developed strategies for increasing their agencies' resources and diverting them towards their particular interests.

It is important to note already here that the main difference between defenders and critics was not that they looked at different characteristics. Both sides focused on the same characteristics, but assessed them based on the values of two different public sector paradigms. Defenders

argued within the framework of traditional public administration, while the main critics applied a managerial perspective. Already early critics noted that:

“The budget should be expressed in terms of work to be accomplished as well as in material things to be purchased...the budget should be supplemented by an operations audit that will measure effectiveness...” (Upson 1924, 69).

They were also unsatisfied with the marginal changes in line-items and valued more periodic reviews of the efficiency and effectiveness of all government programs.

Wildavsky was the key figure in the defense of incremental line-item budgeting. Wildavsky valued traditional line-item budgets because they reflected previous policy decisions, and as such, were a record of historical agreement on ‘fair shares.’ He called attention to the importance of this ‘political information’ and defended incrementalism as the most politically viable process of decision making (Wildavsky 1984, 13-9). According to him, there were no better tools than line-items for control and implementation of incremental political decisions. For Wildavsky, incrementalism also led to stability, as contained conflicts focused on the few changes instead of creating a large scale war on the entire budget. He considered comprehensive budgeting attempts of the enhanced planning and ‘rationality project’ noble, but a wrong target (Wildavsky 1978).

Defenders and critics can fight, but the line-item executive budget survived and has devoted supporters. It will probably survive as long as the traditional paradigm is present in public administration and at those places where it is the dominant ideology.

‘Functional budgeting’ was one of the first attempts to reform the executive budget. Functional budgeting groups budget items around broad functions of government (like

transport, education, etc.) and thus, make the cost of various activity groups visible. A specific type of functional budgeting is the Canadian innovation of ‘envelope budgeting’²². Here spending envelopes are attached to the functions with a defined expenditure ceiling that is approved at the start of the budgeting process to guide detailed planning.

Functional and envelope budgeting clearly present the cost of each function and helps focus policy debate on priorities. Envelope budgeting has the added benefit of decreasing the scope of budget bargaining, and can support the decentralization of specific resource allocation decisions within functional categories (Cothran 1993, 467-68). At the same time, it rationalizes expenditure only through limits (i.e. fiscal pressure) and not more sophisticated incentives.

Another important innovation was the introduction of the ‘multi-year budget projection and budget.’ Here the focus is on better planning and taking control of change process. As the yearly budget carries all past decisions and allows little scope for change, the multi year outlook and plan was introduced to help break out of this fiscal straitjacket (Axlerod 1995, 289). This is not really a separate model of budgeting. It is a tool that, combined with various other tools (line-item, envelope, targets, etc), is applied in most developed countries by now.

The process of multi-year budgeting is often combined with functional grouping which attaches budget targets to functions that, similar to envelopes in Canada, guides planning and discourage piecemeal decisions. Functional grouping, budget envelopes, budget targets, and

²² Part of the Policy and Expenditure Management System (PEMS) developed in 1979.

multi-year budgets are tools that can be used in various combinations with each other or with other models.

Program and Performance Budgeting (PPB) is a comprehensive budgeting system. It focuses on the work to be done and the results to be attained and organizes information according to objectives and programs that implement one given objective. PPB presents the objectives which require funding, the costs of the proposed programs and data measuring their performance. The obvious benefits are the close link between policy and performance measures, justifying the budget allocation. However, while conceptually clear and just, implementation is time consuming and often creates frustration in governments whose units are not necessarily divided by programs, but rather by sectors that contribute to reaching various objectives. Moreover, the development of performance measurement proved difficult and the shift to performance-based allocation, was also hard to make. It really “takes a quantum leap from traditional budgeting to program and performance budgeting” (Axelrod 1995, 286). While more analysts value the PPB concept, politicians, following Wildavsky’s logic, often opted for the safe obscurity and incrementalism of the executive budget.

The next big model is the Planning, Programming, Budgeting System (PPBS).

“Conceptually, PPBS was exciting. It seemed to combine in one system long and medium-term planning of policies; programming of expected performance and costs over five year periods; and annual budgeting. None of the components were new. Weaving them together into a comprehensive system was a new approach” (Axelrod 1995, 293).

The system could centralize decisions and promised a greater level of rationality. It is really the very model of rational planning that creates a formal system of integrated analysis and decision. As such, it was “conceptually flawed from the start and an unrealistic, if not naive,

mechanism for budgetary decision making in a political milieu” (Axelrod 1995, 298). I mentioned this method only because it can be looked at as a Western parallel to the utopia of central planning in socialism. At the same time, budget analysts, defenders of incrementalism and managerial reforms, from both sides of the barricade, like Wildavsky and Schick, shared the opinion that this concept could not penetrate the realm of budgetary routines.

The last method included in my survey is Zero Based Budgeting (ZBB). The principle in this method is that all allocations for activities, ongoing or new, should receive the same review and analysis from scratch, and should compete on the same footing for budget resources. The practice of ZBB was designed and introduced first by the Carter administration in the USA. The Carter model attempted to introduce a very sophisticated system that translates planning results to objectives and intended outputs. Further, it develops performance measures and workload units, and bases allocations and monitoring on the units and measured them in a systematic manner. The intention was clear and rational, but utopist again, like the full model of PPBS. Critics consider the model unfeasible and concluded that few significant changes resulted in budgetary outcomes from ZBB (Hatry and Schick 1982, 85-7). Moreover, the workload demands were onerous and the implementation weaknesses (like, ambiguous goals and objectives, inaccurate data, etc.) seriously discredited results (Axelrod 1995, 299-300).

While the utopist comprehensiveness of the models prevented full implementation of both PPBS and ZBB, used selectively and partially, some of their practices could be applied to help analyze and support more informed budget decisions in specific domains.

Besides the basic budgeting concepts and terms, there are three types of distinctions in the budgeting literature that will be important for our discussion of the case: (1) the distinction

between capital and operating budgets; (2) the distinction made between macro and micro-budgeting; and (3) categorization of budgeting reform strategies.

The first distinction is between the operating and capital budget. The operating budget is designed to control, manage, or plan current activities. The capital budget is designed as a plan for financing long-term capital assets. The distinction between the operating and capital budget is crucial for monitoring and managing operational sustainability. (For a detailed explanation of local budget sustainability and inferences that can be drawn from budget proportions see Annex 8). Calculating operating and capital budgets is important on all levels of government, but especially important in local government budgeting where most countries have a balance requirement. Even though it is an obligation in most countries, there may still be confusion over the appropriate use of each. Despite formal accounting rules designed to require consistent and correct reporting of resources and transactions, many jurisdictions do not comply (Chapman 2005). The reason for deviation can be a lack of capacity but deliberate playing with categories also occurs frequently. Either a better picture of financial conditions than the actual one is presented to lenders, or a bleaker picture is communicated by the financial leadership at the start of the budget debate to tame spending fever. As I will show, introducing this distinction and the inferences drawn from it resulted in a conceptual shift in budgeting in Budapest.

The second distinction, the one between macro and micro-budgeting was an innovation of the late twentieth century that, according to Högye (2002) was of key importance in local budgeting. The concept of differentiation between macro-budgeting and micro-budgeting was introduced by LeLoup. “Macro-budgeting – high level decisions on spending, revenue and deficit aggregates and relative budget share, often made from the top-down. Micro-budgeting

– immediate level decisions on agencies, programs, and line-items, usually made from the bottom-up” (LeLoup 1988, 19). LeLoup considers the distinction between macro and micro-level budgeting fundamentals as it changed the conceptualization of budgeting from a cycle of incremental changes to a complex series of political responses to longer term trends (LeLoup 1988, 36). The separation of the two levels has also directed attention to the inherent tension between guardians who attempt to control aggregates with the aim to maintain budget balance and claimants who fight to maximize the support of their particular functions. This conceptual shift is key to many strategic approaches to budgeting, and will be a cornerstone of managerial reforms.

To categorize recent budget reforms into functional groups, Allen Schick, introduced a third category, distributive budgeting. He distinguishes among three types of innovations: macro-budgetary, distributive and micro-budgetary reform (Schick 2001b, 4). This categorization is very similar to the three level structure of budgeting developed by the World Bank that defines the core functions of budgeting as aggregate fiscal discipline, allocative efficiency and operational efficiency (PEFA²³ 2005).

Schick observed the following trends in recent years, when serious financial constraints created the context for budgeting: macro-budgeting shifts from stimulus toward constraint, distributive budgeting from allocation to reallocation and operating budgeting from control to performance (Schick 2001b). He discusses budgeting in general and reviews examples of central government reforms, nevertheless, the three categories he introduces and most of the

²³ PEFA (Public Expenditure and Financial Accountability) is a multi agency partnership supported by the World Bank, IMF, European Commission. Its task in 2005 was the development of the Public Financial Management Performance Measurement Framework.

techniques are equally applicable to local finances. The recent broad trends he identified are exactly the trends I will demonstrate in Budapest during the subject period. Here, I will discuss only the elements pertinent to local finance and the BBRs from Schick's framework.

Schick considers the Medium Term Expenditure Frameworks (MTEF) a key innovation for strengthening the position of the budget guardians and their capacity to maintain sustainability. The key question is how guardians can enforce limits. Experience shows that two stage budget decision processes, where projections and budget proportions are decided without discussing micro issues, can help maintain control. Even if the initial decision on budget envelopes does not necessarily guarantee enforcement, it at least frames the budget discussion and navigates it to more realistic ground. This feature of macro-budgeting as a control device will be very important for my Budapest discussion.

While the macro-budget is a central control device for balance, development in the micro-budget suggests decontrol and managerial discretion with an aim to improve operational efficiency. This part of budgeting became a "subset of management" (Schick 2001b, 22). Managers required freedom to implement positive changes. The challenge was determining the kinds of controls to devolve and securing managerial efforts to implement policy goals. The solutions were variable and context dependent. Performance measurement, performance targets, reports, audits, benchmarks, performance contracts, and performance budgets are all types of performance information. According to Schick, in this order, they are also increasingly sophisticated accountability mechanisms (Schick 2001a, 22-30). Balancing decontrol and accountability mechanisms will also be key elements of the Budapest case discussion.

The role of distributive budgeting is resource allocation to various budget categories and reallocation among them. Distributive budgeting is either incremental or supported by technocratic mechanisms (Schick 2002). The traditional approach is incremental as distributional decisions entail the most vivid political discussions. Planning type budget reforms that attempted to tame these political conflicts are part of the rationality project that aims to rationalize budgeting decisions through technical means. These reforms introduced program evaluations and the linking of strategic planning to the budgeting process. In principle, program evaluations can indicate efficiency and effectiveness of existing programs. Strategic planning is conducive to the alignment of spending decisions with policy priorities. The use of the two components is always based on the tacit belief that their results can be reconciled, and the final allocation decision can be made on a calculated and rational basis. Nevertheless, distributive decisions could never avoid political conflict. First, because in both program evaluation and planning reforms it is difficult to design the mechanisms that may bring solid results. Second, the results can always be challenged. Third, results from the two domains still remain incomparable - like apples and bananas. Thus, distributive budget decisions continue to trigger the highest level of political conflict, while in most cases debates relate to unimportant portions of resources.

Public Management

The first question is: what is public management? In the literature we find two different definitions of the field. According to the wider concept, “the purpose of the field of public management is to develop an understanding of how public, primarily governmental,

organizations may accomplish the mission charged to them” (Perry and Kraemer 1983, xi). Public management is a sub-discipline within the study of Public Administration. It is an applied discipline, which explores the methods and processes that can be applied in the public sector to improve the implementation of public goals (Horváth 2005, 28).

At the same time, David Coombes writes that “public management is an innovative approach to the reform of the modern European state” (Coombes 1998, 23). In the same book others write: “Public management now describes a ruling paradigm for both the study and the practice of public administration, which in this respect have become more than ever indistinguishable” (Keraudren and Mierlo 1998, 39). Bovaird and Löffler propose an even more restrictive meaning: “We shall take public management to be an approach which uses managerial techniques (often originating in the private sectors) to increase the value for money achieved by public services” (Bovaird and Löffler 2003, 5). They explain this more restricted definition of public management, and the distinction from public administration, in the following manner:

“In the mid-twentieth century, the study of the work of civil servants and other public officials (...) was usually labeled ‘public administration’. There is no doubt that public administration conjured up an image of bureaucracy, life-long secure employment, ‘muddling through’ and lack of enterprise – dark suits, gray faces and dull day jobs.

From the 1980s onward, however, a new phrase began to be heard...public management. ... it was about budget management, not just budget holding, a contract culture, including contracts with private sector providers of services and employment contracts for staff... entrepreneurship and risk taking, and accountability for performance.”

This narrowest definition refers to public management as the study of our managerial paradigm. At the same time, all the three of our paradigms, can be brought under the wider umbrella defined by the first formulation of public management. As the scope here is to

discuss equally practices within the traditional model of public administration, the socialist practice and managerial reforms, we will use the first, wider concept of public management. The analysis of public management reform and budgeting reform will be embedded in this concept. According to this concept of public management, all three paradigms that we will define are part of public management, representing different paradigms within the field.

Public management reform

According to the definition of two authorities in the field, “public management reform consists of deliberate changes to the structures and processes of public sector organizations with the objective of getting them (in some sense) to run better” (Pollit-Bouckaert 2004, 8).

Pollit and Bouckaert, in their comparative analysis of public management reforms of ten developed countries created a framework for the analysis. I replicated this scheme in Annex 7 and will use it for the case description (Pollit-Bouckaert 2004, 25).

Below, I review only the main characteristics of public management reform and the points of debate.

Public management reform is a complex process, whether it is the reform of a national system or of the service delivery of a single local government. Its key features and decision points are also similar. It is always initiated by an elite decision that is mostly the product of external pressure. The external pressure in most cases is a general pressure for better services or a fiscal pressure to rationalize or improve the level of service delivery. The elite group in the center translates the general pressure into specific reform goals and strategy. To succeed they

need to make good judgments about what is culturally and politically desirable and technically feasible in view of capacities and countervailing forces.

This elite decision will be central in my description and analysis of the BBRS, as the initial Draft Strategy (1995) is clearly the document of such a decision. Later officially adopted documents, that will also be discussed (and are included in the annex), describe both the evolution of the ideas and the compromises that were made during implementation against opposition pressures.

While no author negates the necessary complexity of the public management reform process, opinions on the possibility for a clear strategy are divergent. Most analysts practically exclude the possibility of any comprehensive, ex ante reform strategy, claiming that comprehensive reform can be only incremental or emergent (Starling 2002). Gooding expresses this doubt in the following manner:

“Typically there is no single design or designer. There are just lots of localized attempts at partial design, cutting across one another, and any sensible scheme for institutional design has to take account of that fact” (Goodin 1996, 28).

Bouckaert is a bit more permissive: “Practice seems to show that well developed scenarios are rare, and that in some cases limited trajectories exist that are extended in a pragmatic way into chains of trajectories” (Bouckaert 2002, 21). Doubts about a clear architecture of public management reform are present even in sources that do not exclude the possibility. It is often noted that “it is easy to exaggerate the degree of intentionality in many reforms. The final result of the reform efforts... may bear only a loose relationship to the intention embodied in the elite’s earlier manifesto for change” (Pollit-Bouckaert 2004, 26).

The case of the BBRS makes an important contribution to this debate. In this case, the comprehensive, ex ante strategy will be presented and discussed. The empirical study will demonstrate the intentionality and consistency of implementation. Even if planned reforms could not be fully implemented during the subject period, the ex ante plan for the full trajectory, and thus a very rare case of institutional reform, will be documented.

Most authors, with reference to Pollit and Bouckaert, (2000) discuss reform under the categories of the '4Ms': Maintenance, modernization, marketization and minimization of the system. "Different regimes at different times appear to have leaned towards one or other of these strategies. The '4Ms' do not have to be taken in a particular order, but neither can they all be convincingly pursued simultaneously" (Bovaird and Löffler 2003, 20).

These key options will be important for us while discussing and comparing strategic reform choices. Managerial reforms typically focus on marketization, but often include attempts at minimization as well. This was especially the case with NPM. As Dunleavy suggested, "NPM thinking identifies government's optimal role, its core distinctive function, as being an 'intelligent customer' on behalf of citizens" (Dunleavy 1994, 58).

Post-socialist reforms, as we discussed, must establish a very different boundary between public and private domains than the one under socialism and their focus is on modernization and marketization rather than on minimization. As Kornai suggests, "A serious error is committed by those who advise Eastern European countries, like Hungary, starting out with a big state, to follow the example of South-East Asian tigers, or even the United States, and leap from big state to a small state position. This is politically and socially impossible, Hungarian society has not been socialized in that way. Its social norms are shaped differently"

(1998, 39).

With this quote we arrive at the last point: the difficult question of what to target?

Managerial reforms in the West set efficiency and cost savings goals by (1) strengthening public control over goal setting; (2) decentralization of management (both within and beyond government) coupled with (3) performance measurement and (4) strengthened accountability.

All sources on public sector reform highlight that reform is never a neutral, technical process. The intervention habitat can make a huge difference as the penetration of an ideology is dependent on the starting point (Pollit and Bouckaert 2004, 13). I will discuss the BBRS in view of this and explore how choices made in Budapest relate and differ from typical managerial reforms.

In this discussion, similarly to the distinction made earlier between macro and micro-budgeting, it will be important to distinguish macro and micro-level reforms. Macro-level reforms are pertinent to the organization, system, and process design, and aim for high level structural change and general improvement of organizational capacity. Micro-level reforms are pertinent to the lower levels of organization and to specific tasks. They develop skills and introduce methods of management (Pollitt-Bouckaert 2004, 10-11). Macro-level reforms are slow structural reforms, where the intervention habitat has a larger inertia, while micro-level reforms can be faster to implement, but can be rapidly negated if the macro-level structures and incentives work against them (Guess 2001, 430).

Public management reform literature on budgeting reform

Authors in public management reform, when discussing budgeting reform, consider budgeting first of all a management tool. They all see budgeting reform as a process of shifting the budgeting role from traditional financial control to a management tool that supports reform objectives, like decentralized management and better performance:

“Instead of a situation in which annual financial allocations were incrementally adjusted, legalized and made available to legislatures, budgeting has become more intimately linked with other processes – planning, operation management, and performance measurement. Greater integration of these different systems has been a common objective (Pollit and Bouckaert 2004, 67).

Within this context, the introduction of tools and techniques borrowed from private sector management play an important role. Increased control by means of economic and financial information, performance evaluation and the assignment of personal responsibility and the introduction of individual rather than collective incentives both to reward achievements and sanction under-performance or error are all part of this new package of tools (Keraudren and Mierlo 1998, 43-5).

The logic is clear: managerialism means the decentralization of management decisions in an effort to stimulate creativity and entrepreneurial behavior among those who implement policies. As decentralization entails risk, the performance link becomes fundamentally important, as its role is to monitor whether decisions successfully achieved the objective to increase efficiency. Thus, PMS gives security in the risky operation of exerting fiscal pressure and opening public service to experiment and creativity. Under PMS, a new system of performance based accountability can be built that makes managers personally responsible for

performance. Bouckaert is the most explicit on the importance of performance measurement. “The managerial focus in the budgetary process implies that budgets become more performance oriented” (Bouckaert 2002, 31).

At this point it has to be noted that while performance measurement is a key component of the new accountability mechanisms in managerial reform strategy, authors analyzing even the most developed country reform experiences note that: “During almost half a century many countries have experienced considerable and persistent difficulties in trying to establish close links between the performance of programs and their budget allocations” (Pollit 2001, Pollitt-Bouckaert 2004, 70). This fact should be remembered when we discuss arguments for the absence of performance management in the BBRs.

As we have already noted, in managerial budgeting reforms, performance measurement is the basis of the new accountability framework. This brings a slightly different reading of the budgeting models discussed earlier in the chapter on public finance. In this light, incrementalism, ‘cheese-slicing,’ or proportional decreases of allocations under fiscal stress, if implemented in absence of adequate performance monitoring, looks irresponsible, as it creates unpredictable situations in service delivery (Pollit-Bouckaert 2004, 68). Envelopes, ceilings, targets, or frame and block budgeting (the term in the Pollit-Bouckaert study), is more compatible with performance improvement, if coupled with decentralized management, when managers are delegated freedom to use resources under the ceilings. Models that include performance measurement to inform decisions and which are connected to incentive schemes are fully compatible with the tenets of managerial reforms.

In sum, we repeat the importance of performance measurement in managerial reform models.

Performance information is the link between macro and micro-budgeting and plays a crucial role in strengthening accountability. In the new managerial paradigm, central control can focus on policy goals and macro-budgeting, and micro (management) decisions can be safely decentralized only because the performance link connects goals and implementation (Cothran 1993, 449-450).

In my inquiry centered around the BBRS, it will be a crucial question to ask, in the absence of PMS, what can create the new accountability framework? How it is possible to create security and incentives without a formal PMS?

Performance measurement and management

The central function of the performance measurement process is to provide regular, valid data on performance. Performance measurement initiatives in the public sector can be tracked back to the 1940s when the Hoover Commission in the United States declared the necessity of a shifting budgeting from inputs towards functions, activity costs and accomplishments. This was part of a wave of modernizing efforts that aimed to introduce greater rationality in policy making. The earlier mentioned budgeting techniques like PPBS, MBO, and ZBB, were all built on and supported by PMSs. Though most of the monumental rationality projects failed, since the mid 1950s, performance measurement was never taken completely of the policy agenda. Interest in performance management revived in the 1980s and 1990s when fiscal stress focused attention on efficiency increases, cost cutting and later on service delivery improvement. As discussed earlier, performance measurement and management systems became a supporting pillar of managerial reforms.

For our subject, two issues must be clarified in relation to performance measurement. One is the content of measurement, what are the various facets of performance and how is the term used in the public management literature? The other is analyzing the potential role of performance measurement in management reforms.

Regarding the content it is important to note that performance can be measured at different levels. Performance measurement is built on five key components: inputs, activities, outputs, and immediate and final outcomes. In principle, the linking of objectives and outcomes is the basis for evaluating the policy cycle, while the link between inputs and outputs supports evaluation of the management cycle. (The performance measurement scheme that shows these connections, developed by Bouckaert and Doolen (2003) is replicated in the Annex 10).

When reading public management and budget reform literature, this distinction is not self-evident as performance measurement is part of all initiatives and usually referred to without indication of what is measured. The same is true of performance budgeting – many alternative concepts exist and texts rarely make clear reference to the specific concept used.

The root of the confusion is that policy and management processes are closely connected and the ultimate goal of both is to improve the outcomes. Comprehensive budgeting reform strategies centered on policy analysis and program evaluation to improve resource allocations according to policy objectives, are usually focused on the outcomes. They aim to implement program review and planning reforms for improving outcomes and effectiveness of activities (Schick 2002 18-28). Reforms introducing new managerial type budget mechanisms and market driven budget reforms are focused on micro-level allocations and concerned with activity and output-related performance indicators, and less organically linked to outcome

evaluation. Performance measurement is often part of all these strategies and performance-based budgeting can also refer to any of these options. Thus, performance may be defined differently according to the orientation of the strategy.

The second issue relevant for my subject is the potential role of performance measurement in budget reforms. Since the initial enthusiasm, performance management has triggered diverse views over the utility of performance measurement in government. Proponents see performance measurement as a valuable tool to track effects, impacts and outcomes of public activities. They also see the necessity to carefully track the implementation of strategic and policy objectives in order to make the necessary adjustments in implementation mechanisms or policy design when the time comes. They consider tracking performance a must in strategic policy making, to enable informed and prudent decision making, and to ensure transparency. Some even see performance measurement as a key tool to transform management. Skeptics look at the other side of the coin and see performance measurement as a time consuming and costly activity. They feel that the difficulties of obtaining regular, relevant information for policy making well override its potential use. They also see performance measurement as often unreliable, skewing policy. Transparency is not achieved when underlying assumptions are unclear. Many skeptics consider performance measurement systems as part of the naive projects built on the possibility of rationalizing policy making and deemed to fail.

Analysts taking the middle position acknowledge weaknesses and misuses, but claim that “performance measurement cannot be brushed aside as a misleading fad” (Schick 2001a, 41). They seek to divert the debate to the uses, as “the ultimate purpose of performance measurement is to use the measurement information to help make improvements” (Ingham and Moynihan 2001, 329). In public management, the utility of performance measurement can

only be discussed in a framework where performance management, and not measurement, is the objective.

“A ‘performance management system’ is an interrelated set of performance plans, performance indicators and or measures. Strategic or business plans are key ingredients of all performance management systems. Without such plans, government may boast of a set of performance indicators, but does not have a performance management system” (Forsyth 2001b, 520).

The crucial questions are, what kind of performance information can support management reform and how can such information be obtained? According to Harty, “the primary issue [in performance measurement] is to be able to determine what items should be regularly tracked” (Harty 2001, 34). However, this is only part of the game in management reform. According to Schick, “the great mistake of the performance industry is the notion that an organization can be transformed by measuring its performance” (Schick 2001a, 43). Schick and many other reform analysts noted that organizations must be transformed to use data to inform results (Schick 2001a, Guess 1997, Guess and LeLoup forthcoming). As already noted in the Introduction, according to this argument “organizational change must precede, and not follow, performance measurement” (Schick 2001a, 43). Accepting this approach I will treat performance measurement in the BBRIS case analysis as Schick suggests, a ‘handmaiden’ of public and budgetary management (Schick 2001a, 43). Instead of looking for PMS, I will focus on the accountability framework, keeping an open mind to options for establishing performance accountability.

Literature on Post-socialist Public Management Reform

While a vast literature discusses public management and its reforms in the developed Western world, the literature on public management reforms in post-socialist countries is much poorer. I will group the sources in four types: (1) the publications that discuss potential public management reform strategies and trajectories; (2) analysis of post-socialist budgeting reform; (3) case studies; and (4) research and assessment on local government budgeting reform in Hungary.

I do not discuss in detail the numerous training materials and practical guides on local budgeting that were developed by donor programs for the support of decision makers attempting to implement budget reforms, as their conceptual depth is far from my discussion. These publications, in most cases, propagate the implementation of one specific method and offer a detailed blue print for the process. It often happened that one manual was translated in dozens of languages and was distributed equally across mid-Africa and Central Europe. I see my neglect of such materials is justified because consideration of the context-dependence of applications, my focus here, is completely absent in such materials.

Sources on post-socialist reform strategies and trajectories

As I already discussed in the Introduction I see two complimentary, but distinct groups in discussions on potential post-socialist public management reforms and trajectories.

Studies belonging to the first group are mostly written by Western scholars who are either Western academics or policy analysts educated in developed Western countries and had most of their professional experience there. Their starting point is main stream Western theory and knowledge of concrete Western practices. They select the components of their knowledge that

they consider universally applicable and discuss what preconditions should be established for the application of such practices elsewhere. Trajectories they suggest are supported by the necessary preconditions argument. The proposition of Schick (1998) and Sutch (1999) that I attempt to falsify in the dissertation is typical of this. Similarly, Guess claims that the GFOA standards²⁴ for budgeting are “nearly universal and not culture bound,” reviews post-socialist local budgeting reform in this framework, and formulates policy proposals on that basis (Guess 2001).

In the conclusions of the dissertation I raise serious concerns about this train of thought. I can accept Western theory as a starting or reference point. I agree that, after careful consideration whether a certain mechanism or expectation can fit in the given context (and not automatically assuming applicability!), certain formulations of expectations or rules can be imported as a reference system. At the same time I argue that reform trajectories do not necessarily travel, as trajectories have to be built precisely on the given context. As Bouckaert writes, “trajectories should take into account the alpha position and the expressed omega position” (Bouckaert 2002, 21). A trajectory is the road from the specific initial condition to the specific vision of a desirable future condition – both are deeply context dependent. Thus, the precondition argument can lead to bias. Essentially, I demonstrate such a Western bias in the proposition of Schick (1998) and Sutch (1998) that I falsify.

I label the second argument the systemic weakness argument. This view starts from the systemic weaknesses of the given context. It is built on the assumption that if the root causes

²⁴ GFOA is the Government Financial Officials’ Association in the USA that published four purposes that budgets should serve or can be assessed against.

of the systemic weaknesses were changed, the resulting weaknesses can also be effectively treated. This was the leitmotiv of Kornai's (1992) analysis of the socialist system and the assumption of Verhejinen and Coombes (1998) in their book *Innovations in Public Management: Perspectives from East and West Europe*. They built their policy proposals on a thorough comparative analysis of Western and CEE public management tradition.

Verhejinen, in his book edited with Coombes, attempted to classify innovations in post-socialist CEE for the discussion of the applicability to public management. He compared the classical model of public administration, with the socialist administrative tradition. He arrived at the conclusion that certain features of post-socialist administrations make a fundamental difference: structural instability, lack of self-management and routine political interference (Verhejinen 1998, 409). Therefore, none of the main models applied in Western Europe and other OECD countries are suitable as a whole to resolve the specific problems CEE states are faced with" (Verhejinen 1998, 415). As an alternative Verhejinen suggests:

"The development of a 'problem-oriented' rather than an ideologically-based strategy for administrative reform is likely to deliver the best long term results. The adoption of an overall strategy based on the principles of the classical model of public administration or on the basis of NPM theory might solve some of the problems highlighted in this paper, but might aggravate others. Decision makers in central and Eastern Europe would, therefore, be best advised to pick and choose from examples of good practice in OECD countries and attempt to apply individual measures in such a way that they might reinforce one another. Such a 'problem-solving,' even pragmatic approach might be expected to bring better results, even in terms of improving efficiency in the long run, than the adoption of grand strategies" (1998, 416).

In the same book, (Verhejinen and Coombes 1998) Verhejinen's 'problem-solving approach,' and an alternative reform concept appears, that of David Coombes. Coombes starts his argument from the misconception of public management as a corpus of techniques. He criticizes actual seduction by the power of techniques and their predilection for performance

(Coombes 1998, 419). He warns that the Western public management ‘modernization’ agenda “could, paradoxically, renew despised old practices” when applied in central and eastern Europe (Coombes 1998, 422). His suggestion for post-socialist leaders is eclecticism, meaning: “a willingness and capacity to resort to a variety of styles, techniques and media, without prejudice to the latter’s original usage or ideological association” (Coombes 1998, 423). He adds: “central and east European states should preferably adopt a selective, discretionary approach when borrowing from modern western practice” (Coombes 1998, 424). A practice should be applied “because it genuinely meets a need identified from within” (Coombes 1998, 424).

Derry Ormond, Head of OECD Public Management Service at the time, arrived at a similar conclusion just before his retirement: “There is a need for an overall strategy even if it is decided to concentrate on just two or three major objectives. Regardless of the quality of available international assistance, a comprehensive vision can come about *only* from the country concerned” (Ormond 1998, 3).

These two statements on the importance of the “needs identified from within” and “the vision that comes from the country concerned” both square with Kornai’s criticism on the failure of guest stars to step out of their own paradigms. Kornai, in his short paper ‘The System Paradigm’ (1999a), argues that only intimate knowledge of the given system paradigm can lead to adequate choices on reform trajectories. i.e. can guide the eclecticism that Coombes suggested (Coombes 1998, 423). This view of Kornai is the starting point for my inquiry.

In the dissertation I follow this train of thought and attempt to carry it a step forward. The introduction of the system paradigm is a new element, and by my knowledge, not yet applied

to the analysis of local planning or budgeting reform. On the basis of the system paradigms, I attempt to discuss the logic of selection and adaptation of reform components and mechanisms. This is an important contribution to the discussion of reforms for two reasons. One is that instead of listing post-socialist conditions, it explores causes to identify the best points to attack in old practices and sequencing of reform steps. The other component of the new contribution is that in supporting reform design, my discussion goes beyond the suggestion of the pragmatic problem solving of Verhejinen (1998) or the creative eclecticism of Coombes (1998), and offers conceptual support for problem solving or eclectic choices.

Sources on post-socialist budgeting reform

While sources on managerial type financial management and budgeting reform in the West could fill libraries, few reliable sources are available on similar post-socialist reforms. Zupkó notes that in Hungary “little systematic information is available on the application of managerial methods” (Zupkó 2002, 106). Other authors state a void in descriptive data concerning local government budgeting in CEE (Högye and McFerren 2002, 47).

In his analysis of post-socialist budgeting reforms, Bouckaert notes that it appears that only limited trajectories exist which in time might evolve into a chain of trajectories. He groups reforms into three trajectories according to the main objectives of reform: (1) stability and resource allocations; (2) better performance; and (3) accountability and control type reforms. He concludes that “some elements of these trajectories are not really or fully compatible” (Bouckaert 2002, 21-38). I think the apparent incompatibility he states is a consequence of building trajectories on specific objectives. When the comprehensive vision that Ormond argued for above is coupled with a clear goal behind the reform, thus, a full trajectory is

examined, the apparent incompatibility dissolves and can advance as an integrated strategy built on various components. The importance of the BBR case is that it is one of the rare examples of a strategy for a full trajectory that, according to its design, could integrate the above mentioned three elements.

The largest survey on post-socialist budgeting reforms was carried out by LGI and led by Mihály Högye between 2000 and 2002. In this comparative research, eight post-socialist countries were included and a large sample²⁵ of local governments was examined in each country (Högye 2002). Beside important differences in practices, many similarities were also revealed. The key features relevant to my discussion are the following:

- in all countries (with the exception of Croatia) the central government supplies a standard chart of accounts that all local governments must adhere to;
- the information system is a weak point in all countries, and frequent changes in the format of requested information makes temporal analysis impossible;
- publicity is weak, and document incomprehensibility²⁶ is coupled with citizen apathy in all examined countries;
- in general, countries apply line-item budgeting that takes into account only the previous year's costs, but there are some modernizing attempts with varying degree of success;

²⁵ E.g. in Hungary forty municipalities were examined. (Szalai et al 2002, 334)

²⁶ Tönkö (2006) reports three cases from Hungary where a three year long donor project could make some improvement in this area in three localities in Hungary. Driscoll (2004) also reports a case from Romania where a strategic planning project encouraged the local leadership to “translate” part of the budget to accessible language and present it to the population. These cases are surely not the general rule, but are rather exceptional.

- the weakness of the connection between the planning process and budgeting is stated in nearly all descriptive materials²⁷;
- Fully developed performance budgeting systems have not yet been reported from the region, but some improvements have been documented in Hungary and Poland.²⁸ Performance measures when applied are mostly quantity and output measures. Collection of social indicators was reported only in a few municipalities in Poland.²⁹

The Budapest case clearly fits in this context and adds one more detailed analysis to the weak descriptive material on local governments.

Case studies

The situation with case studies is part of the earlier mentioned void in descriptive materials concerning CEE local budgeting. There are very few well documented cases, as most available cases were produced on donor projects and were documented at the request of donors. Donor driven or donor documented projects are an unreliable source of information as they show that writers often mix project reporting to beneficiary with case analysis. Published

²⁷ This is equally true for the eight countries of the LGI research as the country studies in the second volume demonstrate. (Högye 2002) Case study materials usually report the same facts with a few exceptions, like Driscoll (2004), Kayser (2001) Szewczuk (1999, 2000 and 2004).

²⁸ USAID made an attempt in 1996 in Hungary and later in many other countries to introduce program budgets and performance indicators in municipalities. From reviews, it seems that the effort was most successful in Hungary and Poland. Regarding the Hungarian experience, both the study of Nayar-Stone and Tönkö (2004) and that of Högye and McFerren (1998) report the program budgeting project as a success. The later, more detailed, analysis of Tönkö (2006) demonstrated that the result is not a program budget “according to the Western terminology,” and that only improved budget transparency can be demonstrated which has been achieved through a separate budget volume showing program related indicators. Filas, Levitas and Piszczek (2002) report on the Polish Program budgeting project, but they fail to give any results that indicate the moderate success of the experience.

²⁹ Filas, Levitas and Piszczek (2002) report, in general, of such developments. Kayser (2001) and Szewczuk (1999, 2000) indicate such data collection in concrete case studies.

cases are always revised versions of such reports but their focus remains on displaying positive results. Many of the cases I could locate and refer to, share these risks and weaknesses³⁰.

Some cases that were written on the commission of a second donor, not the one financing the budget reform project, are written with a multi-year perspective on the outcomes and offer slightly more balanced assessment (Driscoll 2004, Tönkö 2006). Still, it is common that experts involved in the cases use the descriptions to propagate the implemented models and marketing their own achievements.³¹

The large share of donor projects in case descriptions is also problematic as they skew the picture that can be drawn from the cases.³² The BBRS case is special, as it describes a home-grown strategy that was developed without involvement of donors or international financial institutions. From this angle, it is more representative of local government efforts within the country than the few donor cases that provide the overwhelming majority of documented cases.

³⁰ Tönkö (2006) also states that “in most of the cases, the approach of monitoring the programs was success story oriented, without surveying the results from a critical perspective. The evaluation and the balanced critical analysis of the budget reform are still missing in Hungary.”

³¹ A good example are the cases of Poznan and Swinoujscie from Poland that were both successfully used to support later donor projects on training municipal officials in Poland and Georgia to attempt implementation of similar models. (Kayser 2000, Szewczuk 2000 and 2004)

³² e.g. the most publicized few cases of donor driven reforms represent less than one percent of Hungarian Municipalities and show a different trajectory than the rest.

The Hungarian local budgeting reforms

Hungarian budgeting in most respects shares the characteristics of other CEE countries that I described above, but the key features pertinent to the case analysis need to be discussed in more detail here.

Most analysts note that the national regulation on budget format and reporting is an obstacle to reform, as it puts the burden of reporting detailed information on municipalities, but the structure of this information is built on the national budget needs, not on the decision making information needed at the local level (Péteri 2004, 370-1). The earlier mentioned study that was based on a detailed review of practices in forty Hungarian municipalities of different sizes and conditions, comes to the conclusion that local politicians must make budget decisions without reliable information about public services (Szalai et al 2002, 375).

The Hungarian budget regulation allows cross financing between capital and current budgets, and only one summary sheet has to be presented on their balance as an annex to the budget document. Nevertheless, some municipalities establish a rule prohibiting deficits in the current budget (Szalai et al 2002, 352). In this area, Budapest made an exceptionally firm statement - with a twenty percent operating surplus target and introduction of the CLI model that brings the operating budget balance into the budget debate focus.

It is also a widely shared conclusion among analysts that municipal budgets are not connected to planning results. Though the Hungarian regulation requires different types of planning instruments and multi-year, rolling planning, few municipalities establish any connection

between plans and budgets. The planning skills are still missing at the municipal level and planning as a word still carries bad connotations from the socialist past³³. As Péteri notes, “in practice, local budgets serve primarily as tools of control over public spending rather than for implementing ex ante strategies” (2004, 372). These findings clearly support the systemic nature of planning weakness I discuss in the case analysis.

Hungarian local budgeting is cash based. The budget lists main categories of line-items by organizational units³⁴. Cash management practices in Hungarian local governments can lend up between two extremes: a centralized management within the local treasury system or decentralization based on the principle of management autonomy (Szalai et al 2002, 376). The Hungarian regulation allows both extremes and any solution in between, as most service units are legally independent budget units, with a finance officer personally responsible for finances and asset management. This feature of the Hungarian regulation, that imposes minimal restrictions on the local budgeting process and local requirements, is of crucial importance for budget reforms. The given institution-based line-item structure, in itself, does not support local officials or the public to develop a general understanding of local activities and their costs. The tendency in most municipalities is to tighten line-item control through additional local regulation and apply a budget planning method based on incremental changes of

³³ Péteri (2004, 372) notes the planning problem, but Szalai et al (2004, 350) make even firmer statements that planning skills are also missing. Interestingly, Tönkö, whose program budgeting projects suppose the planning link, also comes to the conclusion that “although all three municipalities have a strategic plan accepted by the local council, there is no link between this document and the local budget. This means that there is no long-term planning, there are no long-term policies and the yearly financial and sectoral objectives are not linked to any long-term goals.” (Tönkö 2006, 2)

³⁴ The obligatory categories include: personal and material expenditure, capital expenditure and transfers and own revenues.

previous year's figures (Szalai et al 2002, 361). The Budapest case will show an example that goes in the opposite direction, towards decentralized management.

Two main types of budget reforms appeared in the 1990s in Hungarian local governments. One was the attempt to introduce formula-based activity financing. Since part of the intergovernmental operating transfers had been calculated on a formula-basis since the late 1980s, this was a logical step. Most of the implementing municipalities planned to introduce it only for material expenditures and services. Still, in most cases, introduction was halted once it showed that allocations on a calculation basis would require more resources than current appropriations (Szalai et al 2004, 365).

The other attempt was the introduction of program budgeting. These attempts brought only partial results, however, as, the mostly quantitative output measures were collected on performance and not connected to the allocations, but only presented in documents parallel to the budget. Thus, analysts conclude that the indicators were not appropriate for measuring performance and not connected to financing which could produce the incentives for efficient management (Szalai et al 2004, Tönkö 2006).

Considering the two types of budget reforms, the Budapest case represents a unique type that attempted a fully formula-based financing of institutions, directly connecting performance data to financing.

Chapter 4. The Conceptual Framework

Weber discussed bureaucracy in the frame of an ideal-type.

“The ideal-type is not meant to refer to the ‘best’ or to some moral ideal, but rather to typical or logically consistent features of a social institution or behaviors. The ideal-type involves determining the features of a social institution that would be present if the institution were a logically consistent whole, not affected by other institutions, concerns and interests. The ideal-type never corresponds to concrete reality but is a description to which we can compare reality. The ideal-type was a tool with which Weber prepared descriptive material for comparative analysis” (Elwell 1996).

The concept of paradigm was introduced into the philosophy of science by Kuhn. For Kuhn, a paradigm constitutes a long-lasting common way of thinking by a scientific community. He conceptualized the evolution of science as a sequence of scientific paradigms that raise and get substituted by a new paradigm (Kuhn 1962).

Kornai, in his paper, *The System Paradigm* (1999), applied the concept of paradigm to social sciences, maintaining the idea of the long-lasting, common way of thinking, but allowing the parallel existence of different system paradigms (Kornai 1999a, 3). For Kornai, a researcher who think in terms of a system paradigm, “is concerned with the system as a whole and with the relations between the whole and its parts,... focuses on more permanent institutions, within which these events and processes occur and which largely determine their course, ...interested in big changes, in the big transformations” (Kornai 1999a, 8-11).

In his book, *The Socialist System* (1992), Kornai synthesized his understanding of the socialist system in a system paradigm. Kornai’s description of the socialist system paradigm is very

similar to Weber's ideal-type. One writes about the organizational model of traditional public administration, the other about the organizational model of socialism.

Kornai's socialist paradigm and Weber's ideal-type bureaucracy provide a good framework for a comparative study of administrative models. Both offer positive descriptions and systemic analysis. They are analytical constructs that focus on systemic constellations and system-specific features. System-specific values, strengths, shortcomings and dysfunctions are equally part of the descriptions.

A note has to be made on the paradigms. "One of the foundations of the system paradigm is to grasp reality, so far as possible, in its entirety, not just a thin slice of it. So it is prepared to make heavy concessions in rigor and exactitude. Its methodology is 'softer' than that of a 'semi-hard' (or ostensibly hard) economic paradigm. On the other hand, it is prepared to face puzzles the latter avoids" (Kornai 1999a, 11). This is a qualitative method. "It requires from its exponents consistency of logic, with statements supported by argumentation and contrasted with similar or contrasting cases...it may not require either strict mathematical proofs of propositions, or support for them from econometric analysis that has stood the trial of statistical science" (Kornai 1999a, 14).

Concerns could be raised about using such a 'soft method' in a dissertation but two arguments can be raised in its defense. One is that this tool will be used for solving a puzzle that I could not solve within the framework of mainstream concepts. The other argument is that this method is used only to develop a specific tool, a reference system, for the analysis. It will not substitute for detailed case analysis.

I will complete the earlier developed paradigm descriptions with features typical to local government, and I will connect the paradigm descriptions to the specific methods of local planning and budgeting that logically fit in the given paradigm. My focus is the coordination system in the public sector generally, and local government specifically. Therefore, paradigms refer to the various public sector coordination paradigms.

My description of the organizational logic and actors' behavior is based on the seminal works of Weber and Kornai and other state of the art sources on public administration, management and finance. My contribution is establishing the connection between specific planning and budgeting methods to the paradigms. I explain why it is logical that such methods are the dominant approaches within the given paradigm. These systemic connections will be very important in the discussion of reforms and new methods, and the sequencing of their introduction during a transformation from one paradigm to another.

It must be noted that most referenced sources discuss government in general. Very few sources treat local government separately or give comments that refer to the specific realities of local governments. Comparative analysis of local government systems give little direct input for my analysis, as is not carried out in the framework of system analysis, but rather it describes and compares country differences within one paradigm.

Nevertheless, at this level of abstraction, differences between central and local government are not considerable. I speak about the logic of the organizational model and mechanisms, their characteristic features and interdependence. I describe the logic of internal operation of the government, motivations and expected behavior of civil servants and politicians, planning and budgeting methodology and systemic strength and weaknesses. At this systemic level,

central and local governments are similar and most of the findings are applicable to both levels. At the points of difference, I will make a clear note and provide reasoning.

The paradigms developed in this manner will be used as a reference system for the description and analysis of the BBRS. A summary of the key characteristics is also given in two tables in the Annex 5 and 6. Annex 5 is a comparative table of the typical context and key features of the three paradigms, while the table in Annex 6 compares the local government specific features of the paradigms. The tables in the Annexes aim to provide a summary of the discussion, thus, a relatively full picture. The case analysis must focus on a limited number of criteria. At the end of this chapter, a table (Table 1) will summarize the characteristics of the paradigms whose criteria will be applied to the case analysis.

The Socialist Paradigm

Kornai named the organizational model of the classical socialist system ‘centralized bureaucratic coordination.’ The center of coordination was the socialist party. The party leadership controlled the system through the centralized state by the nomination of persons for key positions of both the party and the administration. This created a chain of vertical dependence which allows vertical coordination through command.

As I have discussed earlier, the system was ideology based. In principle, consistency of actions had to be established through the central plan. The technical component of the planning methodology was similar to the Western comprehensive planning method that

Friedmann (1987), in his planning theory, labeled a “rational, technical planning” method. Both methodologies were built on information collection, analysis and planning on the basis of instrumental rationality. According to its ideology, however, the Western comprehensive planning method was technical, as technicians’ work was clearly separated from the process of political decision making³⁵. At the same time, the socialist central plan was policy making in itself.

The main goals of the central plan were decided by the party leadership and then elaborated under the strict supervision of the party. According to the intention, by centralizing information and making the best choices from complete information, order was created, and through commanding chains of activities, consistent implementation resulted. It seems paradoxical that such a centralized planning and command system did not develop a systematic control mechanism over the implementation, similar to Western bureaucracies.

The logical explanation is based on systemic features of the planning mechanism. In reality, planning information was inadequate and skewed, decreasing the prestige of the planning results. Moreover, arbitrary interventions often diverted implementation plans. This led to the third systemic feature of coordination, the vertical bargain. The bargains and frequent intervention allowed only for localized, direct control by staff. The atmosphere of complicity created by the vertical bargain, did not allow strong direct control. Control mechanisms were multiplied and interwoven throughout the society. Weak control was a systemic problem and the multiple control solution was a systemic weakness of socialism.

³⁵ Here we discuss the inconsistency of socialist planning. At the same time it has to be noted, that the ideology

In the socialist system, the local councils were the implementing agents of local service delivery. These councils were deconcentrated, multi-purpose units of the central government. As a result, the following factors impacted the scope of local action and local strategies. First, the source of legitimacy of local action was the same ideology and party power that ruled the whole system. Second, local leaders were members of the same party and bureaucratic elite. As they were not locally elected, but appointed from the top, their accountability was not directed to the local community³⁶. Third, local councils were integral parts of the central planning and implementation system. Permission and resources for activities had to come from the center, and allocations were determined through the system of vertical bargaining. Fourth, links and coordination between local service departments and the relevant line ministries was often stronger than the coordination among various local functions. The dominance of vertical links led to fragmentation at the local level. In this situation, local councils had practically no independence, and no possibility, or incentive for, consistent local planning and efficient service delivery.

Local politicians and administrators were clearly part of a larger vertical system that was only loosely connected to the locality. Their accountability was defined within the vertical system, and characterized by strong personal dependence on superiors. They were held accountable for compliance with the commands. That is, they were accountable for implementing the plans when and where it had not been overruled by a specific vertical command or bargain.

of “rational, technical planning” has also been attacked for inconsistency. Dichotomy of politics and planning is equally impossible, as dichotomy of politics and administration. See Peter’s quote earlier.

³⁶ This statement does not exclude the possibility of commitment by local leaders or council staff to local constituencies or to certain activities it just states that accountability to the local community is not built into the system.

Control was direct, only the direct superiors knew what final task was supposed to be. This bred servility in the administration and killed innovation and strategic thinking. Taking initiative or entering into conflict were not systemic features. “A subordinate wanting to do something should cover himself in advance by obtaining his superior’s prior approval and spreading the risk over as many superior leaders as possible...servility and heads-down mentality prevail and leads to weak accountability” (Kornai, 1992, 121).

Central planning was a monolith system that formally operated on two vertical channels: the bottom-up channel of information collection and the top-down channel of planning. As I have already discussed there was a third, informal channel as well, the vertical bargain.

Local councils were obliged to contribute to both formal channels. They were aware that the information they sent upwards would impact the commands and allocations traveling downwards. The same was true for local staff. They also knew that the information they supplied influenced the level of expectations. Consequently, actors at all level made political use of the information that they had, and withheld key components. The absence of market mechanisms and prices, two key information sources, caused information on real cost and demand to be unavailable. As hard market information could not work against the information asymmetry, rules of thumb substituted for calculation at all levels. This was the systemic inconsistency of central planning. It was built on the ideology of the possibility of rational calculation and comprehensive planning, but it necessarily operated without the information needed for rational calculation. The system logically did not produce such information through the parted channels of information and command. This systemic weakness explains why it is always impossible to find relevant information for informed policy making at the beginning of the transition and why the policy capacity of civil servants is so weak.

According to Kornai, the vertical bargain was a systemic weakness. For my analysis, its perverse impact on local planning is important. As permissions and resources for projects had to be obtained from superiors through the vertical bargain, the best strategy was to start the bargain with overestimated needs. There was a systematic incentive to promote all possible projects to increase the chances of obtaining resources. This was a misguided incentive, as it diverted attention from real needs that should be the cornerstones of planning. Local planning became an instrument of bargaining instead of rational resource allocation. This situation led to the physical planning practice – planning that was based on physical parameters and completely lacked any cost calculation³⁷. Because major decisions were made by ministries, bargaining occurred within parallel sector channels which fragmented local planning, leaving little possibility of horizontal cooperation.

In this context, most vertical resource allocation channels ran through the local council. This fact degraded the local budget to a record keeping and accounting document. The budget recorded the results of the bargains for each service unit. All incoming subsidies and allocations for departments and service units were listed. The traditional form of yearly, input-based line-item budgets could easily fulfill this role. The typical socialist budget gave the expenditure allocations in a departmental and institutional break down. This system did not allow for the calculation of the cost of services, or its share of operating and capital expenditures on the basis of budget information. The budget successfully hid from outsiders all important information. The main role of budgeting was, similar to planning in general, to

³⁷ I use the term *physical* planning in order to distinguish it from the *technical* planning practice characteristic of the traditional paradigm. I will explain the differences in more detail when I discuss planning challenges in Chapter 6, The Case Description.

serve the bargain. If it had been a control tool, like in the traditional paradigm, it would have clearly reflected what uses (inputs) could be made from the resources. In the socialist local government, direct control and strict permission based functioning substituted the control function of the budget. Bureaucrats could do only what was explicitly permitted.

The socialist paradigm was successful to the extent that local services contributed to the social security of citizens along the lines of the greater plan. The system was also successful in engendering in local staff personal servility and loyalty typical in socialism. Local councils were operationally and culturally integrated into the big system. However, as strategic thinking and initiatives were not rewarded in the system, these skills became extinct, and were not available for efficient internal management either.

Local councils, instead of using integrated planning, focused on the bargain for specific projects. Policy relevant information was not available, and even what was produced was withheld. For local planning, long project lists were prepared to improve bargaining positions.

Finally, I make a strong statement. Policy making, according to the Western concept, was not a local function under socialism. Local leaders could take part in policy making through the information they supplied for the central plan and through vertical bargaining. This led to politicking rather than policy making. Strategic use of information within the bargain meant withholding and distorting, and agreements were made through mostly personal ties and lobbying. These factors explain the oft-noted weaknesses of post socialist countries: lack of information, lack of policy making capacity, weak horizontal coordination and weak accountability (Verhejinen 1998a).

All the characteristic features of local councils' operation under socialism explained above are summarized in a table format and compared to the relevant features of the other two paradigms in Annex 6.

The Traditional Paradigm

As Kornai remarked, the traditional paradigm of the democratic West is built on partial bureaucracies. Local governments' political leadership and administration have differing levels of independence and separation from central government in various countries, but are never an integral part of the central government. This offers scope for local planning and policy.

Political leadership is locally elected and, in principle, accountable to the constituency. The accountability is secured not only through election, but through local revenue collection as well. In the traditional paradigm politicians make the decision on policies. As parties rarely have an overwhelming majority, decisions are the result of negotiations among political forces. As a general practice, this leads to incremental policy making.

In addition to policies, plans are also prepared in the traditional paradigm, but they are never meant to be the main coordination mechanism. Planning is a technical activity, based on analysis and the application of instrumental rationality. This is why in his planning theory, Friedmann (1987) labels the key planning methods used by classical bureaucracy as 'rational, technical planning' methods. These methods are exclusively built on information analysis and

the technical skills of planners, and executed on the basis of strict separation of planning from political decision making. In the 1950s, Simon (1955) and Lindbloom (1959) challenged the possibility of rational planning in the face of complex problems. Nevertheless, technical planning is still applied in the public sphere for specific functional domains or for guiding specific interventions. Plans are prepared to support decision making³⁸.

In the traditional paradigm, the civil servant's position is legally regulated, merit-based, and professional. They work according to the rule of law and strict procedures. Their role is to implement the policies and plans decided by the politicians. They do their work according to detailed regulations developed on the basis of plans and policies. These regulations clearly define the scope of discretion, and protect civil servants from political interference. Civil servants are supposed to effectively implement instructions and are accountable for compliance with the rules and procedures.

The input based, line-item budget is the traditional method in classical bureaucracy. As we discussed earlier, it is an excellent tool for control. It controls the work of the administration and it can also control deficits through hard budget constraints. At the same time, it provides good support for the incremental policy making prevalent in this paradigm. By the Axelrod (1995) terminology, executive and functional budgets are the typical forms, but multi-year planning or any other innovation that does not negate incrementalism can also be part of the system.

³⁸ Even if the plan is not comprehensive, but rather sectoral or functional, the impossible dichotomy of the political and rational dimensions of planning still remains a problem.

This strictly regulated system and its clear, standardized procedures are meant to produce efficiency in carrying out instructions and certainty of results. These are its clear merits. At the same time, systematic regulation and control creates an automaton, whose functioning is rigid and has a limited scope for creativity and innovation. It can apply only standardized best practice that may not always be the best way to accomplish broader public goals.

All the characteristic features of local governments' operation in the traditional paradigm that are explained above are summarized in a table format and compared to the relevant features of the other two paradigms in Annex 6.

Key Differences between the Socialist and Traditional Paradigm

While the socialist local council was an implementation unit in the state bureaucracy, local governments in the traditional paradigm are more or less independent bureaucracies, whose operation is based on the separation of politics and bureaucracy. In principle, the clear separation of the domains of politics and administration saves bureaucracy from the arbitrary intervention of politics. From civil servants it expects neutrality, professionalism and compliance with laws and procedures. In the socialist paradigm, both politicians and bureaucrats were nominated by the party. The borderline between politics and administration was blurred and political interference in administration was a daily practice. This condition engendered vertical dependence, servility and direct control mechanisms – coordination

mechanism that are very different from the ones applied in the traditional paradigm.

In the traditional paradigm, politics is messy. It is the arena of negotiating where information and interests are confronted and agreements are reached. The administration is a systematically organized and regulated structure designed for efficient and reliable implementation of the decisions. In the socialist ideology, the rationality of planning substitutes for messy politics. Key decisions were formally made through central planning³⁹ mechanisms under close supervision of the party. Theoretically, as information and decisions were centralized, the planning could create consistent action. The inherent problem in this model is that local information and decisions on local affairs, and were included in the central system. This made both planning and implementation messy. The blurred border between politics and administration, and the vertical bargaining process concealed actual decision making practices, leaving it undefined and fragmented.

The typical input based, line-item format of the budget is similar, but the content of the budgeting process is logically different. The independent local government of the traditional model is responsible for its finances and service delivery. It operates on hard financial constraints, and must use budgeting for control. Balanced budgets are secured through hard expenditure controls and marginal changes in allocations still allow for effective service delivery.

³⁹ It is important to note that comprehensive planning is applied not only in the socialist paradigm, but in the traditional paradigm as well. The difference is that in the traditional paradigm comprehensive planning is not systemic. It is only a short-lived planning approach that is never meant to substitute or become dominant at the expense of the political process. Planning in the traditional model of the West is meant to be a support, and not a means of decision making.

The socialist local council had no financial independence and therefore no accountability. It received allocations through bargains and operated under soft constraints. The budget of a local council was the result of the yearly bargain. It recorded bargaining results on the revenue side, and presented data on the expenditure side in a form inaccessible for outsiders. The budget was institution based as institutions were the smallest agents in the bargaining process. The lack of budget transparency was logical as lobbying for resources was a more important objective than financial control.

In the traditional paradigm, the clear separation of political decisions and administrative implementation, and the systematic organization of the implementing bureaucracy allowed for systematic compliance control and operational certainty. In the socialist paradigm, where the decision process was fragmented by bargains and interventions, only soft direct control was possible which led to uncertainty.

Bureaucracies of the traditional and socialist paradigms are equally criticized for their lack of creativity and enterprise. It has often been noted that Weber's bureaucracy is like an automaton. Given that, socialist bureaucracy is an unreliable automaton.

The paragraphs above compared the first two columns of the table in Annex 6.

The Managerial Paradigm

Both the traditional and socialist paradigm engendered static organizations that are adapted to operate in relatively stable environments. Managerialism is the product of a rapidly

changing context. It introduces strategic approaches and flexible management that allowing the implementation of public goals in such an environment. Managerialism grew under the parallel obligation to cut costs and improve services. Market type solutions are applied for both goals. To establish a balance between these goals, efficiency increases had to be brought forward.

As we have discussed, managerialism creates entrepreneurial government. Managerial government, at higher and local levels, is led by professional politicians and managers. The typical coordination mechanism is action oriented strategic planning and management (Bryson 1995). Implementation of carefully selected key goals is the focus of this planning approach. Goal setting is obviously a political act, but management is a professional activity that is flexible, creative, risk-taking and adaptive to changing conditions. The leadership and higher management are focused on identifying and clearly defining the public goals. Managers are contracted to implement specific goals and objectives, to use their skills and creativity for finding the most efficient solutions. They are personally accountable for the results. Whether the manager leads a public or private implementation unit, depends on the result of competition or economic analysis.

As the goal is to find the most effective solutions, the rigid input regulation used in the traditional paradigm is substituted by performance objectives. Nevertheless, managerialism does not completely negate the administrative tradition. Public values, like the rule of law and clear procedures are safeguarded, but there is a qualitative change in the regulation of the procedures.

Thus, setting goals and procedures are centralized and implementation management is

decentralized. Control is focused on performance that is systematically monitored. This is a market type contract culture, where resources are given for certain, well defined products or outcomes.

The two features have a strong impact on budgeting reforms. Strategic planning necessarily works on a multi-year perspective and a contract culture necessitates performance specifications, with allocations adjusted to performance and the establishment of hard budget constraints. Budgeting has to become part of strategic management and transformed into an effective policy tool.

The logical approach is to adjust the budget to the strategy. Key budget proportions and macro figures can be adjusted to a strategy with a multi-year outlook through a macro-budgeting process. Macro-budgeting can translate strategic priorities to budget proportions and macro figures. New tools, like budget envelopes, budget targets and block budgets can convey these decisions to implementing agencies by setting ceilings for planning, or even defining more specific incentives. Micro-budgeting can be decentralized to managers and given wide discretion on specific expenditure decisions. Macro and micro-level decisions have to be connected by a performance based control mechanism. This glue can either be performance monitoring, or a system of performance incentives, or a combination.

In sum, a managerial paradigm means strategic planning and policy making that keeps a strong grip on setting goals, specifying expected performance and encouraging performance through personal accountability. In the security created by systematic performance control, the system can courageously decentralize implementation management and offer the freedom for creative solutions. Vertical relation is a performance based contract type relation. In this

system the ideal budget is also strategic. Executive control is focused on the macro-budget, and micro-budget decisions are decentralized. Line-item control is substituted by performance control. Thus, the budget becomes an implementation tool for the strategy. Similar to planning, it has a multi-year perspective. On a macro-level, it ensures balance and allocations proportional to priorities and on the micro-level, offers a package of incentives.

All the characteristic features of local councils' operation in the managerial paradigm that are explained above are summarized in a table format and compared to the relevant features of the other two paradigms in Annex 6.

Key Differences and Similarities among Paradigms and Challenges

The traditional and managerial paradigms share a democratic foundation: the rule of law, transparently regulated procedures and a clear definition of discretion. On such a basis, both systems establish non-personal relations between actors and expect prudence and professionalism from them. The rule of law and a culture of merit and professionalism contrasts greatly with the socialist paradigm built on unlimited party power with its command system, chains of vertical personal dependence, discretionary interference and servility.

The traditional and managerial paradigms both establish some kind of framework that structures the system and develops the discipline of the key actors. The traditional paradigm is based on the dichotomy of politics and administration and the managerial paradigm is

based on the separation of goal setting and implementation. However, as the role of administration in the traditional paradigm also requires implementation, this difference in separation could even be unimportant.

In reality, the fundamental difference is in the approach to implementation. The traditional paradigm constructs a reliable automation for implementation. Bureaucracy is based on a rigid architecture that is adapted to the slow change and stability of conditions of the epoch when it was developed. In contrast to this, the managerial paradigm fixes the goals and objectives only, and for the implementation, develops a flexible network of provision through public and private agencies, all equipped with the freedom to make implementation decisions adaptable to changing conditions. The basis of traditional bureaucratic functioning, the standardized and rigidly institutionalized 'best way,' is substituted in managerialism by clear goals and the flexibility and creativity of managers and their personal accountability for results. It is a key component of the shift from the traditional to the managerial paradigm to change the rigid implementation framework to a flexible, objective driven system. Bureaucrats must transform themselves from risk averse, execution cog-wheels into independent, risk-taking, creative managers. The permanent elements of a rule-based system, transparency and disciplined actors that follow the rules of the game, are important parts of both the traditional and the managerial paradigms.

The shift from the socialist to managerial paradigm is very different. The socialist heritage lacks values like rule of law, transparency, and discretion. It is built on personalized relationships between politicians and bureaucrats and subordinates and superiors. As entrepreneurship was not rewarded in socialism, creativity was not used to find solutions within the rules, but to 'outwit' the rules to avoid punishment. Traditional and socialist

bureaucrats are similar in the sense that both are socialized to be risk-averse, cog-wheels who do not take personal responsibility. They are also very different. Instead of a culture of legality and discipline found in the traditional paradigm, in socialism servility and shrewdness are the starting points.⁴⁰

Budgeting is an integral part of the implementation system. In the traditional paradigm the executive budget systematically allocates and controls resources according to each necessary input. It implements marginal changes according to decisions stemming from the incremental policy process. It secures safe functioning and control of the rigid bureaucratic apparatus. For managerialism, it is necessary to loosen this rigid control and allow managerial discretion over the resources available for the function they oversee. For this, some functional reorganization of the budget (or at least a calculation) is surely necessary, as well as remodeling allocation decisions according to performance (outputs, results, or outcomes). As the input based line-item budget supplies actual cost information this can be the beginning of a shift to a performance based budget.

The shift from a socialist budgeting system to a results oriented budgeting system is more problematic as the socialist budget does not directly allow for basic calculations or actual input costs. The budget discipline is also weak, as the decades long bargaining practice and system of soft constraints separated technical and financial planning. If a project was accepted in the bargain, financial subsidies had to be allocated from above. The focus was to squeeze

⁴⁰It must also be noted that post-socialist countries still start from a much better condition than most developing countries that attempt to implement managerial reforms. Specific practices and political and administrative cultures needs to be transformed, but the tradition of bureaucratic functioning and sophisticated technical skills are already there and are great assets for the process of transformation (Ebel and Weist 2006).

the project into the 'big plan' with minimal starting cost for the first year which pushed the responsibility for future allocations to the superiors. When post-socialist local governments were set up, it was a major conceptual shift to turn attention away from vertical lobbying towards internal competition for resources and establishing a budget balance. Through the case analysis I seek to answer whether the advice of Allen Schick (1998) is valid, that as a first step, a reliable and cost based executive budget and budget discipline has to be established. Or are there any other valid trajectories towards result oriented budgeting?

In the traditional paradigm, the incremental policy process results in marginal changes that can be safely implemented by the rigid mechanisms of classical bureaucracy. In principle, the flexible implementation mechanism of the managerial paradigm can also implement instructions, nevertheless, here the system encourages longer term thinking. If stability of goals is possible, it facilitates performance review and developing the most efficient structures.

In the socialist paradigm, local councils have no real policy making role. Local planning is also more a means of politicking than planning. As discussed, local planning serves subsidy maximization. This is a perverse incentive, as it diverts attention from needs and opportunities. Local leaders can take part in policy making only through the information they supply and vertical bargaining. This is a fundamentally different role than either traditional or strategic policy making and planning. It clearly explains the often noted weaknesses of post socialist countries: lack of information, lack of policy making capacity, weak horizontal coordination and weak accountability (Verhejinen 1998a).

Transformation from the socialist to the managerial paradigm usually starts, and it can only become a priority, during the post-socialist era. This means that a multi-party local political

arena and incremental policy making ability must already exist. In this respect⁴¹, the transformation challenge is similar to the traditional to managerial shift: achieving some stability of objectives and, if possible, agreement on strategies. Such stability can greatly aid reform and the development of managerial approaches. However, all authors on public management reform remark that this is not even a necessary condition for managerial reforms (Pollit-Boukaert 2004).

In sum, these are the key differences between the starting points of the traditional and socialist paradigm and the challenges posed by the transition to a managerial paradigm. The findings here will be used for explaining those features of the Budapest strategy that escape mainstream explanation.

At the end of this comparison two special notes have to be made: one on information and the other on pragmatism, as these two points will play a key role in the case analysis.

It has to be noted that in the traditional paradigm, similar to the socialist paradigm, the information, planning and decision channels were also somewhat split. However, there were three key differences that work against the dominance of vertical bargaining. The first was that only socialism unified partial bureaucracies into a monumental state bureaucracy. In partial bureaucracies the routes were considerably shorter. The second is that, while in socialism discretionary decisions regularly diverted planning outcomes, and led to political use of information, (i.e. distortion and no information), functioning in the traditional paradigm

⁴¹ The other aspect would be the political culture. Differences in political culture are huge between the political arena in the West and that of the post-socialist CEE. Unfortunately, the change of political culture is slow and impacts everything. Nevertheless, I do not discuss this aspect, as this is beyond the scope of my research.

is rule-based. The third is that in the traditional model, the strict separation of technical and political activities can rationalize the structure of the information and decisions process. These features explain why there is an absence of information in the socialist paradigm, and only imperfect information in the traditional paradigm.

It is also important to note that the socialist system is ideological and discretionary. Ideology dictates the misconception of centralized information that results in lack of information, and discretion can override rules or planning results. This creates a system where allocations result from lobbying rather than from transparent procedures. In contrast to this, both the traditional and managerial paradigms were developed in societies where the rule of law prevailed. Both systems are transparent and rational where decisions are made on the basis of available information. In the traditional model, decisions are made by politics on the basis of incomplete information and these decisions are implemented through strict rules and systematic top-down control. In the managerial paradigm, only the goals are decided in politics, on the basis of the incomplete information at the top. Implementation is decentralized and flexible, and based on localized information in the hand of implementing agents. This provides a close link between the information source and the decision point.

The last note is on pragmatism. The causal line of explanation for the socialist paradigm could be built on the traditional principle of an administrative, political dichotomy. The key explanatory difference of the managerial paradigm to both the socialist and the traditional

paradigms is its pragmatism. In the managerial paradigm, the goal is efficiency⁴². This reverses the line of causality! (See the scheme in Annex 12).

The efficiency goal requires decentralization of managerial decisions. In the managerial paradigm, managers must have the freedom to find the most efficient and effective solutions. However, decentralized management is possible only on the basis of clear goals and accountability – two forces that guide and constrain managers. This creates a system where the leadership keeps strategic control over objectives and rules and decentralizes management. Decentralized management connects localized information, planning and decision. Goals and rules are still set at the top and on the basis of imperfect information, but at the top the focus is on directions and incentives instead of final decisions.

The case analysis shows that the difference in handling information and connecting information to decisions and accountability frameworks are the most substantial factors of change. I demonstrate that a new system of information and accountability, not a PMS, is the reason for the successful transition from the socialist to managerial paradigm. This is a solid new contribution to the scholarly debate on local government reform that also has serious consequences for the practice of local public management reform.

⁴² Efficiency is a broad term. As I discussed earlier in the first generation of managerial reforms it was mostly connected to productive and operational efficiency, while in later phases allocative efficiency and a holistic concept of efficiency in implementing societal goals also evolved.

Conclusions: Criteria for the Case Analysis

On the previous pages of this chapter I discussed the logical consequence of each paradigm on the systemic features of organization, policy making, planning and budgeting in local governments, and made comparisons of various aspects of the paradigms.

The key system specific features pertinent to local government organization and planning within the three paradigms are summarized in the table in Annex 6, *Comparison of Characteristic Features of Local Government Operation in the Three Paradigms*. In the table I summarize all key characteristics of the paradigms that I have discussed above, this supports the presentation of the different logic of the three paradigms.

At the same time, the Annex tables contain far too many features for focused case analysis. In Table 1 below I selected those features that will be the concrete criteria for the case analysis. Here the focus is on the differences in planning, policy making, implementation and budgeting, and the link between information and decisions. The focus of the following case analysis is on these criteria. The listing of the characteristic features of practices in all three paradigms is important as the directions of reforms will be determined according to these.

The table below summarizes the key features discussed above.

Table 1: Criteria for the case analysis

	SOCIALIST	TRADITIONAL	MANAGERIAL
SYSTEM	ideological central decisions from above discretionary not transparent	rational – principled centralized authority rule-based transparent	rational - pragmatic devolved authority objective-based transparent
PLANNING	physical plan	technical plan	strategy
POLICY	bargain for interests	incremental decisions	goal setting
RULES	discretion	regulation and compliance	incentives and accountability
IMPLEMENTATION	fragmented scope for discretion and bargain	systematic, top-down regulation and compliance	decentralized implementation of goals
INFORMATION-DECISION LINK	myth of centralized information political use of information	imperfect information, but centralized for political decisions	localized link between management, information and decisions
BUDGETING	institution based within the year soft constraint	incremental, line-item input control hard constraint	Multi-year Performance-based hard constraint

Chapter 5. Methodology

I selected a case study method for my dissertation. My plan was to systematically explore documents, mechanisms and events related to the BBRS drafting and implementation between 1995 and 1999 to gain a sharpened understanding of the process.

My initial hypothesis was that the BBRS was not exclusively a public finance reform, but also a public management reform. That is, the conceptual framework of public management can better capture the essence of the process than the conceptual framework of public finance. The review of the documents and literature review of the two fields easily proved that the strategy and objectives were relevant to institutional restructuring, and the issues faced in public management reform. Budgeting reform was the means to encourage the implementation of the management reform goal.

At the same time, through the review of the state of the art literature of both fields I realized that the absence of a PMS in the BBRS contradicted the expectations formulated by managerial reforms in both fields. This helped focus my research questions and exploration. I posed the first of two research questions: Is the absence of a PMS really a mistake or inconsistency in the BBRS?

With this question, the originally exploratory case study research required an explanatory

dimension. To answer this first research question, I either had to demonstrate a clear explanation for why the BBRS is consistent even without PMS, or the inconsistency had to be demonstrated.

Deeper investigation of the public management theory and a review of sources on post-socialist reform, did not reveal an explanation. Instead, it offered an alternative proposition: post-socialist reform should first establish a functioning administration according to the traditional paradigm and PMS, and then turn towards managerial reform only later, on the basis of this foundation (Sutch 1999). My preliminary knowledge of the Budapest case suggested a different trajectory, therefore, I chose to examine the validity of this proposition as a second research question.

Case Selection and Adequacy of the Case

I used the case to call into question two highly generalized propositions of the state of the art literature and to test them by examining one instance – the Budapest Budgeting Reform Strategy. This is the method of falsification. Flyvbjerg defines the method of falsification in the following manner:

“The case study is ideal for generalizing, using the type of test that Karl Popper (1959) called “falsification,” which in social science forms part of critical reflexivity. Falsification is one of the most rigorous tests to which a scientific proposition can be subjected: if just one observation does not fit with the proposition it is considered not valid generally, and must

therefore be either revised or rejected. Popper himself used the now famous example of, “All swans are white,” and proposed that just one observation of a single black swan would falsify this proposition and in this way have general significance and stimulate further investigations and theory-building. The case study is well suited for identifying ‘black swans’ because of its in-depth approach: what appears to be white often turns out on closer examination to be black. (Flyvbjerg 2006, 228)

Flyvbjerg distinguishes two types of cases: most likely and least likely case studies. He writes that cases of the most likely type are especially well suited to falsification propositions, whereas least likely cases are most appropriate to the test of verification (Flyvbjerg 2006, 231).

Budapest can be categorized as a most likely case in the context of the specific inquiry related to PMS. Budapest was the capital city of Hungary, one of the most advanced countries of the post-socialist block. It was the largest city of CEE with human resource capacities that greatly surpassed the level of capacity of most localities (Enyedi 1998, 51-52). Since the 1980s, Hungary had already carried out substantial public sector reforms. It had started introducing sophisticated quantitative analytic methods and formula-based financing (László 1998, 129).

If PMS could not be set up in Budapest it is most likely⁴³ that most local governments in the region could also not set up such a system at the start of the post-socialist transformation⁴⁴.

Potential bias of the observer

It is a special and not uncommon case when the case study writer was an insider and active participant of the events. Between 1990 and 2001 I worked as an expert in the Mayor's Cabinet and I was participating in the drafting and implementation of the strategy process I describe. This fact carries both risks and benefits.

The benefit is the thorough knowledge and access to all available information. That is, not only officially published documents, but internal documents and intimate knowledge. The more than ten years experience working in the given environment offered an understanding of the context and events that is hard for a researcher arriving from outside the context to reach. "The proximity to reality, which the case study entails, and the learning process that it generates for the researcher will often constitute a prerequisite for advanced understanding" (Flyvbjerg 2006, 236). Giddens also stated that valid descriptions necessitate intimate closeness: "I have accepted that it is right to say that the condition of generating descriptions of social activity is being able in principle to participate in it. It involves "mutual knowledge

⁴³ It is important to note that the "most likely case" argument by no means implies that the conclusions from the case analysis are generalizable. I do not attempt to generalize any of the conclusions, as my focus is on the one case study.

⁴⁴ The case studies of municipal financial management reforms included in the reference list (Kayser, Tönkö, Pohosyan, Jefremienko) and the results of the research on local government budgeting led by Mihály Högye and carried out in eight post-socialist countries also demonstrate the weakness of information systems and the absence of a coherent performance measurement system. (Högye 2002)

shared by observers and participants whose action constitutes and reconstitute the social world” (Giddens quoted by Flyvbjerg 2006, 236).

The information advantage can hardly be overestimated in the post-socialist context where official documentation of processes was weak, and an air of secrecy was still often part of policy-making and political processes. According to analysts, these are key reasons for the lack of well-explored and documented post-socialist cases.

The risk is bias that can lead to subjectivism and justification of preconceived ideas and results. It is probably impossible to rule out bias in this case. At the same time, it can be demonstrated that I rejected or revised many of my initial views, assumptions and concepts during the dissertation writing process⁴⁵. The examination of the material according to the conceptual framework compelled rethinking and revision on essential points that I had previously made. I had to reject or revise parts of the conclusions of my earlier publications on the topic and my book written between 2001 and 2003⁴⁶.

Books on case study research methodology confirm the probability of such a revision process. Ragin called this a “special feature of small-N research” (Ragin 1992, 225). Flyvbjerg also

⁴⁵ E.g. one good example is my judgment on the strategic character of the Draft Concept, which has been reconsidered during the writing process. The substantial revision of the introductory chapter in September confirms this.

⁴⁶ The two focal points in the dissertation – decentralized management and the information problems – were missing from my earlier publications. The discussion of decentralized management was completely missing from my book, articles and book chapters and the information problem was mentioned only in connection with the 1993 CIP. Perhaps the most decisive change is my judgment on local planning and the utility of planning results for decision making. The sources of task financing failure, however, are also evaluated differently than in my earlier publications.

suggests that the probability of subjectivism is lower in the case study method, as the researcher can be corrected by the object of study that is constantly talking back to honest analysts. The field itself is a powerful disciplinary force: assertive, demanding, even coercive (Geertz quoted by Flyvbjerg 2006, 235).

Sources of Information

The research was based on the review of different kinds of primary written sources: official documents, internal documents, budget concepts, budgets and other financial information materials. The *Budapest Model* book that was published in 2003 was a secondary source of information, as politicians and experts who had been involved in the reform process gave a thorough description and analysis of the events in the various chapters of the book. Interviews made with Budapest municipal staff and other practitioners between 2000 and 2003 when preparing the book were also secondary sources.⁴⁷

Besides the written sources, my own recollection and review of my earlier notes on the process were used. These helped recall contemporary debates in the Cabinet, in teams of experts working for the Mayor's Cabinet and in other forums – events that were officially not recorded.

⁴⁷ Interviews made with Mayor Demszky, Deputy Mayor Atkári, László Láng, Sándor Tóth, Aladár Madarász, Olga Ray, Ferenc Szűcs and staff of various departments and service units.

Information from these sources was combined with interviews in 2006 with leading figures of the reform and with experts who knew about it, but were not directly involved.⁴⁸

The Case Description

A well designed case study needs substantial narrative. The thick narrative on the internal and contextual forces indicates the richness of the particular problem uncovered by the study. In a dissertation it is a dilemma whether to offer the rich narrative or make summarizing and generalizing statements. Research design experts often alert that summarizing cases is not always useful and can even get counterproductive. “Case researchers tend to be skeptical about erasing phenomenological detail in favor of conceptual closure” (Flyvbjerg 2006, 239).

When case studies are prepared for educational purposes, the detailed narrative is a key component of the teaching process. The dissertation has a broader, more fundamental purpose; therefore, conceptual summaries and generalizing descriptions are permissible. There was an additional reason for choosing the summarizing narrative style. The detailed narrative account of the events had already been published in the *Budapest Model* book, which serves as a reference for detailed information on relevant events (Pallai, 2003). At the same time, it must be noted that the text of the *Budapest Model* book and the dissertation are substantially different. The book is descriptive material that was prepared for active decision makers, administrators and experts working for local governments in the post-socialist region.

⁴⁸ Interviews made with Mayor Demszky, Deputy Mayor Atkári, László Láng, Sándor Tóth, József Hegedüs.

Most of this audience lacks thorough education on the specific subject of budget reform. Therefore, the teaching material had to offer a story line, a parallel to the story as well as explain the underlying logic of certain solutions. This approach is distinct from a dissertation which requires a clear conceptual framework drawn from state of the art theory. As such, it aims for conceptual consistency and generalization of events and neglects anecdotic detail.

The Frames of Analysis

The analysis is built on two different, but complementary frames. The first is the conceptual framework developed in state of the art public management theory. I use this framework to describe and categorize different components. Thus, I use this frame for the exploratory track of my dissertation.

Public Management theory evolved from the analysis of managerial type reforms in developed Western countries. In these places, the managerial reforms were initiated in an administrative and public service environment characterized by high standards of integrity, well-developed accountability mechanisms and a good degree of transparency. The literature focused its analysis on the transformation from the traditional to the managerial paradigm. Many authors who developed their concepts on this basis, consider certain features of the traditional paradigms as preconditions for managerial reforms. It is a crucial question in my research whether this expectation for the characteristics of the traditional paradigm to pre-exist managerial reform arises from a Western bias or is a proposition that is defensible independently from the given context.

I introduce three system paradigms – traditional, socialist and managerial – in order to explore the internal logic of features within in them. In the framework of the system paradigms, I develop the internal logic of the three paradigms in the forms of ideal-types.

I use the seminal work of Kornai to describe the socialist paradigm and deduce characteristics pertinent to the functioning of local administrations within the socialist paradigm. I conceptualize the traditional and managerial paradigms according to the descriptions given in public administration and management sources. I use this conceptual framework of the system paradigms to explain the logic behind different reform trajectories. Thus, paradigms support the explanatory track of my dissertation.

The two frames overlap inasmuch as the traditional and managerial paradigms are part of both and even the system paradigm description of these two paradigms is based on Western public administration and management theory sources.

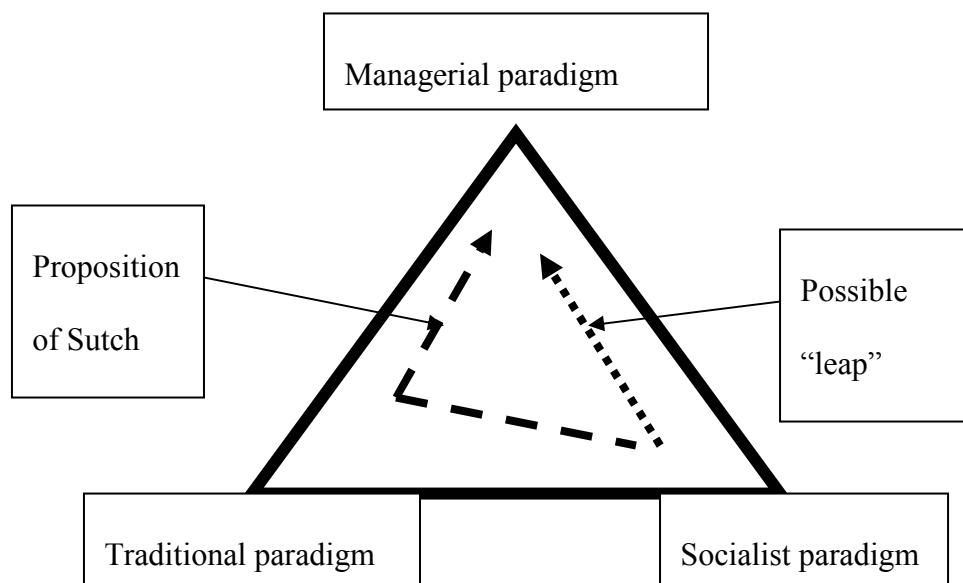
There is one important difference between the two frames applied. The public management frame is focused on the reforms and modernization attempts of the traditional administration which ultimately evolved in the managerial paradigm. The focus is on process and mechanisms that can improve system efficiency.

The paradigm frame describes ideal-types. That is: perfect conditions that are never achieved. As such it supplies static reference points that can help determine the directions of moves among the paradigms. The three paradigms create a triangular space where the corners are the paradigms, and all existing systems are inside, representing a certain combination of the three paradigms (see Figure 2 below). Statements related to the moves do not entail quality

judgments on decisions, they only qualify the logic of the move.

Figure 2 shows the three paradigms as three corners of a triangle. The corners mean the ideal-types, i.e. the extreme positions. All possible existing local management methods are within the triangle as they represent a certain combination of elements of the various paradigms (Bovaird and Löffler 2004). Reforms result in moves: managerial type reforms are moves towards the managerial corner and reforms that strengthen traditional control mechanisms would mean a move towards the corner of the traditional paradigm. The proposition of Sutch (1999) that the second research question challenges claims that post-socialist managerial reforms must first establish key components of the traditional paradigm, and can only then move towards the managerial paradigm. This reform trajectory is represented within the triangle by the broken line. The alternative trajectory, the potential leap, is shown in the triangular space as a straight line pointing towards the corner of the managerial paradigm.

Figure 2: The second research question in the paradigm frame



If it can be demonstrated that a potential trajectory can lead from the corner of the socialist paradigm directly towards the managerial paradigm, the above mentioned bias of the Western literature is demonstrated and the second general proposition has to be revised or rejected.

Research Questions and Focus of the Case Analysis

Both research questions refer to the validity of two different but connected general propositions of state of the art theory. The first proposition is that PMS is a systemic component of managerial type budgeting reforms. The related research question is: does the absence of PMS shows inconsistency within the Budapest strategy? To answer this, an explanation must be given for why there was no attempt to develop a PMS. Further, how can the managerial system be consistent without PMS?

The second general proposition is that post-socialist budgeting reform must first establish essential components of the traditional paradigm and PMS, as reliable elements of traditional functioning and PMS are necessary preconditions for managerial reforms. That is: the reform process must go through the traditional paradigm. The related research question is whether a leap would be possible? This is a simple case of falsification. If it can be demonstrated in the single case of the BBRS that an alternative trajectory is feasible, the general proposition must be rejected or revised.

In the dissertation the single case of the BBRS, described in the framework of state of the art theory and explained through the system paradigm framework, will be used to answer both

research questions. Two highly generalized propositions of the state of the art literature will be called into question through examination of this one instance. The case analysis is based on a thorough review of primary and secondary sources, and an attempt to consistently reason.

Findings and Conclusions

If a consistent argument applying the system paradigms can be built which explains the absence of PMS, it can be concluded that the absence does not necessarily lead to inconsistency. The specific post-socialist condition supports the alternative strategy. At the same time, consistency of the BBRS can only be demonstrated, if it can also be shown that even without PMS, a new accountability framework could be created that requires decentralized management to implement public goals. That is: the decentralized authority is coupled with an adjusted accountability framework.

Regarding the second research question, it has to be demonstrated that the BBRS could establish decentralized management accompanied with an accountability framework without first strengthening traditional top-down input regulation and compliance control. Such a finding is adequate to successfully falsify the general proposition that post-socialist reforms must first establish traditional control mechanisms, and only afterwards move towards managerial reform.

Chapter 6. The Case Description

As it has been discussed in the literature review, Pollit and Bouckaert (2004) created a widely acknowledged model for analyzing public management reform. They identified five main components that shape the course of reforms: (1) socio-economic forces; (2) the political system; (3) the change events; (4) elite decision making on what is desirable and feasible; and (5) the administrative system. The scheme of Pollit and Bouckaert depicts the interplay of these components (the Pollitt-Bouckaert scheme is replicated in the Annex 7).

In the center of the Pollit-Bouckaert scheme is the elite decision. The initial elite decision on the reform results from the first three components: the socio-economic forces, the political system and the change events. These contextual forces urge the elite to recognize the need and possibility for reform. The decision on what is desirable and feasible, and the scope of the reform package, comes from comparing the influencing factors and the conditions of the given administrative system. Feedback and monitoring of results during the implementation process, can inform reconsideration of what is desirable and feasible. This in turn leads to changes in the implementation process and/or the scope and content of the reform package. In the Pollit-Bouckaert scheme, the direct interplay during the reform process happens between the elite and the administrative system.

My analysis is derived from the public management reform analysis model developed by Pollit and Bouckaert⁴⁹. I also concentrate on the elite decisions and the interplay between the elite⁵⁰ and the system. The focus is on the content of the reform package and the implementation experience. The political and socio-economic context and political struggles among parties and interests are treated as external factors.

The starting point of the analysis is the 1995 Draft Concept for the BBRS – the initial formulation of the reform package. The goal of the reform was to create the conditions for a sustainable, balanced budget. In this chapter, I first review the evolution of the reform strategy in relation to this goal and its implementation. Then I discuss the key mechanisms that were implemented as part of the reforms. Finally I present the resulting system of budgeting and its implications to local management.

I analyze the strategic decisions of the municipal leadership and changes in the administrative system in the period 1995 and 1999. This is a period when the political system, socio-economic forces and intergovernmental relations were relatively stable in the sense that they exercised the same impact on the strategic goal and process – the creation of the conditions of sustainable budget balance. The reforms had to be implemented under conditions of

⁴⁹ Pollitt and Bouckaert analyzed the public management reforms of developed countries. Their focus was the central government level. The scheme is the general framework that depicts the relation of environmental impacts and the reforms. They developed it for the discussion of comprehensive or any partial trajectory of reform (within any administrative and political context), where the leadership has a choice on reforms and policies. After the transition, the newly elected local leaderships in Hungary did have such a choice. This choice was influenced by the context, by the starting condition of the administrative system and the reactions of the system to interventions. Thus, the general scheme captures this process.

⁵⁰ In my case the “elite” is the political leadership of the city. Key figures in this leadership were the Mayor and the Deputy Mayor responsible for city finances, with them a small group of experts directly employed by the Mayor’s and Deputy Mayors Cabinet worked to help elaborate reform concepts and shape the reform agenda.

considerable local independence, fiscal pressure, and a national budgeting regulation that did not generate valid policy information. The stability of these three key external factors allows me to focus the case description on the interplay between elite decisions and the administrative system.

I discuss the case within the conceptual framework of the system paradigms that I developed earlier. In this chapter I give the case description that focuses on the logic and architecture of the reform process. I discuss the content of the strategy documents and key decisions, such as reaching a strategic goal, and the objectives and mechanisms designed to implement the strategic objectives. This description is distanced and factual to the extent possible. My goal is to systematically record events and connect them with the concepts discussed in the previous chapters. In the next chapter I give the case analysis. I discuss the specific mechanisms in more detail and I evaluate both the strategy and its parts with reference to state of the art theory and system paradigms.

In both the case description and evaluation, the emphasis is on the general applicability of the mechanisms and not on their minute design. I seek answers to key systemic problems of the post-socialist condition: lack of information, lack of policy and planning capacity, weak horizontal coordination, and the culture of bargain and soft constraints. I describe the initial conditions and reforms with the help of the criteria and characteristic features that I developed at the end of the previous chapter (Chapter 5, the Conceptual Framework).

In my analysis, only the long term and critical influences, and features of the context matter. Therefore, I have only two questions related to the context: (1) which supporting pillars of the socialist paradigm could be dismantled and (2) what change drivers were produced by the

new context? I put the detailed description of the context in the annex and only shortly mention its main features here. I elaborate more on the values and ideas of the Budapest leadership, i.e. the leading elite, and the initial conditions. The focus, and the bulk of the text in this chapter is on the internal logic and implementation sequence of the reform process.

Starting Conditions – the Socialist Heritage

Before the first local elections in 1990, in Budapest, a local council was responsible for organizing and delivering local services. This local council was part of the state bureaucracy – it was a deconcentrated state agency. The local council had two basic functions: supplying information for central planning and implementing decisions of the government. Its departments were vertically linked to line ministries. Horizontal coordination among departments and institutions was weak as resources and decisions arrived through vertical channels.

In this context local planning was fragmented in sectors and concentrated on bargaining for resources for local services. In order to maximize chances for resources, local planners collected and presented all possible projects. The goal was to get projects approved, as approval laid responsibility for financing to the higher approving authority. In this context, local planning was exclusively physical and void of any cost dimension⁵¹.

⁵¹ In my terminology I make a distinction between physical and technical planning. I use the term “physical planning” in the socialist paradigm and “technical planning” in the traditional paradigm. Both are technical

Priority setting was not part of local planning either, as choices among potential projects were made at higher levels. Strategic thinking instead of optimizing resource use, aimed to maximize the number of approved projects through the vertical bargain. This focus necessitated the political use of information and personal connections. This planning process completely debilitated the planning and policy skills⁵² of staff and worked against generation of valid data for informed decision making.

As a result of the planning and vertical bargaining process, financial resources were transferred to the local council's budget from the resources of various ministries. At the central government level, investment project finance was based on individual decisions and operating resources were allocated according to a basis logic, meaning that the previous year's allocations served as the base that was incrementally changed the following year. In the late 1980s, in most human services, the allocation rule of intergovernmental operating subsidies changed. Transfers were made according to the number of service recipients. Nevertheless, normativity of this system was weak, as the recipient number was only a simple multiplier, as norms were still decided on basis logic and not with reference to costs, products or outcomes.

planning methods according to the terminology of planning theory (Faludi 1973, Friedman 1987, Faragó 2005). They are both underpinned by the dichotomy between politics and planning and they apply the rational calculation and technical norms of the given field of expertise. In the traditional paradigm, the "rational dimensions" of technical planning includes specific sector norms, and the implementation options and financing. In socialist planning that is operating in a system where the information and planning channels are split, and planning is fragmented, costs and most implementation dimensions are completely neglected. Therefore, we confront a different planning method in socialism. I call this kind of limited technical planning "physical planning" throughout the dissertation.

⁵² Obviously, planning and surviving in the given system also necessitates skills. The remark here refers to the absence of a consistent teleological activity in planning and the absence of policy analysis and solutions based on the results of the analysis.

In the local council, the investment subsidies were channeled through the local budget to the given purpose. The operating subsidies were allocated to various service providers⁵³ according the basis logic, previous years lump sums were taken as the base. A change of tasks or content of the service was the only way for service providers to argue for a different incremental change. Changes were lump sum decisions that from that year on became the new basis for allocations. Such changes were made through individual budget decisions and allocated lump sum changes to the specific providers for the given year. From the following year the increased amount served as the base for the given service provider. Institution based finance is adjusted to the smallest bargaining unit in budget decisions. One successful negotiation on a base change secured increased resources for all the following years. Consequently, the financing level of various service providers varied substantially according to their bargaining history.

Local financial management in these conditions was limited to the given fiscal year. Local managers kept record of incoming and outgoing resources, and could reallocate only small portions; the budgeting process only recorded lump sums and divided available operating resources in proportion to the previous year's allocations with few discretionary changes. Budgets aggregated a few cardinal figures from the books of individual departments, organizations and institutions. Institution based line-items only kept a record of inputs to

⁵³ In Hungarian terminology, the service providers are the municipal departments and "institutions." The term "institution" survived from the socialist past. In practice, since the transition, institutions are independent or quasi independent service units. Independent units have their foundation charter that regulates responsibilities and relations to the municipality, have their own budgets, and directors and financial officials who are personally responsible for performance. Therefore, in the text I call them service delivery units or service units that tell more about their role and position than the term institution.

institutional functions. Broad functional areas were indicated only in the budgets of departments.

As financing responsibility for approved projects and operating finance was beyond the local council, local accountability was weak and budget constraints were soft⁵⁴.

In sum, vertical dependence led to perverse planning practices, a lack of valid information, a lack of planning and policy skills and weak horizontal coordination between planning and implementation. Budgeting was diminished to the simplest book keeping exercise implemented amid soft constraints.

Key Impacts of the Context

In 1989 and 1990 the foundations of a decentralized public sector in Hungary were laid down. The new 1989 Constitution guaranteed local government independence. Local elections changed accountability relations and, in principle, liberated local leaders from party loyalties, and turned the accountability of local government towards the constituency.

The 1990 Act on Local Governments stipulated a wide range of rights, tasks and responsibilities that were decentralized to local governments. From a legal perspective, local

⁵⁴ Soft budget constraint is a term that was discussed in previous chapters. It refers to government bureaucracies that could always obtain additional resources to avoid service closures or failures. (Kornai 1992)

governments received full independence – their decisions could only be challenged on legal grounds. In principle, this abolished the main link of vertical dependence. Most of the new sector regulations reinforced this independence through a logical separation of local and central government policy areas and mandates. This created an incentive for responsible local planning and horizontal coordination of local policies.

For local financing, the situation was more complex. In the early 1990s important revenue sources and considerable financial resources were devolved to local governments, but in the course of the following decades the revenue base of local governments was continually decreased and an increasing portion of the resources became earmarked (Ebel and Várfalvi and Varga 1998). These developments limited freedom of expenditure policy of local governments.

While decisions on yearly changes on the aggregate level of intergovernmental finances remained within the full discretion of the parliament, the allocation of the available resources became more rule-based and transparent. This allowed the central government to change local government funding levels through yearly decisions on the national budget. Deteriorating fiscal conditions during the first half of the 1990s and a strong tendency for resource centralization during the second half of the 1990s produced a strong fiscal squeeze on local governments. In conjunction with revenue centralization, the central government also established hard budget constraints for local governments (László 1998, 145). Thus, local reforms had to be implemented with considerable local independence and responsibility, but at the same time under increasing fiscal pressure.

As a result of independence, hard constraints and local fiscal accountability, there was a

strong incentive for responsible local planning and for the establishment of valid information systems that could support the local planning and policy process. At the same time, although the national regulation of local budgeting and accounting went through major changes, it failed to develop a system that would generate valid policy information. Local budgets and financial statements prepared according to the national regulation offered weak support for prudent decision making. In this context, local governments often had to develop parallel systems to generate and analyze decision making and management information⁵⁵.

Annex 8 gives a detailed description of the wider context, the intergovernmental framework and their changes during the 1990s. I do not go into further detail here as the above mentioned key factors produced the most crucial impacts. They remained stable during the subject period and are sufficiently applicable to support the inferences made in the following parts. The reforms had to be implemented under considerable local independence, fiscal pressure, and a national budgeting regulation that did not generate valid policy information.

Values and Principled Ideas of the Leadership

After the transition, at the first local elections in 1990, a former dissident was elected Mayor of Budapest. He was elected on a liberal platform and collected a circle of like-minded

⁵⁵ The later discussed Credit Local International model is an excellent example: because the municipal budgets prepared according to the national regulations did not reveal important financial information, the Municipality of Budapest had to adapt this financial analysis model to enable reorganization of the budget and draw out key macro figures and their expected changes in order to support policy decisions.

advisors around him. Their philosophic principles regarding the role of the public sector and public finance were based on modern liberal theory: primacy of the individual, modified markets, enabling state, a mixed economy (Bailey 2003, 8-9).

On the basis of liberal values, the leadership was convinced that the socialist system unnecessarily limited individual freedom and market forces. Further, socialism was intrusive, inefficient, corrupt and fiscally burdensome. The new leadership believed in free choice and competition, in the efficiency of the market, and the effectiveness of decentralized information and decisions. Many of them had a strong background in economics and public choice. They were logically inclined to apply private sector techniques to management and look to the market for service provision and financial resources. Their principles accorded with the principles underpinning the managerial paradigm.

The commitment to transparency and rule of law were also important components of their liberal credo:

“... [our experience contests] the importance of establishing and agreeing on the fundamental principles, goals and rules of the game which the city’s leadership will follow (i.e., the procedural rules pertaining to the specification of the goals). Once these goals and rules are set and approved, it becomes more difficult for politics to enforce particular interests on a day-to-day basis” (Demszky 2003, 21).

At the same time, neither the new leadership, nor any of the core members of the supporting team had previous bureaucratic practice. This left them free from routines and ingrained practices and allowed for distanced evaluation on the desirability of bureaucratic mechanisms to solve specific problems. This lack of experience prompted the search for new approaches to governing.

The thinking pattern and policy approach of the new leadership was also non-bureaucratic. They were fully aware of the impossibility of making long, or even medium, term plans amid the rapidly changing conditions. Consequently, they openly refused the application of traditional planning in the context of rapid structural change. They felt that plans which fix future interventions would lead to bureaucratic voluntarism (Atkári 2000). They consciously built their policies on the stability and clear definition of goals and claimed that implementation decisions should always seek the most efficient solutions within the actual situation. The Budapest leadership called this approach “process regulation” (Pallai 2003b, 52-3). In essence, this concept of process regulation is the same as the strategic planning and management concept of the managerial paradigm: keeping hold of goals and making management of implementation flexible, adjustable to the changing context, allowing for the most efficient resource use decisions⁵⁶.

In sum, the values and goals for the functioning of public administration, and the policy approach of the leading Budapest elite clearly pointed towards the managerial paradigm.

It is also important to note that the Mayor of Budapest that was elected in 1990 was reelected three times, and at the time of writing in 2006, was still the Mayor of Budapest.

⁵⁶ In order to prove that the two terms process regulation in Budapest and strategic planning and management in the managerial paradigm cover the same concept, I cite a short part of a conceptual paper written by János Atkári, deputy Mayor responsible for finances and key member of the core elite team, in Annex 13. The text is also important for later discussion because it clearly reflects to what degree logical, pragmatic thinking, but non standard international practices influenced the thinking of the key designer of reforms.

The Evolution of the Reform Strategy

Budgeting and institutional reform processes are very complex. The strategy I present and analyze has a complex set of objectives and multiple tools. Detailed description and analysis of individual components would go well beyond the volume of the dissertation and was already published in Pallai 2003a. Therefore, in the description here I focus on the logic behind the reform process and the architecture of it. Only those components will be discussed that were planned to be or became a system change and/ or led to answering the research question. Detailed discussion and analysis of specific components will follow in the next chapter.

The antecedents

As a result of transferring of tasks during the first years of the transition, assets and revenue sources changed the conditions of local management with an incredible speed. This fact made even medium term forecasts practically impossible. The absence of proper databases also made it impossible to predict the costs of tasks or capacities of various revenue sources at any given moment. It was equally difficult to foresee the impact of new intergovernmental mechanisms.

During these first years, the socialist planning routine could easily survive as the Municipality's accountants recorded broad lines of financial flows throughout the year and sector planners continued the physical planning practice that had no relation whatsoever to financial possibilities. As sector leaders and planners were not socialized to consider financial limitations and the accountant approach of the budget office could not produce any estimate

on financial outlooks beyond the year, resource allocation was determined more or less on the basis of interest enforcement capacities instead of consistent policies. This shows that the vertical bargain culture survived in the new context when it became mostly restricted to the Municipality⁵⁷.

The first trigger for change came in 1992. In 1991, the country's Parliament decided to host a World Exhibition (EXPO) in Budapest in 1994 (later postponed to 1996). Budapest was expected to finance part of the preparation which meant a huge commitment⁵⁸. As the Municipality had no previous experience in harmonizing physical and financial planning processes, the Mayor's Cabinet had to undertake the coordination role. In the effort to estimate potential financial resources and costs of necessary investments, the local leadership realized the complete absence of valid information for financial planning and the chaotic condition of financial records⁵⁹.

⁵⁷ As it was discussed earlier, the vertical bargain was a result of the power monopoly and central planning. The long time separation of the information and decision channels within the central planning system allowed for its existence. In the new situation, in principle, these channels should have been connected within the municipality, but establishing such a connection was a multi-year struggle for the leadership. Therefore, paradoxically, the vertical bargaining practice survived after its causes were abolished. This is a typical post-socialist condition.

⁵⁸ The detailed description of the events and their impacts can be found in Pallai 2003b, 58-61 and Pallai 2003c, 114-22.

⁵⁹ The shocking realization of the absence of planning information in late 1992 is a shared personal memory, as I was involved in the CIP process. Nevertheless, the perception and memory I had was checked and reinforced later through interviews with János Atkári in January 2003 and Gábor Demszky during various discussions during 1999 and 2000.

With incredible effort, a Two Years Capital Investment Program (CIP) was prepared for 1993-4, and was adopted by the Municipal Assembly in the form of a decision⁶⁰ in 1993 (Office of the Mayor of Budapest 1993). It became a municipal decision – a public document⁶¹ - that determined investment decisions for the following years. At the same time, the Municipality also published it in a special document, made it available to the press and all the partners involved in further negotiations on the investments and implementation of plans. Thus, the document was solid and distributed to the extent possible within the available public relations infrastructure⁶², but unfortunately the CIP process was a one time experiment – it was not instituted as a rolling planning mechanism. Nevertheless, it set an example of using a multi-year outlook, collecting comprehensive information, and establishing links between physical and financial planning. At least, in the capital budget plan, three fundamental components of modernized budgeting, even if applied in a restricted domain and only in one instance, had occurred.

⁶⁰ The Municipal Assembly adopts Decisions and Decrees. Decisions are relevant to internal functions, decrees are local laws that regulate local affairs and the behaviors of individuals and entities external to the local government. Budget Concepts are passed through decisions, as they are adopted to form the basis of budget planning. Local budgets are decrees that regulate financial flows and allocations.

⁶¹ Assembly documents, decisions and decrees are materials in the public domain, made widely accessible. All proposals, decisions, and Assembly protocols are also posted on the municipality's website in a searchable form.

⁶² Here it must be noted that Budapest was a large city, bringing consequences from its communications with the public. As a large municipality that often made decisions on large sums, media attention was given in general, but this attention was restricted to issues that were considered communicable within the context. Both the quality of the media and the political education and interest of the public were factors in coverage. The municipality, similar to other large post-socialist city governments, could not develop an effective infrastructure for public relations and participation in the 1990s. The CIP in 1993 was discussed in public as individual projects could be captured, but as I will later discuss, the communication of the BBRS was a much more difficult challenge.

The EXPO was canceled by the central government in 1994, its financial mechanisms were dissolved and the financing of on-going projects halted. This directly led the Municipality to a liquidity crisis in 1995⁶³.

Another parallel episode can also be treated as an antecedent. In 1994, World Bank experts preparing a paper for a volume on post-socialist decentralization, made an analysis of the financial conditions of the Budapest Municipality. They also confronted the absence of a good database, but through their estimates concluded that the budget had a structural deficit (Ebel and Simon 1995). The experts advised the Budapest leadership to take discretionary actions to prevent the structural deficit from becoming a recurring operating deficit.

In 1995, in the middle of the liquidity crisis, the municipal leadership signed a contract with the Credit Local International Conseil (CLI) for the adaptation of the CLI's financial forecasting and planning model that calculates the operational deficit/surplus⁶⁴.

The liquidity crisis and the realization that the budget had a structural deficit were the two key change events that led to the creation of a reform strategy. On the one hand, the structural deficit required the leadership develop a reform strategy that had many politically costly and restrictive components. On the other hand, the ongoing liquidity crisis and the threat of

⁶³ For more information on these events see Pallai 2003b, 58-61 and Pallai 2003c, 114-22.

⁶⁴ The CLI model arranges budget entries in a transparent structure which separates operating and capital revenue and expenditure items. It includes the three previous years and, according to the hypothesis fed in by the user, it calculates future trends of indices. It analyzes the budget's long-term viability through a series of time sequences based on past budgets and future budget projections, and it also evaluates the internal proportions of the budget through indices calculated on the basis of cardinal figures.

insolvency prepared the political ground for pushing it through the local political decision process.

A note has to be made on privatization though it cannot be considered as a direct antecedent. It was a process that started before the budget reform and later became a component of the strategy. In 1994 the Municipal Assembly adopted the Privatization Strategy (Office of the Mayor 1994). Between 1995 and 1997, three major utility companies and many other smaller companies were privatized (Pallai 1999). Privatization was a managerial type reform⁶⁵, planned and launched before the budgeting reform. In Budapest it was possible to start privatization process independently of the budgeting reform as in the early 1990s all utility companies were corporatized. Thus, the assets and budgets of the independent legal entities were separated from the Municipality, and only the subsidies transferred to them were registered in the municipal budget (Pallai 2003e). Also in the mid 1990s the municipal government accomplished a pricing reform of utility services that resulted predictable financial flows, and cost coverage in the domains later privatized (Valentiny 2003). These conditions allowed the Municipality to privatize the companies. Here I do not comment these transactions, as they are well documented elsewhere (Szűcs 2003).

⁶⁵ I use managerial type reform to indicate that the given reform fits in the reform agenda set by the managerial paradigm. It must be noted that the term managerial reform and managerial strategy are used with two different meanings in the literature. One is my meaning, i.e., part of the managerial paradigm (Bovaird and Löffler 2003; Hughes 2003; Pollit and Bouckaert 2004). The other use distinguishes between managerial and market-type reforms in recent public management reforms (Schick 2002). Obviously, these managerial and market-type reforms are both components of the managerial paradigm according to the first definition.

The initial strategy in 1995

1995 was a critical year in the Budapest Municipality. The leadership was already fully aware of the absence of relevant policy information. This was especially true for financing – while local budgets presented information and explanatory texts on some 400 pages every year, they did not offer information that would support policy making⁶⁶ in practice. It was also clear that the CIP preparation in 1992-3 had not changed the behavior of budget agents: sectors still applied physical planning methods and used the same vertical bargain techniques as under the socialist system. The crucial difference was in the conditions: the Municipality already operated under hard financial constraints.

The leadership believed a structural deficit existed, even if the available data did not make it precisely calculable. The direct cause of the liquidity crisis was the EXPO investment package, but Budapest finances were, even apart from the EXPO, on an unsustainable track. A strategy was needed to lead the city out of the crisis, and towards sustainable functioning. At the same time, it was critical to determine what kind of decisions could be made in the void of relevant information and calculations.

⁶⁶ E.g. the 1995 municipal budget document is 396 pages long. A telling episode is that in the mid 1990s it took weeks of work for the head of the Mayor's Cabinet and an expert (me) – both with multi year experience in the municipality - to solve the simple task of digging out and calculating from budget figures how much the city actually spent for various tasks, like education, juvenile protection, etc.

The first formulation of the strategy, the Draft Concept for the 1996 Budget (later, Draft Concept) was an internal policy paper. It was a document presented to the Mayor's Cabinet⁶⁷ at the end of 1995, for discussion to build political and administrative support for the reform, but it was never made accessible to the wider public (see full text translated in the Annex 1).

The document argues for the necessity to change from the accountants approach to budgeting to strategic budget planning. It defines strategic budget planning as a process where:

“We attempt to position the given fiscal year in at least medium-term trends, to reckon with constraints and variable conditions. Processes can be encouraged or restricted, there is room to maneuver to rationalize the Municipality's operational structure for several years ahead, and to utilize the available scope of activity by clearly establishing priorities, and using financial constraints to enhance the desired changes in content” (Deputy Mayor of Budapest 1995, 1-2).

In mainstream terminology this means the intention to introduce multi-year forecasting and budget planning; connecting planning and financing; strategic management of institutional reform; and the use of financial incentives. Thus, strategic budget planning in Budapest conceptually means modernizing⁶⁸ reforms in budgetary planning and the declaration of a managerial approach to institutional reform.

⁶⁷ The Mayor's Cabinet is the advisory board of the mayor. The deputy Mayors, the heads of the coalition party fractions and chief administrators are permanent members. Depending on the topics discussed, the mayor invites staff or experts involved or other guests. All important proposals pass through before the Assembly debate.

⁶⁸ I use the word modernizing, instead of connecting the mechanisms to a given paradigm, because multi year forecasting and linking planning and financing are techniques not exclusively used in the managerial paradigm. These are mechanisms that were first introduced in budgeting through the modernizing reforms of the mid-twentieth century (Axelrod 1995, 281-9). Though the idea behind these innovations points towards a managerial approach, they do not yet signal the managerial paradigm. Nevertheless, there is a slight difference among paradigms: budgeting in the traditional paradigm can use these tools, but can also function without them; in the managerial paradigm these tools are needed in some form.

The objectives ⁶⁹ identified in the document are as follows:

1. Deal with public finance reform trends that are probable or can be influenced
2. Increase the scope of revenue possibilities
3. Build in 'shock absorption' for investments
4. Create realistic work plans and medium term investment planning
5. Enforce institutional reform while acknowledging professional autonomy of sectors and safeguarding functioning capacity

Under each objective, specific implementation mechanisms are listed. Most mechanisms pertain to micro-budgetary reform. Many of them contest an affinity to the managerial paradigm: privatization of public utilities in order to increase efficiency; conceptualization of user charges as an incentive on users and producers; asset management to create a positive value portfolio; rationalization of the institutions' operation through financial incentives and decentralization of management decisions to sectors.

Nevertheless, there are also important differences from reform components defined in mainstream literature. One is that the decentralized management is not yet coupled with a new accountability mechanism (like performance measures or audits), but only with fiscal squeeze

⁶⁹ The Budapest documents often use a terminology that is not in harmony with the terminology of mainstream literature. Moreover the terminology changes through the years. For the clarity of my discussion I have to use the same terms for the same content. In this document a statement is in the center (the aim is to introduce strategic budgeting). The central statement (aim of balanced budget) is called a 'strategic goal' in the final version of the strategy in 1997. Therefore, I use strategic goal from here on to define the main intention behind the strategy. Under the strategic goal, key components are listed, and in the later strategies supporting conditions. I will consistently call this level of the strategy objectives. Under the objectives, specific tools are introduced in each version of the strategy.

and some incentives. The logical explanation can be that, in absence of valid information, it was impossible to introduce new accountability mechanisms similar to those developed in Western countries. One can say that such decontrol was blind and naive. It was blind, as the squeeze was not based on calculations, and it was naive because it hoped that incentives were strong enough to secure cooperation of agents⁷⁰. By the same token, in the actual situation, this seemed to be the only option.

The other difference is that some tools were typically post-socialist as they were designed to act against systemic weaknesses inherited from the socialist system: against vertical bargains, political use of information and physical planning. More details on these follow later at the description of implementation steps in 1996.

The 1995 Draft Concept is a first declaration of the intention to implement a conceptual change in budgeting. It clearly stated the necessity for a strategic shift, and it was built on a combination of managerial reform tools and specific rules designed to break ingrained behaviors and solve the information problem.

The same declaration of the need for new strategy appears in the Budget Concept for 1996 that was approved by the Municipal Assembly at the end of the year 1995 (Office of the Mayor 1995, 3). This was a different level of decision than the Mayors Cabinet, as Budget Concepts are public documents, adopted by simple majority of the Assembly and binding on

⁷⁰ While performance measurement was not introduced, it must be noted that performance links existed: in the foundation charters of service units their tasks and certain performance criteria were defined, and the new sector laws passed in the mid 1990s further specified the deliverable services (see reference list for Acts on education, social services, etc).

further decisions. When Budget Concepts are adopted, the Assembly declares that it will use the rules defined for the budget planning of the following year.

In the 1996 Budget Concept the sentence following the declaration of the need for a new strategy, tells that until the launching of the reform process, the old accounting method will be applied – the residual treatment of capital investments⁷¹. This might look strange, but the leadership had no other alternative, as the CLI model, that could technically support the paradigm shift to strategic budgeting, was not applicable yet⁷².

The plan to establish an Institution Rationalization Fund⁷³ was also announced in the 1996 Budget Concept. Yet, it was only declared that the idea was to “offer support for rationalizing changes that are proportionate with the rationalizing result, and give the freedom to use the results of cost savings, with certain restrictions, within the given sector” (Office of the Mayor 1995, 5). This tool, even in this early formulation, was “typically managerial”: an output based incentive for efficiency increases, coupled with decentralized project design and management, with all this included in a pro forma contract between the institution and the Municipality. A more detailed description is given later.

⁷¹ By residual treatment of investment I mean that in the budgeting process before 1996, all operation and refurbishment expenditures had been budgeted and the remaining funds had been allocated to the capital investment projects. The CLI model and the 1996 strategy brought the paradigm change. After 1996, the targeted operating surplus was first determined which defined the proportions of operating and capital expenditures in the budget. Thereafter, all other (micro) decisions were adjusted to these macro figures.

⁷² Staff of the Mayor’s Cabinet and the budget department were already working with the French experts on the adaptation of the CLI model since the summer of 1995 in hopes that the tool would be applied for the 1996 budget concept, but time ran out and it would have been politically risky to introduce such an important mechanism without an adequate technical and political preparation.

First steps in implementation in 1995 and 1996

While the absence of an adequate data and processing mechanism rendered a systemic shift to strategic budgeting premature, important changes could be implemented along the objectives of the 1995 Draft Concept.

While main allocations for sectors were still planned incrementally according to base year proportions, sector ceilings were stabilized, and sector⁷⁴ management devolved. The new rule was that sectors could take new tasks only at the expense of the earlier tasks (Office of the Mayor 1995, 5). In practice this meant that the fiscal leadership only determined the aggregate sum allocated to the individual sectors, and the sectors then had the right to decide on the distribution of resources between various functions and service delivery units. Thus, withholding resources could be effectuated unevenly, based on the awareness of these conditions prevailing within the individual institutions. This is an approach to improving efficiency that acknowledges that departments and service units have better information in their specific domains, and that this localized information can be exploited for better decisions. Use of localized information is a managerial principle that directly opposes the myth of centralized information in the socialist paradigm. In the post-socialist context, it is important

⁷³ For a detailed presentation of the Rationalization Fund and its application in the Budapest municipality see Pallai 2003c 166-71.

⁷⁴ I use the word sector with the meaning of functional fields, like transport, education, waste management, etc. Each sector has a department or a sub-department in the city hall. Departments coordinate service delivery within the sector. They are guided by a Deputy Mayor and the relevant committees of the Assembly. I use the term management decentralized to sectors and not to departments as the relevant political actors often have close working contact with the departmental staff.

not only to increase operational efficiency, but also to change the culture of controlling information for political reasons and the practice of physical planning.

At the same time, defined ceilings produced pressure for efficiency. The new practice was a form of macro-micro budgeting: control over some macro blocks and micro decisions within the blocks were decentralized to departments. It aimed to harden budget constraints and incentivize sectors to optimize resources.

Another new rule was that changes in sector strategies and policies would only be approved if they contained an integrated financing concept as well. This rule was meant to break the physical planning tradition. All three objectives and tools mentioned, to the degree they were implemented, worked against the practice and culture of vertical bargaining.

1995-96 also witnessed the introduction of the CLI model⁷⁵. In 1995, the Budget Office and Cabinet staff worked with the French experts on the adaptation. Entries of the municipal budget, that was prepared according to the national regulations, had to be transferred one by one into the various categories of the model. This was great training for those involved to understand the logic of economic analysis of the budget. Thus, by the end of 1995, staff were already trained and committed to apply the new tool and concept.

When the data was fed into the model, the calculation confirmed the hypothesis of the structural deficit. The leadership spent 1996 persuading the other decision makers voting in

⁷⁵ For a detailed presentation of the CLI model and its application in the Budapest municipality see Pallai 2003c 155-62.

the Assembly of the validity of the new approach and of the main conclusions that could be deducted from the simulations. Key decision makers accepted the need for a conceptual shift in budgeting and the necessity of supporting budgeting decisions with a multi year analysis. The conditions that the tool and staff had prepared, and the realization of the need for the new technique were widely accepted, and opened the way to the institutionalization of the new mechanism. Institutionalization of the new routines related to the innovation is a key to sustainable reform (Bouckaert 2002, 28). As I will show, this was part of the implementation tactic and as such beyond the strategy documents, but key to lasting impact.

Before the decision on the 1997 Budget Concept at the end of the year, two other points also became widely accepted: (1) the municipal budget can be considered balanced if it manages to keep the capital expenditures at real value and at an acceptable level; (2) capital expenditures will be at an acceptable level if the operating surplus⁷⁶ reaches twenty percent of operating revenues and stays at that level (Deputy-Mayor of Budapest 1996, 3-4).

Here a note has to be made. The importance of a balanced budget beyond the year, an awareness of operating surplus, and the necessity of a capital budget were undeniable. At the same time, the two conclusions drawn from the model were political decisions that could be easily challenged. The targeted level of capital budget and operating surplus were both arbitrary decisions. In the actual situation, they could not be supported by any calculation, or sound argument. The fact that they were equally accepted signaled that only the need for change was accepted and the new logic was not necessarily understood or embraced by most

⁷⁶ Operating surplus means the surplus of current revenues above current expenditures.

decision makers. This reinforces the assumption of the importance of the elite decisions in the reform process, and as such, supports my choice of the Pollitt-Bouckaert conceptual model.

The reformulation of the strategy in 1996

The importance of the introduction of the CLI model can hardly be underestimated. The CLI model, originally a tool developed for assessing private sector creditworthiness, is a tool to analyze financial health of sub-sovereign borrowers. As such, it diverts attention from the yearly budget struggle to longer term trends and structural analysis of resource flows. This shift led to the paradigm change in budgeting and helped to harden local budget constraints⁷⁷.

The introduction of the concept of an operating surplus into the political debate and the calculation key budget trend indices helped the reformulation of the Budgeting Reform Strategy⁷⁸ (Office of the Mayor 1996, 2-7). A balanced budget became the strategic goal.⁷⁹ The necessary conditions of a balanced budget were defined through the twenty percent operating surplus and maintenance of the real value of the capital budget. The strategy for reaching these conditions was the simultaneous increase of revenues, the decrease of operating expenditures through institutional restructuring, and a priority to rationalizing

⁷⁷ The impact on budget agents, the claimants, was like Kornai's concept of hard budget constraint concept.

⁷⁸ While the dissertation raises serious concerns about technical assistance, the CLI assistance to Budapest was a strong positive case. The model was adapted for Budapest at the request of the municipality, at a time when the municipality realized the need for it and was prepared to make good use of it. The adaptation was a demand driven process, in contrary to most donor projects that are weakly targeted supply driven interventions (Pallai and Driscoll 2005).

⁷⁹ A detailed explanation of the concept of balance and the importance of the division of capital and operating budgets is given in Annex 9.

investments. According to the strategy, the capital budget resources remaining after the rationalization projects could be allocated to key strategic projects.

In financial terms all this meant a fiscal squeeze on operations resulting in a shifting balance of operating and capital budgets in the coming four or five years. It was anticipated that capital revenues from asset sales and privatization in addition to borrowing would fill the investment gap that resulted from the low operational surplus' during the transition years.

These were the key elements of the strategy that became a public document in November 1996. The Budget Concept was discussed and approved by the municipal Assembly and adopted as the basis for budget planning. The decision passed by simple majority. (The part of the 1997 Budget Concept containing the strategy is translated in Annex 2).

The concept of an operating surplus helped the leadership to conceptualize the goal, and its calculation helped to define the strategy and structure of the objectives more logically. In the reformulated strategy, instead of strategic budgeting (that is not a goal but a method), the goal became a sustainable balanced budget underpinned by the targeted operating surplus. The objectives and tools remained the same as in 1995, but were more logically structured by the leitmotiv of the operating surplus.

While the Draft Strategy was only a declaration of the goals, this document was already a strategy: it defined not only the aims, but also designed the way this aim could be achieved. This was a conceptual shift in planning. Instead of a socialist or bureaucratic technical plan focused on what to do, here the focus was on how to do it. This type of strategic planning aimed to optimize the route to goal attainment. In the strategy only the key goals and long

term approaches were fixed (e.g. elaboration of sector strategies that identify service screening and development targets). These factors were fixed to guide how shorter term implementation decisions would be made and adjusted to changing conditions. The firm hold over the goals and devolution of the implementation process is the essence of the strategic approach of the managerial paradigm. Thus, at the level of the BBRS, the change in planning methods and approaches qualifies as a definite leap to the managerial paradigm. That the BBRS produced a highly professional (highly strategic) strategy, makes it a unique case in the post-socialist region, where planning skills and strategic thinking are weak and strategic planning became an empty frame⁸⁰.

The coherence and compactness of a strategy is a key determinant of the strength of its impact. In the strategic approach, the development of the tools is underpinned by the logic of the strategy and objectives. The importance of compactness is that none of the components can be removed without sacrificing consistency. This made attacks against the implementation of the strategy difficult and helped to push new components through the decision process and get to implementation⁸¹.

⁸⁰ Thanks to donors' efforts and EU requirements, there is a mass production of local strategies in the post-socialist region. However, the products were very weak, in most cases they were not strategies. Pawel Swianiewicz stated in a dissertation defense at CEU in September 2006 "strategic planning became an empty frame" in the post-socialist region. The non-strategic nature of strategic planning was analyzed by Masa Djordjevic's dissertation at CEU and in various articles (Pallai and Driscoll 2005, Pallai 2006a and b).

⁸¹ Here it must be noted that the BBRS is a restrictive public management strategy of a large city's local government. As such, it is highly technical and includes many unpopular components that go against various group interests. This kind of strategy cannot be produced or implemented through a widely participatory method, but only through initiatives of the leadership. The role for the leadership is to build consent, not active stakeholder involvement. This is the reason why I apply the Pollitt-Bouckaert model for the analysis. As a supplementary factor, the imminent financial crisis required urgency – urgency in itself would exclude the time consuming participatory solution.

Even though the twenty percent operating surplus target and the requirement to maintain the real value of capital investments, were in principle set at arbitrary levels, they were not openly attacked. The targets were not achieved before 1998, but after the adoption of the strategy by the municipal Assembly, their relevance as reference points was not seriously challenged. The introduction of the new mechanisms was also, accepted relatively smoothly and only the tools whose implementation clearly failed were later negated.

One important note has to be made here. In any discussion or interview, when I asked the Deputy Mayor, or any member of his Cabinet Office, what supported the sustainability of the achievement, they rarely spoke about the strategy. At the same time, they never failed to mention the fact that the CLI model of calculation was institutionalized. They realized that institutionalized new routine had the strongest impact on the future. The calculation technique resulted in an environment where arguments had to be connected to the issue of the balance. The strategy was adopted, but could have at any time been changed by another Assembly decision. Changing the conceptual approach and the institutionalized working processes and techniques that the Finance Department applied was much more complicated and difficult. The result was that the 'reachable' operating surplus figure could be attacked year on year, but the relevance of it could no longer be negated. Thus, the institutionalization of the technique supported and stabilized the conceptual (paradigm) shift in budgeting.

The implementation between 1996 and 1998

From the very beginning it was obvious that it was easier to make relatively rational choices on new investment projects than reforming the operating finance of departments and the huge network of institutions. While reform of the whole budget was targeted, reform of the capital

budget was always ahead of the operating budget reforms.

The CLI model calculated revenue capacity and resources available for capital expenditure for seven years according to the hypotheses introduced in the model. This was a great support for reforming the CIP process in Budapest in 1996. The decision was to allocate the forecasted capital expenditure to sectors in proportion of their previous share from municipal capital investments. The resulting sums were set as ceilings for sector plans. Sectors prepared priority lists of projects, for each of the projects indicating costs over the next four years (after 1999, for the next seven years). Decisions on the order of priority was decentralized to sectors with the condition that decisions could not conflict with earlier decisions and strategies without adequate supporting arguments. A Plan Coordination Board was set up to check the compliance of the new proposals with already approved policies or to ask for adequate arguments supporting the deviation⁸². The part of the project list that could be financed by the resources allocated to the given sector was practically approved. Change of proportions, that is, reallocation of funds among sectors, had to be clearly supported and politically approved⁸³. The first four year CIP was part of the 1997 Budget Concept that was approved in November, 1996. From this time on, the mechanism was institutionalized and the CIP was designed year-by-year through a rolling planning mechanism.

⁸² A small Plan Coordination Unit was established whose role was to check whether proposals were in accordance with previous plans and decisions, or if they were not, were adequate reasons given for the deviation. Each new project proposal went through this control before a decision was made. The Plan Coordination Unit did not make decisions but only revealed the inconsistency. Nevertheless, this had a strong impact on the preparation of proposals and arguments (Office of the Mayor 1996b).

⁸³ For details more on the mechanism see Pallai 2003c, 176-83.

In the CIP mechanism, we again see the top-down control of macro figures and decentralized (bottom-up) micro management of project lists. Micro-budgetary management of project lists and proposals were controlled only through rules. They had to comply with or propose changes to earlier strategies and policies. Policy changes and reallocations among sectors, i.e., distributive decisions, were political decisions, made one by one. Hence, they were similar to traditional, incremental budget decisions, but the redistribution arguments still made a difference.

I have to make a note on borrowing, though – similar to privatization - the borrowing strategy was not elaborated as part of or as a consequence of the BBRs. The borrowing strategy preceded the BBRs. Since 1995 the Municipality had a borrowing strategy that - similar to the Draft Concept - was not a public document. It was prepared as a policy paper in the Deputy Mayor's Cabinet and discussed only in the Mayor's Cabinet. Its role was to clarify among city leaders the potential role and strategy of borrowing (Deputy Mayor 1995b). The borrowing strategy proposed using borrowing as an active facility to speed up implementation of key projects or for spreading the burden of payment to actual beneficiaries. It also declared that debt financing of projects could support improvements to project planning and preparation. The large revenues from utility privatization between 1995 and 1997 were crucial in implementing the borrowing policy: (1) the revenues could be used for “anticipated loan payments when such a move would bring financial gains; (2) the Municipality could use them to build up sizeable financial reserves in the form of government bonds and treasury bills” (Pallai 2003c, 188). This swap of loans, the financial reserves and the results of the reforms of

local financial management considerably improved the creditworthiness of the Municipality by 1998⁸⁴. Thus, capital budgeting and capital financing was considerably reformed.

The largest portion of the municipal budget was disbursed for operations. Service screening and increased operation efficiency were imperative according to the strategy. In the 1996 formulation of the strategy, that was adopted together with the 1997 Budget Concept, two tools were introduced for to implement these two objectives: (1) each sector was expected to design a Service Delivery Strategy that clearly identified what functions would be omitted, decreased or developed; and (2) the Rationalization Fund was established to facilitate operating cost savings.

The elaboration and endless discussions of the Service Delivery Strategies started in 1997 and by the end of 1998 had proved to be a nearly complete failure. Departments anachronistically attempted to bargain instead of plan. It became clear that they did not have the capacity to change their behavior and planning practices and think in terms of the strategy. They could not estimate costs beyond the year or see the longer term consequences of decisions. Although the lack of planning skills had been obvious since the beginning, the leadership did not support sectors with planning training or offer indicative guidelines⁸⁵. After the local election, at the end of 1998, the objective to develop Service Delivery Strategies disappeared from the reform agenda. In the Budget Concept for 1999 that was approved at the end of 1998 these strategies are no longer mentioned (Office of the Mayor, 1998).

⁸⁴ For more on the Budapest Borrowing policy and results see Pallai 2003c, 183-93.

The other tool designed to decrease operating costs, the Rationalization Fund, was more successful. In the following years, an increasing portion of the capital budget was allocated to the Fund. The Fund offered one time investment support to municipal institutions that: (1) could demonstrate that the investment would generate operating cost savings and produce a return on the investment over a given period; and (2) accepted that the calculated cost saving would be automatically deducted from their operating subsidies.

In this mechanism, decisions on total funds and return periods were controlled by the leadership, but project design, management and accountability was decentralized to institution heads. This was a managerial reform based on top-down control of goals and decentralized design and management. The advanced investment financing was a good incentive for institutions to reveal information on cost saving possibilities. The automatic deduction exercised the squeeze, and a strong accountability frame was also established through the contract made on the automatic decrease of operating subsidies.

The operation of the Fund was very successful and maintained until 2003. Many successful institutional restructuring projects were assisted by the Fund during this period. The application of the mechanism was only limited by the managerial and planning skills of institution heads⁸⁶, most of whom unfortunately did not have the capacity to design cost

⁸⁵ E.g. the six pragmatic and fundamental were questions developed before the 1994 Canadian Program Review started in order to guide the review process in sectors (Schick 2002, 25).

⁸⁶ A note on an interesting fact: As I mentioned, the lack of planning skills had become obvious earlier, by 1998. When the Service Delivery Strategies failed no attempt was made to offer training on planning or any kind of technical support for the process. In 2001, when the need for project preparation and management skills was obvious, the Cabinet Office of the Vice Mayor initiated a training program for departments in project design and management. The training probably helped EU project preparation, but the project design failure could not be fixed.

saving restructuring on larger or more complex dimensions (e.g. establishing common servicing units for similar institutions). The Fund was abolished, in 2003⁸⁷.when the leadership felt that most of the remaining cost savings were these type.

The innovations implemented until this point resulted in considerable changes to the budgeting process:

- The budget was made on the basis of multi year forecasts of trends and constraints.
- The adopted goal of budgeting became a sustainable balance, and the new mechanism of budget planning was centered around this goal. This rendered budget preparation more technical.
- The CLI model calculation that became part of the budgeting concepts, resulted in the separation of macro budget decisions from the debate on distributional and micro decisions. This helped frame budget debates and set constraints on decision making.
- The capital budget decisions, macro, distributional and micro processes were re-regulated.
- To achieve increased operating, efficiency, the Rationalization Fund was introduced which could support small steps of facility renewal and institutional restructuring.

Reformulation of the strategy in 1997

The strategy was slightly reformulated again in 1997 in the Budget Concept for 1998 (Office of the Mayor 1997, 2-7). There are two differences. One is that the phrasing became more strategic (e.g. this is the first time when the term strategic goal was used). The other

⁸⁷ Source of information is an interview made on August 17, 2006 with János Atkári, Deputy Mayor responsible for financial and economic affairs.

difference is that the shift from base financing to task financing appeared among the objectives. (The part on BBRS in the 1998 Budget Concept is translated in Annex 3).

The actual system of base financing meant that operating subsidies were disbursed among departments and institutions according to the previous year's proportions. This allowed only the same incremental or decremental change for all service units. Only a few specific cases were discussed at the Assembly where a different increment had to be defined. It was obvious that the financing level of various service units substantially differed due to the long years of applying such a financing method. Already the Draft Concept declared in 1995 that the 'lawnmower method' (i.e. across-the-board-cuts implemented through base financing) was impermissible and risky. Nevertheless, no systematic alternative was found. Task financing meant a zero based operating finance scheme where allocations were adjusted to performance⁸⁸. The plan was to be developed and introduced in the course of the following three or four years. If successfully introduced, the method could result in considerable cost savings and a paradigm change in budgeting.

Another aspect of the performance based task financing scheme was equally important. The systematic reform of operating finance was the last missing component of a consistent budgeting strategy. The strategic goal was the balanced budget. To reach this goal, it was declared that forecasting, integrated technical and financial planning and strategic use of capital resources were necessary; in addition to decreased operating costs. The CLI model, the new CIP mechanism, the Borrowing Strategy and the Service Reform Strategies, if successful,

⁸⁸ For details more on the mechanism see Pallai 2003c, 171-6.

covered the capital budget reform. At the same time, the Service Reform Strategies and the Rationalization Fund were tools for institutional restructuring. They facilitated individual steps towards cost savings, but did not supply an on-going and systematic incentive for efficient operational management. The task financing scheme was the only missing component to create the conditions to accomplish all of the objectives and the strategic goal.

Implementation in 1998 and 1999

In the following years the CLI model, the CIP scheme, the Rationalization Fund and the Borrowing Policy proved to be successful. As I mentioned earlier, the Sector Strategies failed and the introduction of the task financing scheme also failed.

The task financing scheme wanted to put all subsidies transferred to service units onto a calculation base, i.e. on zero base. After a monumental survey of all activities and each line-item in each service unit's budget, and complicated statistical maneuvers, part of the operating costs were successfully translated to norms. However, the translation of some other costs more connected to physical conditions and assets failed⁸⁹. Thus, the original plan also failed, as it could not fully associate financing norms with the parameters defining specific tasks.

In the budgeting literature the usual explanation for the failure of zero based schemes is the political resistance (Guess and LeLoup forthcoming, Chapter 7, 31). Some other authors claim that full zero based budgeting is unfeasible and has never been accomplished (Axelrod 1995,

⁸⁹ The factors that escaped the norms were the costs associated with buildings and equipments, and the revenues of institutions. No accepted method was designed to factor these costs and revenues in the allocation norms.

307). In Budapest the failure cannot be blamed on political resistance: the local leadership kept the effort alive until the consultants designing it admitted their incapability to complete it according to their contract, and no other consultant could be found who could complete the task. This squares with Axelrod's view. It indicates that here the plan was unrealistic. The failure will be addressed with a more detailed analysis later, after the detailed presentation of the planned task financing scheme.

The Key Mechanisms

After providing the chronology of the events, I give a more detailed discussion of the key mechanisms that were introduced as part of the BBRs.

The CLI model

The CLI model was a spreadsheet analysis that calculated various indices from the data introduced in the model and the hypothesis of future trends made by the users. The model divided the budget into three parts: (1) the operating budget; (2) the borrowing and debt service; and (3) the capital budget. The operating budget part of the model calculated the operating surplus as the difference of operating revenues and expenditure. The analysis of borrowings concentrated on debt servicing. Although debt service was a recurrent expenditure, its separated treatment was useful as it revealed the level of indebtedness. Loan and debt service items were classified between existing and new loans, to facilitate borrowing decisions. The capital budget included all annually non-recurrent revenues and expenditures.

The CLI model presented the factual data of the preceding three years and the projections for the following seven years. The user had to first feed the budgetary data of the preceding years and the planned figures for the actual year into the application. Using these figures, the model calculated the indices mentioned previously. Then the user had to define hypotheses for the future. The model granted total freedom to the user, who could come up with any kind of hypothesis based on factual or calculated figures in order to get the other relevant values calculated. For the accomplishment of an objective specified in the hypothesis, the model showed in figures the required changes in all the other related values.

The CLI model was a tool for macro budgetary analysis. The regular calculation of macro figures and the testing of consequences of policies in a multi year framework was crucial support for aggregate fiscal discipline – one of the three criteria of the common World Bank, IMF and EC scheme for evaluating financial management (PEFA 2005, 6).

In the Budapest strategy two conditions were determined as necessary to support the strategic goal of a sustainable balanced budget: (1) achieving a twenty percent operating surplus in the medium term and (2) maintaining the real value of capital expenditures. The model showed the operating cost consequences of this strategy on the basis of any accepted hypothesis of future revenue trends. As the calculation was simple and (after some training and education of users) obvious, debate was restricted to the hypothesis on future trends. The consequences of any unrealistic proposal were rapidly revealed by calculation. Thus, the simple technical model became a major support in the political struggle to lead Budapest's municipal management to a sustainable track.

After the expected macro budgetary figures were calculated with the CLI model, expenditure

ceilings were determined for the sectors⁹⁰ for the following seven years. This means that a Medium Term Expenditure Framework (MTEF) regulation was introduced. In Budapest, similarly to Australia, where the MTEF was applied with the most success, the medium term framework model is applied in a two-step budget process. In the Budget Concept, adopted months before the actual budget, decisions were made on the macro figures only, and without discussion of specific projects. On the basis of this decision, expenditure ceilings were determined for sectors which were then expected to prepare detailed budget proposals in the following months according to the ceilings. The process was also similar to the Australian in that most of the expenditure detail compiled in the proposals was devolved to departments, thereby freeing up the Cabinet for policy making on aggregates, allocations and policy changes resulting in reallocations (Schick 2001b, 5).

The MTEF model meant a new approach to cost savings. The earlier practice of across the board cuts had been a typically traditional type, purely top-down and input oriented method. The Draft Concept declared that simple across the board cuts were impermissible and risky (Deputy Mayor of Budapest 1995, 1). At the same time without good policy information it was difficult to assess the reserves in various service units' allocations. The MTEF implemented a different trajectory for cost savings than simple 'slicing' and thus it was an amendment to the traditional approach (Bouckaert 2002, 30). The two stage process allowed time for adjustments within sectors and the introduction of a bottom-up component in the final decision.

⁹⁰ I use the word sector for functional fields, like education, health, transport. I use the term sector, and not department, as the municipal budget separately lists allocations to the department responsible for sector policy and management and the specific institutions involved in the delivery of the services in the given field of activity.

CLI was not a specific managerial tool. Such models and MTEFs can also be used in governments run mostly under the traditional paradigm. Still, the logic fit better into the managerial paradigm, as it was a tool of macro budgetary control using expenditure targets and rules. Thus, it was indirectly a tool to guide and to decentralize micro-budgetary planning.

Beside these Western parallels and paradigms, the impact of the CLI model on the specific post-socialist weaknesses should be mentioned. First, the model made the impact of decisions on sustainability transparent, important information that could not be deduced from the municipal budget prepared according to the national regulations. Second, the model set a new agenda for the budget debate – instead of citing goals, proponents of projects had to argue for priorities according to accepted policies. Thus, the typical Kornai type vertical bargaining arguments, that had ruled budget debates before introduction of the scheme, were disqualified from the budget debate. Third, the imposed cost ceilings pushed agents to leave physical planning practices and include cost dimensions in planning. Fourth, in the environment of not being able to increase aggregate resources, the spending ceilings diverted discussion from new allocations to redistribution – to pursue new activities, agents had to reveal what could be decreased or terminated. In sum, the new order of budget discussion based on the CLI model, urged agents to step out of bargaining and physical planning, and use the information in their hands to make micro-budgetary suggestions according their policy priorities.

Capital investment planning

The earlier practice of individual treatment of new investment projects was already halted in 1992 when the Two Year CIP was prepared. During the preparation process, the sectors had to come up with full and prioritized lists of investment projects. The CIP filled up all

available financing resources, in 1993 when the CIP was adopted. As it was not possible to increase the overall envelope, a rule was adopted requiring new projects to be proposed only if the proponent could also argue which project would be substituted for it. This new rule was important to counter bargaining practices and improving planning skills. It made clear that projects compete for limited local resources – a very different approach than the socialist concept of getting the most out of common resources. The aim of making this new framework explicit was to encourage more responsible decision making and encourage better preparation of projects; thus, improving policy and planning skills.

After the introduction of the CLI model, the CIP process was modified, and the new, rolling planning mechanism was institutionalized in 1996. The new mechanism rested on the seven year financing projection of the CLI model. The programming was performed in two distinct steps. Using the Budget Concept, the Municipality prepared its resource projection and determined the sums assignable to capital expenditure over the next seven years. The resulting amount was allocated to sectors according to the previous years' proportions. The seven-year projection of available resources was revealed to the individual sectors at an early stage of the budgetary planning process. In the second step, each sector created a prioritized list of its proposals⁹¹. Projects from the list could be entered into the CIP up until the limit of the given allocation frame. The projects that did not fit into the allocation frames appeared as below the line-items during the internal negotiations. The importance of below the line projects was not questioned, but they could not be launched under the prevailing budgetary conditions. The sectors could advance more projects, i.e., challenge the positioning of the line, only to the

⁹¹ In the first two years, 1996 and 1997, the CIP proposal for the budget was only for four years ahead. Since 1997, that is the Budget Concept for 1999, the seven years CIP is applied.

detriment of the projects of other sectors. Such redistributions were political decisions that were first discussed in the Mayor's Cabinet and then proposed to the Assembly for decision.

Although the committees kept track of the apparatus' project proposals from their inception, they had the right to propose amendments during the Assembly debates as well. Finally, the General Assembly decided on the proposals set forth in the draft budget and approved the city's investment program⁹².

All positive features of the MTEF mentioned earlier can be repeated here: ceilings established and rationalized sector planning; limits encouraged better choices; decentralized decisions on priorities left energy for the leadership to focus on policy; the agenda set by the technical tools rationalized budget debates, etc. At the same time, it has to be noted that priority lists could not be deducted from longer term sector strategies in Budapest, as sector plans, according to the tradition of physical planning, still proposed fatally oversized packages and failed to establish priorities. I discuss later the failure to renew planning practices in general. Here, it only needs to be mentioned that this mechanism, without a supporting planning and evaluation tool meant there was only financial coordination which did not necessarily promote efficient allocation of resources that planning type budget reforms target in more developed practices (Schick 2002, 25-7). This will be discussed further below.

At the same time, the mechanism produced impacts that were important in the specific post-socialist struggle for information, planning tools and fought against the bargaining culture. This was a mechanism that established clear rules and procedures and clearly determined the

scope of decisions and level of discretion. By decentralizing priority setting, it optimized the information and judgments made at the sector level. Relying on the assumption of civil service ethics and the technical expertise of staff in their own technical domains, better decisions could be expected on priorities under this decentralized framework, than the decisions made by the leadership on the basis of the available weak sector plans. The multi-year programming and priority setting exercise also worked against the physical planning practice and the interest-representing bargaining game that had attempted to gain from fragmented, individual decisions.

The Rationalization Fund

According to the founder's formulation, the role of the Rationalization Fund was to "provide incentives for reducing the per unit operating costs through subsidizing one-time investments. In the longer run this makes it possible to maintain the quality of the services while continuously reducing the real value of the associated expenditures" (Office of the Mayor 1998, 4).

The operation of the fund was as follows: the financial criterion for the subsidy was the per unit return, i.e. the ratio between the one-time investment and the yearly reduction in the operating costs. Following the Budget Concept, a decision was made on the detailed conditions of the tenders. Municipality owned service units could apply for funds. The fund covered the costs of the transformations specified in the winning projects, but the municipal

⁹² For more detail on the mechanism see Pallai 2003d, 176-83.

budget automatically deducted the committed cuts in operating costs from the applicant's subsequent operating subsidies. While the committed operational cost saving was taken away from the specific service delivery unit, sixty percent of the savings was left for disposition within the sector. This way the fund granted interest-free investment loans for the institution and created a financial incentive for the sector to restructure. The Municipality of Budapest did not check if the projects were realistic (doing so would have led to endless and boundless debates). Instead, after the realization of the project, the city began to deduct – in installments – the previously committed cost reductions from the institution's subsidies.

The system left the decisions to those who had the necessary information. The financial leaders submitted proposals to the Assembly every year for sums to be allocated to the Rationalization Fund and for the returns criteria (i.e. financial criteria), in light of the Municipality's financing potential. The sector leaders decided on the content criteria of the selection, and were also in charge of identifying the projects to be supported in view of sector objectives and strategies. Finally, it fell on the head of the service unit to work out the project details and analyze the projected returns, since he or she was best informed of the situation within the institution.

For the service unit it was worth losing part of the subsidies in exchange for access to investment resources. The incentives for the sector leaders to explore the possibilities of rationalization included the latter consideration, as well as the fact that sixty percent of the savings could be used by the sector to finance its future quality investments. Consequently, the system provided ample incentives for cooperation with the financial leadership and – unlike the earlier practice of professional lobbying and bargaining – it endowed the institution and the sector leaders with genuine decision making responsibilities. Thus, the mechanism

meant decentralized decisions, along a clearly set performance target and with a new accountability mechanism – a perfect application of the managerial paradigm.

The Rationalization Fund successfully operated until 2003 when it was terminated. The explanation of the leadership at the time was that further rationalization necessitated such management skills that the institution heads did not have. In the early times, when obvious and simple cost savings could be targeted like heating or insulation repair or merging underutilized services units, the operation ran smoothly. Later, when costs savings could be achieved only through more complicated projects, institution directors did not have the management skills to plan, negotiate and implement such projects.

The limit was the weakness of planning and managerial skills – systemic problems in post-socialism. The logical remedial actions, like planning and management training for staff, was not applied⁹³. There was no attempt to systematically develop the planning and management skills that were necessary for the implementation of more complex rationalizing projects. This was a big mistake because due to this gap, the strategy implementation lost not only the information-revealing impact of the scheme, but also the huge asset of potential cooperative energies.

Another logical solution could have been to hire better managers. This option was not possible because according to the civil service regulation salaries were limited at a level that

⁹³ The municipality has a Human Resource department and each year human resource development (HDR) plans and programs are developed for each civil servant's professional education. This statement does not imply the absence of HDR activities. It states only that the strategy implementation was not connected to the HDR activity of the municipality.

was not attractive to skilled managers. The residual solution was to re-centralize certain decisions, sacrificing the localized information advantage and cooperative energy, and take rationalizing steps with the support of external expertise contracted by the leadership.

The task financing scheme

By the mid 1990s, it had become clear that while the Municipality was unable to finance the increase in the service units' projected expenditures, it had to find a solution for financing the mandatory tasks fulfilled by the service units.

The previously established base financing system⁹⁴ regarded the institution as the basic unit, and thus – without analyzing the fulfilled tasks – financed the expenditure of the service unit. Recorded figures did not even connect task and financing measures. Thus, the untransparent nature of base financing made it impossible for the municipal leadership to safely identify the reserves hidden in the system, and thus safely force the service units to increase their efficiency by limiting their access to certain resources. The aim was to introduce a new scheme that allocated financing to service delivery units according to the tasks (outputs) delivered. It also aimed to put the allocations fully on a calculation base, i.e., on zero base. Such financing, if achieved, could eliminate the differences in financing levels that had been produced by the long base financing practice, and adjust the fiscal squeeze to the differences.

⁹⁴ Base financing means that the institutions are allocated subsidies in the municipal budget on the basis of the previous year's figures (i.e., according to the previous year's proportions).

In 1997 The General Assembly decided to launch preparations for the transition from base financing to zero based task financing. It initiated screening of the complete institutional network, which entailed detailed analyses of the fulfilled tasks as well as the resources spent on these activities. (The relevant part of the strategy is translated in Annex 3). The results of this screening made it possible for the Municipality to create a detailed map of the Municipality's task and activity structure, and to evaluate each service unit's financial coverage. The accurate and detailed analysis of the activities and tasks enabled the Municipality to model the structure of the expenditures directly to specific tasks, and it could establish norms for subsidies associated with specific tasks (e.g. education of one secondary school student). The analysis of the level of actual financials made it possible for the Municipality to schedule the gradual elimination of the long-standing inequalities (i.e., to gradually bring the individual units' level of financing closer to the calculated values).

In 1998, the Municipality completed a shadow budget⁹⁵ alongside the official budget. The aim of the shadow budget was twofold: on the one hand it allowed control and necessary refinements of the new system; on the other hand it enabled the Municipality to compare and contrast the subsidies resulting from the old system with ones resulting from the new system, and plan the possible deflection of subsidies towards the calculated figures. The plan was for the Municipality to verify and refine the new system for three to four more years, and to gradually adjust the exorbitant values to the calculated values during this transition phase.

⁹⁵ Shadow budget means that the city drafts another budget along with the official budget. The aim of the shadow budget is exclusively to test and analyze certain hypotheses. The figures in the shadow budget do not in any form affect the allocation of budgetary resources.

By 1999, based on this data and the relevant regulations, the Municipality could calculate norms for at least part of the components of the institutional expenditures – the variable costs directly connected to task units (material and personnel expenditures). For other cost components, such as the costs related to buildings and equipment, certain specific subsidies, and the unit revenues, were practically impossible to establish from calculated norms.

Soon it became clear that a full analysis of the whole institutional sphere would present an enormous challenge to the professional staff working on the issue. The 2000 budgetary concept came up with the following compromise proposal:

“There is need to reduce the number of institutions involved. There is need to define the circle of sectors where zero-based budgeting can be introduced, and dates should also be specified for the transition”(Office of the Mayor 1999, 4).

Although the General Assembly had approved the proposal, the consulting firm in charge of elaborating the system could still not meet the requirements concerning the content elements in 2000, even with postponed deadlines. Gradually it became clear that the firm’s professional resources were insufficient to solve the problem. Since the Municipality could not find another consulting firm fit for accomplishing the task, the implementation of zero-based task financing ended in failure.

The planned task financing system was a performance based system. Financial norms were calculated to each task. A task was defined as a unit of output (teaching of one student, provision for one orphan, etc.). The system aimed to allocate resources to institutions according to the output units delivered. This was a strong version of performance budgeting – by the definition of Schick - as “expressly related increments in resources to increments in performance” (Schick 2001a, 49). The that the basis of calculation was the output, and not the

outcome, was not considered problematic, as regular checks on key outcome indicators was considered to be an adequate supplement of any activity or output based costing scheme. “By themselves, activity measures do not provide much of the information policy makers need to design and implement effective programs. But activity measures provide essential information for budgetary decisions and program managers” (Schick 2001a, 55).

The Budapest Municipality was thus close to establishing performance based operating financing. The task based norms for variable costs were prepared. The experiment failed, as most previous ZBB attempts, because it attempted to put all cost coverage on a calculation basis. Another option could have been the solution applied in New York state, where variable costs are computed on the basis of norms multiplied with work units and fixed costs are added (Schick 2001a, 57). On the basis of the first round of calculation the variable part was ready in Budapest as well. Thus, this technique could have been successfully implemented in Budapest and considerably improved transparency and institutional cost efficiency, as operating finances consume the bulk of municipal resources.

The shift from base finance budgeting to performance based budgeting clearly represents a turn towards the managerial paradigm. It is important to note that in Budapest the plan was not to go through strengthening line-item cost controls, but straight towards performance norms. There were no steps taken to restrict the freedom of departments in using resources⁹⁶, the new mechanism aimed only to adjust the financing levels. Severing control probably would have triggered strong opposition. The need was only to identify where reserves existed

⁹⁶ Practically the only restriction was on using capital resources for operation, but this is a basic sustainability and prudence criteria, the so called golden rule of budgeting.

as they were probably in the units that had the strongest interest representing capacity, enough of a counter weight. Even the failed story of the Budapest performance based task financing indicates that the way to managerial reform is not necessarily through traditional model.

Two notes have to be made here in order to place this in the Hungarian context. The first is that Hungarian regulations pose only minimal restrictions on the local budgeting process. Local governments have the choice to what extent they strengthen traditional micro control of line-items or go towards decontrol of management. Though in my conceptual framework it seems logical, it was not an obvious choice for Budapest to go straight in the managerial direction. Experience shows that many municipalities over emphasized the control requirements, and very few experiment with global budget allocations and decontrol of service units' financing rules (Szalai et al. 2002, 360-1).

The other note is, that according to the large survey of Hungarian local government budgeting practices made by Szalai et al. (2002), some other Hungarian municipalities also attempted to introduce formula based financing in certain domains. In most cases they attempted it only for operating cost financing or part thereof. Often the scheme was not implemented as experts claimed that it would require more funds. Szalai et al. concluded that the cause of the failure was that for Hungarian experts, the ZBB meant the application of a scientific calculation method for defining minimal costs. The failure of the Budapest scheme might be also blamed on the overly scientific approach targeting full calculation and rationality, as in Budapest shadow budgets prepared on the calculation base did not result in an aggregate cost increase, only redistribution of some resources.

Connecting planning and financing

In the case description, the sector strategies⁹⁷ were already mentioned as failed planning efforts. Here, it is necessary to speak about these and some other strategies in more detail as the link between budget decisions and policy priorities is a key theme of the budgeting literature and practice (PEFA 2005 and Schick 2002, 2001b and Axelrod 1995).

The coordination of planning and financing decisions was a component of the Budapest strategy since the first formulation, the 1995 Draft Concept. In the Draft Concept the design of development strategies and medium term sector strategies were planned⁹⁸.

The aim of the sector strategies was to define the structure of activity and servicing that corresponded to the new public sector approach and national regulation. The target of these strategies was to define what functions should be eliminated, decreased, or strengthened and what kind of new functions need to be developed. For such work, the political leadership could set principles and point out directions, and financial planning could define the foreseeable resource limits, but it clearly required sector-specific professional knowledge to draft the concepts and propose the necessary steps. In principle, the desirable activity structure could only be defined through a process that iterates among considerations pertinent to

⁹⁷ According to the wording used in Budapest, these sector strategies are called Task Fulfillment Concepts. However, as the meaning implied by the term is medium term sector strategy, for clarity of the discussion, I use sector strategy here and later.

⁹⁸ The wording in the Draft Concept is “strategic and mid term development concepts,” but these imply city development strategy and medium term sector strategies in mainstream terminology. For clarity I use the mainstream terms.

professional, political and the financial and planning. Design could only be successful if sector professionals want and can (i.e., have the necessary skills to) cooperate with financial staff.

Committed sector professionals socialized and educated in the previous regime, who had to play a cardinal role here, could not practically contribute to the process. They opposed rationalization in almost all cases when the filtering of activities was the obvious option.

The first problem was that the long tradition of physical planning debilitated skills to adjust desires to possibilities. Professionals had learned to think only about goals, objectives and projects – all ideas organized along the question of what would be desirable. The other components of planning, asking what is feasible had been intentionally neglected, as local planning had to support the vertical bargain for resources. Internal consistency and the rationality of this physical planning process meant that goals and objectives should supply adequate reasons for the specific projects. Thus, the lobby tool (the plan) is logical and consistent⁹⁹.

The idea of sector strategies was already part of the Draft Concept. A decision was made on the need for sector strategies in late 1996. Work on the strategies started in early 1997, and until the mid-year signs of the staff's incapability was visible. A long process of drafts, discussions with Cabinet staff and refusals started. Interestingly, even when the inability of

⁹⁹ Even traditional technical planning has a reversed logic: it starts from goals and objectives, and distinguishes between desirable and feasible. Strategic planning is even more different, as it deducts proposals from goals, but also aims to optimize intervention according to the goals – this means an equal representation of the *how* question and *what* question.

staff to plan became clear, no decision was made to offer training to improve their planning skills. Other support mechanisms were also not developed, like clear planning guidelines or defining key questions to answer, that could support the process. After two years of failed attempts, the process was dropped at the end of 1998.

Overlapping with the sector strategies, in 1997, another large planning initiative was also launched – the drafting of a city development strategy. The treatment of this project was the complete opposite of the treatment of the sector strategies. A decision was made not to make an attempt to design it in house, but to contract external experts through a public tender. The expert group was expected to work independently. The leadership did not guide or even comment on the work. At various phases, documents produced by the expert group were published as strategy drafts, and at the discretion of the expert group, professional and public meetings were held to discuss the drafts. In this process, the dichotomy of politics and technical planning, the fake dream of the traditional paradigm, was applied in the extreme: no involvement of politics, and an expectation that professionals alone could come up with the strategy¹⁰⁰. The final outcome was the document adopted by the Assembly in 2003 – a typical socialist plan including all possible goals and projects in a huge matrix that was meant to emanate air of rationality and consistency. The oversized plan could obviously not impact budget decisions, as it lacked strategy and priorities that could guide decisions and could be referred to for supporting anything included¹⁰¹.

¹⁰⁰ This is a misconception common among many post-socialist leaders. It is also reminiscent of the earlier mentioned scientific planning idea that is a deeply rooted socialist legacy.

¹⁰¹ While I must deeply criticize both the process and the outcome, I must also note that the “strategies” of comparable cities, like Prague and Warsaw, are the same type of rationally organized huge project matrixes.

It would be interesting to analyze the causes of the planning failure, but it is beyond the scope of this dissertation. For us here only the outcome is important – the Municipality did not have strategies and plans that defined clear priorities and strategies. In this context, adjustment of financial planning to other planning results was logically impossible. Decisions on financial allocations and plans could only be made according to personal convictions, or some personal, strategy ideas evolving from the minds of individual decision makers. In the absence of officially adopted strategies, allocation decisions depend on the strengths of interest representation, or idea representation¹⁰², of individual actors or parties.

Thus, from the three components of budgeting (macro, distributive and micro-budgeting), the distributive budgeting component¹⁰³ remained incremental and ad hoc in Budapest. The relevant component of the three accepted criteria of the Public Financial Management Performance Framework developed by the World Bank, IMF and the European Commission in a joint effort, is that “planning and executing the budget in line with government priorities contributes to implementation of government objectives” is just not applicable for Budapest (PEFA 2005, 1).

Moreover, it is a common problem of post-socialist local strategies in general that they conclude with such unusable documents (Pallai 2006a and b).

¹⁰² I included this unusual term “idea representation” to balance the selfish connotation of interest representation. I do not want to exclude those decision makers who make decisions following a certain ethos, and not on the basis of particular interests. However, here the result is the same, decisions are not made on the basis of agreed goals and rules.

¹⁰³ Distributive budgeting is responsible for strategic allocation of resources according to allocative efficiency (Schick 2001b and PEFA 2005).

The Resulting System of Budgeting

According to the tripartite division of budgetary analysis used in state of the art theory¹⁰⁴, the financial planning system that came out of the strategy in Budapest produced mixed results.

On the macro budgetary level, the CLI model introduced a mechanism that made the key factors of financial health and sustainability transparent. Thus, it supplied an adequate tool for macro budgetary analysis and planning. The institutionalization of the CLI model supported a paradigm change in budgeting process. The old routine of covering all recurrent requests first and using residual funds for capital investment was left behind. The new financial planning mechanism defined the targeted operating surplus first, and adjusted operating and capital resource allocations accordingly. Besides the paradigm change, three other consequences have to be mentioned: (1) the clearly set limits to operating and capital finance could not completely eliminate the bargaining, but by framing the budget debate, could considerably decrease its scope and extent; (2) a seven-year CIP process could be introduced that allowed better planning and financing of capital projects; and (3) a relatively predictable, but stable fiscal squeeze was exercised on operating finance.

Besides the planning support, the CLI model also offered good support for guiding budgetary decision making in the direction of fiscal discipline. The two stage budget planning process applied in Budapest is a widely accepted method that, if coupled with an adequate enforcement mechanism, is considered one of the best ways to both maintain balance and

¹⁰⁴ State of the art budgeting analysis use a tripartite division: (1) macro-budgetary planning and analysis; (2) distributive budgeting; and (3) micro-budgeting (Schick 2001b, 4).

boost efficiency (Schick 2001b, 7-8). The fact that estimates of budget ceilings were calculated and given at the start of the micro-budgetary planning process greatly facilitated the adjustment of the bottom-up micro-budgetary proposals to the top-down constraints. This two stage budget planning process can be considered a managerial approach, where the leadership keeps control over the goal of sustainability through macro budgetary ceilings and decentralizes micro-budgetary planning and management within the given frame.

On the level of distributive budgeting, two issues have to be assessed: the accordance of policy priorities and the effectiveness of expenditures. In relation to priorities, it should be assessed whether allocations and reallocations happened according to declared priorities and objectives. Effectiveness control, in principle can happen through program evaluations that assess the relation of targets and outcomes (Schick 2002, 25). In Budapest, in absence of accepted policy priorities and strategies, these questions are meaningless. In Budapest, distributive budgeting could only remain incremental and ad hoc.

Intuitively, the clear procedure on CIP seems to contradict to this strong statement on the weakness of distributive budgeting. However, on closer review, it is obvious that the clearly regulated process and decentralized design of the first proposals, in the absence of adopted strategies, does not equal priority based planning. It is a management and not a planning reform.

On micro-budgetary planning level, by 1997, we see the efforts to achieve a similar paradigm change as on the macro budgeting level. The goal at the micro-budgeting level was to decrease expenditure and encourage restructuring. One part of the plan was to introduce a new performance based financing system – in principle, the strongest tool of increasing operating

efficiency. The planned performance budgeting was a strictly rule-based allocation mechanism that adjusted financial resources to outputs. As such it would have decentralized micro-level management and would have encouraged cost savings. Performance budgeting meant a paradigm shift compared to the earlier mechanism that had incrementally adjusted input allocations to the previous year's figures and new requests. If implemented, performance budgeting would have signaled a clear leap to a tool belonging to the managerial paradigm. Failure to develop and introduce the planned performance based budgeting was a major weakness of the strategy implementation.

In a stable situation, performance budgeting alone can be considered an adequate incentive to achieve efficient operations (Schick 2001a. 58). This is especially true when applied under a fiscal squeeze. In the post-socialist context, larger scale investments are also needed when major institutional restructuring is necessary. Performance budgeting in itself is not designed to supply such resources. It was the role of the Rationalization Fund to cater for such one time interventions. Allocation criteria in the Rationalization Fund was the recovery time of funds, thus, it was again a clearly managerial type, rule-based mechanism that decentralized micro-level management and encouraged cost savings. In principle, the two mechanisms together, if adequately implemented, could supply incentives for cost efficiency both in recurrent financings and one-time, larger capital investment needs.

In sum, the plan for managerial type budgetary reforms at the macro and micro-budget level was complete, but the implementation was only partial. At the same time, the planning type reform necessary to reform distributive budgeting did not happen because strategic and sector planning failed. As the goal of the inquiry is to decide the direction of the changes in relation to the paradigms, it is important to note the third type, the control type reforms as well as

traditional, is underpinned by strengthened control mechanisms. In the BBRS, control was strengthened only over balancing requirements, but this meant the control of a key goal of the reform process – thus part of managerial paradigm. At the same time, strengthening line-item control, the typical feature of the budgeting in the traditional paradigm, was not even targeted.

Chapter 7. Case Analysis

In the previous chapter I presented the events and key steps in strategy drafting and introduction of reform mechanisms in a chronological order. I discussed the key mechanisms and tools that were introduced as a consequence of the reform strategy and the impacts achieved by 1999. In this chapter I discuss and evaluate BBRS in reference to international standards and assess the results achieved. In the closing I summarize an evaluation of the components to define the direction of changes with reference to the paradigms.

Evaluation of the Strategy

Most of the points that are summarized here have already been made in the previous chapters. The new element in this first part of the chapter is the evaluation. Evaluation is done from four angles. The first compares the strategy and its components with international standards developed for the evaluation of budgeting and financial management. The second discusses the strategy from the angle of post-socialist transformation, reviewing how the strategy aimed to deal with the inherited systemic weaknesses. These first two parts evaluate the strategy as a plan for actions. The third and fourth parts look at the results of the implementation and changes resulting from the strategy. In the third part, I discuss how much of the strategy could

be implemented and in the final part I look at the implementation results.

Comparison of the strategy with international standards

According to the standards accepted by the largest international financial institutions, the World Bank and IMF, a budgeting evaluation should focus on the “assessment of the extent to which the existing system of public financial management supports the achievement of aggregate fiscal discipline, strategic allocation of resources and efficient service delivery” (PEFA 2005, 6). In the first part of the analysis I discuss how much the BBRS could comply with these standards. By strategy, I mean to the text of the documents and not the accomplishments. Thus, this first review is of to the declared intentions.

In 1995, the Draft Concept argued the necessity of changing the ‘accountants approach’ to budgeting to ‘strategic budget planning, as it was already clear that revenue trends could not maintain of the level of expenditures, the operation of services and institutions on the same level costs. It is more accurate to say that the leadership clearly realized the need for change, and for them change did not mean cutting costs only, but reconsidering public sector roles, the structure and content of services the Municipality provided and the mechanisms applied for service provision. Since the beginning of the transition, when the new leadership was first elected, it made repeated attempts to develop a strategy for comprehensive reform. During the first summer in 1991, the Mayor published his first urban policy program and initiated public debate about it. In 1994, he ran the election campaign with a program that focused on local public management reform – a peculiar choice for an election program (Alliance of Free Democrats 1991 and 1994). As I already mentioned, the earlier programs could not elaborate a strategy yet, but were very important for the evolution of reform ideas, and clearly

demonstrate the intention for substantial reform. At the same time, at the time of the 1995 financial crisis, the argument that could effectively support a reform strategy – that contained many restrictive components – could only emphasize the necessity of cost savings.

While the argument about the unavoidable nature of change was based on the decreasing resources, the strategy clearly stated that the spending decreases must be the result of better planning and institutional restructuring. The role of strategic budget planning was to support strategic management of resources and institutional reform. For these goals the following measures were targeted: (1) introducing multi-year forecasting and budget planning; (2) connecting planning to financing and; (3) using financial incentives for institutional restructuring and increasing cost efficiency. These three components point to the three levels of budgeting: macro, distributive and micro-budgeting. Thus, these elements reflected consistency with international standards. Planning and management type budget reforms were announced by the Draft Concept, but only broad directions were declared, and the real content of later reforms was not clear yet.

In 1996 the introduction of the CLI model and the concept of an operating surplus led to a reformulation of ideas and to the first formulation of a real strategy. Achieving a balanced budget became the strategic goal, and the necessary conditions of a balanced budget were defined as a twenty percent operating surplus and maintenance of the real value of the capital budget. From the context it was clear that decreasing amounts of intergovernmental resources could be expected in the following years and that an increase of revenues could not be expected to offset these losses completely. In order to reach a sustainable balance the strategy defined the following objectives: (1) exercise a fiscal squeeze on the operating budget and introduce incentives in operations to increase cost efficiency and shift the balance of operating

and capital budgets; (2) use capital revenues to cover the investment gap until the time when the operating surplus target could be reached; (3) use the remaining capital resources for strategic projects; and (4) use borrowing as an active facility. This formulation was already a strategy, as not only the goal and objectives were declared, but the way to achieving it was also determined and adjusted to the foreseeable conditions of the context.

This strategy formulation already explicitly covered the (earlier discussed) three assessment criteria of PEFA: aggregate fiscal discipline, strategic allocation of resources, and operating efficiency.

On the level of macro budgeting, the goal was to achieve a twenty percent operating surplus and a stable level of capital investments. The two stage budget process that, by changing the order of budget planning, brought the operating surplus to the center was the key tool for accomplishing this goal. According to state of the art theory, this two stage MTEF is a better method of fiscal squeeze than simply top-down, across the board cuts, as it also contains a bottom-up adjustment component that can possibly lead to better decisions (Bouckaert 2002, 30). Scholars also note that this is the mechanism most successfully applied in macro budgeting in the developed World (Schick 2001b, 6-7).

On the level of distributive budgeting, the goal was strategic alignment of planning and budgeting. According to the plan the supporting pillars were: the drafting of a strategic plan; sector strategies for service delivery and restructuring and; the introduction of the multi-year CIP. If plans had been drafted and their implementation completed with regular strategy and program reviews, in principle, the strategic allocation of resources could have been secured.

On the level of micro-budgetary planning, by 1997, we see the same consistent strategy as on the level of macro budgeting. The goal on the level of micro-budgeting was to decrease expenditures through efficiency increases and encourage restructuring that would provide better quality and more efficient and effective service delivery. In principle, the sector strategies should have revealed the directions of restructuring and service development. The macro squeeze on operating finance, caused by limited resources and the targeted increase of operating surplus, exercised a strong push factor. According to the plan, the squeeze should have been coupled with new mechanisms to encourage efficient micro-budgetary planning and management.

One part of the plan was to introduce a new performance based financing system – in principle, the strongest tool to increase operating efficiency, if it is coupled with the decontrol of micro-budgeting. In principle, it is a perfect new managerial tool. In Budapest the performance based allocation would have introduced a similar cost ceiling for service units as the one for sectors in the capital allocations, and the ceilings would have had an impact on efficiency.

It is important to note one difference between the Western experience and Budapest. When performance budgeting is applied in a government that was previously operating on the basis of traditional line-item control, performance budgeting is implemented with parallel decontrol of micro-budgetary management in order to allow flexible decisions on cost savings. In the post-socialist context of Budapest, in the absence of effective previous line-item input control,

not much decontrol was practically needed¹⁰⁵. In the Budapest strategy the only important decontrol component was the decision to share the result of cost savings with sectors. I already mentioned that the savings resulting from Rationalization Fund projects were deducted from the budget of service units, but sixty percent of it remained at the discretion of the sector to incentivize them to be partners in cost savings. In the regular budgeting of service units, to strengthen independent and responsible financial management, units received discretion¹⁰⁶ over their own revenue sources retained the possibility of shifting unused funds from one year to the following. This decentralized discretion is a very important principle that demonstrates the intention to strengthen decentralized management. The earlier mentioned large survey of Szalai et. al revealed that most municipalities in Hungary also decided to navigate in this direction and only a few deprived service units from such funds (Szalai et al 2002, 379).

In a stable situation, a performance budget coupled with decontrolled financial management is considered an adequate tool for incentivizing efficient operations. In the post-socialist context, where not only efficiency increases were needed, but also a considerable screening of functions and restructuring of service delivery, larger scale investments were often needed. The Rationalization Fund had to cater for such one time interventions. In principle, these mechanisms – task financing, decentralized management and the Rationalization Fund –

¹⁰⁵ Decentralization and decontrol of management are terms used equally in the description of Western managerial reforms. In the case of Budapest I use only the term decentralized management, which refers to the result and not decontrol to reflect the transition from the traditional to managerial paradigm.

¹⁰⁶ I use the word “discretion” here, as the principle is true as an intention during the whole period, but year-by-year the exact rules were defined in the frame of budget decrees. These rules in some years – when financial stress on the municipality made it unavoidable – prescribed a sharing of these resources.

together, if adequately implemented, could supply both incentive and the possibility to improve efficiency in service units.

The paragraphs above looked at the three PEFA criteria for the assessment of the financial management system. As a conclusion of my analysis of the public management reform literature, I arrived at three different criteria for the new managerial paradigm: (1) central control on policy goals and macro-budgeting; (2) decentralized (micro) management decisions and; (3) an adequate accountability framework that constrains managers to work in the direction of the determined public goals. I have not yet discussed this last component - the accountability framework. In Western texts, the managerial accountability framework is based mostly on a PMS (or performance contract and PMS) and the personal responsibility of managers for performance. The question in Budapest is: what is the new accountability framework in the absence of a PMS?

Instead of the routine answer that a manager's accountability is for performance that has to be tracked by a PMS, let us look at the causes and the logic behind this statement. The goal of the accountability framework is to *make managers manage* along the lines of the public goals. In Budapest, when municipal institutions were transformed to independent service units, a founding charter defined the duties of each unit, the relevant regulations of activities, their relation to the municipal government and the tasks and responsibilities of their directors (managers). During the 1990s, the new national sector laws introduced a clear, and mostly output based regulation of services. These national laws and regulations clearly defined

performance content and standards¹⁰⁷. This component of the Hungarian context is a key supporting element for the managerial turn of BBRs. Local regulation could further specify and attach any performance rule that reflected local policy priorities within the scope allowed by the national laws. Managers became personally accountable for producing the service results¹⁰⁸.

One more important component of the new accountability framework is the relation to clients. The possibility to control revenue generation established a new relationship with clients. Those who used the services where a contribution was required, also became also customers of the service units, that is a 'performance monitoring agent.' Moreover, in most sectors, except for utility services where there was only one provider, since the transition, clients could choose their provider (e.g. parents chose schools, patients chose doctors, etc.). This created competition among providers and strengthened the 'customer's' position.

All the above shows that the possibility for a new accountability framework evolved in Hungary: output regulation, personal accountability of managers and the customer position of service users. These are the components offered by the intergovernmental framework. In Budapest, the local rules decentralizing service units' management, the local incentive system that urged service units to earn their own sources of revenue, and the other local financial incentives are the components of BBRs designed to exploit and strengthen the potential

¹⁰⁷ Here the output based regulation is important because it represents a difficult conceptual shift from socialist regulation that has not been achieved in many post-socialist countries.

¹⁰⁸ Consequent from Law on Public Finance (Act XXXVIII of 1992).

impact of those components of the national framework that could support the shift to the managerial paradigm.

In sum I conclude that at the level of the strategy formulation, the BBRS was a strategy for managerial type reform. The new mechanisms, the performance budget coupled with sector strategies and the Rationalization Fund, all operated on managerial logic. The firm hold on the goals, the use of incentives to increase operating efficiency, the decontrol of operation management and the new accountability framework based on performance, were the essential components of the strategic approach of the managerial paradigm.

Dealing with specific post-socialist weaknesses

As I discussed earlier, in the socialist system the general behavior of the local government was directed to the vertical bargain. Soft budget constraint was both the result of and the necessary condition for the bargain. Political use of information, focus on wishes, physical planning neglected cost dimensions and the resulting huge lists of potential projects supported the bargain. The result was an absence of information needed for responsible policy making and weak planning and management skills.

In Hungary after the political transition, the budget constraints of local governments became firm and planning and decision making was to a large extent liberated from the vertical dependence. Within local governments the bargaining culture still prevailed, however, between institutions and departments and departments and the leadership; staff exploited the lack of adequate information systems that could supply data on higher levels to make rationalizing decisions.

In this situation, the CLI model had a symbolic meaning. The hard constraints were demonstrated by the fact that it made key budget figures transparent and helped show the limits of local government financing. It made clear that instead the perceived 'common grazing field' of a socialist national budget, the resources within the local government were strictly limited, and the limits were not only for the year, but instead, would constrain actions over the long run. This is a signal that more prudent planning would be required.

The regulation that new projects (both capital investments and new activities) could be suggested only at the detriment of other projects, strengthened the competition for resources and, in principle, urged better planning and the construction of better arguments based on clear data sets. The new CIP mechanism, that decentralized the priority setting according to defined resources to the sectors, in principle, should have worked against physical planning and for the inclusion of cost and feasibility dimensions in the planning process. The fact that decentralization could mean only that project lists prepared by sectors set the agenda for final political decisions in the Assembly, and that all redistribution decisions were made in the Assembly, also encouraged better planning and preparation of supporting materials for projects. These conditions generated the need for valid information and supporting arguments for projects.

The Rationalization Fund operated on the same logic. It decentralized project design and decisions. It was even stronger in pushing for the generation of information and better planning, as institutions bore the full responsibility for planning results because planned savings were automatically deducted from future subsidies. This left no room for the bargain. At the same time, no attempt was made to centralize information, as the information generated was locally used in the given institution. Thus, the scheme is built on a managerial

logic and was aimed not to work under the old withholding instinct.

The effort of the leadership to change planning practices was obvious. All these mechanisms encouraged better planning. Staff were encouraged to abandon physical planning practices, to generate valid information for planning, and integrate financing and feasibility considerations into planning. It was also obvious that success would be possible only if staff could make a quantum leap in planning. It reflects either a naive belief that incentives can do everything, or a mistake, that no technical support or systematic training was part of this policy package that would have helped civil servants to improve their planning skills and change their habits.

The goal of task financing was clear: take out the bargaining dimension of institutional finance (and end the resulting inequalities) by putting the allocation of resources on a calculation basis. Such a scheme could not be designed on localized information as had the other tools. A huge survey had to analyze budget items for each service unit. When introduced, the scheme would have encouraged localized use of information, better planning and more responsible management. The shift from socialist to managerial was obvious here as well. Instead of institution based, tasks, there was performance based financing, instead of un-transparent and discretionary it was transparent, rule and objective based; and all this was coupled with managerial discretion over resource use.

It is also an important component of the reform process that all these new mechanisms aimed to put financial planning and decision making on a systemic basis. The goal was to change the un-transparent negotiations of the earlier regime into a transparent, rule-based mechanism where the scope for decision and discretion was regulated and the outcomes less dependent on personal networks. This is a paradigm shift in management.

Implementation of the strategy

The targeted three levels of budgetary reforms were obvious in the strategy. However, as I discussed earlier, only part of the targeted components could be implemented. Thus, implementation diverted actual results from the targeted ones.

On the level of macro-budgeting, the CLI model and the two-stage budget planning process were the mechanisms planned to maintain the aggregate balance. The two-stage process was not a new element as the national regulations prescribed the preparation of budget concepts. However, according to the regulations, the budget concepts had to consider only the outlook for the following year. The seven year outlook and the CLI model showing macro figures and the impact of planned policies on the trends of these figures, were new elements in Budapest. The introduction of the CLI model was successful, as I will show later, the new planning process, in the hand of the leadership, was strong enough to lead to the accomplishment of macro-budgetary goals.

On the level of distributive budgeting, the reform brought mixed results. The goal to integrate planning and financial management failed because of the failure of strategic and sector planning. Distributive decision making remained not only incremental, but ad hoc in the sense that most decisions could not be related to adopted policies and priorities. Thus, the objectives defined in the strategy were not accomplished in this sphere.

At the same time, some improvement was made in the distributive budgeting process. The institutionalization of the rolling, seven-years CIP made the process transparent and defined a clear scope for decision and discretion within each budget agency and decision making body. It also devolved priority setting within sectors and linked the sources of information and

decision. Sector lists set the agenda for budget debates on CIP. Decentralizing the task of creating priority lists to the sectors introduced a bottom-up element, and was an incentive to improve planning and encourage optimization of resource use.

Operating budget redistribution remained entirely political, but the obvious competition for decreasing resources also called for good supporting arguments that in turn encouraged improved planning. In sum, the objective based managerial transformation could not happen due to the lack of planning skills, but at least a more rational and rule-based system was introduced. Transparency and rule-based systems are characteristics of both the traditional and managerial paradigm. The difference between the traditional and managerial paradigm is its objective basis, thus, its absence is a gap in the BBRS implementation compared to the managerial agenda.

On the micro-budgetary level, the planned role of the sector strategies and the Rationalization Fund was to facilitate individual steps of cost saving interventions. The fiscal squeeze resulting from macro-budgeting, and the new task financing were intended to supply an ongoing and systematic incentive for efficient operational management. All these were coupled with decentralized management. As both the sector strategies and the task financing scheme failed, only the fiscal squeeze, decentralized management and the support of one time investments remained. These three tools obviously produced pressure for efficiency increases and offered some scope for it as well. The package was, nevertheless, far from a sophisticated managerial model. The first statement of the Draft Concept, and the reason for launching the reform process in Budapest, had been to impose a fiscal squeeze along with other techniques. The Rationalization Fund was an obvious success. The accountability framework offered by the national regulation and strengthened by local policies, was a supporting component, but

did not make the fiscal squeeze more sophisticated than the across the board-cuts. The only improvement in this field was the multi year planning and two stage budget process that made the constraints transparent and hard, and allowed time for adjustment to the already more predictable resources. In sum, the direction is managerial, but only small steps could yet be achieved.

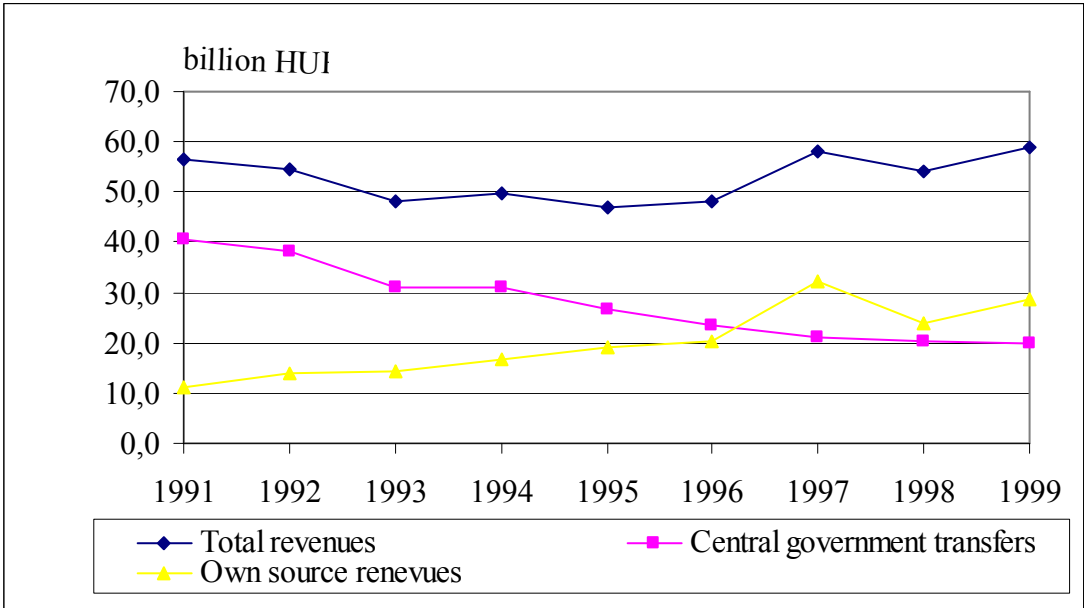
Implementation results

The strategic goal of a balanced budget means maintaining aggregate fiscal discipline. After the introduction of the CLI model, this goal was effectively put in the center of the budgeting process.

Each formulation of the BBRS was based on the following projections: (1) “current revenues will not grow at real value, and even from 2000 on, only the maintenance of the real value can be expected; (2) revenues from asset utilization (privatization, sale of real property and portfolio assets), which are the basic components of accumulation and capital type revenues, would necessarily dry up” (Office of the Mayor 1996, 3).

The inference was that own current revenues had to be increased to maintain an aggregate level of resources. Chart 1 below shows the revenue trends in real value. The figures contest the decrease of intergovernmental transfers, the success of increasing own revenues, and even shows some increase of the real value of aggregate resources.

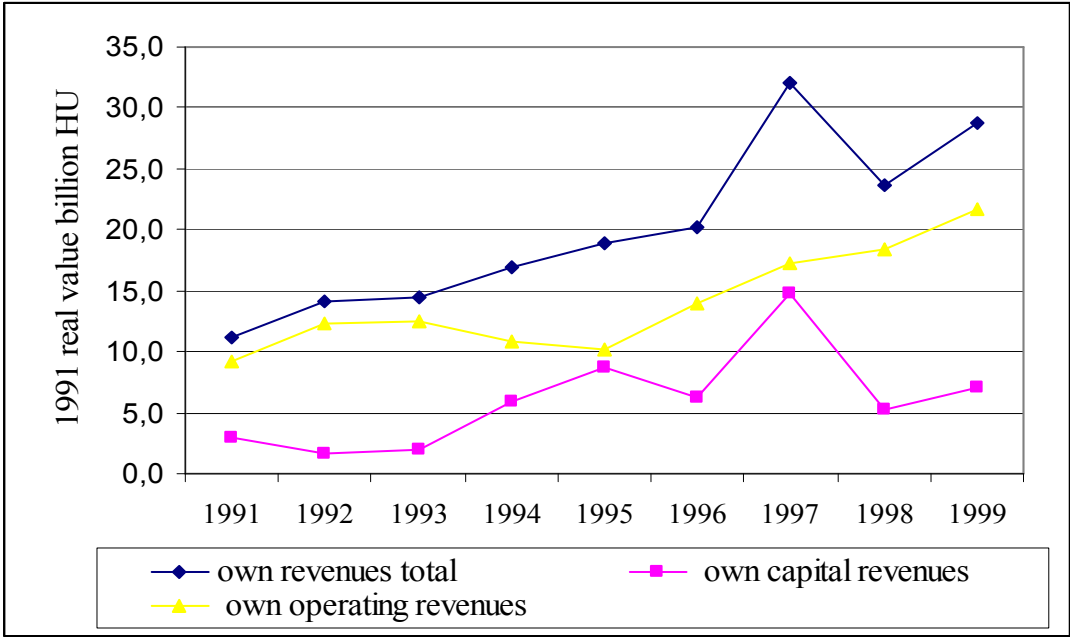
Chart 1: Revenue types between 1991 and 1999



Source: Ray, 2002

If we separate the revenues to own operating and capital revenues – as shown in Chart 2 - we see that after 1995, a rapid increase of own operating revenues started. The extraordinary figure of 1997 capital revenues is the consequence of the privatization of two major utilities, the waterworks and the sewage company (the two transactions together amounted to twenty percent of the municipal revenues of the given year). This second chart shows that the increasing operating revenue was not only successful, but according to the BBRs, it was gradually taking over the own revenue earning function from the capital side.

Chart 2: Own revenues between 1991 and 1999



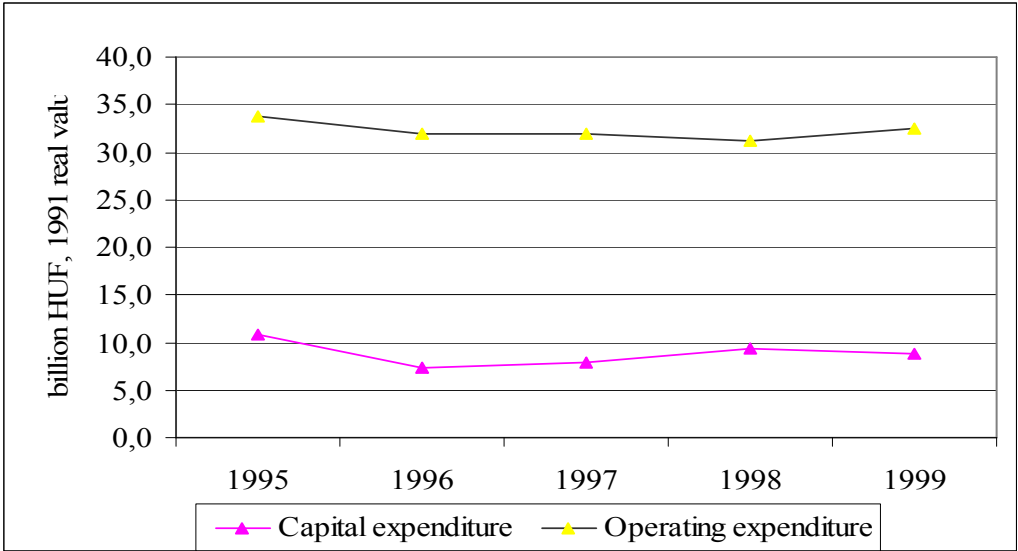
Source: Ray, 2002

The first two charts also show that the revenue projections on the non-increasing real value of total revenues proved strongly conservative. Thanks to the success of own operating revenue, the total level of resources also increased.

In the BBRs, the assumption was that the twenty percent operating surplus and maintenance of real value of investments could create the conditions for sustainable service delivery. These two conditions were defined as targets to be reached in the course of a few years and then to

be maintained. This meant that after the drying up of capital revenues, the twenty percent operating surplus alone would create a sustainable balance and until the time when the operating surplus could be reached, capital revenues and borrowing could fill the investment gap. Analysis of budget figures show that in the subject period between 1995 and 1999, the real value of capital expenditure could be maintained, the decrease of operating resources could be halted and an increasing operating surplus contributed to the resources available for capital investments. (See diagrams in Annex 11).

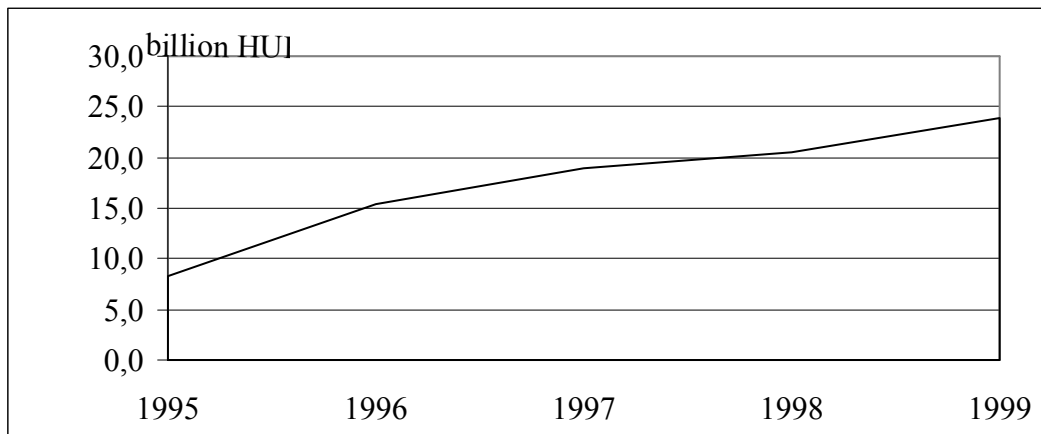
Chart 2: Trend of operating and capital expenditure between 1995 and 1999



Source: Ray, 2002

As Chart 3 shows, the key target, increasing the operating surplus to twenty percent was reached in three years.

Chart 3: Operating surplus between 1995 and 1999



Source: CLI model calculations, 1997-2000

The budget figures contest on the successfulness of controlling aggregate sums. This means that the CLI model forecasts and the two-stage budget planning process, in the hands of the leadership, were strong enough to accomplish the macro-budgetary goals.

On the distributive budget level, it is more difficult to assess the results. As strategies did not set priorities, and plans in all sectors included proportionally oversized project lists, the only conclusion that can be reached is that the approved projects did not contradict the approved plans. However, this does not really indicate strategic allocations.

It is even more impossible to assess the results of micro-budgetary reforms. The constantly varying tasks, obligatory conditions and the changing regulation of various cost components (salaries, material expenses, etc.) make precise assessment impossible. It can only be stated

that the new sector laws defining minimal service levels and standards for institutions, and some of the other regulatory changes relevant to local service delivery, increased the resource need of services under unchanged delivery mechanisms. The fact that a stable level of operating expenditures could cover the costs of improving quality and increasing quantity of services, supports the view that efficiency increased. At the same time, in the condition of cash based financing and weak monitoring of asset conditions and asset related finances, such statements are only weakly indicative.

After the long stock taking of success and failure, I attempt a summary assessment of the strategy implementation. The reform process started in 1995 because, according to the Draft Concept, it became obvious to the leadership that the fiscal squeeze and across the board cutting in isolation was risky. It could unintentionally undermine operations which began with lower than average financing levels. By 1999 the Municipality accomplished many important budgeting process reforms that helped cut costs, restructure and improve efficiency. Budgeting as a mechanism became more transparent, better organized and the financial health of the Municipality improved considerably. Nevertheless, in 1999 (and today as well), due to the failure of planning and task financing, the fiscal squeeze was still the key incentive for cost savings.

The Paradigm Change

In the Conceptual Framework chapter I summarized those characteristics of the three paradigms that are most pertinent to budgeting reform: the type of planning and policy

process, rules, implementation, use of information, basis and constraints of budgeting. Here in the closing part of the chapter, after the detailed evaluation, I discuss the direction of the reform components and the strategy as a whole in relation to the traditional and managerial paradigms. The task is to identify which components point towards the traditional paradigm and which components point towards the managerial paradigm and why.

One key difference among the paradigms is how they plan. I have already discussed in detail the difference between socialist physical planning and traditional technical planning. At the same time I also mentioned that both conclude in plans. The role of plans is to define what should be implemented in the following years. Implementation of the plans in the socialist paradigm entails discretion. In the traditional paradigm, systematic top-down regulation guides the implementation of policies and plans. The managerial paradigm typically operates with strategies. I have also already discussed that a longer term strategy is built on goals and means. The strategy is an overall idea on how to implement the goals. Decisions on implementation details are made at times when the implementation conditions are clear and at lower levels where specific information relevant to the decision is available. Incentives and accountability mechanisms link the goals and management of the implementation.

The BBRS fits perfectly into this concept of managerial strategy drafting. It is built on the clearly formulated goal of a sustainable budget balance. Only the necessary conditions are fixed for the long term; the type of mechanisms that will guide the implementation of the goal; and the process for implementation is adjusted to changing conditions. This is a strategic approach, and at strategy formulation level, a conceptual shift to the managerial paradigm. At the same time, it must be noted that this success was achieved within the background of complete failure of other plans to shift from the physical planning tradition to the strategic

approach. This was (and is) the only strategy of the Municipality.

The control of macro figures through the two stage macro-budgetary planning process is also managerial: as macro indices secure goal attainment, their control means control of the goal. The expenditure ceilings given to departments, and the freedom of departments to manage their domains, can be equally explained as a managerial type decentralization of implementation.

According to the strategy, the predetermined expenditure ceilings and specific incentives encouraged increased efficiency. In this framework the result of the planned task financing scheme was also a ceiling – a resource ceiling calculated according to the expected outputs. The ceiling determined according to performance was obviously a different approach than the previous allocations made on base proportions, as the performance link would have incentivized goal attainment. It would have offered a new, performance based accountability framework. The strategy supported by task based budgeting gave a vision of a managerial system where the leadership kept control on budget balance, strategy, goals and final decisions; but at the same time decentralized project preparation and operation management along clear lines of performance expectations. Thus, with task financing in place, the managerial strategy would have been complete.

It has to be noted that the CLI model based two-stage macro-budgetary planning method is not exclusively managerial: it is *modernization* that can serve both the traditional and the managerial model. There is still a difference. Budgeting in the traditional model establishes line-item input control that can be effectuated within the year and a multi year outlook that is a supplementary improvement. The strategic orientation of the managerial paradigm needs the

multi year outlook and the fixing of key parameters that support and guide the performance based decentralization of implementation management, and creates a predictable environment for micro-budgetary management decisions. These are necessary conditions for exploiting micro-budgetary management's potential for efficiency increases.

While at the strategy level a clear leap to the managerial paradigm was obvious, at the implementation level, the results were mixed. As I discussed earlier, the introduction of an objective based managerial transformation could not happen in CIP due to the lack of strategy and planning skills. The new system introduced in 1996 was at least a more rational and rule-based system, and allowed some bottom-up adjustment. These were important, but small steps towards the managerial paradigm.

The Rationalization Fund was built on a clearly managerial logic: the leadership set the goals and supplied incentives; it strictly connected finance to performance; introduced a new accountability mechanism through the agreement to automatically deduct cost savings; and decentralized the design and implementation of projects. It is important to note that this tool provided the incentive to exploit localized information available at the decision point within the given institution. There was no attempt to collect or centralize the information or that of project design and management.

Task finance, if successful, would have been a performance based budgeting system. Clear definition of expected outputs was given in the funding documents of institutions and the

national regulations¹⁰⁹. The units of output changed year by year. Therefore the scheme calculated financing allocations according to the number of output units. Performance based allocation was coupled with managerial decisions on resource use and management within the scope of broad rules. This was again a managerial logic.

However, the financing scheme that remained in place after the failure of the task financing scheme was similar to socialist based budgeting. Operating finance allocations were (and still are) calculated on the basis of previous year's allocations that are only randomly related to the costs of tasks. Changes still happened. Managerial independence at the bottom was only an intent. Even the limited number of restrictions were abolished, and managers were practically free to decide how to use the resources for service delivery. At the same time, the consequence of the success of the strategy on the macro-budgetary level was that operating finance was put under a fiscal squeeze, but thanks to the multi year planning scheme, under a much more predictable squeeze. This was still a 'blind squeeze,' as nobody calculated the risks because decision makers did not have adequate information to assess the impacts of the squeeze on various institutions. Consequently, as a key component of micro-budgetary reform failed, macro-budgeting could make accountable decisions related to the sustainability of finances, but not necessarily for the sustainability of operations. This was a major weakness of the resulting system.

The accountability framework is the last element of the managerial paradigm that I have to discuss. In the BBRS new accountability mechanisms were successful where direct

¹⁰⁹ They together clearly regulate what services should be supplied for each beneficiary and what the acceptable methods and minimal standards are for these services.

performance links could be established. Accountability became clear through these links - the pro forma contract in the Rationalization Fund, or the real contracts in privatization and contracting out¹¹⁰. In the domain of task financing, where a sophisticated information system was planned, the efforts failed. As I discussed above, in general, the task definitions, personal responsibility of managers and the new customer role of clients became the pillars of the accountability framework at the micro management level.

¹¹⁰ I discussed privatization earlier, but only shortly, as it is not a mechanism introduced as a consequence of the strategy. It was initiated earlier. I mentioned that the pricing reform of the utility services that introduced transparent and predictable formula based financing was the necessary condition for a correct, competitive privatization. The pricing scheme also means a performance (output) based financing scheme, i.e. a direct link of performance and pay. Similar, competitive and performance-based contracting-out process was initiated in social services and some other sectors in Budapest. In these domains performance-based contracts established the clear link to performance. More sophisticated performance measurement systems were only later designed on the basis of the information gained from the first years of the experience.

Chapter 8. Conclusions

In the introduction I posed two questions related to propositions of state of the art theory of public management reform. According to public management theory, managerial type reforms rest on three pillars: control over goals; decentralization of management and; an accountability framework based on performance measurement (Cothran 1993). The Budapest Budgeting Reform Strategy aimed at managerial type reform, but did not intend to establish a Performance Measurement System (PMS). My first question was: whether the absence of a PMS in the Budapest Budgeting Reform Strategy was really a sign of simple inconsistency of the strategy, or can a better explanation be given?

The second question was closely related to the first one. Most scholars argue that PMSs are the necessary preconditions for managerial reforms; therefore, they must be in place before managerial decentralization takes place. Some authors writing about managerial reforms in developing and post-socialist countries explicitly suggest that reforms should first develop the control mechanisms pertinent to traditional administrative structures and procedures. Then embark on managerial reforms only from the solid basis of a transparently functioning administration that works under systematic organization, formal rules, systematic control mechanisms and a PMS in place (Sutch 1999). My question was whether the post-socialist local government reform trajectory must go through the traditional paradigm and establish all these conditions, or is a leap straight to the managerial paradigm possible?

My hypothesis was that a deeper analysis of the Budapest case and a focus on the specific

post-socialist problems may explain the absence of a PMS and show an alternative trajectory to the one suggested above. For the case analysis I constructed a conceptual framework based on three paradigms: the socialist, the traditional and the managerial paradigm. The paradigms treat the three systems as ideal-types. They reveal the logical connections among systemic elements within each of the three systems. As such, they are used to establish causal connections amongst the apparent features and direct attention to the causes of problems and weaknesses.

The parallel analysis of the case, according to the concepts of state of the art public management and public finance theory and the paradigms, showed the importance of thinking in system logic. Not only could the absence of PMS be better explained but also the sources of success and failure of various reform components were clearer in the framework of system logic, than within the framework applying theory developed for the transformation from traditional bureaucracy to managerial government in Western countries.

The Absence of Performance Measurement System in Budapest

The concept of PMS arrived to post-socialist local governments with the transition. Predetermined performance criteria had long been part of most business deals and contracts. Their use in the public sector and establishment of their systemic review were expectations introduced through donor programs and later the EU. With the advances towards managerial approaches in the public sector, the importance of performance measurement became widely acknowledged, but post-socialist local governments rarely succeeded in establishing reliable

measurement and monitoring systems for their service delivery¹¹¹. The systems that are in place are usually directly supported by donors or dictated by international agreements and treaties.

Explanation without the paradigms

Four logical reasons that explain why offsetting up a PMS is nearly impossible in the post-socialist context.

First of all, the culture of performance is absent. Socialism was not merit based but paternalistic. All routines and instincts ingrained in socialist public service are against PMS. Bargaining, withholding and neglecting information and the 'right to discretion' are all put at risk under a PMS. It is unrealistic to start reform with a step that is so against an ingrained culture.

The second obstacle is the absence of relevant PMS information¹¹². It would entail a huge effort and cost to build up the mechanism. This resource need has to compete for seriously limited resources with other, more urgent and visible issues that are related to basic service problems. Like deferred maintenance, infrastructure upgrades, improvements to technical equipment, etc.

¹¹¹ Even those donor driven projects that reported success using a PMS during the project implementation, on review of results years after the donor left, showed little success in maintaining and operating the PMS (Nayar-Stone and Tönkö 2004, Tönkö 2006).

The third simple reason is that defining good performance measures requires strategies that incorporate clear goals that define the expected outcomes¹¹³. Agreement may be built on some expected outcomes, but without effective and systematic planning, these outcome indicators cannot be developed into a consistent and comprehensive PMS. Measuring a few selected indices entails the risk that they will skew performance in their specific directions (Ingraham and Moynihan 2001, 329).

The fourth problem is that the decentralization system is in flux. Conditions, tasks and obligations rapidly change. In such a context it is extremely difficult to set good base lines or make valuable comparisons of results.

These concerns show the difficulty of setting up a PMS in post-socialist conditions¹¹⁴. The difficulty leads to the question whether an alternative reform trajectory could be found that is not built on PMS.

¹¹² It is important to qualify this statement: it does not imply the absence of data in general. In socialist and post-socialist governments a lot of data was collected, but the type of data necessary for policy analysis and design was not recorded and collected in most cases.

¹¹³ Péteri (2004) also notes regarding Hungarian local budgets that “because no clear strategy for services exists, output criteria (performances) cannot be identified”.

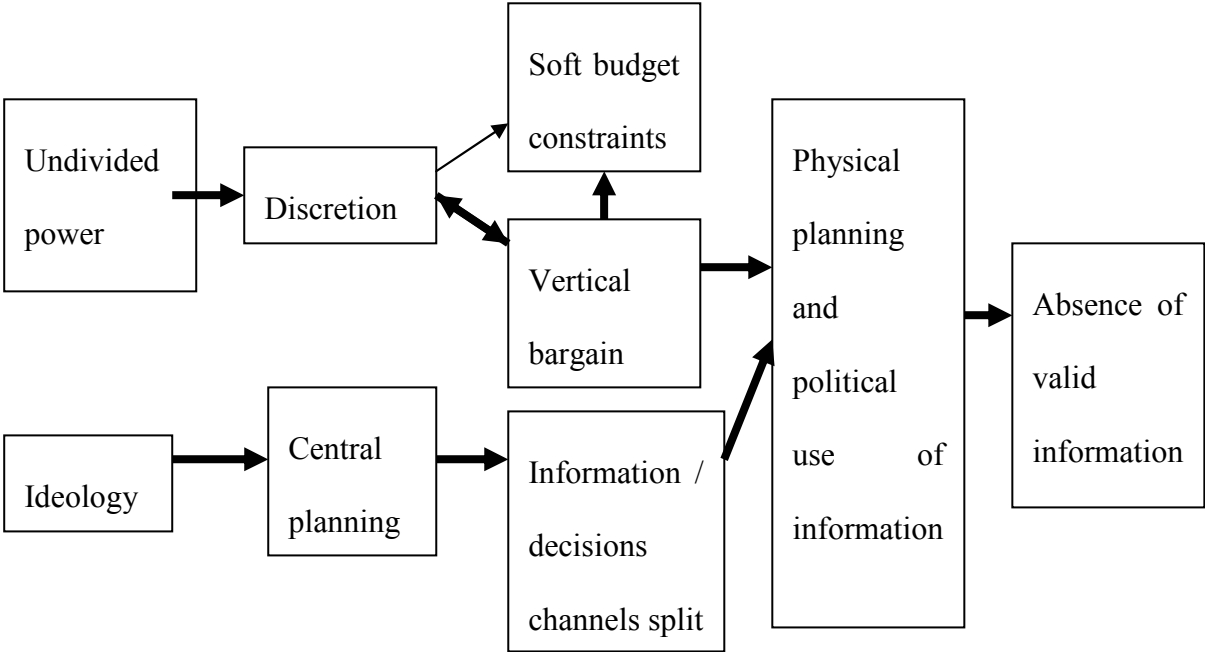
¹¹⁴ Beside the logical arguments it must also be stated that results of field research support the fact that information systems are weak in all post-socialist countries and frequent changes in regulations make temporal comparison impossible (Högye and Mc Ferren 2002).

Explanation with the system paradigm

The concerns raised above were all related to well-documented characteristics of post-socialist conditions. They were connected to specific traits that work against PMS. These specific traits provide adequate support for the argument that PMS is extremely difficult to set up and there is a good chance that it will not work. At the same time, these arguments do not prove impossibility and are also not sufficient to underpin an alternative reform trajectory that could prove the consistency of the BBRS even in absence of PMS. The paradigms can help reveal underlying causes of characteristics and connect specific phenomena in order to find points to break out from the trap.

A key point in Kornai's analysis of the socialist system paradigm was that an absence of information was systemic to the socialist system. It was the consequence of a line of causality. At the source was the dominant ideology and undivided power of the communist party. Ideology underpinned the bureaucratic central planning and command systems and the power monopoly offered the possibility of discretion. On the one hand discretionary intervention led to vertical bargaining and soft budget constraints being systemic characteristics. On the other hand, the central planning system meant that decisions were made at the top on the basis of information gained from a long channel of bottom-up information collection, and plans and decisions were implemented through an equally long channel of top-down decisions. The two channels were split (Kornai 1992). Physical planning and political use of information were logical reactions of administrators who had to represent their sector's interests through vertical bargaining. As parties in most cases had to make concessions in the bargain, it was against their interest to enter into the bargain with good data. They were interested *not to have* reliable data that could control arguments.

Figure 3: Casual chain leading to the lack of valid information



The first conclusion related to the first research question

The socialist system paradigm helps us understand that the absence of information in socialism is the last consequence on a long casual chain (see Figure 3. above). This supports a solid argument for not starting reforms at a phenomenon that is the final consequence of different factors. If the phenomenon is the consequence of the system, lasting change cannot be achieved without changing the system that engenders it. This is surely a more solid argument for not building a reform trajectory on PMS, than the argument that establishing a PMS is difficult. This finding leads to the conclusion that the absence of PMS in the Budapest

Strategy is neither a simple mistake nor an inconsistency.

This is the same conclusion that Schick arrived at in 2001:

“The great mistake of the performance measurement industry is the notion that an organization can be transformed by measuring its performance...This optimism is not justified, for organizations – public or private alike – can assimilate or deflect data on performance without making significant changes in their behavior. Performance information can affect behavior only if it is used, and it is used only when there are opportunities and incentives to do so” (Schick 2001a, 43).

If the applicability of PMS as a precondition for managerial reforms is challenged, the question is whether alternatives can be suggested.

Is a Leap to the Managerial Paradigm Possible?

Alternative trajectories towards the managerial paradigm

The political transition abolished the fundamental causes of the socialist system: undivided party power and the dominant ideology. It also abolished the central planning mechanism. In principle, this meant that information and decision channels could be connected within local government. This considerably shortened these channels and offered the possibility for the local leadership to decide at which levels they would like to connect information and decisions. The extent of decentralization in Hungary also meant that local governments had the right and opportunity to reorganize internal decision processes and decrease the scope for discretionary decisions. Thus in principle, the Hungarian decentralization framework offered

the possibility for local governments to tackle the sources of the information problem¹¹⁵.

The Budapest case analysis showed that the culture of vertical bargaining, paradoxically, survived in the local government, in a context where vertical dependence became limited. I use the term paradox, as under the conditions of local independence, budget constraints became hard for the local government. The information, planning and decision channels had to be connected within the local government. This considerably changed the context for decision making. The Budapest case showed that service units, departments and sectors, still attempted to use the old techniques to bargain with the local leadership. It soon became obvious to the leadership of Budapest that such practices could not be changed rapidly.

The BBRS attempted to abolish – or at least, as much as possible restrict – the vertical bargain by setting hard budget constraints on sectors, departments and service units, and a transparent decision making system. The multi year outlook on resources rendered changes more predictable and, thus, helped to harden the budget constraints. The new sector laws and the founding charters of service units clarified the tasks and responsibilities of the directors of service delivery units. The incentive for own revenue raising strengthened the customer-provider relationship between service units and their clients. These factors were critical parts of a new accountability framework based on personal responsibility. Parallel to this, in order to break the physical planning approach, the leadership also encouraged decentralized decisions. Decentralized management is an incentive to connect information, planning and

¹¹⁵ The information advantage is a fundamental component of Oates decentralization theorem as well (Oates 1972).

decisions locally at the decision point, where the most decision specific information is available. All this was part of an attempt to couple discretion with accountability.

There was also an attempt to introduce task based performance budgeting and to develop service strategies and incentives to guide decentralized decision making in accepted directions, but the lack of planning skills seriously limited these efforts. As I showed, incentives were successful only in domains where they were mostly of financial character and could be designed by the leadership itself.

If the planned system could have been fully implemented, it would have been a full and consistent managerial system. The three components of the managerial paradigm - control over goals, decentralized management and a new accountability framework - were all part of the system. There was no PMS included as part of this vision, but the accountability framework and performance based financing effectively substituted for a PMS by establishing a clear performance link. Thus, this post-socialist reform strategy, built on the understanding of the specific context, showed an alternative trajectory to managerial reform – a trajectory that was consistent without PMS.

Was a leap to the managerial paradigm possible?

The case study showed that the reform strategy could only be partially implemented. Even the partial results succeeded in establishing a good degree of macro-level goal setting and incentives, decentralized micro-level management and elements of a new accountability framework. On the basis of these findings, I concluded that even the partly successful reforms resulted in a paradigm change from the socialist type to a managerial approach to public

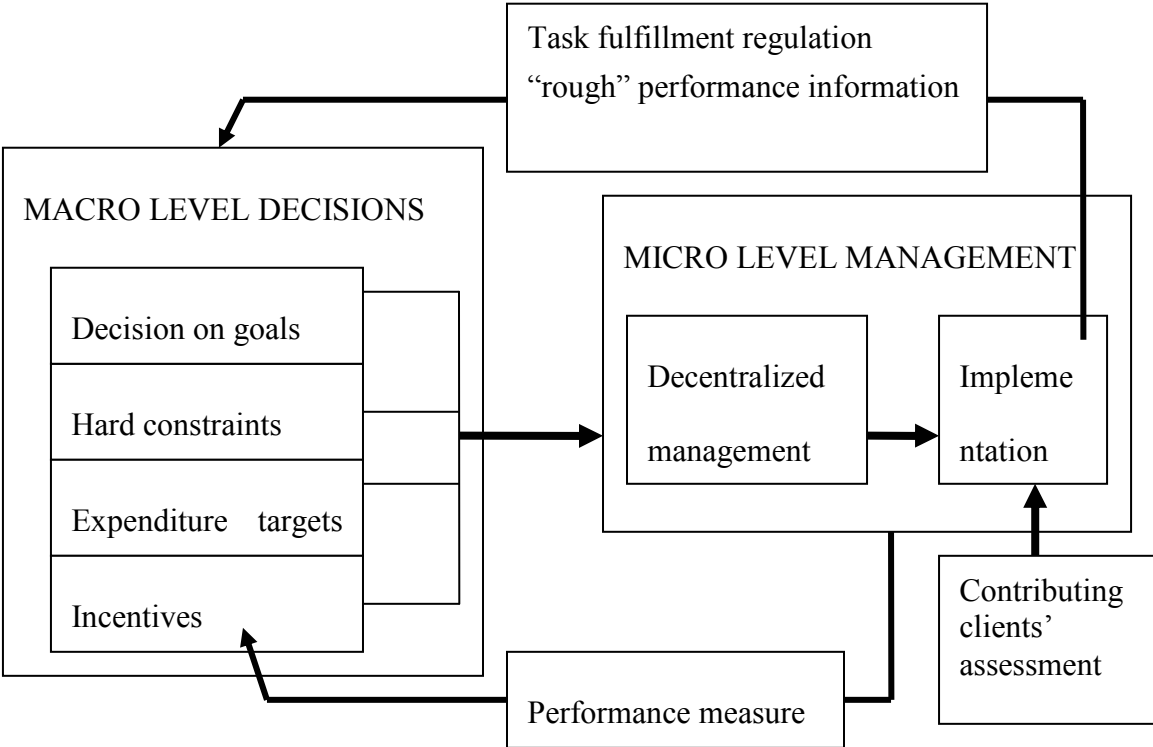
management. The hard financial constraints, transparent processes and clearly defined decision rights and responsibilities effectively worked against the old type of vertical bargains; decentralized micro-level management started to generate valid information at the micro-level. The clear definition of tasks (outputs), own revenue raising and the personal responsibility of service unit directors created a new accountability framework. The classic two sides of management reform: let the managers manage and make the managers manage existed in some form. Decentralized decisions *let* them manage and hard constraint, task definition, and personal accountability, *made* them manage. Without the task financing scheme, the results in Budapest are far from a perfect managerial framework, but certainly point in the managerial direction.

When we understand through the system paradigm that in the socialist system, discretion led to bargaining which in turn led to the lack of planning and information, we understand the logic behind the Budapest strategy. Remove discretion and bargaining in order to have information and prudent policy. Clear goals, a rule-based decision system, hard constraints and transparency all limit discretion, and with incentives (e.g., the Rationalization Fund), they help performance motivation. Surely not a panacea, but improvements can be achieved through incentives and accountability for output.

The Budapest solution is a leap towards the managerial paradigm, as there was no attempt to centralize authority, implement systematic top-down control or strengthen line-item resource control. It was not built on a compliance framework, like the traditional model. It was built on controlling macro indicators, goals, tasks and incentives and on decentralized micro-level management. The new accountability mechanism – the third component of a managerial framework – due to the failure of planning and task financing, could only be established on

variable basis and with varying success. In general, the reference system for performance was the task definition. This is a rough performance indicator, nevertheless, it is a performance link. At the same time, in some cases, like the Rationalization Fund, privatization or contracting out, more precise performance contracts and links could also be established (see Figure 4 below). The new aspect of the relationship to clients resulting from own revenue generation was also a component of the new accountability framework.

Figure 4: The Budapest management scheme in 1999



The second conclusion related to the second research question

With this finding I arrived at my second conclusion. Managerial reform in the post-socialist context does not necessarily require progression through the traditional paradigm and PMS. Trajectory is surely dependent on the starting condition of the administrative system (intergovernmental and local), but the Budapest experience showed that a leap was possible. As the proposition that a post socialist trajectory of managerial reforms has to go through the traditional model, was a general proposition, this one observation, according to Popper's falsification test, proves the need for revision or rejection of the proposition (Flyvbjerg 2006, 228).

The administrative system in the mid 1990s in Hungary, while demonstrating all the post socialist traits, also had a degree of rule-based and transparent organization, not characteristic of all intergovernmental relations and local governments in the post socialist region. Therefore my recommendation is not to reject the original proposition, but to revise it in the following form. Depending on the condition of the administrative system at the start of reforms, a reform trajectory leading through the strengthening of administrative structures and mechanisms pertinent to the traditional paradigm may be suggested. In other cases, the trajectory from post-socialist towards the managerial paradigm can start by decentralizing management if the goals, tasks and targets can be clarified, and some performance link can be established which creates a new accountability framework.

Here a last note has to be made on the findings and conclusions. The conclusion here is that the Budapest reforms demonstrated a leap towards the managerial paradigm. This meant that they did not go through the traditional control mechanisms. At the same time, the result in

1999 was far from a paradigmatic example of managerial public management. This does not discredit the findings. Paradigms are concepts, like ideal-types, they show how institutions would work if they were logically consistent. The research questions referred only to the direction of change.

Additional Remarks

The Budapest experience also showed that not necessarily the quality of information available at the top for decision making (i.e. what PMS targets), but the quality of the incentive can also be a determining factor of rationalizing success. If an incentive is strong and good, and is coupled with a strong accountability mechanism, like in the case of the Rationalization Fund scheme, decentralized information will be applied, making efficiency gain possible within available capacity.

Moreover, we should not forget that the socialist vertical bargain led to suboptimal results not because sector administrations were not committed to their profession, but because the system transmitted perverse incentives. Rational analysis of reforms is often built on the model of the 'economic man' who is driven by his sheer personal interests. At the same time, professional commitment and civil service ethic that are equally assumed in the traditional and managerial paradigms, should not be neglected. Civil service ethic is not my topic here, therefore I make only one remark. The systemic problem in socialism was the perverse incentives. The often suboptimal accountability framework that evolved in Budapest after the transition is not a fatal mistake on the basis of the assumption that civil servants are committed to their work.

The experienced limitations of the system were not cases of obstruction, but of weak planning and management skills.

Weak planning skills take us back to the PMS. The establishment of a PMS necessitates, as planning skills as a precondition. Clear goal setting and clearly defined objectives must exist before performance indicators are defined and information collected. Consequently, weak planning skills are a fundamental obstacle to setting up a PMS. In absence of good planning, it is premature to discuss PMS. The alternative approach in the Budapest strategy was to build incentive schemes in some domains and generate information and skills. By gradually and strategically occupying different territories with performance incentives and constraints, information was gradually generated and that in turn pushed out the old regime.

The problem of weak planning and management skills was not solved in the BBRS, and it cannot be solved within the restricted domain of budgetary reform. Training and incentives help, but a civil service regulation that allows employment of better managers would also be important. Committed managers could initiate changes and establish a culture of decisions made on information. Thus, better information would be generated that could later evolve into a real performance information system.

My second point is that in the post-socialist context, PMS can be a mistake even if successful. As it attempts to centralize information in one system, it can bring back the socialist mistake of trying to centralize information. This can trigger serious resistance – partly based on the

ingrained culture of secrecy and partly on emotional instincts¹¹⁶. Managerial reforms turned towards the market for inspiration. The market operates on localized information and decision making (Hayek 1945). There is no need to centralize information if the system gives adequate incentives to use localized information for the public goals. This leads to the ability to establish hard constraints, reduce bargaining, and incentivize efficiency increases through localized use of information. This is a tenet of decentralization as well (Oates 1972).

Bird, Ebel and Wallich, in their analysis of post-socialist transformation, also remarked that performance measurement had often been used as a central tool for continuing control and to undermine, intentionally or unintentionally, the shift from political to fiscal decentralization. They contrasted this potential use of performance measurement with performance incentives that can be important tools in decentralizing efforts (Bird and Ebel and Wallich 1995).

The contrast between centralization and decentralization as the main driver of change is the real difference between the two trajectories of reforms that I discussed. Strengthening top-down traditional control and establishing a PMS as a precondition for managerial reforms is based on the idea that centralized control of public service functions is a precondition of managerial reforms. The alternative trajectory, the one applied in Budapest, was built on decentralization logic: exploit the benefits of decentralized management for cost savings and better results. It was built on the assumption that decentralization along the right incentives can bring improvement, experimenting and creative new solutions (Oates 1972). The crucial

¹¹⁶ Coombes also criticized actual seduction by the power of performance measurement and alerted that the Western public management 'modernization' agenda "could, paradoxically, renew despised old practices" when applied in CEE (Coombes, 1998, 419-22).

question was not PMS, but finding an accountability mechanism that can ensure that creativity is employed in the direction of public goals.

Instead of a PMS as a unified system in Budapest, reforms were started with what was possible on available information, and introduced mechanisms that started to generate the data minimally needed for prudent decisions.

Closing Words on the Research Results

The case analysis and conclusions demonstrated the explanatory power of the paradigm system. The parallel analysis of the case, according to the concepts of state of the art theory and according to the paradigms, showed the importance of thinking in system logic. Not only could the reform goals, strategy and results be better explained, but the sources of success and failure were also clearer in the framework of system logic, than within the framework developed in Western theory for transformation from traditional bureaucracy to managerial government.

This conclusion supports a key tenet of reform management. In post-socialism, or in any other context, the causes of problems should guide reforms and not models developed in other places. The logic and ideas must be understood and creative new ways must be found that are rooted in the deep understanding of the given context. Systemic features rather than surface phenomena have to be changed for lasting reform. While theory is rational and consistent within given domains, practice must be creative and make new associations of components of

knowledge from different domains.

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ANNEXES

ANNEX 1: Draft Concept for the 1996 Budget

(Internal document. Policy paper for the Mayor's Cabinet that has never been published)

Translated by László Láng, manuscript

In 1996, the Municipality of Budapest – like the vast majority of the Hungarian local governments – has to reckon with the toughest economic conditions in its history up to now. You are familiar with the reasons, and I have also touched upon this problem already. Here and now I will not provide detailed explanations on the local government aspect of the stabilization of the national economy and on the municipal burdens of the stabilization. Neither will I detail certain efforts that might establish more reasonable and rational proportions between the two subsystems of the national budget (government budget and local governments' budget) in the next budgeting year, and I merely touch upon the (clearly defined) efforts to create quasi-constitutional guarantees for producing these reasonable proportions. Surely, this very important question will be the topic of the near future, but now I wish to present you, how the Municipality of Budapest intends to treat – within its competence – these tough conditions in the next year.

Bookkeeper versus strategic budgetary planning

Basically, responsible urban financing management has two ways to tackle with financial constraints. One solution is the bookkeeper approach with its rigorous base financing in planning and enforcing the “lawnmower principle” even to the detriment of quality parameters. This method can be legitimate for controlling short-term crises, but for prolonged difficulties – which we are exposed to, considering macroeconomic conditions – pure bookkeeper planning may lead to an uncontrollable situation concerning both municipal tasks and financial perspectives.

Or, following the other way, we should attempt to position the given fiscal year in at least medium-term trends, and for several years ahead to reckon with constraints and variable conditions, with the processes to be encouraged or restricted, with the space of maneuvering for structural reforms, and to utilize the available scope of activity relying on unambiguous priorities, and even make use of the financial constraints to enhance the desired changes in content.

Planning with foresight, “breaking down” trends to the next fiscal year

What are the main elements of this approach concerning the conditions of the Municipality of Budapest?

Reckoning with the expected and with the suggestible trends of the public finance

system

In our opinion it is both necessary and possible to preserve the existing proportions between the two main sub-systems of the national budget (central and local government finance), contrary to the current tendency detrimental to the local governments. This is desirable even under the present, hardly normative system. The necessary corrections – still under this system – can be made through retaining the ratio of the local governments' PIT-share, fully including PIT's dynamics, while in the case of normative state grants, changes in resources

must reasonably be adjusted to the changes of tasks. (This is the essence of the present proposal of the local government associations.) The system should include normative state grants for subsidizing metropolitan public transport instead of the individual, occasional state aid of our days. (Currently, this task is not included in the normative subsidy package for local government responsibilities.) Other advisable modifications are the following: changes in the state and local government ratio of the so called shared tax revenues (e.g. motor vehicle tax and the proposed real estate tax or property increment tax), and another modification reducing the rate of central PIT could provide greater space of maneuvering for the local governments on their own. All these would not yield more money to the local governments, not even a thicker slice from the public cake, but merely would lead to a halt in the decline of the local governments' relative positions and to a more predictable and plannable system of financial conditions.

Moreover, it is possible to implement – under the conditions of the stabilization process and keeping local autonomy intact – a radically new financing system in two-three years, that is able to apply normatively three main principles: task-proportionate financing, income generation potentials (resource capacity) and resource localization.

Neither option needs a detailed presentation in this paper, but here and now we must formulate an important conclusion: interpreting macroeconomic perspectives in relation to the financial conditions of the local governments, neither possibility can even preserve the real value of the centrally regulated resources, and in the best case only a slowdown and certain predictability in the pace of decline can be expected. Because of the threat of total failure, local governments cannot let this loss in real value be perceived in their responsibilities in a medium-term period, so partly they have to increase their own income, and partly their operation has to be subjected to a cost effective rationalization process.

Expanding the space of manoeuvring – own revenues

Compared to the centrally regulated resources, the own revenues of the Municipality of Budapest have significantly increased in the past few years. Our intention is to intensify this progress through the possibilities still at hand, and strengthen the base of the financial management autonomy of the local government.

Taxes

Current public finance system hardly gives any chance to increase the total tax burden of the population at the initiative of the local governments, and they can take only minor steps at negligible fields. Furthermore, levying tax directly is not a free option for the Municipality of Budapest owing to the double sovereignty established in the capital (district governments' own right to impose taxes may limit the relevant rights of the Municipality of Budapest). Anyway, the Municipality of Budapest will grasp all the legitimate – and solvent – possibilities to increase tax revenues, namely, the rates of business tax and tourism tax, as well as (via sharing of funds with the districts) motor vehicle tax and real estate tax.

Asset management

Contrary to common beliefs, the volume of assets with earning power belonging to the

Municipality of Budapest is negligible, its ratio to the assets total is even lower, than in the districts. At present, the real gain on our legally transferable and marketable municipality assets is in the negative. On the one hand we need an asset management system, that – properly converting the elements of the asset stock – is able to produce a positive yield. On the other hand, the financial balance of the municipality needs to be supported from the asset management side – but at the smallest decrease in our assets with earning power and without any loss in our total assets. It means, that income from assets must not be allocated to operation, and at the worst, only asset conversions contributing to the stock without earning power can be used for part-financing investments. And even these conversions should serve the purpose of facilitating “shock absorption” in investment fluctuation – a purpose that I am going to discuss later.

Keeping to the above mentioned principles, the conclusion is, that there is no real way of increasing municipal real revenues from asset resources.

Privatization as a source of income

The primary aim of the privatization in Budapest is to establish more efficient – consequently, in the final outcome, cheaper – public services. Income oriented privatization may be accepted only if it is subordinated to this aim. In the future, after the privatization of the City Gas Works Co., Pharmafontana Co. and the pharmacies, further privatizations are only very limited options from a budgetary point of view. And even these revenues must finance “shock absorption” in the first place.

Operating and financing public utility companies

We shall go on with the transformation of public utility companies into shareholding companies, and continue tailoring the companies already transformed so as they meet market requirements – the aim is the same as in the case of privatization.

In this respect, the pricing of public utility services is of utmost importance. A company operation can be really cost effective and market conform only if the expenses of the services are fully covered by the income from rates. If our aim is to minimize the grand total of the public burden financing public utilities, we must realize, that just for this reason, in the final settlement, the cost covering, higher rates are the cheaper ones for the citizens who cover the expenses anyway. Customers get incentives and possibilities for further savings by this more reasonable, non-redistributive system, where payment is proportionate to consumption.

In 1996 the Municipality of Budapest will reach the position where – taking the above principles very seriously – the rates of public utilities fit for individual metering will cover the expenses of the basic services (with the exception of public transportation), that is, the municipal budget will be relieved from the operative and investment burdens of these public utilities. This increases the redistributive capacity of the Municipality to be utilized in the framework of service systems that primarily lend themselves to that (education, welfare policy, public cultural institutions). In other words: cost covering utility charges appear as indirect municipal revenues, because the Municipality does not have to allocate resources to subsidize these utilities any more, and this indirect income can be allocated to other purposes.

Automatic price regulation through the established price formulae, as well as the volume of the medium-term investment projects show, that rise in prices should not go above real value

in the next few years.

“Shock absorption”

The 1980s created an ‘investment vacuum’ in the capital city, and this was one of the reasons behind the municipality’s decision to subscribe to the development obligations presented by the World Exhibition and buttressed by surplus resources. However, these extra resources were accessible only through the mobilization of sizeable own resources. This required the city to draw large loans. As a consequence of the lasting burdens of this investment peak, in the following one or two years, the city could keep its budget balanced only through a series of extremely tough cuts in investment, and a practically complete freeze on further borrowing. ‘Putting on the brake’ will send wild and lasting shocks across the municipality’s financial system. These shocks must therefore be absorbed as soon as possible, preferably during the first “cycle”.

We have done such moves already in the rising phase of the sine curve. These were investment reductions (at the same time keeping the key elements of the developments intact) to lower the peak at a time when central budget restrictions reduced the resources at the disposal of the Municipality. (Also the modification of the Lágymányos bridge investment belongs to this effort.)

The efforts for making utility charges be able to cover the expenses also serve the aim of shock absorption, because the basic utility investments have been shifted to the company sector and this way have become really achievable aims, lessening the “investment gap” in the near future.

Last, but not least, ensuring harmony between the four-year work-plan that rigorously reckons with the possibilities and the medium-term development conceptions derived from more general visions also contributes to shock absorption. This coordination makes possible the specific planning-preparatory work, that heeds the possibilities of financing for the following years, and focuses only on the projects that can be really completed in a decade and can be launched in time, parallel with the expansion of the financial possibilities.

Realistic work-plans and medium-term development conceptions

Planning with due foresight, with a “rolling” method is a key element in promoting an efficient financial system, so it is worth giving a short description of it. [...]

- Working out a financial-economic model of analysis and prognosis-support
- Strategic and medium-term development conceptions resting on the possibilities of financing
- “Fine tuning” within the framework of rolling planning and the annual budgets

Enforcing the reforms of the institutions without trespassing on sectoral autonomies

Our problem is not only, that the real value of the resources allocated to the operation of the

institutions cannot be preserved, but even following structural changes and keeping the relevant level of financing (so called leveling) – that is, providing for the adjusted nominal level – is almost impossible. Leaving the structure unchanged and continuing base financing would lead to a complete disaster in the institution sphere, and a financial collapse of the Municipality would come about, if it tried to allocate money to this sphere beyond its capacity.

At the same time, general experience show, that this very sphere is the least receptive to rationalizing changes, and – of course by voicing “professional considerations” – here you find the toughest resistance to and refusal of any changes that do not draw more money from the city budget. How is it possible to enforce the rationalization of operating costs without trespassing on sectoral professional autonomies, without financial regulations interfering into fields of professional contents? How is it possible to encourage the professional sectors to formulate their operation conceptions themselves and to apply cost effective solutions themselves? Below I enlist some tools to be made use of in the 1996 annual budget to achieve the above mentioned aims.

- New tasks can be undertaken only to the detriment of the existing ones, or only transposing priorities between sectors.
- Any change in content is possible only relying on a financially verified sectoral conception.
- Expenses kept at nominal level, increased only by the expenses of structural changes and leveling.
- Net (non revenue-transposing) extra resources can be gained only for the purposes of cost rationalization (through a to-be-established Rationalization Fund); applications for this fund should be ranked according to the “return” undertaken by the sectors.
- Any budgetary extra income that has not been planned can be used only for increasing the Rationalization Fund, or to improve the content side of the “enforced reform”.
- The same principles should be kept in the case of the “internal” savings of the individual sectors (both in the fields of operation and asset management – as targeted income).
- New regulation must be implemented for the own revenues of the institutions that incite tougher planning and financial management, at the same time ensuring institutions’ freedom in allocating the extra resources.
- In extreme cases, individual financing limits must be established for certain institutions (“lawnmower” method to a safe extent, not hurting considerations of content).

ANNEX 2: The BBRS in the 1997 Budget concept

(Part of the official, public document presented to the Municipal Assembly and adopted in 1996.)

Translated by László Láng, manuscript

On the measures originating from the requirements of the financing strategy to be applied under the probable financial conditions of the next few years

Why do the financial conditions of the next few years demand particular attention?

The answer relies on the financing projections (Annex 1).

The projections show the following expectations for the next few years:

- current revenues will not grow at real value, and even from 2000 on, only the maintenance of the real value can be expected,
- revenues from asset utilization (privatization, sale of real property and portfolio assets), which are the basic components of accumulation and capital type revenues, would necessarily dry up.

Reckoning with the revenues foretold in our financing projections, to what extent can operation and accumulation costs be covered?

Naturally, the real value increase of the municipal revenues would be favored, but this turn cannot be expected within reasonable time. Under unchanged conditions we have an enforced choice:

We may decide, if we try to keep either operation or accumulation expenditure close to real value,

or both type of expenditure will be subjected to real value decline.

In the **first case**, maintaining operating expenses at real value would result in the gradual exhaustion of accumulation resources within a short period of time, and eventually even the financing of operation would become impossible.

The **second case** leads to gradual, steady deterioration. (Of course, we may risk waiting for some non-foreseen factor to stop us on this “slope”.)

What can be the way-out of this trap? How can we reach a balance in the municipal budget?

Our starting point – that **must be accepted and make it accepted** – is, that the financing conditions of operation may be improved not only by providing funds at least meeting the rate of inflation, while operating in the same structure, leaving all the conditions unchanged. The alternative approach is: per unit operating costs should be reduced by one-time – accumulation type – expenses, that is, the standards of services can be maintained or even improved at the diminishing real value of the operating expenditure.

To this end, accumulation expenditure (and non-recurrent, cost rationalizing operational expenses) designed to improve conditions and to reduce costs of operation at the same time must be kept at real value or even increased.

Under these criteria, we may speak of a balanced municipal budget, if accumulation expenditure – amounting to a reasonable level – is kept at real value, with special emphasis on the accumulation expenses (and non-recurrent, cost rationalizing operational expenses) that are allocated to improve the financing conditions of operation.

Due to the drying up of accumulation and capital type revenues, the only significant source of achieving a balanced budget is operating surplus. Consequently, the desired objective can be specified as a ratio of operating surplus to current revenues.

According to our projections, the budget of the City will be balanced and the accumulation expenditure will reach an acceptable level, if the operating surplus rises to 20% of current revenues and remains at that level.

Clearly, due to the delicate character of operations (due to their “inertia”), achieving this aim in a year or two cannot be realistically expected. Real changes of current revenues and of current expenditure may be "diverted" from each other only by a few percentage points each year.

The temporary boom of accumulation revenues in 1996–1998 offer an opportunity for the Municipality to cover the investment gap, thus to span the time gap during which operating surplus is not yet sufficient to provide the necessary funds for accumulation.

At the same time, **divergence** must reach the specific rate at which – having an effect on trends – **a balanced budget can be achieved** over a period of four or five years.

It is clear, that the model presented above – though it may be accepted as an inevitable requirement – only provides for a desirable financial framework of urban financial management, and **it is not the financial management in itself**. The mechanic, linear application of this framework – if, in the lack of other measures, we may be forced to apply it this way – implies grave consequences. It is quite obvious, that in the given structure, any significant diversion of the nominal growth of current revenues from that of operating expenses, that is **the significant increase of operation surplus, cannot be undertaken**, as it would result in a drastic real value reduction in the financing resources of the services.

Consequently, the **only way out** is to allocate the given investment resources basically to the rationalization of operation, first of all through multiplying the Institute Rationalization Funds.

If balanced municipal financial management is considered a strategic goal to be achieved in any conditions within a given period of time, it is inevitable to answer the following questions – keeping to a priority list –, and to take and undertake the relevant measures:

Which non-mandatory municipal activities should be **stopped in full**, in order to be able to perform mandatory tasks as well as non-mandatory, retained tasks that are deemed absolutely necessary?

Which individual institutions shall be fully closed down as a consequence of the reduction in the overall volume and content of the retained tasks?

Which quality elements of the retained tasks should be reduced intentionally and selectively, in contrast to the general character of the real value loss.

What way, what non-recurring extra expenditures will be able to reduce the operating

costs of the retained tasks?

Which new or already undertaken services should be improved, if – after accomplishing points 1-4. – extra savings occur compared to the target value. The aim can be either capacity enlargement or quality improvement. (Till reaching the strategic goal, the “allowance” of the sectors or institutions to be preferred can be only some moderation in cutbacks.)

Summary

Till the point we reach the devised level of operating surplus, only reducing current expenditure to the level modeled in our financing projections can be **the way to reach the balanced municipal financial management** – defined above as our strategic goal. To the time we achieve the necessary operating surplus, temporary extra resources from privatization may be used to ease the relative decline in accumulation, the investment “gap”.

After the scheduled filtering of the operation tasks, in order to increase operating surplus not by reducing task fulfillment or the real value of expenditure – either to an unbearable level – a **predominant rate of the investments must be allocated to rationalization, to the reduction of per unit costs in operation**. The other, residual part of the investments must be allocated to the main strategic goals.

What financing strategy should be followed in the annual budgets, till the time we achieve the balanced municipal budget?

At present, the financial positions of the Municipality – mainly due to the last year privatization revenues, a part of which serve as reserves for debt servicing – can be considered stable. Net debt (gross debt less the investments in government securities) has decreased to the level where debt management is neither a risk factor nor the cause of any extra budgetary tension.

The development policies of the past four years, financing infrastructure investments partly by borrowing, could ensure that the amount of the annual investment expenditure remained roughly equal. Had this practice not been pursued by the City, investments would have been implemented with delay, on the one hand, and great fluctuations would have characterized development activities (subject to the actual receipt of privatization revenues) on the other hand.

The strategy to be followed in financing until a balanced budget is achieved, is the one in which the active borrowing policy and the maintenance of financial reserves are present concurrently.

The proposal to adopt an active borrowing policy is justified by the following:

- It is important to keep the investment activities free of fluctuations over the medium-term, and to go on with continuously tendering the scheduled phases of the long-term investment projects that cannot be fully covered by the current annual budget, but are approved by the General Assembly.
For the next few years we have taken into account several revenue items that cannot be exactly defined in advance, neither in amount, nor in timing. E.g. these are the revenues from public utility privatization, or from settling our accounts with the

Hungarian Privatization and State Holding Co. These revenues have a significant effect on the financial positions and the investment capacity of the Municipality. By an active borrowing policy, shock waves triggered by *ad hoc* revenue items – that influence investment capacities – can be absorbed, and appropriate schedules for their utilization over time can be elaborated. On the one hand, borrowing would facilitate the earlier implementation of urgently needed infrastructure investments, on the other hand the accumulated debt portfolio, as a “consumption buffer”, would offer a natural framework for the rational utilization of large amounts of *ad hoc* revenues via repayments.

- This technique ensures that services, available as a result of such investments, will be paid for at the time of consumption and by the consumers who actually use these services during the life span of the investments. In terms of accumulation expenses, it means that the costs of a project should be paid for – in the depreciation phase of the project – by the consumers; in other words: the expenses of the investments must be imposed upon the very customers who use the relevant services in the depreciation phase.

The equivalent financial technique, the features and structure of which are in line with the technique outlined above is financing a project with a maturity equivalent to the depreciation period, that is **financing by a loan with a maturity equivalent to the depreciation period of the project**. (Loan amortization and interest payments take place during the time when the services resulting from the investment are operating.)

While adopting an active borrowing policy, **special emphasis must be laid on maintaining financial reserves**. The volume of the reserves should be defined from time to time on the basis of the projected annual debt service obligations (the amortization of the principal and the interest payments) and the projected operating surplus (operation income less operation expenditure).

Naturally, maintaining financial reserves has its costs that originate basically from the difference between the rates of loans and the rates of savings.

Due to a high degree of pre-determination of the budgetary processes – if investment projects are to be implemented along an active borrowing policy –, it is imperative for the Municipality to hold permanent financial reserves equivalent to at least one year’s debt service obligations. This can ensure financial stability, the safety of meeting debt service obligations without jeopardizing operations.

We can state as a **conclusive summary**, that accepting medium and long-term investment plans as well as their implementation in a smooth run is closely attached to the elaboration of the proper financing policies. Long-term investments require predictable resources and a loan portfolio with **shared financing risks**.

In the course of external financing, it is advisable to rely on **foreign money markets too**, and fund raising should be extended the bond market, besides the market of bank credits. Though, up to now, we have not met difficulties in our domestic loan raising, we have found, that the market of medium- and long-term credits is small, thus raising a large amount of loan can be accomplished only at rising premium rates, consequently at weakening bargaining positions.

The City’s entry into the international bond market can be justified primarily by strategic considerations. The timing of the “debut” is of crucial importance with a view

to financing the municipal investments from the international money market in the future

According to expert opinions, **the conditions of the entry are very favorable at the moment:**

As a debtor, the Municipality of Budapest has a good reputation, its stock of debts are relatively small, the investment portfolio is big.

- Both the privatization process and the development of the urban landscape have gained international reputation.
- The trust in the country has increased due to the perspective of entering the European Union.
- Due to the ample foreign currency reserves of the National Bank of Hungary, no significant international bond issue is expected, so squeezing out is improbable.

What task-list is to be accomplished under this process in 1997?

It is most urgent to prepare and launch the accomplishment of operation and investment tasks in the direction of a balanced municipal budget, and to carry out the first bond issue.

Operation

The present capacity and structure of the budgetary institutions predict such an automatic increase in expenditure determined by inflation that – without filtering tasks and rationalizing institutions – it will be intolerable in the long run. The need for reforms go beyond the scope of fiscal restrictions. It is a must to establish step by step a new system of municipal tasks that can be continuously financed and to elaborate the clear, stable rules of the system. In 1997 – following the modest measures of 1996 –, remarkable financial resources must be allocated to the reconsideration of the municipal institution network, to the reorganization of task fulfillment with regard to efficiency, professional principles and quality, to the rational utilization of capacities, to the enforcement of cost-effectiveness.

Disbursements from the Institute Rationalization Fund can be used for purposes (investments, renovations, adjustments, reorganizations, staff cut-backs, ensuring the minimum conditions for the individual professional activities):

- that can be derived from medium-term operation conceptions elaborated for the given sector and approved by the Assembly,
- that aim at reorganization, cutbacks co-coordinated at sector level (and primarily that are entitled to financial subsidies from the central budget),
- that effect savings on the operation expenditure financed from municipal resources.

Developments

Investment projects should be devised within the framework of the medium-term development plan, facilitating to establish more purposeful investment proportions for the individual sectors, granting a reasonable share for the operation rationalizing investments – naturally, besides the key projects of urban development strategy.

The four year development plan for the years 1997-2000 is presented in Annex 2.

We propose the Assembly to approve the four year development plan as the planning basis of the annual development budgets.

ANNEX 3: The BBRS in the 1998 Budget Concept

(Part of the official, public document presented to the Municipal Assembly and adopted in 1997.)

Translated by László Láng, manuscript

On the measures originating from the requirements of the financing strategy to be applied under the probable financial conditions of the next few years

Why do we repeatedly stress the importance of the probable financial conditions of the next few years?

The answer can be found in the updated financing projections (Annex 1.). According to these – similar to the projections made a year ago –, in the following years

- we cannot expect any real value increase of the **current revenues**, and even preserving their real value can be expected only from 2001 on,
- concerning **accumulation and capital type revenues**, we have to face the drying up of the sales revenues.

These conditions can only induce us to repeat our questions formulated last year:

- Reckoning with the revenues foretold in our financing projections, to what extent can operation and accumulation costs be covered?
- What can be the way-out of this trap?
- How can we reach a balance in the municipal budget?

The answers are also similar to the ones formulated a year ago:

- Our strategic goal is to achieve a balanced financial management of the Municipality.
- we may speak of a balanced municipal budget, if accumulation expenditure – amounting to a reasonable level – is kept at real value, with special emphasis on the accumulation expenses (and non-recurrent, cost rationalizing operational expenses) that are allocated to improve the financing conditions of operation.
- According to our projections, the budget of the City will be balanced and the accumulation expenditure will reach an acceptable level, if the operating surplus rises to 20% of current revenues and remains at that level.
- Due to the drying up of accumulation and capital type revenues, the only significant source of reaching our strategic goal, the balanced municipal budget, is operating surplus.
- A balanced municipal budget can be reached (in four-five years) by squeezing, “diverting” operation expenditure, as it is shown by the financing projections.
- In the first years, the deficit of the operation surplus – compared to the needs of the desired level of accumulation – will be compensated by the boom of accumulation revenues in 1996–1998 and by bond issue.
- After the scheduled filtering of the operation tasks, in order to increase operating

surplus not by reducing task fulfillment or the real value of expenditure – either to an unbearable level – a predominant rate of the investments must be allocated to rationalization, to the reduction of per unit costs in operation. The other, residual part of the investments must be allocated to the main strategic goals.

- The strategy to be followed in financing until a balanced budget is achieved, is the one in which the active borrowing policy and the maintenance of financial reserves are present concurrently.

What task-list is to be accomplished under this process in 1998?

Operation

Shift to a task financing system

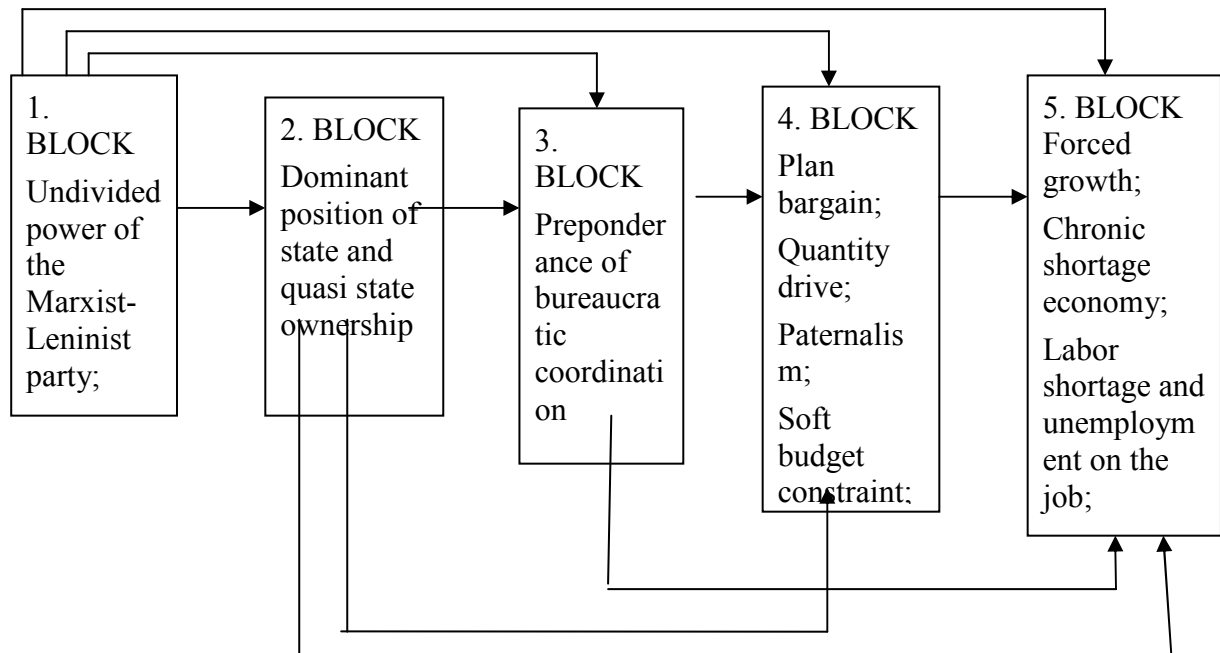
Parallel with the approval of the budget conception for 1997, the Assembly of the Municipality of Budapest passed a resolution [No. 1578/1996. (XI. 28.)] on the preparation for shifting to the task financing system in the 1998 fiscal year. To this end the Assembly ordered

- the elaboration of the medium-term sectoral operation conceptions with the relevant rationalization conceptions,
- the full screening of the budgetary institutions and the elaboration of an operation conception at comprehensive municipal level,
- the preparation of a zero-based draft budget for 1998, built on the operation conception (to be approved)
- Sectoral and municipal level operation conceptions will be submitted to the Assembly continuously, from September on.

In order to meet the tasks formulated in the latter two orders, **we have to carry out reform-like modifications in the budgetary planning process.** Initial steps have already been done, when – instead of the leveling processes applied in base financing – **we started preparations for a financing system that relies on natural indicators and normative regulations.** We want to apply the zero-based budgetary planning process, that uses professional and financial indicators, is supported by analysis, and is based on the survey of the institutions' primary data.

ANNEX 4: Line of Causality according to Kornai

Source: Kornai, János. 1992. *The Socialist State*.



ANNEX 5: Comparative Table of Systemic Features of the three Paradigms

paradigm	Socialist centralized bureaucratic coordination “IDEOLOGIC”	Traditional classical bureaucratic coordination “PRINCIPLED”	Managerial market-type coordination “PRAGMATIC”
theoretical basis	Ideology of socialism	law (later ‘scientific management’)	economy and management
environment	stable, command economy	stable democracy	rapidly changing
political position	party support	voters’ support	voters’ support
politician	Paternalism and loyalty to party	representation of constituency	professionalism and representation
local government	deconcentrated unit of government	independent government	entrepreneurial government
Legitimacy	ideology	rule of law & clear procedure (input)	efficiency (output)
Coordination mechanism	integrated bureaucracy central planning + vertical bargain hierarchical command system	partial bureaucracies rigidly regulated hierarchical system systematic coordination and control	management by goals and objectives flexible, creative management personal accountability for results
SRUTINY	fragmented direct control	systematic compliance control	systematic performance control
civil servant	vertically dependent	neutrality and professionalism	efficiency and independence
rule of the game	do only what is explicitly permitted!	do what is allowed through rules!	do anything what is not prohibited!
his accountability	compliance with orders	compliance with rules	achievement of results
his culture	servility	legality and discipline	contract based independence
policy and Planning	comprehensive central planning	incremental policy making and technical plans	strategic policy making and planning and management
implementation	vertical command and bargain	standardized regulation and control	creative, adaptable solutions
Budgeting (B)	yearly, input-based, line-item B B is result of bargain B is record keeping of accountants soft constraint	yearly, input-based, line-item B incremental budget planning B is means of control hard constraint	strategic budgeting B is multi-year, performance based B is policy tool, incentive package hard constraint

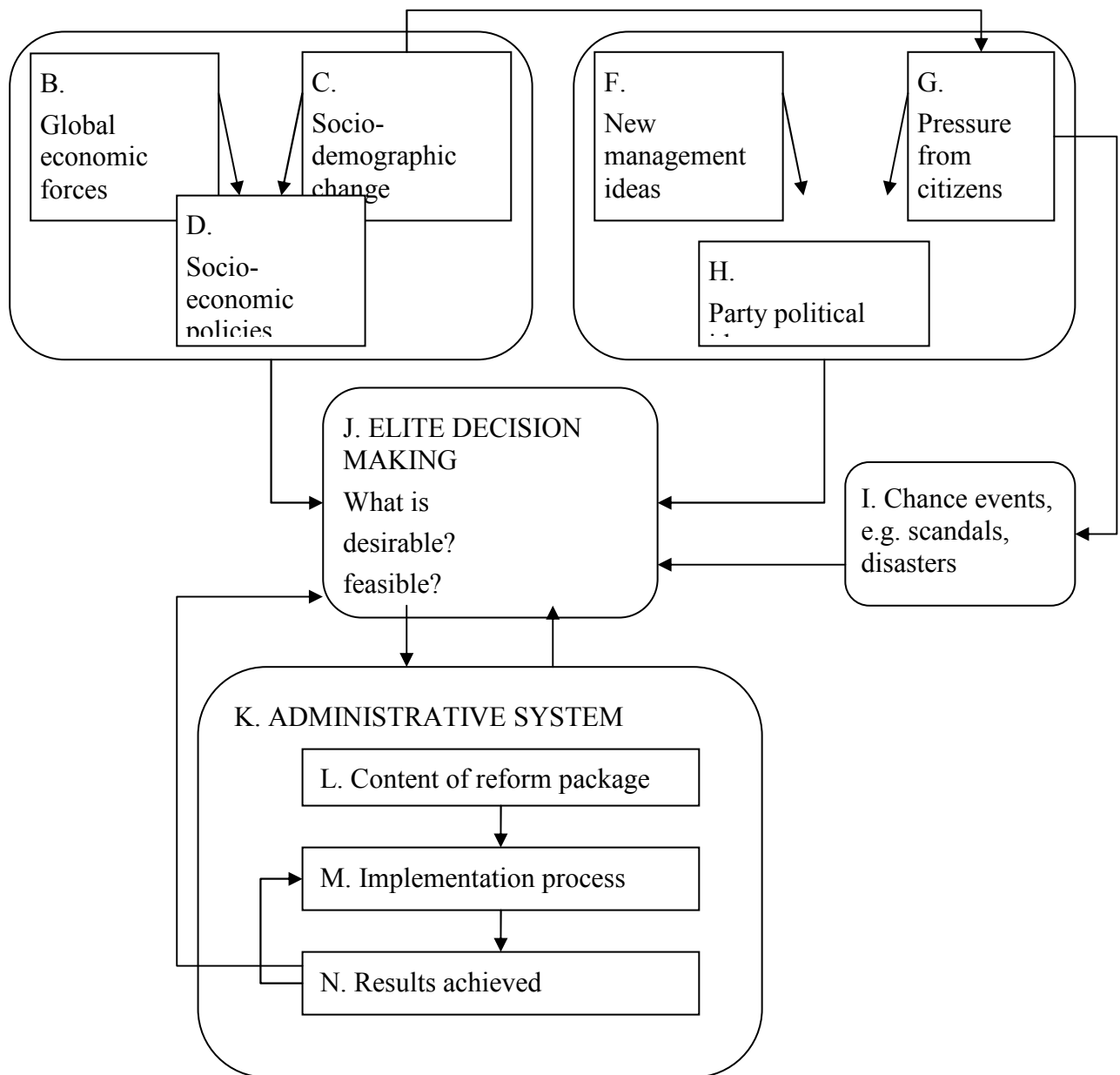
paradigm (cont.)	Socialist centralized bureaucratic coordination “IDEOLOGIC”	Traditional classical bureaucratic coordination “PRINCIPLED”	Managerial market-type coordination “PRAGMATIC”
strength	social security for individuals	effective implementing instructions rule of law and clarity of procedure certainty for citizen	effective in implementing goals efficiency gains flexibility
weaknesses	lack of horizontal coordination lack of policy relevant information lack of policy making capacity weak accountability kills creativity and ownership inefficient and ineffective	unnecessary restriction of competition and freedom of choice dichotomy of pol/admin is a myth rigid system and slow change weak implementation accountability kills creativity and initiative	insensitive to deeper values problematic goal setting

ANNEX 6: Comparison of Characteristic Features of Local Government Operation in the Three Paradigms

paradigms →	Socialist	Traditional	Managerial
local government specific features ↓	ideology based approach centralized bureaucratic coordination	rational-principled approach classical bureaucratic coordination	rational-pragmatic approach market-type coordination
WHAT? service delivery	administrative provision of local services and support functions	administrative provision of local services and support	consumer choice and market-type and market-based provision included
HOW? LOCAL Coordination mechanism	physical planning (costs ignored) vertical bargain political use of information weak accountability	incremental policy process and technical plans detailed regulation compliance with rules	Local strategy Political control of goal setting decentralized management performance control
information	dream of centralized “information”	incomplete information	“localized” information
functioning	un-transparent and discretionary	transparent and rule-based	transparent, rule- and contract-based
Budgeting (B)	B is means to implement decisions yearly, input-based, line-item B institution-based un-transparent, lack of information soft constraint	B is means to implement plans yearly, input-based, line-item B incremental budget planning B is means of control (item control) hard constraint	B is means to implement objectives strategic budgeting B is multi-year, performance based B is policy tool, incentive package hard constraint
control	external ex ante and ex post control – throughput control	external ex ante control and compliance audit – input control	ex post audit and intrenal control – output control
systemic weaknesses	absence of policy information lack of policy & planning capacity weak of horizontal coordination weak accountability inefficient and ineffective system	restriction of competition rigid system and slow change weak implementation accountability kills creativity and initiative	insensitive to deeper values problematic goal setting

ANNEX 7: Public Management Reform

Scheme developed by Pollitt and Bouckaert(2004)



ANNEX 8: The Context of Municipal Reforms¹¹⁷

Political and financial conditions in the wake of transition

Up until the 1980s, Hungary in several respects shared other socialist countries' problems. The "paternalistic state" extended a series of services to all its citizens. The centralized state apparatus operated through an unregulated decision-making mechanism and case-by-case bargaining exercised heavy control over the whole economy. Central economic planning meant that important strategic decisions were made by the Central Committee of the Communist Party with strategic management carried out by the line ministries. These strategies were rooted in the state's normative goals, and planning was based on a markedly supply-orientated approach. Artificially set prices and wages (extensive price and product subsidies, symbolic public utility rates, and a largely dysfunctional market) meant that decision-makers did not have the necessary information on changes in demand. The ideological and supply-oriented thinking led to a system what János Kornai termed "wasteful poverty" and – by the 1980s - to the exhaustion of resources. (Kornai, 1992)

By the late 1980s, the country's deteriorating macroeconomic condition had clearly signaled the end of the previous system. Reform ideas were in the air, and the harbingers of the new institutional system had already appeared, prior to the "official" change in the political system. Although the long-needed comprehensive public finance reform could not get on the agenda, a few important measures were implemented. Among others, the state introduced personal income taxes and general turnover taxes to buttress the revenues' side of the central budget. The subsidies granted to the municipal governments became a separate entry in the budget. Simultaneously, initial measures were introduced towards the normative financing of the municipal governments.¹¹⁸

The change in the Hungarian political system was very strongly influenced by liberal thought, as the establishment of democracy and the market economy – the necessary initial steps of this transition – very much coincided with the liberal drive. The challenge of transformation meant for the country that a new legal system had to be created for its emerging constitutional democracy. Hungary had to redefine individual and property rights, had to eliminate the excess regulations that hampered the emergence of a free market, it had to reduce state redistribution and redefine social solidarity. Thanks to the political maturity of reform-minded intellectuals, and also to the cardinal agreements reached at the Opposition Roundtable¹¹⁹

¹¹⁷ The description of the system change and evolution of the local government system is partly based on my earlier texts written for Katalin Pallai ed. *The Budapest Model*. Budapest: LGI. 2003.

¹¹⁸ This process will be discussed later in more detail.

¹¹⁹ Against the backdrop of the Soviet Union's rapid decline and the dissolution of its alliance with the Eastern bloc countries, Hungary's new or reemerging democratic forces launched the Opposition Roundtable in the spring of 1989. Under the auspices of the Independent Lawyers' Forum, six opposition parties and two other organizations pooled their talents in an effort to ensure a peaceful political transition by entering into

(which prepared the country for a peaceful political transition), Hungary succeeded to put itself en route towards a functioning democratic market economy. (Bozóki 1993)

In the early 1990s, Hungary made a number of bold steps towards the inevitable replacement of the previous political and economic system. The country established the institutions of a multi-party parliamentary democracy. Independent and responsible local governments were created in accordance with the stipulations of the European Charter of Local Self-government. The new act on public finance introduced a series of important regulations and prescribed a more transparent, detailed budget. The early 1990s witnessed a marked reduction in the role of central price regulation and price subsidies. New acts were passed on accounting and on bankruptcy, and the country's banks were consolidated. On the basis of all these, the country could start work on the transformation of its economic system. A great beneficiary of all these changes was the country's capital city and only genuine metropolis – Budapest.

The fast change of the system was inevitably accompanied by a deep transformation crisis. The natural side-effects of the transition period included the disappearance of certain companies and economic activities, an increasing rate of unemployment, the destruction of the welfare net, and a decline in real wages. Despite its relative economic strength, Budapest was also adversely affected by social problems. Although average wages in the city grew faster than the national level, living costs increased also faster. (Horváth and Péteri 2003, 384) Budapest also witnessed the negative effects of the economic and social decline of lower social layers and the strengthening of social polarization. Among other things, Budapest became a major hub for the country's homeless.

But for all the problems, the bold first steps resulted in a series of positive changes. The private sector picked up speed rather quickly. While in 1992 it contributed 50 per cent of GDP, by 1997 this figure had increased to 70 per cent. (Horváth and Péteri 2003, 381) The structure of production was also renewed. The process was most dynamic in Budapest. By the second half of the 1990s, the services sector had already become responsible for 77 per cent of GDP produced in the city. Foreign capital started appearing in Hungary as investors started taking interest in the country and city. (Central Office of Statistics 1999) During the first decade following political transition, about half of the total foreign investment capital that appeared in the region ended up in Hungary (USD 22.5 billion). This gave a significant boost to the restructuring of the economy, and greatly promoted subsequent moves towards stable economic growth. About 50 per cent of the investments made by foreigners in Hungary materialized in Budapest, which significantly strengthened the capital city's role as the country's economic center. (Equity Central Europe 1999) It was amid such conditions that the city's leaders had to manage the reforms to be outlined below.

In the 1990s Hungary was successful in implementing a new political system and creating the conditions necessary for a free market economy. However, much less has happened with regard to public sector reform.

The political leaders of the first government cycle did not venture to introduce all the comprehensive measures required for restructuring, and chose only to re-regulate the

negotiations with the ruling Hungarian Socialist Workers' Party (MSZMP), which already identified itself as a socialist party.

budgetary process. By the beginning of the second government cycle, redistribution had affected 61 per cent of GDP, the deficit of the central budget reached 8.5 per cent, and the state's debts amounted to 85 per cent of GDP. (László 1998, 139) International financial circles put Hungary in the same bracket as Mexico. By 1995 it became inevitable to reduce the deficit and curtail redistribution. The country's second, socialist-liberal governing coalition attacked the problems with what has become known as the "Bokros package" (named after Finance Minister Lajos Bokros). This stabilization program undertook to address a number of imperative economic policy issues: among others it launched the process of economic liberalization, extended the privatization process, and curtailed private consumption. It also ventured to launch some public finance reforms. As a result, the country's economy returned to a sustainable path. Within two years, the program reduced redistribution to 50 per cent, slashed the budgetary deficit to 3.2 per cent and the state's debts to 65 per cent of GDP. (László 1998, 139) However, for all its successes, the program did not include reforms of the largest redistributive systems (health care, welfare policy, and education). Consequently, the "Bokros package" fell short of reforming the public sector as a whole. While it managed to put the country on the path leading to stable economic growth, Hungary's public sector still retains structural problems.

The period from 1997 can be characterized by steady economic growth, dropping inflation and unemployment. It was a period when "growth in equilibrium started". (Horváth and Péteri 2003, 374) However, in this period, when available resources started to grow, more and more anti-decentralization arguments arose and led to centralizing tendencies affecting the local government system. (Horváth and Péteri 2003, 377-8)

The system of local governments in Hungary

The marked decentralization process of the Hungarian governmental system was a salient feature of the change of the political system, and one which determined subsequent developments. As a result, the country's local governments were established according to the principles laid down in the European Charter of Local Self-government.

The first crucial step for decentralization happened before the first elections. After long negotiations of the earlier mentioned Opposition Round Table the new Constitution (adopted in October, 1989, a half year before the first elections) stipulated that:

- local governments are legitimate representations of local interests
- local governments receive full autonomy (i.e. autonomous decisions on property, budget, partnerships and all other public issues)
- strong guarantees for this autonomy (i.e. local decisions can be challenged only if illegal and local governments can appeal in court or Constitutional Court if their rights are infringed)
- local governments have the right to adequate resources to cover costs of tasks. (Constitution, Section IX)

The constitutional guarantees established were important to navigate the debates on decentralization in the newly formed Parliament during the debates of the Act on Local Government. (ALG – Act No. LXV of 1990) The new law passed on broad rights and responsibilities to local governments. At the same time, many issues pertinent to the local government system could not be brought under the umbrella of this basic law that can be changed only with two-third majority like the Constitution. Nevertheless, as we will see

from the presentation of the “resulting system” the stipulations could achieve systemic change and establish a decentralized public administration system. (Péteri 1991)

In Hungary, the independence of the local governments is guaranteed by the Constitution and the ALG. Local government decisions can only be challenged on the basis that they do not comply with the law. (Constitution Sec. IX. Article 44.a) Local governments are obliged to provide public services both in the physical (roads, sewage etc.) and the human infrastructure (education, healthcare etc.) fields and to institute local regulations (cf. the summary table below). They are free to choose the way they perform these services, i.e. they can co-operate with other local governments, or they can subcontract or privatize services. Furthermore, the local governments are entitled to undertake other activities as well, provided that these do not interfere with their mandatory services.

The local governments’ mandatory services were specified in the ALG. Under the Act on the Local Governments’ Assets (Act No. XXXIII of 1991), local governments were given the property rights for the assets needed to perform mandatory. They also received the property rights for plots on their respective territories that were not private property. Furthermore, local governments were authorized to generate their own revenues and to receive transfers from the state such as shared taxes, normative subsidies and investment grants. During the period between 1990 and 2000, these resources totaled between 17 and 11 per cent of GDP that represented the highest share of local government resources within the post-socialist region. (Koppány, Wetzel and El Daher 2004, 10) Municipal governments were authorized to complete their investment resources by drawing loans independently (the limits of which were regulated in 1995).

Local governments’ tasks

The ALG spelled out local governments’ obligations. The specifics of these tasks, associated requirements, and the division of related responsibilities and scopes of authority were normally defined in functional and sectoral laws. Consequently, Parliament’s decisions on these laws led to changes in the conditions that regulate the fulfillment of local governments’ tasks, and change their expenditure assignments.

The local governmental tasks relating to infrastructure services were regulated rather early, in the first half of the 1990s. In 1990, the ALG defined the infrastructure services that had to be provided by the local governments. The so-called Asset Law of 1991 contained stipulations pertaining to the transfer of assets associated with the decentralized services and in 1993 and 1994 the price setting authority for certain services was also transferred.

Local governments set the rates for water, sewage, waste disposal, district heating and chimney-sweeping services. They also set local public transportation rates, although this requires the Finance Ministry’s consent. The rates for gas services are still set by the state. In the field of infrastructure services, the rational decentralization of tasks, transfer of assets and the relegation of rights to decide on revenues have created a system that makes planning and envisioning strategies possible on the local government level. As local governments can also choose the mode of operation of services, many (like Budapest) decided to privatize service companies in the mid 1990s. (Horváth and Péteri 2003, 376)

In the field of human sector services, certain educational, welfare, health care and cultural tasks were decentralized, and the assets needed for their provision were transferred to local governments. These human services were partly financed by “normative grants”¹²⁰, and partly by local resources. State investment grants as well as local sources financed investment into these services. Sectoral laws approved between 1993 and 1997 established the related quality requirements in the fields of education, welfare and childcare.

Logically, the aim of these national regulations was to ensure citizens’ access to public services independently of their domicile, at a level of quality that was prescribed by law. It was up to local governments to create the conditions thanks to which citizens access these services. This often burdened them beyond their financial means. Although this system was also rational from the point of view of functional decentralization, some of the new sectoral laws created serious tensions, as the state failed to offset the obligatorily increased expenditures.

Healthcare is the only system where decentralization defied rational policy logic. Here the local governments functioned as owners of the assets tied to the services. Consequently, they were responsible for maintenance and investments (hospital buildings, instruments and equipment). The operating costs were covered by the National Health Insurance Fund (NHIF). Although these sums were transferred to institutions through the local governments’ budget, the municipality could not change allocations (the sums appeared in a separate column in the budget).

Omitting the small private healthcare providers, Hungarian healthcare institutions were owned either by the state or by the local governments. The owners decided on their respective institutions’ spheres of activity, and they were in charge of assets and investments. However, the state alone determined the system of norms that covered operating costs. This system was often changed haphazardly, without the involvement of or consultation with the other owners (e.g. the local governments). The NHIF was also entitled to decide whether it will finance operating costs deriving from local government investments (e.g., new diagnostics equipment). This division of assets and operation financing was unfavorable for local governments (and for the healthcare system as a whole). It did not sufficiently allow for planning and for the chance to improve efficiency. This framework did not encourage a search for optimal solutions. Progress was not incited, but depended only on both sides’ commitment to serve the public interest.

Under the ALG, local governments were free to undertake tasks beyond their mandatory responsibilities. However, these tasks must not in any form threaten the fulfillment of their legally prescribed responsibilities.

Besides mandatory and voluntarily assumed tasks, local governments also had delegated powers. The exercising of these powers had serious financial implications. E.g. the regulations pertaining to land use and zoning could lead to expropriations, and the value of certain properties could appreciate or depreciate in the process. While it fell on local

¹²⁰ A normative grant is a resource allocation through annually specified sums tied to units associated with a given task.

governments to cover the costs of expropriations and compensate those who were negatively affected by the regulatory changes, they partook in the profits (coming from appreciation) only indirectly – if at all.

In the case of large cities, local government tasks were influenced by two more factors.

First, the financing system did not recognize the tasks and services particular to large cities. The system did not compensate for the extra costs of these services (e.g. local public transportation), and did not recognize the fact that large numbers of non-local residents also used some of the subsidized services.

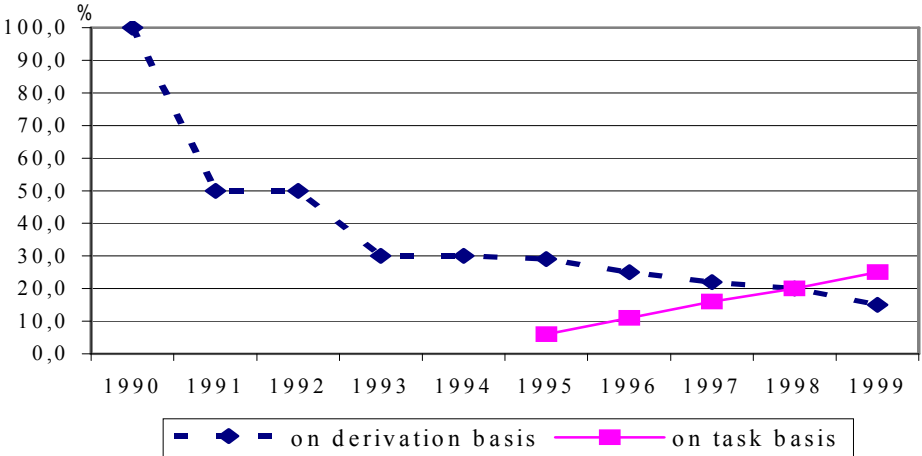
Second, it is important to note that, at its inception, the middle tier of the Hungarian system of local governments was based on the traditional intermediate units of public administration – counties. (Brid, Ebel and Wallich 1995, 71) However, counties did not square with society's and the economy's organic, regional units. The creators of the new system divided the tasks of this “missing level” (i.e. the legally non-existent organic region) between the large cities and the “non-organic” counties. Yet they failed to properly regulate the provision and financing of these services and did not include appropriate resources in the cities' subsidies to ensure that they could fulfill these tasks beyond their borders. This situation generated a spider web of conflicts (riddled with clashing interests, requirements, and conflicting tasks). Attempts to resolve these conflicts through fair and positive-sum solutions were only slowly evolving in the Hungarian public administration system.

The local government financing system

Alongside the tasks outlined above, the ALG also specified local government resources. These were composed of state transfers and own source revenues. The main source for the former was the personal income tax (PIT). In 1990, PIT revenues were fully channeled to local governments but these soon became shared revenues between local governments and the state. Since 1997, PIT revenues also became a source for the local governments' “normative grants” (i.e. a part of the PIT covers intergovernmental transfers for the local governments' operation). In 1990, 100 percent of the PIT revenues were allocated to local governments on a derivation basis. By 2002, this figure had gradually decreased to 5 percent.¹²¹ Meanwhile, 35 percent of the PIT revenues was used as coverage for “normative grants” and equalization transfers. As a result, the local governments' share of the PIT revenues collected from their respective jurisdictions decreased to two percent of their budgets in their budget. (Horváth and Péteri 2003, 397-8)

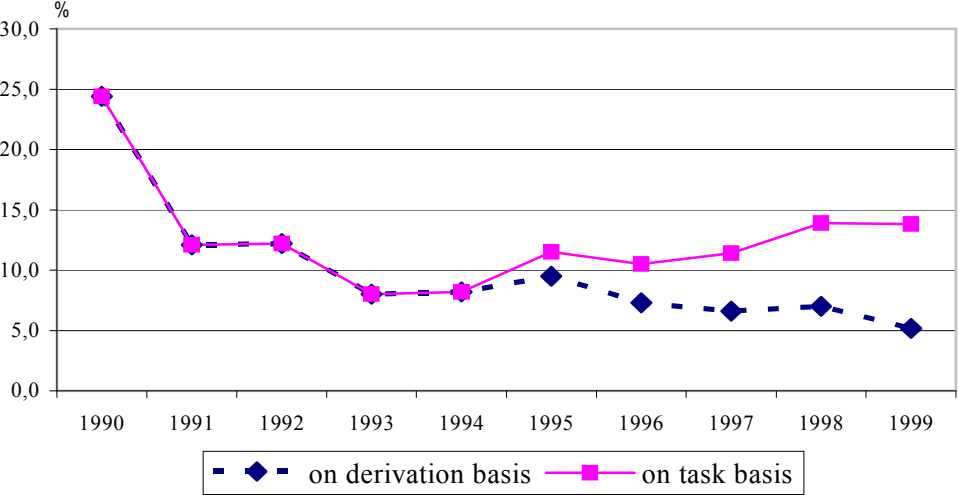
¹²¹ In principle, the percentage of PIT revenues *directly* re-channeled to local governments who collected them rose to 10 percent in 2003. However, the rise remained fictitious for those settlements where the change would result in substantial extra revenues. On the one hand, withholdings grew due to the change in the method for calculating tax potentials, and on the other hand a new regulation reduced (in proportion to the local tax potentials) the very state subsidies that ought to have been guaranteed in accordance with the change of mandatory tasks. Thus the growth in PIT revenues was practically withheld by the reduction of central revenues resulting from these two measures.

Chart 1. The re-channeling of PIT revenues to local governments, 1990-99



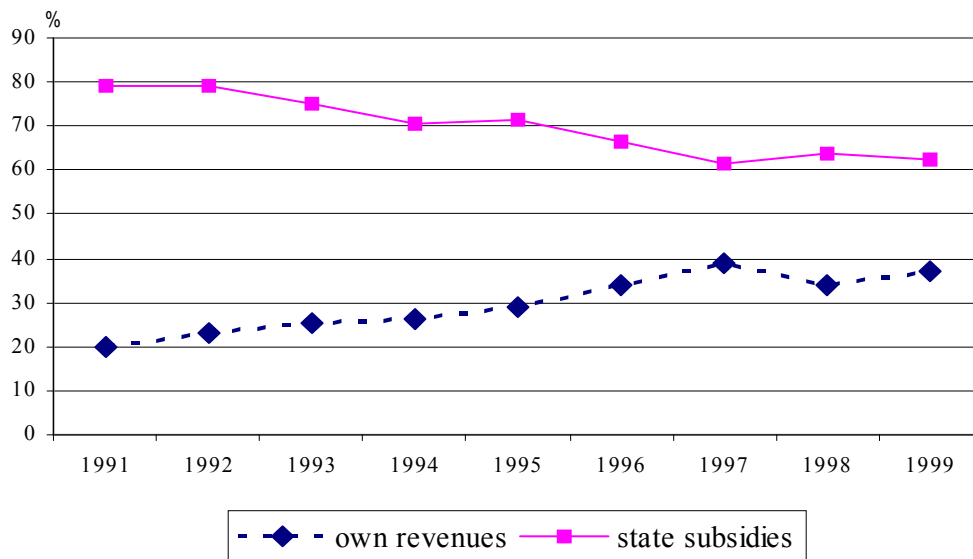
Source: Finance Ministry

Chart 2. Share of PIT revenues in local government budgets, 1990-9



Source: Finance Ministry

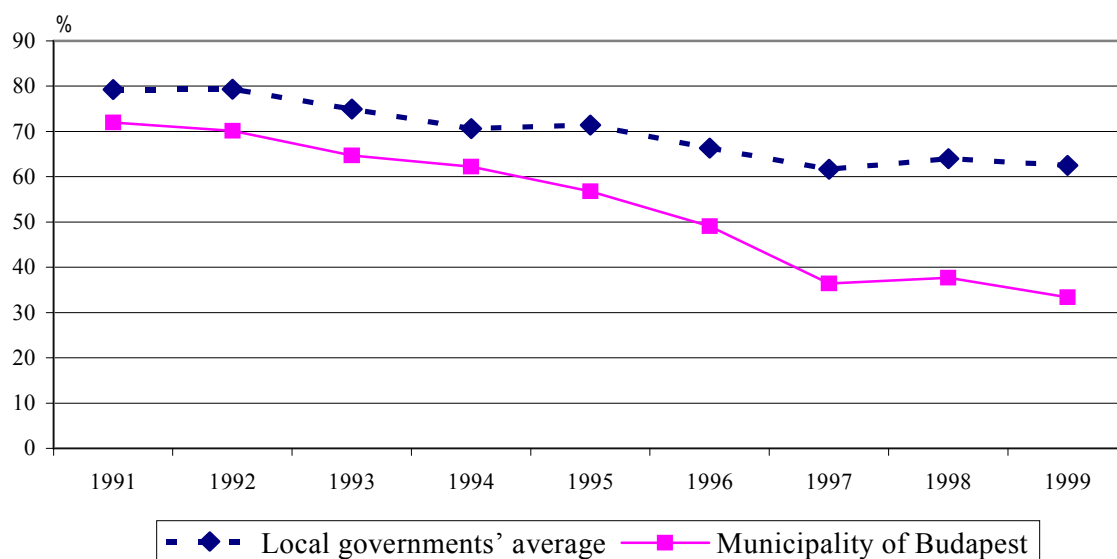
Chart 3. State subsidies and own source revenues in local government budgets, 1990-9



Source: Interior Ministry web site, August 22, 2002

The aggregate share of state subsidies in local government budgets has also been steadily decreasing. In 1999, state subsidies accounted for 62,5 percent (on average) of local governments' total revenues. In Budapest, the respective figure was 33 percent. The charts clearly illustrate the decrease in state subsidies, which is especially drastic in the case of Budapest.

Chart 4 Share of state subsidies in local government budgets, 1990-9



Source: Interior Ministry web site, August 22, 2002; City hall papers, 2002

The new system also had a rational side: the earlier practice of cost financing¹²² had been replaced with a basically normative system of resource regulation.¹²³ In this new system the operating state subsidies were awarded in a normative manner, and only the investment subsidies remained to be decided on individually. This discretionary part of investment subsidies, however, accounted only for a mere 4 percent of the local government revenues.

Centrally regulated resources also included the sums transferred from the health insurance fund for the operation of the health care institutions that were earmarked.

Alongside the normatively distributed operating funds, the central government also had the right to award investment subsidies to local governments based on discretionary decisions.

¹²² Under the cost financing mechanism, that had been in use until the late 1980s, the central budget covered the declared expenditure requirements of the councils. For any given year, the amount of subsidies was, as a rule, set on the basis of the previous year's figure. Any changes to this rule were based on individual decisions.

¹²³ The new name was meant to signify a conceptual change: the new system regulated the parameters according to which the operating subsidy part of the central budget was allocated to specific tasks. The new system was introduced before the change of the political system, in 1988.

These subsidies were identified as targeted and addressed investment grants¹²⁴, and as contributions paid out from investment funds¹²⁵ outside the government budget. The investment subsidies were awarded through tenders. Certain aspects of this process were regulated¹²⁶, but the discretionary character of the decision remained a key element. The discretionary element was needed, as not everything could be translated to normative rules. Though, unfortunately, from time to time it allowed for the prevalence of certain parties or groups' interests.

Local governments collect their own source revenues from local taxes, as well as from fees, charges, stamp duties, fines and revenues from asset management. The local governments are free to decide the extent to which they draw on local taxes (within legally prescribed constraints). On average own source revenues accounted for 34 percent of the local governments' total revenues. In Budapest, the municipality's own source revenues in 1999 represented 60 percent of the total revenues (calculated without loans). Business taxes represent the most important form of local taxes: in 1999, these taxes accounted for an average 86 percent of the total local tax revenues. (Puskás 2000, 131) In Budapest, the respective figure was 97 percent. (The Office of the Mayor 2001, 26) Revenues from stamp duties varied according to localities, the more active the real estate market was (typically in big towns) the greater importance they had. Revenues from fines and institutional fees were not significant. The user charge revenues from public utility services did not appear in the local governments' budgets.¹²⁷ The revenues from asset utilization varied rather widely according to local government and period. After all, these revenues were determined by fundamentally diverse asset structures, the financial transactions applied and the pace of the privatization process. In Budapest's budget, the revenues from asset utilization were highest between 1995 and 1997, at the time of the privatization of the large public utility companies.

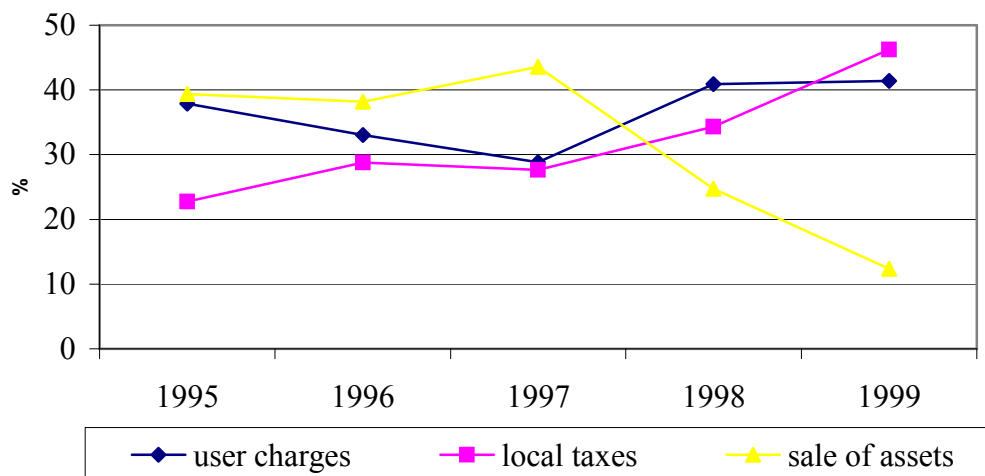
¹²⁴ The sums earmarked in the central budget for targeted subsidies were allocated to the local governments on the basis of, and in proportion to, the latter's specific claims. The addressed investment grants were likewise tied to specific goals. These grants were allocated by Parliament through tenders and based on case-by-case decisions. In general, these grants covered 70-90 percent of the actual investment costs.

¹²⁵ The bulk of these funds were eliminated in 1995, while some of them were referred to the competence of the ministries.

¹²⁶ These regulations affected the procedures and the general aspects of judgment. In general, the peculiar aspects of judgment were spelled out in the individual tender documents.

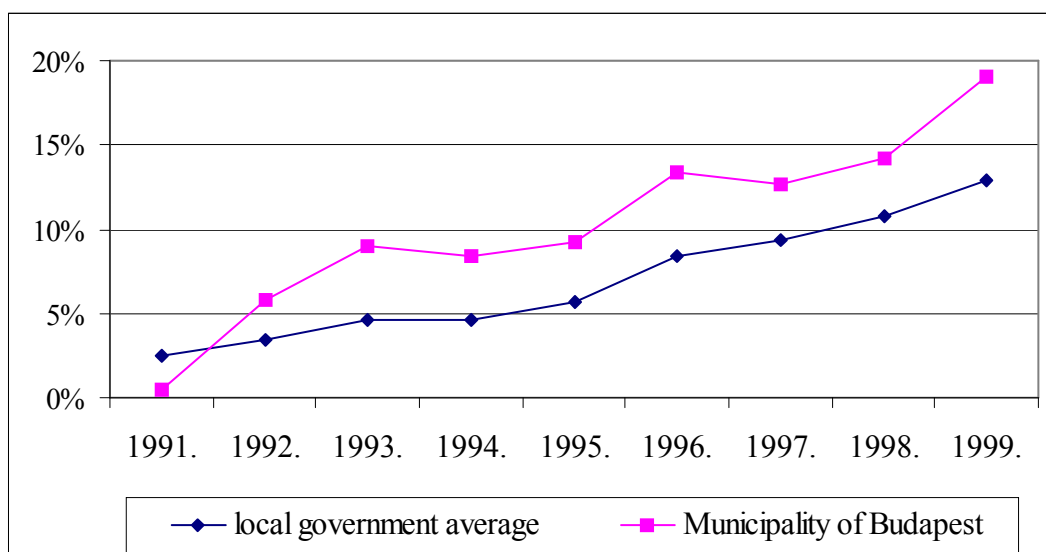
¹²⁷ These user charge revenues are amounts comparable to all budgeted revenues. The aggregate size of the budgets of the public utility service providers in Budapest is larger than that of the municipality. (Pallai 2003, Table 4 in Annex)

Chart 5. Share of own source revenues in the local budgets



Source: Puskás 2002

Chart 6. Share of local taxes in the local budgets



Source: Interior Ministry; Ray 2002

Regulation local governments budgeting and financial management

Under the ALG, the local governments became independent financial entities, i.e. their decision making bodies independently decided on their annual budget drawn up according to the relevant laws. This budget was an annual financing plan for fulfilling the local governments’ mandatory and voluntary tasks. For this reason it had to specify the revenues

and expenditures of the local government and its budgetary institutions, as well as the subsidies granted to its independent economic units. The central legislation regulated the format of the budget tables required in the local budgets. This ledgered, line item budget was cash based, and had to be balanced at the end of each fiscal year. On the revenue side of the budget resources were listed according to types of own and transferred revenues, while on the expenditures side the order was institution and department based. Under the institutions and budget units expenditures were broken down by groups of operation, refurbishment and capital expenditures. Though the regulation required vast amount of information, the budgets did not contain any performance related information. Local politicians had to make their decisions without reliable information about public services. (Szalai et al. 2002, 375) The appendix to the budget included a balanced summary of projected revenues and expenditures on operation and accumulation.

Local governments provided large part of their services through institutions. These institutions were either independent or quasi-independent budget units. Independent budget units had their financial officials who were responsible for financial management of the institution. It was the decision of the local government whether they established centralized financial management system (even local treasury if they wished) or allow decentralized financial management for these budgetary units. (Szalai et al. 2002, 376)

The local governments were entitled to borrow (draw loans and issue bonds) as prescribed by the Public Finance Law. In a given year, the amount of credit that could be drawn by a local government must not exceed 70 percent of its own current revenues minus the short-term obligations. Furthermore, the local governments were entitled to deposit their temporarily liquid funds (excluding state subsidies) in banks or invest them in securities.

The Law on Debt Settlement (Law No. XXV. of 1996) was a pioneering attempt in regulating the local governments' financial activities. It regulated the process aimed at restoring the liquidity of insolvent local governments. The law aimed to guarantee the provision of local governments' basic services, and to satisfy the debtors' interests within realistic and feasible boundaries.¹²⁸

Weaknesses of the local government financing system

It was most likely impossible to create a perfect system for local government financing in the early 1990s. The weaknesses of the emerging systems occasionally presented serious problems to the municipalities.

The system employed in Hungary for local government financing had two fundamental weaknesses that are worth highlighting and discussing in detail in the context of our analysis of the municipality's financial management reforms. The first one may be identified as the unpredictability of the financing system, and the second as the financing system's limited normativity.

¹²⁸ This means that the payments are made in proportion to the claims, up to the extent of available marketable assets.

The legal stability of the Hungarian system of local governments was guaranteed by the Constitution and the Act on Local Governments (which could only be amended by a two-thirds majority¹²⁹). At the same time, the key financing parameters were stipulated by simple-majority acts.¹³⁰ The most important of the latter was the act on the state budget. Each year this act specified the sums allocated to local governments in the various resource categories. Accordingly, the governing majority could alter (sometimes significantly) local operating conditions at will.

The established system of financing did not in any form tie the regulation or central subsidization of the local governments' resources to any macroeconomic or public finance indices. This made it rather difficult to prepare projections for the availability of local resources, and it enabled the political circles to influence the local government sector, occasionally through voluntary party policy decisions. The paragraphs in Parliament's annual budgetary decisions pertinent to local governments easily fell victim to short-term political maneuvering. In the absence of "financial constitutionalism" the system was simply unable to guarantee predictability, which is key to efficient local planning.

In connection to the predictability of the financing system, it is also important to note that investment subsidies were also allocated on the basis of discretionary decisions.¹³¹ Although some elements of these decisions were regulated (procedure and certain decision criteria), the whole process is still dependent on the politicians' discretion, which did not help to make the system more predictable. The regulation of the decision-making process had remained unchanged, and the extent to which politicians abused of their discretionary power varied according to political elites' adherence to the unwritten laws of democracy.

The second crucial problem was the weakness of normativity of local government financing. The normativity of the intergovernmental system of financing is closely related to the previously discussed expectations of predictability.

The 1990 Act on Local Governments created a system that was operable. However, it was obviously not possible to create a satisfactory normative system for local government financing in just one try. There was clearly a need for adjustments on the road to full normativity. However, these adjustments were never implemented. As a result, the system developed following a series of uncoordinated (and quite often counter-productive) measures, rather than developing systematically. During the subject period, the share of discretionary elements increased, which reduced the system's normativeness as well as its predictability.

¹²⁹ The approval or amendment of this type of acts requires the support of at least two-thirds of the MPs present at the vote.

¹³⁰ This type of law requires the support of at least half of the MPs present at the vote.

¹³¹ Targeted subsidies are exceptions. Under certain conditions, municipalities can directly access these funds.

ANNEX 9: Sustainable Financial Management and Operating Surplus¹³²

Sustainable financial management

Financial management reform aims to create the conditions necessary for sustainable service delivery. This requires setting up a financial management system that guarantees the long-term sustainability of the local government's financial balance.

The financial balance may be construed as consisting of three different levels. These are: the "operation's direct balance"; the "sustaining balance" that sustains the organization's operation at a given level; and the "adaptive balance" that enables operation to adapt to recurrently changing requirements.

"Direct operational balance" can be guaranteed by revenues covering every-day operating (current) expenditures. To keep up the "sustaining balance", the revenues should cover not only the direct operating costs but also the costs of maintenance and refurbishment (to counter-balance depreciation in order to ensure operation at the given level). Finally, the "adaptive balance" requires not only revenues to cover direct operating costs plus the costs of maintenance and refurbishment, but also the costs of necessary service or infrastructure development or – if demand decreases – the costs of orderly cutbacks.

It goes without saying that adaptive balance alone can guarantee sustainability. A "sustainable balance" hinges on the municipality's ability to maintain the quality of its public services and continuously adjust them to the prevailing demands. This creates a favorable environment for the city's population and economic activities – thus ensuring that the city's revenue raising potentials will cover the costs of its future services.

If a municipality fails to maintain the quality of public services and to continuously adjust them to the prevailing demands, it becomes less competitive, its affluent residents and leading businesses move to other cities and eventually the city cannot stay afloat. There are several examples to prove this point, perhaps the best known being the decline of the downtown areas of large North American cities. Meanwhile, thriving world cities not only maintain their public services but also continuously renew and develop their servicing infrastructures and adjust them to the changing demand.

Cornerstones for sustainable financial management

The balance of the (current) operating expenditures and revenues (later to be called operating budget) plays a key role in promoting sustainability.

The importance of a balanced operating budget may seem obvious, since only revenues that flow incessantly into local government budgets can be expected to cover recurrent operating costs. When the recurrent revenues are not sufficient to cover the operating costs, and thus the difference must be covered from the capital revenues, we cannot talk about sustainability even

¹³² The explanation of the terms and concepts below is partly cited and partly based on text in Pallai 2003c.

on the direct operating level. In these cases, the one-off revenues originating from the sale of assets are available only temporarily, since the marketable portfolios are bound to be gradually exhausted. Consequently, attempts to cover the operating costs from capital revenues are doomed to fail, since using these marketable assets eliminates the resources, while the operating costs of the operation are bound to remain.

However, if the direct operating costs consume all the recurrent revenues, it is likewise untenable in the long term to try to cover operating costs from the recurrent revenues. In such a situation the direct operating budget might remain balanced for a short while, but (since maintenance and adaptation are financed exclusively from the capital revenues) the revenues from the sale of assets will quickly dry up and the sources of maintenance and adaptation will become exhausted. The results are predictable: deteriorating infrastructure, increasing operating costs and ultimately the inevitable choice between the need to cut back the quantity or the quality of the services.

Consequently, a basic rule of sustainable financial management is that recurrent revenues must exceed operating costs, i.e. there must be an operating surplus that is produced.

Previously, we defined sustainable financial management as one under which the revenues continuously cover direct operating costs, necessary maintenance and adaptation to the changing external conditions. The local government's own capital revenue sources are limited, as they can be drawn only from the local government's own assets. They are bound to eventually disappear if they are used to cover the operating costs. In order to avoid the loss of assets, a second basic rule can be formulated: capital revenues can only be used to cover capital expenditures.

However, we must also see that even capital revenues cannot continuously cover the costs of refurbishment and adaptation. Consequently, the local governments must create the conditions for using the operating surplus (which draws on the recurrent revenues) as the source for their capital expenditures. This is a third rule for sustainable management.

Although the operating budget is the key to sustainability, capital revenues may also play a cardinal role in the grand transformation projects that characterize the post-socialist transition period. Local governments might be able to complete previously postponed refurbishing and investment projects and set their services on a sustainable course, if they spend the revenues originating from the sale of their assets and from the privatization of part of their services on transforming and upgrading infrastructure. This step (which qualifies as a peculiar "transitional scheme") may also provide remarkable leverage to shape the necessary conditions for balanced financing management.

The operating surplus

As we have seen, the operating surplus (i.e. the recurrent revenues not committed to operation) can serve as the resource for the city's longer-term non-operating expenditures. The operating surplus may also serve as coverage for debt amortization, i.e. it may be considered a key factor in determining the city's creditworthiness.¹³³ The operating surplus

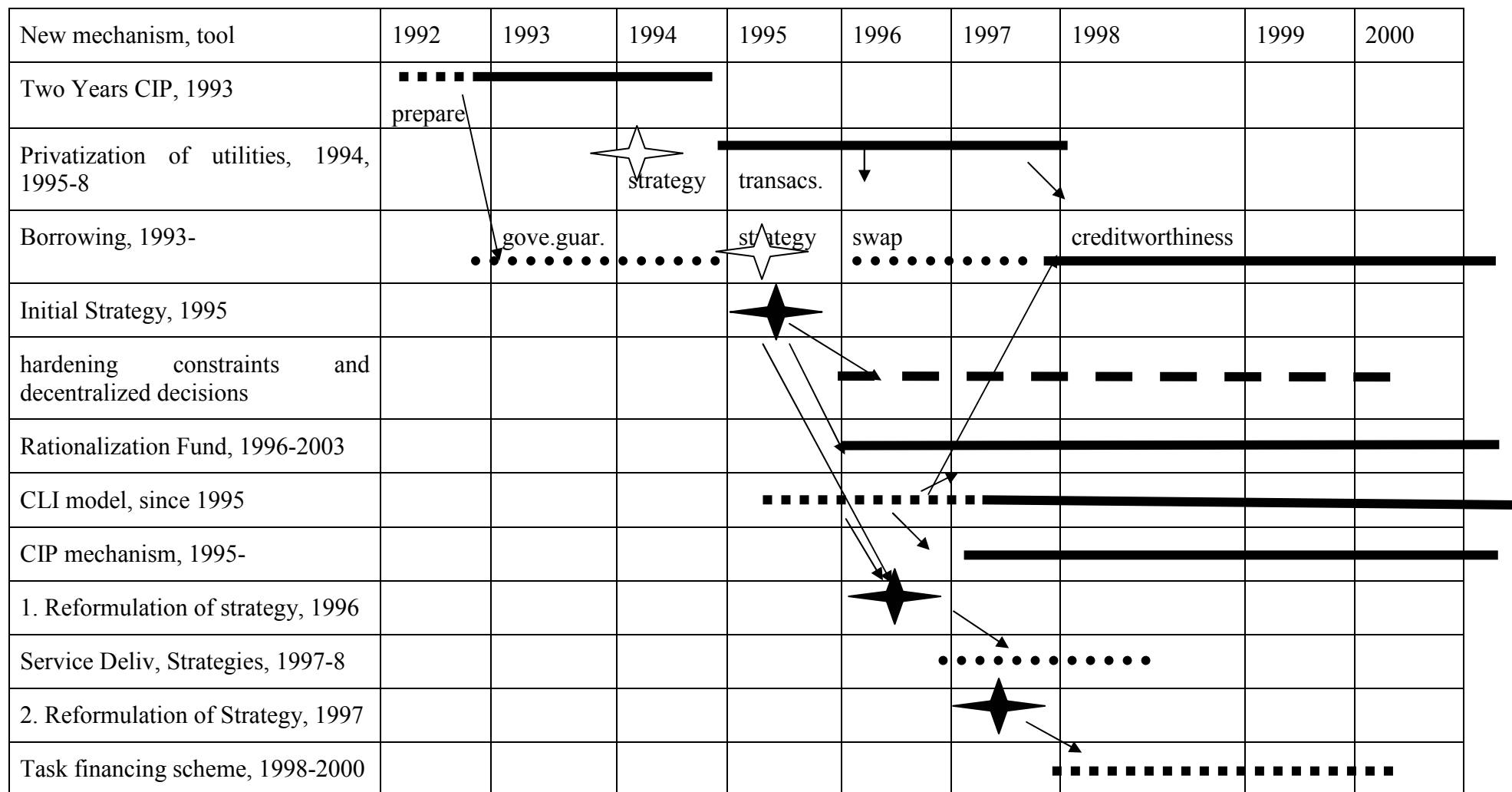
¹³³ According to the logic of financial management this statement may be considered accurate. However, a more precise definition would be to say that the *adjusted* operating surplus can serve as the debt service of any newly

constitutes an important element of the analysis of a local government's financial activity, and it is widely agreed that the local financial management strategy must specify its targeted level.¹³⁴ At the same time, there is no universally accepted and applicable benchmark that can be used as reference, primarily because its expected level is always determined by the context (the structure of assets, tasks, funding; strategies etc.).

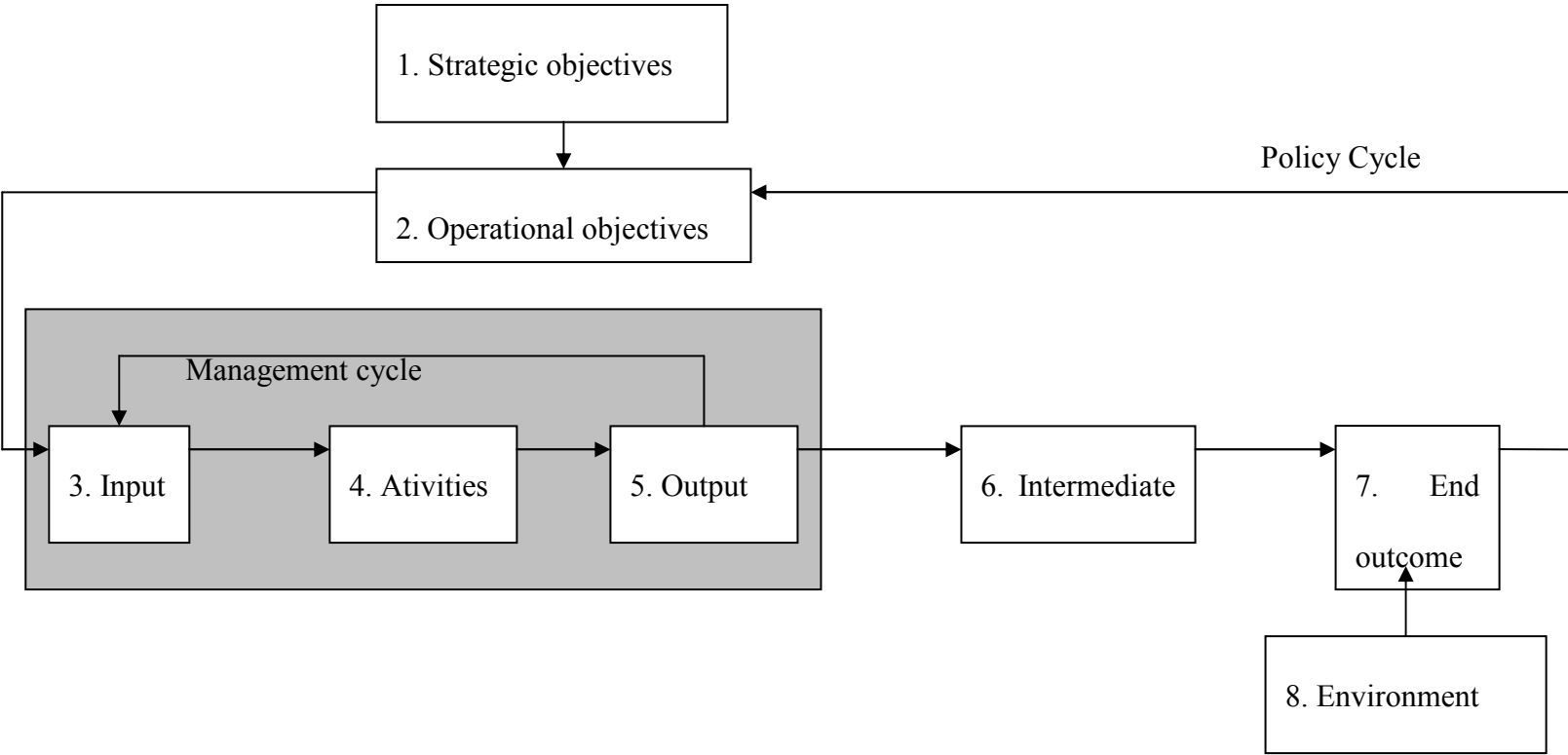
raised loan. This is the part of the recurrent revenues which is not committed to financing the operation or repaying the earlier debts. Under Hungarian regulations this is identified as corrected own revenue, which equals that part of the previously mentioned sum which comes from own resources.

¹³⁴ The capital city's financial management strategy, which was approved in 1996, prescribed the accomplishment and maintenance of a 20 percent operating surplus.

ANNEX 10: Chronology of Reforms



ANNEX 11: Performance Framework



Sources: Boukeart and Van Dooren 2003, 130

ANNEX 12: Line of causality in local budgeting

