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# *The Debt Consolidation of Hungarian Local Governments*

**SUMMARY:** The total debt of Hungarian local governments accumulated during the 2002–2008 period was consolidated in full by the government between 2011 and 2014. Most of the debt assumed by the central budget was denominated in foreign currency, which involved high exchange risk and, therefore, financial instability for both the central and the local subsystems of public finances. According to some economists, the bailout of local governments by the state is another manifestation of the soft budget limit, showing that the Hungarian market economy is unable to break with the bad culture of centrally planned economy. The present study – building on primary research – presents the process that led to the indebtedness of local governments, as well as the theoretical and practical background of consolidation. The author believes it is unwarranted to enforce a hard budget limit for the local governments at any price.

**KEYWORDS:** debt consolidation, local governments, soft and hard budget limit, transition to market economy, new systemic approach to state finances

**JEL CODES:** E62, E69, H12, H70, P41

## SYSTEMIC INTRODUCTION

The new Hungarian state reorganised from 2010 carried out successful financial consolidation by 2013. Large international corporations and banks were made to contribute more to public dues, while the corporate income tax for mostly Hungarian-owned companies with lower revenues, and the personal income tax for wage earners in households were reduced<sup>1</sup> and a wide range of social measures<sup>2</sup> were introduced. The expansion of solvent demand resulted in an increase in domestic consumption as well as the willingness to invest. As a result of comprehensive fiscal measures, Hungary was removed from the countries that were under the excessive deficit procedure of the European Union. Instead of an automatic, normative enforcement of the European Union's principles of monetary policy, in March 2013 Hungary

began to reshape the tools of the National Bank of Hungary in order to ensure economic expansion and macro-economic stabilisation. The audits of the State Audit Office of Hungary have contributed to defining the directions of fiscal consolidation and the assessment of loans taken out for bailout.<sup>3</sup> In the period after the summer of 2010, the first round of measures focused on the mitigation of payment costs in the central budget and then in the social security system.

National bankruptcy in Hungary in the period of 2008–2013, which would have resulted in a total failure in the operation of the national economy, can be typified in five ways and in terms of five categories on the basis of a systemic approach:<sup>4</sup>

- the central budget becomes inoperable, the operation of the state becomes impossible, state public services and debt service fail,
- the social security and especially the pension system accumulates a chronic deficit,<sup>5</sup>

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the payment of pension allowances stalls and eventually fails,

- en masse bankruptcy of banks and companies, operative environment becoming unstable, state and household savings stuck, basic production functions eliminated, unemployment becoming unmanageable,
- en masse bankruptcy of local governments in the local system of public finances, social conflicts and problems in local public services generated,
- families with foreign currency loans becoming insolvent and facing eviction on a social scale.<sup>6</sup>

In order to maintain the operation of market players, the Hungarian government assumed an active role to influence economic policy. The ruling idea of the neoliberal market economy model – which holds that market players are capable of self-regulation, sectoral regulation and creating a balance – was replaced by the state playing an active part in the regulation of the economy. It regulates and supervises the operation of market players. It breaks with the basic philosophy of the Washington Consensus.<sup>7</sup> It creates sales markets for businesses, declares the economic policy of opening to the East, while it continues to view the European Union as its major ally and partner. It seeks to finance the operation of the state by optimising the tax system, in other words, creating extra tax revenues through reorganising the public dues system. Instead of using the loans granted by international financial institutions (IMF, World Bank) and observing the economic advice attached to them, it seeks to solve the financing of the central budget by using internal resources<sup>8</sup> and the inclusion of new “eastern” partners. After comprehensive fiscal and monetary reforms, the second quarter of 2013<sup>9</sup> saw the beginning of marked and continuous economic expansion in Hungary.<sup>10</sup> The state consolidation of local governments that took place between 2011 and the

spring of 2014 was extended to another segment of public finances.

## ECONOMIC PROCESSES AT LOCAL GOVERNMENTS AFTER THE POLITICAL TRANSFORMATION

The act on local governments<sup>11</sup> used the provisions of the former Constitution to define the operative rules for local governments, which replaced the Soviet-type council system of the socialist centrally planned economic system. The local governments with broad responsibilities were given a high degree of autonomy in terms of financial management as well as in the area of restructuring.

The National Assembly continued to enact laws in order to strengthen the economic foundations of the local government system, which provided more leeway for local governments and which were required to create an environment for effective operation and economic independence. In addition to the act on local taxes, the State Property Act applying to local governments, which was enacted in 1991 by the National Assembly, played a crucial role in providing economic independence for local governments. The Local Government Act provided that the ownership of – among others – public utility companies owned by councils, the education, healthcare, cultural and other institutions run by the local councils, state tenement flats, all financial assets, all securities and other economic rights of the councils should be transferred to the local authorities. Some of the assets were transferred to local governments pursuant to the Act on Local Governments, while others were transferred by the property transfer committees set up for this purpose. It was at this time that legal background and the organisational framework for targeted and earmarked subsidies were created.

However, the local government system that began to develop in the 1990s saw a significant decentralisation of tasks from the state and the central budget, but the deployment of tasks was not followed by the decentralisation of central resources, so by the turn of the millennium, there was a significant operating deficit in the local public finance subsystem. It became quite common for the local governments to use development resources, especially investment loans, secretly, for operating expenditure.<sup>12</sup> The decentralisation of tasks that began in the middle of the 1990s resulted in the decentralisation of deficit within public finances and soon afterwards the total debt of public finances also got into a decentralisation vacuum.

After becoming a full-fledged member of the European Union in 2004, new development subsidies became available for local governments. They were able to use significant EU and domestic grants provided for development purposes for investments, renovation and the procurement of equipment implemented in order to create, maintain and develop the infrastructure required to carry out their tasks. With the emergence of European resources, the subsidy system of domestic development projects has changed. Point 1 of Chapter 2 of National Assembly Resolution No. 67/2007 (VI. 28.) on regional development support and the principles of decentralisation defines the need for the concentration of purely domestic resources not meant for co-financing to ensure that they are used efficiently. However, the budget acts did not provide or allow for sufficient resources to fund the development tasks of local governments, especially for the own contributions required for EU development grants. Between 2006 and 2010, HUF 388 billion in central budgetary appropriation were made available for development grants for local governments. HUF 185 billion in targeted and earmarked subsidies, HUF 55 billion

in centralised appropriations, HUF 31 billion in chapter-managed appropriations and HUF 117 billion in decentralised regional development appropriations. The largely infrastructural development sources made available after the EU accession boosted investment at local governments. As, however, they did not have sufficient funds for their own contribution to the development grants, they took out loans and issued foreign exchange bonds to ensure this contribution – taking advantage of the opportunity provided by the government. As a result, the indebtedness of the local government subsystem of public finances, along with the decentralisation of its debt portfolio, began to increase further. On top of all this, the loans taken out, along with the EU grants, were mostly spent on infrastructural rather than productive investments. Therefore, there was no direct return, hence no coverage for the credit service generated from profits. Local governments did not have sufficient foreign currency revenues for repayment either. With the 2008 crisis, the financial instability of the local government subsystem – due to the higher exchange rate risk – affected the whole of public finances.

### THE FIGHT AGAINST LOCAL GOVERNMENT DEBT IN THE WORK OF THE STATE AUDIT OFFICE OF HUNGARY

After 2010, the debt issue, which damaged the fundamentals of the state's operation, was at the centre of Hungarian financial policy. Although the total debt of the local governments was insignificant compared to the amount of debt accumulated by the central government, by 2011 the audits of the State Audit Office of Hungary (SAO)<sup>13</sup> proved that the local subsystem was extremely fragile in a financial sense.<sup>14</sup> Under previous governments, there was no coverage for the repayment of local

government credits and debenture loans. The State Audit Office of Hungary focused most of its audit capacities on local governments in 2011. Act CLXXXIX of 2011 on Local Governments relies on the findings of the SAO. These findings were incorporated into legislation, whereby the supreme audit institution contributed to good governance and the establishment of an efficient state.

The SAO reports clearly showed that the financial equilibrium of Hungarian local governments deteriorated between 2007 and 2010, and financial risks increased over the same period.<sup>15</sup> The audit institution pointed out the reasons that lead to this situation. The lack of operating and accumulation funds emerged simultaneously in the local government system. The exposure of local governments to banks increased, forcing them to renew and extend the amount set out in their liquidity loan contracts. The debt issue was truly serious challenge to meet because most of the local governments failed to create the reserves required to repay the liabilities to financial institutions. The funds serving as coverage for repayment were not identified. It was also risky that some of the property items that belonged to the nominal assets of local governments were also offered as security for loans. The SAO also warned that in the case of the issued bonds, beyond the unfavourable developments of the exchange rate, pre-term reconversion or conversion into Hungarian forints could also cause unexpected expenses. The increase in trade payables represented further risk. The provision of funds required by the subsequent financing of projects implemented with the help of EU grants also caused liquidity problems. By the end of 2010, the local governments accumulated HUF 1154 billion in future commitments due to their investment projects in progress. In addition to the EU grants, domestic government grants and their own revenue, town local governments

operating in the medium range needed an additional HUF 217 billion in external funding. Giving up on investments was not an option either, as the infrastructure of local governments was outdated and, on the other hand, it was the investments implemented at the medium level that gave momentum to the country's performance, which was already in crisis struggling with falling GDP.<sup>16</sup> Thirdly, due to the shortage of central budgetary funds, 90 per cent of new facilities in Hungary are built using EU funds.

On top of all this, the business associations under the majority ownership of local governments also accumulated significant debts. Local governments failed to pay sufficient attention to control the indebtedness of their business associations. In 2011, the only possibility to resolve the debt issue was for the government to assume these debts, which process began at the end of 2011 by the assumption of county local government debts. Prime Minister *Viktor Orbán* announced on 27 October 2012 that the government would assume the entire debt portfolio of towns with a population of less than five thousand and some of the debt of the towns larger than that.<sup>17</sup> In 2014, the government assumed the remaining debt of the towns with more than five thousand inhabitants as well. The auditing work and the proposals of the State Audit Office<sup>18</sup> provided a good basis for the implementation of the debt consolidation at local governments. The local governments that had not taken out loans in the so-called general period of indebtedness to increase their wealth received a total of HUF 12,1 billion in compensatory development grants in 2014.<sup>19</sup> Therefore, the “economising” (often uncreditworthy) local governments that managed their finances without loans typically did not generate “losses.”<sup>20</sup>

The question often arises why the consolidation of debts took place in the middle of the government term and especially why it

was necessary. The financial situation of local governments was disastrous. They were unable to resolve the situation on their own. The en masse bankruptcy of local governments would have resulted in the negligence of their public tasks. A wave of discontent, social conflicts and eventually national bankruptcy would have set in. With the turn in fiscal trend, the government managed to consolidate the central budget by the middle of its term. There was an opportunity (growing financial buffer and leeway) for assuming the debts of local governments. On the other hand, it made political sense to propose it before 2014, when the circumstances were “ripe” for it. If this consolidation had begun towards the end of the term, Brussels might have put obstacles in its way. However, without shedding light on the problems – for which the credit goes to the SAO – the consolidation of the local governments could hardly have taken place (without conflicts). By implementing this, the government managed to avoid another national bankruptcy.

## PRESSURE FOR CONSOLIDATION

The debt of local governments does not just affect the people living at the given settlement. It is in the interest of the national economy to avoid recreating indebtedness since the fight against debt is at the centre of the Hungarian financial policy. The financial equilibrium of the local governments deteriorated considerably in the past decade, especially between 2007 and 2010, and financial risks increased significantly. The lack of operating and accumulation funds emerged simultaneously in the local government system. The exposure of local governments to banks increased and it became common practice to renew these liquid loan agreements annually, mostly out of necessity and in increasing loan amounts. It

should also be noted that the HUF 388 billion in purely domestic development grants used in the 2006–2010 period was rather disproportionate. This amount was HUF 121 billion in 2006, HUF 107 billion in 2007, HUF 103 billion in 2008, HUF 47 billion in 2009 and only HUF 10 billion in 2010. This trend shows that the local government sector was under-financed from the outset.

The liabilities of local governments against financial institutions increased by a total of 77.7 per cent by 2010 compared to 2007, although the increase was varied for the various types of local governments. The liabilities of the subsystem of local governments resulting from bond issuance showed a nearly 25-fold increase. Compared to the opening total value in 2007, there was an increase of HUF 564 billion, amounting to a total value of HUF 588 billion in 2010. The increase in liabilities due to borrowing was of a more moderate pace; compared to the opening total liabilities in 2007, there was an increase of HUF 192 billion (41 per cent) in 2010. 75 per cent of the total increase in debts (HUF 756 billion) – realised primarily in 2007–2008 – was due to bond issuance.

84,6 per cent of the total debt of HUF 1247 billion, recorded by the local government subsystem at the end of 2010, was generated by those local governments – Budapest, the counties and the towns with county rank – which were rated by the State Audit Office as highly risky and therefore subject to a comprehensive audit<sup>21</sup> in 2011–2012.

One of the main reasons for indebtedness was that local governments did not have funds for their own contribution to EU supported investments. Therefore, long-term resources had to be found which could help local governments apply for EU grants. They raised these funds by issuing foreign currency-denominated bonds. The debt issue was a truly serious challenge to meet because most of the

local governments failed to create the reserves required to repay the liabilities to financial institutions. The funds serving as coverage for repayment were typically not identified. It was also risky that each of the property items that belonged to the nominal assets of the local governments were also offered as collateral for the loans. In the case of bonds issued, beyond the unfavourable developments of the exchange rate, pre-term reconversion or conversion into Hungarian forints could also cause unexpected expenses. However, the main risk factor was exposure to the exchange rate since there was no running coverage for the liabilities due in foreign currency. Local governments did not have revenues in a foreign currency which they could use to safely repay the principal and the interest of foreign currency loans free from the volatility of exchange rates. The investments implemented from EU grants and foreign currency loans are typically non-productive, so it was not possible to use the returns to generate the required funds.

In addition to the subsequent financing of projects from EU grants, the increase in trade payables and their high level against the monthly average of non-personnel expenses also created additional risk. Due to the limited availability of funds, local governments typically considered suppliers instruments of external financing. Between 2007 and 2010, the trade payables portfolio of the local government sector grew from HUF 85 billion to HUF 105 billion, with overdue debts increasing from HUF 26 billion to HUF 44 billion (by 69.2 per cent). In the same period, monthly non-personnel expenses rose from HUF 44 to HUF 53 billion.

The business associations under the majority ownership of local governments also accumulated significant debts, and at the same time, for lack of legislative authorisation, before 2011 the State Audit Office of Hungary did not have the right to audit these compa-

nies owned by local governments, which in turn failed to pay sufficient attention to prevent their business associations from becoming indebted. In many cases, they also failed to present their own financial risks together with that of their business associations. Liability as owners—if certain conditions are met—for the debts of business associations constitutes both financial and consolidation risk, such as in the case of the Budapest Transport Company (BTC). In 2011, at the initiative of the new SAO management but before the new SAO Act was enacted, the mandate of the supreme state audit authority was extended to business associations owned by local governments, and the first company to come under the microscope of the auditors was the BTC.

Assessing the financial management and audit processes of local governments up to 2010, it is important to stress that the central regulation regarding the limitation and rationalisation of debts was also unable to fulfil its function. Since the local governments took, that is, were entitled to take liabilities that exceeded their financial capacity, central debt management was inevitable because a large number of local governments going bankrupt would have caused unpredictable problems in public finances.

## THE PROCESS OF DEBT CONSOLIDATION AT LOCAL GOVERNMENTS

The government consolidated the debts of local governments in three stages. The first round of debt consolidation involved settlements and towns with less than 5000 inhabitants. The state assumed a total of HUF 74 billion in debts owed by 1710 settlements and towns stemming from 3848 contracts. In accordance with the applicable procedure, the local governments paid HUF 3.5 billion in security deposit to the treasury.

In the course of the consolidation of debts owed by settlements and towns with less than 5000 inhabitants

- the HUF-denominated debts of 1684 local governments in the amount of HUF 50.5 billion were consolidated and HUF 73 million was paid to the Treasury as security deposit which came from the termination of loan agreements,
- the debts owed by local governments in Swiss franc (foreign currency loans in the amount of CHF 94 million owed by 97 local governments on the basis of 103 loan agreements) were also settled,
- 13 of the local governments included in the consolidation process had EUR-denominated debts in the amount of 2.9 billion euros (on the basis of 16 agreements). In this case, the government also decided on debt settlement and concurrently ordered the affected organisations to pay HUF 50.5 million and EUR 50.000 as security deposit to the account of the Government Debt Management Agency.

Pursuant to statutory provisions, a separate government resolution stipulated that the debt consolidation of 14 towns must be realised by 28 June 2013 in accordance with the 2013 Act on the Budget. The reason for this was that some of these local governments were either under debt settlement proceedings or they only had interest for default stemming from previous loans or their agreements could not come under the scope of consolidation (e.g. a financial lease agreement), and there were seven local governments which did not want to take advantage of consolidation.

The exchange rate used in the procedure was HUF 238.6 for Swiss franc and HUF 288.3 for euro-denominated loans. The consolidation of the debts was entered into the accounts on the basis of portfolio data recorded on 11 December 2012, followed by financial settlement on 28 December 2012.

In the second stage of debt consolidation, pursuant to Article 72(1) of Act CCIV of 2012 on the 2013 Central Budget of Hungary, the Hungarian State partially assumed the debt portfolio, and the contributions associated with it up to the date of assumption as at 31 December 2012, of local governments with populations over 5000 – including the Municipality of Budapest, the district local governments. The debts affected by partial assumption included outstanding debts due – on loans or credits, securities constituting a debt instrument as well as the issuance of bills of exchange in the case of assumed debts – to a financial institution in accordance with Act CXCV of 2011 on Hungary's Economic Stability and the act on credit institutions and financial enterprises. The Hungarian State assumed the full amount of debts and related contributions payable by local governments with over 5000 inhabitants as defined in Article 72(2) of the Act, in other words, the loans taken out in connection with inpatient institutions and certain specialised social and child protection institutions which had already been transferred over to the state for operation. A further condition for consolidation was that the given local government should not have any debt settlement procedure in progress as at 31 December 2012, pursuant to the act on the debt settlement procedure.

The details of consolidation for towns with over 5000 inhabitants were set out in Articles 72–75 of Act CCIV of 2012 on the 2013 Central Budget. Pursuant to the Act on the Budget, the assumption did not apply to the pre-financing of grants paid from the central subsystem of public finances, grants directly awarded by the EU or provided by international organisations, payment obligations stemming from the advance payment of VAT and other revenues constituting a debt, and payment obligations deriving from loans assumed from a water utility association by a local government affected by a grant. Pursuant

to the Act on the Budget, the local government had to pay to the state the amount of deposit or outstanding balance used as coverage or security expressly for the debt item affected by the assumption, in proportion to the amount of debt item assumed and at most in the amount of this debt item.

The Act on the Budget referred to before also defined the set of conditions that govern the benchmark amount of the assumption. One of the frequently used methods in the local government financing system is the calculation of tax capacity, which is based on the “revenue-generating” potential of local governments in accordance with pre-defined criteria. The calculation performed by the Ministry for National Economy is based on the local business tax base recorded and declared in the 2012 semi-annual financial statements of local governments. 1.4 per cent of this was used to determine the average realisable revenue from local business tax (calculating with 70 per cent of the maximum 2 per cent local business tax rate) for every town, divided by the number of inhabitants as at 1 January 2012, which gives the tax capacity per capita.

After these calculations had been carried out, the towns were classified into various categories. The Act on the Budget defined four town and settlement categories. Then the per capita tax capacity data of the towns within each category were sorted in terms of size, and the data of the top 10 and bottom 10 per cent were filtered out. Using the remaining 80 per cent of the data, a simple arithmetic average was calculated to determine the adjusted average of each town category. Next, on the basis of the amount of debt assumption for each town, the per capita tax capacity of the given town was calculated with respect to the adjusted average of its town category.

If the tax capacity of a local government affected by assumption with respect to the adjusted average of its town category:

- was equal to or over 100 per cent, 40 per cent of its debt,
- was between 75 per cent and 100 per cent, 50 per cent of its debt,
- was between 50 per cent and 75 per cent, 60 per cent of its debt,
- was below 50 per cent, 70 per cent of its debt was used as the basis for debt assumption by the state.

Calculated in Hungarian forint, the tax capacity category averages were as follows:

- towns with county rank, HUF 35,997,
- other towns with over 10 thousand inhabitants, HUF 23,550,
- other towns with between 5 and 10 thousand inhabitants, HUF 16,049,
- settlements with less than 5 thousand inhabitants, HUF 13,278.

The Minister of National Economy and the Minister of the Interior had the right to determine an assumption ratio higher than the ratio set out in the Act on the Budget (40–70 per cent).

In accordance with the Act on the Budget, local governments and financial institutions had to supply data for the debt items outstanding as at 31 December 2012 and affected by consolidation until 11 January 2013 via the Treasury’s electronic system. 278 local governments supplied data for a total of 2015 agreements in the amount of HUF 1033 billion in debts (calculated at the exchange rate valid as at 31 December 2012), which formed the basis of partial debt consolidation.

Broken down by currency:

- HUF 334.5 billion in HUF-denominated debts as at 31 December related to 1527 agreements,
- CHF 1.8 billion in CHF-denominated debts (HUF 422.1 billion) related to 370 agreements,
- EUR 949.4 million in EUR-denominated debts (HUF 276.5 billion) related to 118 agreements.

The debt items that were included in the consolidation stemmed from overdraft facilities, wage loans, short-term loan agreements, long-term loans (HUF 476.9 billion), bond issuance (HUF 472.8 billion) and bills of exchange. A total of HUF 477.1 billion in debt was assumed of the debt indicated (on the basis of assumption levels defined by the Act on the Budget).

The data supplied by the local governments indicated HUF 9.1 billion in loans taken out for the operation and development of inpatient institutions and certain specialised social and child protection institutions, which were assumed in full.

The local governments had to pay HUF 6.8 billion in security to the central budget for the debt items affected by consolidation (on the basis of the assumption levels defined by law). As the conclusion of the first stage of consolidation – in compliance with applicable regulations –, the affected local governments and the state concluded an agreement by 28 February 2013 on the assumption levels, which was followed by a trilateral agreement made by 28 June between the Government Debt Management Agency, the financial institutions and the town concerned.

During the consultations between the parties, 90 per cent, a total of 250 affected local governments said they would need higher assumption values for the following reasons:

- local business tax revenues have significantly decreased since the data were supplied,
- the given local government does not see any opportunity for expanding the range of taxes and generating more tax revenues,
- comments on the 2013 budgetary conditions (difficulties in planning the budget without operating deficit, schools have to be operated fully from own money without budgetary funds, local government tasks continue to require additional funds

provided by the local government, the compensation is low, and the leeway of local governments with local business tax revenues becomes restricted),

- the business associations of local governments have significant debts; in many cases they undertook an absolute guarantee which is – naturally – not part of the consolidation,
- a lump-sum repayment obligation within a relatively short term arises, which was extended only to 30 June 2013 by the financial institution pursuant to the stability act,
- problems of a structural nature which represent extra burdens for local governments (high unemployment, number of socially handicapped individuals constantly rising),
- in order to increase employment and local revenues, local governments plan to implement economic development projects which require considerable own resources,
- local governments were able to use only some part of the development credit lines by 31 December 2012, which were allocated for large ongoing development projects.

The objections raised during consultations justify the need for improving the monitoring activity of the central administration and the audit work of the State Audit Office of Hungary to ensure economic discipline and rationality. This means that it is expedient to put audit pressure on local governments, one the one hand, to avoid giving rise to less-than-careful asset management, and on the other hand, that town local governments, which have been relieved of a large number of obligations and public functions (see Széll Kálmán Plan 2.0), play a more important role in local food supply, while the county local governments, which also have significantly less functions (compared to the previous period) take a big-

ger share in regional economic development. With the changing role of local governments – the maintenance of institutions was replaced by the promotion of economic development –, new local government functions could be based on the technical infrastructure base, realised with the help of foreign currency loans.

For practical reasons, local governments concluded the debt consolidation agreements with the state in nominal value rather than on a percentage basis. This is how the Ministry of the Interior responsible for consolidation wanted to prevent any “hairsplitting bargaining” and over-scrupulous debates that lack any professional basis. So, the trilateral agreements were concluded by 28 July 2013 and the contracting parties had to conclude financial settlement by the end of 2013.

The state assumed HUF 612 billion in debts from 1956 local governments during the consolidation process which took place over the summer of 2013, which created very favourable conditions for bank portfolios. If the government had not acted, banks would have suffered significant losses. The assistance provided by the state resulted in the improvement of bank portfolios and better earnings, whose related public dues were resolved.<sup>22</sup>

The last stage of the consolidation of local governments took place in the spring of 2014. The state assumed the remaining debts of the local governments with populations over 5 thousand as well. This stage involved the consolidation of debts due on the outstanding transactions of all local governments and their associations to financial institutions as at 31 December 2013. In accordance with applicable regulations, these transactions may have involved a credit, loan or security constituting a credit relationship (bond), financial lease, deferred payment at least for a period of 365 days and instalment payment. HUF 64 billion in uncapped appropriation was allocated in the 2014 central budget for state grants re-

lated to the debt consolidation of town local governments. HUF 4 billion of this amount was planned to cover the consolidation of local governments which would conclude their debt settlement procedure in 2014. The actual amount paid out was HUF 67.4 billion. The payment was recorded as expenditure in the budget and as revenue in the subsystem of local governments, so its effect on the balance of public finances – and government debt – was neutral. The last round of debt consolidation concluded on 28 February cost HUF 456 billion, HUF 30–40 billion more than estimated, eventually amounting to a total of HUF 1344.4 billion.

## NEW DIMENSIONS IN THE OPERATION OF LOCAL GOVERNMENTS

Currently, the autonomy of local governments is affected by several restrictions – in order to maintain their financial stability. For example, the act on national property restricts the rights of local governments regarding the foundation of economic associations and the acquisition of stakes in economic associations. At the same time it is a fact, as it has been mentioned before, that the State Audit Office of Hungary’s mandate only covers the auditing of business associations owned by local governments since 2011, which had unforeseeable consequences in the past few decades (see the Budapest Transport Company). Therefore, the restrictions set out in the act on national property serve transparency and efficiency, since it takes time for the government and the audit authority to acquire appropriate information on all the companies owned by local governments.

A local government can only have a stake in an economic organisation if its liability does not exceed its financial contribution (for example, a limited liability company or a joint-

stock company). The business activities of local governments should not jeopardise the performance of their mandatory functions. As of 1 January 2012, several restrictions apply to the transactions of local governments that create debt (such as taking out loans, issuing securities). These rules are contained in the Stability Act. Local governments may carry out transactions creating a debt only with the prior approval of the government (in special cases). They can take out only liquid loans for operating purposes, which means they cannot finance the deficit planned in their operational expenditures from external sources (loans), but only from internal sources (such as residues generated in the previous years). As of 2013, pursuant to the new statutory provisions, no operating deficit can be planned at all.

While local governments are part of the system which executes public functions regulated by statutory provisions, they have relative economic autonomy in terms of how these functions are performed and in several other areas. Act XV of 1997 on the Declaration of the European Charter of Local Self-Government sets out the following on the scope of authority of local governments (Article 4): *“Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy.”* So, the Charter suggests that where a public function cannot be ensured on site, it should be carried out by the administrative authority that is closest to the citizens. This means that the foundation of joint local government offices (the new Local Government Act, Act CLXXXIX of 2011) is in accord with the European principles of local governments.

In accordance with the Local Government Act, as of 2013, towns within a borough with less than 2000 inhabitants must set up a joint local government office. The total population

of settlements belonging to the joint office thus created should be at least 2000 or the number of villages should be at least seven. Settlements with over 2000 inhabitants may also belong to the joint local government office set up by virtue of law. This measure can help generate considerable savings in costs and improve the level of services.

The county institutions and the healthcare institutions run by the Municipality of Budapest were transferred to the state’s maintenance as of 1 January 2012, followed by the hospitals maintained by town local governments as of 1 May 2012.

As a result of the measures introduced on the authorisation of loans pursuant to Act CXCV of 2011 on the Economic Stability of Hungary, the deficit of the local government subsystem decreased significantly. In accordance with Article 34(5) of the Fundamental Law, which entered into force in 2012, a separate law may make the commitments of local governments subject to certain conditions or to the approval of the government in order to maintain budgetary equilibrium. On the basis of this authorisation, the Stability Act provided that the payment obligations of local governments resulting from transactions that create a debt in the current year may not exceed 50 per cent of their own revenues in any year until expiry. This regulation was meant to ensure that the local governments do not become insolvent due to their debt service obligations. Concurrently with this, the ban on taking out additional loans by local governments that have already exceeded this limit created an opportunity for reducing exposure to debt. In addition, any transaction with a development or operational purpose that creates debt for a local government was made subject to the approval of the government.

Certain credit transactions were possible without the approval of the government. The loans taken out for advancing EU develop-

ment grants, that is, for providing the own contribution in these tenders were removed from the loans requiring approval, since these loans were connected to investments supported by EU funds and the coverage of loans was the development grant provided by the European Union. Loans taken out for operational purposes with durations of less than a year are also not subject to approval, as they do not have an effect on the year-end status of government debt. On the other hand, their authorisation would cause too much delay, weakening the liquidity of local governments.

The transactions related to restructuring loans taken out for the conclusion of creditor agreements during the debt settlement procedure may also be carried out without the approval of the government. In addition, transactions below HUF 10 million, HUF 100 million in the case of the capital and towns with county rank, which create a debt are also not subject to government approval.

The procedure for the contribution to the commitments of local governments is regulated by Government Decree No. 353/2011 (XII. 30.) on the detailed rules on the contribution to transactions creating a debt. This regulation also defines what own revenues can be used as a collateral for the transactions creating a debt.

## SOME THEORETICAL ASPECTS AND THE EVALUATION OF DEBT CONSOLIDATION

The financial instability created by previous governments inevitably pushed the current government into a stabilising and restructuring role. The debts of county local governments were assumed by the state in 2011, followed by the decision on the comprehensive settlement of the debt portfolios of town local governments in 2012 and 2013. The maintenance of institutions performing public func-

tions in towns and villages (schools, certain specialised social institutions, hospitals and outpatient healthcare institutions) were also transferred to the state's scope of authority or liability.

The bailout of town local governments is quite common in the international arena as well.<sup>23</sup> The enforcement of soft budget limits<sup>24</sup> is, therefore, a widespread global phenomenon.<sup>25</sup> In these cases, the soft budget limit means that on the basis of past experience, local governments (and the banks financing them) trust that the state will save them anyway. Those who believe that the soft budget limit, that is, state consolidation, is wrong<sup>26</sup> argue that the government should not bail out economic entities that are loss-making – whether they are market players or entities belonging to public finances – because it will not force them to observe the rules of responsible financial management. However, as far as the indebtedness of the Hungarian local government sector is concerned, it is important to stress that neither the centrally planned system, nor the neoliberal macro-economic policy enabled local governments and market players to take a course that ensures sustainable development and modernise their infrastructure. The new government in 2010 had to face non-viable local governments, which was the result of the bad macro-economic policy pursued in the past few decades. In most cases, state authorities meant to supervise and regulate the activities of local governments rather than the local governments themselves should be held responsible for the financial problems that have emerged. The lack of effective state regulation and supervision, the poor fiscal policy that was forced to introduce decentralisation as well as the basic neoliberal philosophy which gave too much freedom to local governments, but at the same time used strong restrictions on resources, along with irresponsible budgetary practice, should be

held responsible for these problems in the first place. However, leaving local governments to their fate would have resulted in even more serious problems in the national economy, leading to the failure of the performance of local public services, socio-economic conflicts and ultimately – if they escalate – total financial collapse of public finances. Therefore, the bailout using taxpayer money entails lower social

costs than letting the local government system “sink” and leaving it in a non-viable state. Putting the operation of local governments on a sustainable course, after they have been freed from their debts and their range of functions reduced, and keeping them on this course is the responsibility of a government that pursues an economic policy which supports active supervisory and regulatory functions.

#### NOTES

- <sup>1</sup> The legislator reduced the personal income tax rate from 36 to 16 per cent. According to the new rules, the preferential 10 per cent corporate tax rate was raised from a tax base of HUF 50 million to HUF 500 million, with the provision that in the future the use of the preferential rate will not be subject to any specific conditions.
- <sup>2</sup> In addition to family tax reliefs, public utility charges for households were reduced through official price regulation.
- <sup>3</sup> The controls for the utilisation of public funds focused on performance audits and the supervision of the solvency of public finances at the subsystem level. The audit mandate of the SAO was extended to economic enterprises owned by local governments. The circumstances of the USD 25 billion stand-by credit line of the IMF–WB–ECB consortium (debt of the central subsystem of public finances, 2012).
- <sup>4</sup> For more details see: Lentner, 2013. Chapter XII
- <sup>5</sup> The law enacted in 1998 offered “tempting” tax relief and promising returns to young people, career starters and those with a higher income to join private pension funds, even making it mandatory for some age groups. The contributions paid by them to private pension funds created an increasingly larger gap in the state pension budget, making it difficult to cover the payment of pension for the already retired age groups. The state lost revenues and its financial instability was growing constantly.
- <sup>6</sup> Permanent retail foreign currency loan bailout packages beginning in 2011 and the reinforcement of financial consumer protection represent consolidation by the state.
- <sup>7</sup> According to the basic principle of the Washington consensus, the state is a bad owner, so it calls for the privatisation of state assets. It advocates the free, unhindered flow of goods, services, capital and workforce. It proposes to minimise state control and supervision.
- <sup>8</sup> The demand of households for government securities can be increased by enhancing the discretionary income of households, which is ensured by the government through fiscal and official price regulation measures.
- <sup>9</sup> The year of full-scale fiscal consolidation.
- <sup>10</sup> In the second quarter of 2014 (annual data, year on year), GDP-growth is as high as 3.9 per cent, the highest in Europe, while the economic performance of the euro area hardly reaches 0.7 per cent. The intervals of Hungarian growth: Q2 2013, 0.3; Q3 2013, 1.9; Q4 2013, 2.7; and Q1 2014, 3.5 per cent.
- <sup>11</sup> Act LXV on Local Governments
- <sup>12</sup> Lentner, Cs., 2005. Chapters 6–8 detail the financial management of local governments

- <sup>13</sup> Audits conducted at 62 town local governments (Audit on the financial situation and financial management system of local governments in 2011, SAO report, April 2012)
- <sup>14</sup> The local government subsystem took on a sort of black box nature. The cash flow deficit (without credit and security transactions in a GFS system) was HUF 42 billion higher in 2010 than the underestimated plan in the annual budget. This also contributed to the exceeding of the calculated public finance deficit of 3.8 per cent. See: Summary evaluation, 2011. Following the consolidation, the local government public finance subsystem recorded a surplus.
- <sup>15</sup> SAO Chairman László Domokos spoke about the debt issue of local governments and the audits performed by the audit institution that shed light on the matter in his lecture, delivered to the students of the National University of Public Service on 3 December 2012.
- <sup>16</sup> Instead of a comprehensive crisis management concept, the investments implemented at the town level helped resolve the tension and the bottlenecks stemming from the operation of the central government, especially as far as their carryover effects in the 2008–2010 period are concerned.
- <sup>17</sup> At the beginning of 2013, there was only talk of partial assumption.
- <sup>18</sup> The findings of the State Audit Office of Hungary and its chairman were supported by specific local government audit reports equipped with a new audit methodology (e.g. *The Financial Matters of Local Governments*, April 2012) as well as academic publications. Domokos, 2010; Domokos, 2011; Pulay, 2011; Domokos, 2012; Gyüre L.-né, 2012).
- <sup>19</sup> Its legal basis was the tender opportunity set out in Point 10 a) of Annex 3 of Act CCXXX of 2013 on the Central Budget of 2014. Ministry of the Interior Regulation No. 10/2014 (II.19) provided for the detailed rules of tenders. The 2014 HUF 10 billion budget fund was increased by HUF 2.1 billion by the Ministry of the Interior.
- <sup>20</sup> János Kornai (2014, pp. 74–75) does outlines “losses”, but in my view, most of the local governments that did not take advantage of the loan opportunity were less “economising”, but for the most part rather uncreditworthy, lacking a development concept necessary for the loan.
- <sup>21</sup> Audit on the financial situation of local governments... April 2012
- <sup>22</sup> The second “Varga package” announced at the end of June 2013 proposed a 7 per cent tax rate after the assumed debts, but the government eventually renounced it. Instead, the banks had to pay a lump-sum amount. The amount to be paid was 208 per cent of the transaction duty payable for the period of January – April 2013. The increased transaction duty payable by the banks represented a one-off revenue of nearly HUF 75 billion for the budget in 2013 (see the 2013 final accounts for its actual realisation). With the 7 per cent tax rate, the banks would have paid HUF 40–50 billion to the budget. In my view, with its final decision (involving an “indirect legal title”) the government wanted to ensure that another bailout of the banks (after the retail foreign currency debtors) would have a long-term favourable effect on the earnings of the banks which should be settled proportionately in terms of public dues.
- <sup>23</sup> Fink-Stratmann, 2011., Josselin – Padovano – Rocaboy, 2012., Dietrichson – Ellegárd, 2013., and as a new development, the unmanageable amount of debts run up by the shadow banking system at local governments and their business associations in China and their likely central settlement (Risky Business Global Threat, FT, 2014). Furthermore, the indebtedness of local governments, SAO international conference, 17 April 2012 (Spanish and Swiss experiences).
- <sup>24</sup> The name is based on János Kornai (Kornai, 2011 a, b; Kornai, 2012.; Kornai, 2014)

<sup>25</sup> Banks, companies of key importance, households or even certain countries should be bailed out in some cases.

<sup>26</sup> Essentially, this is a reference to János Kornai and to those who advocate the hard budgetary limit as a general solution.

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