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Bailout of Local Governments and the Introduction of Active Control in Hungary After 2010

Abstract

Comprehensive legal reform in Hungary affecting the regulation on the whole fiscal sector was made after the general parliamentary election of 2010. It covered the renewal of the rules on local governments too. Regarding local public finance two changes are of paramount importance from the aspect of budget sustainability: 1) passive control was replaced by active control in confining local borrowing; 2) local governments were bailed out by the central government. These changes allowed Hungarian local governments a new beginning in the management of their functions, however, massive centralisation of public services was implemented. These parallel processes transformed the substance of localism in Hungary; meanwhile, the framework of local governments has remained stood constant since the transition.

Keywords: Hungarian local finance, confining local borrowing, hard and soft budget constraint, bailout of local governments

I. Setting out the problem

It is said that the economic crisis arrived in Hungary in late 2008, where ongoing budgetary crisis management dominated the fiscal policy. The consequence of this coincidence was that conflicting fiscal policies should have been undertaken by the government.[1] Expansionary and contractionary fiscal policy cannot be made successfully at the same time in a small open economy such as the Hungarian one. Under these circumstances, the public-debt-to-GDP ratio just exceeded 80% in 2010 and in 2011, being a historical peak in the 21st century up to now.[2] Debt service was at critical level for the central government and challenged Hungary's debt tolerance

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1 Neményi, J., A monetáris politika szerepe Magyarországon a pénzügyi válság kezelésében, (2009) 56 (5) *Közgazdasági Szemle, (393–421)* 401–405.

2 *Hungarian Central Statistical Office,* http://www.ksh.hu/docs/hun/xstadat/xstadat_eves/i_int040.html (Last accessed: 01 May 2017).

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ability.[3] Many local governments were imprudent, because their revenue (or current) budgets were unbalanced due to insufficient intergovernmental grants and because their Swiss franc debt service rose greatly due to the weakening of the Hungarian forint.[4]

The general parliamentary election of 2010 brought about big changes in Hungarian politics. The former opposition parties (FIDESZ and KDNP) won more than two-third of the seats in the Parliament, after which Parliament, as the constitutional and legislative power, reformed the legal system affecting the whole fiscal sector. First and foremost a new constitution of Hungary called the Fundamental Law was promulgated. Furthermore, many important new acts were enacted. Two of them have to be noted in the light of the topic: 1) Act CLXXIX of 2011 on Hungarian Local Governments No. (hereinafter referred to as: LGA 2011); 2) Act CXCIV of 2011 on the Economic Stability of Hungary (hereinafter referred to as: ESHA).

In sum, the renewal of the law covered the rules on local public finance, out of which this paper aims to highlight the bailout process and the changes in local borrowing limits. These two are inseparable in terms of their history and effect. In the first place I start my thoughts with a summary of theories on confining local borrowing and I summarise the history of the relevant Hungarian legal provisions. Then I come to my core points.

II. Main models of confining local borrowing

Local borrowing can be confined according to five main theoretical models, based on international comparison.[5] These are the following: 1) market discipline model;

[3] It refers to manageable sum of public debt where default is unlikely. See in more details: C. Reinhart, K. Rogoff and M. Savastano, *Debt Intolerance,* National Bureau of Economic Research, WP 9908 2003 (National Bureau of Economic Research, Cambridge, 2003) 3–8.

[4] Vigvári A., *Pénzügyi kockázatok az önkormányzati rendszerben, (Állami Számvevőszék Kutató Intézete, Budapest, 2009)* 6–8.; L. Domokos, Operating Risks and the Increasing Indebtedness of Hungarian Local Governments. Audit experiences of the State Audit Office of Hungary, (2012) (2) *Public Finance Quarterly,* 155–163.

[5] T. Ter-Minassian, and J. Craig, Control of Subnational Government, in T. Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice,* (IMF, Washington D.C., 1997) 156–172.; B. Dafflon, The requirement of a balanced budget and borrowing limits in local public finance: setting out the problems, in B. Dafflon (ed.), *Local Public Finance in Europe – Balancing the Budget and Controlling Debt,* (Edward Elgar, Cheltenham, 2002) 1–14.; J. Rattso, Fiscal controls in Europe: a summary, in B. Dafflon (ed.), *Local Public Finance in Europe – Balancing the Budget and Controlling Debt,* (Edward Elgar, Cheltenham, 2002) 277–290.; P. Swianiewicz, The Theory of Local Borrowing and the West-European Experience, in P. Swianiewicz (ed.), *Local Government Borrowing: Risks and Rewards – A Report on Central and Eastern Europe,* (Open Society Institute, Budapest, 2004) 1–23.; P. Swianiewicz, Comparing International Experiences: Emerging Markets of Local Borrowing?, in P. Swianiewicz (ed.), *Local Government Borrowing: Risks and Rewards – A Report on Central and Eastern Europe,* (Open Society Institute, Budapest, 2004) 385–422.; P. S. Florestano, State Limitations on Local Fiscal Authority, in J. Rabin and D. Dodd (eds), *State and*

2) co-operative approach; 3) passive control; 4) active control; 5) direct democracy control. In practice, legislators can mix the models via general and special rules and no one can deny that each regime has its own characteristics. The content of these theoretical models can be summarised as follows.

The first model relies solely or primarily on market discipline. Local governments are free to take out a loan if creditors are willing to give a loan to them. The mechanisms of the financial market represent the limit in this model. The market discipline model has inherent malfunctions, since there are failures in the local debt market for many reasons. Soft budget constraint[6] is an important example of the reasons. Therefore, the legislator has to apply other models to limit local borrowing. Nevertheless, other models do not replace the market mechanism, but complement it. Even so, local governments can take out a loan if creditors are willing to give a loan to them.

The second model is the co-operative approach. In this case, the representatives of central governments and each local government conclude a gentlemen's agreement on confining indebtedness. The agreement is the outcome of a negotiation process. The parties follow the agreement without legal obligation to do so. One example is the Australian Loan Council.[7] In my view, this model suits the federal-member state relationship, because the number of member states is limited and the federal government treats member states as partners, especially because the sovereignty is shared with them. In contrast, the number of local governments is too high in most countries and central government is prone to treat local governments as handmaidens, not as partners.

The third model is the so-called rules-based approach or passive control. Limits, which are extra to the market mechanisms, are laid down in the laws and local governments follow the special rules as a norm without direct central control. For instance, this model has been applied in England since 2004.[8] The norms are specified in the Prudential Code for Capital Finance in Local Authorities issued by the Chartered Institute of Public Finance and Accountancy.

Local Government Administration, (Marcel Dekker, New York, 1985, 103–119) 109–110.; J. de Torres, *Financing Local Government,* Studies in Business Economics 96. (National Industrial Conference Board, New York, 1967) 26–27.; G. Kecső, The Impacts of Public Debt and Deficit Convergence Criteria on Local Indebtedness in Hungary, in A. Piekutowska and I. Wrońska (eds), *Ten Years of the Visegrad Group Member States in the European Union,* (Oficyna Wydawnicza Aspra, Warsaw, 2015) 59–70.

6 An organisation faces a hard budget constraint if it does not get outside support to cover its deficit and is obliged to reduce or cease its activity if the deficit persists. The soft budget constraint occurs if a supporting organisation is ready to cover all or part of the deficit. J. Kornai, E. Maskin and G. Roland, Understanding the Soft Budget Constraint, *Journal of Economic Literature,* (2003) 41 (4) 1095–1136., https://doi.org/10.12 57/002205103771799999

7 R. Webb, The Australia Loan Council, (2001–2002) (43) *Department of the Parliamentary Library Research Note,* (1–2) 1.

8 Local Government Act 2003, Section 3 Para 5–7; Section 15 Para 1 and 2003 No. 3146 Local Government, England, the Local Authorities (Capital Finance and Accounting) (England), Regulations 2003 Section 2.

The fourth model is the administrative approach or active control. Limits are specified in the laws and central government approval of local borrowing is required. Local governments are obliged to ask central government's permission to conclude credit agreements or issue bonds. Active control means extra safeguards against excessive local indebtedness. This is the main advantage of this model, to my mind. The fear is that central government is prone to exercise this power on the basis of political discretion. This model was used in England, for instance, until 2004.

The last model is based on direct democracy instead of indirect democracy. Decisions on borrowing are up to the local voters. The ultimate reason of this model is that local residents have to finance the interest part and the capital part of the local debt through paying local taxes if there is hard budget constraint for local governments. This model is applied in some states within the USA.

Each of the theoretical models has advantages and disadvantages from certain points of view. Their proper application in practice requires conformity to country-specific circumstances. For example, direct democracy control prerequisites a traditional, well-functioning democracy in which voters are personally involved in the management of local public affairs. The precondition of the market discipline model, which is perfect competition, hardly ever exists fully in the local debt market. Active control represents strong borrowing confines on the one hand; on the other hand, it restricts the local decision-making autonomy to the highest degree. Consequently, there is no eternal ranking of the five models in theory, as far as I am concerned.

III. Historical regimes in Hungary since the transition

Three different regimes have been applied in Hungary since the transition (1989–1990). These can be classified as belonging to the model of market discipline (1990–1995), passive control (1996–2011) and active control (from 2012).

The old Act on Hungarian Local Governments No. LXV of 1990 (hereinafter referred as LGA 1990) contained no special provisions on limiting local borrowing. Thus, the market reliance model was in effect, despite the fact that the Hungarian financial market started to evolve just before the transition. The reason for the application of this regime was that the reforming Parliament intended to contradict almost everything that was similar in logic to the previous system.[9] The standard of local borrowing, however, stood low during this term and afterwards.

[9] Kulcsár K., Politikai rendszer és politikai kultúra, in Glatz F. (szerk.), *A demokrácia intézményrendszere Magyarországon,* (MTA, Budapest, 1997, 11–31) 13.

Passive control was introduced by the so called Bokros package. Mr. Lajos Bokros served as Minister of Finance from 1995 to 1996. This package named after him contained some austerity measures as amendments to other acts. On top of that, it amended the LGA 1990 as follows: the upper ceiling of local liabilities, such as credits, loans, bonds and their interest, was their adjusted own revenues, defined as 70% of its own local revenues, deducted by liabilities matured within the fiscal year. Liquid loans were out of the scope of the limitation.[10] The new regime became effective as of 1 January 1996.

Under the period of passive control, local debt increased swiftly. Its sum was 1255 billion HUF in 2010, twenty times more than the debt in 1995 (59.6 billion HUF).[11] That is why passive control was such a concern in Hungary. There were two elemental features behind this trend. First, smaller municipalities received disproportionate intergovernmental grants for their mandatory public services and their own fiscal capacity was too weak. Consequently, they financed their loss through loans and bonds. Second, counties and larger city municipalities contributed to the rise via issuing bonds denominated in Swiss franc in 2007 and in 2008. This extra risk made many local governments vulnerable. The budgetary and financial crisis could easily harm these municipalities through weakening the Hungarian forint.

No local governments can be liquidated, unlike private companies.[12] Minimal local public services have to be managed forever in the society and state in which we live. After 2010, the legislator made two basic changes regarding the topic of this paper. Central government bailed out local governments and active control of local borrowing was introduced in the ESHA in order to prevent excessive indebtedness in the future. The next two points are about these themes.

IV. Bailout of Hungarian local governments between 2011 and 2014

The bailout process started at the end of 2011, where counties' credit liabilities were transferred to the central budget in their entirety. Most of the smaller municipalities received earmarked intergovernmental grants to redeem their loans in 2012. Other municipalities were bailed out in 2013 and 2014. Table 1 summarizes the four steps of the bailout. The outcome of this process was that local governments became almost totally free of debt and their revenue budget came prudent.

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[10] LGA 1990 Sec 88.

[11] Eurostat http://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do (Last accessed: 01 May 2017).

[12] It is formulated by Kornai et. al. that "financial difficulties do not normally lead municipalities, towns and districts, let alone countries, to exit". Kornai, Maskin and Roland, Understanding the Soft Budget Constraint, 13.

Table 1. Bailout of local governments in Hungary 2011–2014[13]

	Sum of bailout (bill. HUF)	Local governments affected	Legal techniques used	Legal source
2011	196	All counties	Cent. gov. assumed local credit liabilities	Act on restructuring counties No. XLIV/2011.
2012	74	Almost all municipalities which have no more inhabitants than 5000	Cent. gov. gave earmarked grants to loc. gov. to redeem loans	Act on central budget 2012 No. XXVIII/2011.
2013	625.5	One part of municipalities which have more inhabitants than 5000	Cent. gov. assumed local credit liabilities according to the main rule	Act on central budget 2013 No. CCIV/2012.
2014	472	Remaining part of municipalities which have more inhabitants than 5000	Cent. gov. assumed local credit liabilities according to the main rule	Act on central budget 2014 No. CCXXX/2013.
Sum-total	1367.5			

According to the theory, bailout has a detrimental effect on the behaviour of the recipient organization if it can expect to be rescued from trouble by a supporting organization (moral hazard). In local finance, the recipient organisation is the particular local government; the supporting organisation is the higher level government (in Hungary the central government). Bailout – according to the theory – distorts the recipient's decisions on management, because it does not face the consequences of deficit spending.[14]

The soft balance constraint syndrome can be considered as an issue regarding Hungarian bailout at first glance. The reasoning could go that local governments will run their budget in a non-sustainable manner in the future, since they expect to be

13 Kecső, The Impacts of Public Debt and Deficit Convergence Criteria on Local Indebtedness in Hungary, 68.

14 Kornai, Maskin and Roland, Understanding the Soft Budget Constraint, 4–15. 1.

bailed out by the central government again. The introduction of active control has an important role at this stage of the argumentation. Hungarian local governments are obliged to balance their revenue budgets[15] according to the concept of the golden rule[16] and central government's prior approval of local credit liabilities is required by the ESHA.[17] Thus, even if local governments expect a repeated bailout in the long run, they are not able to conclude any valid credit contracts without central permission. The future behaviour of local governments does not depend on their own acts, but the central government's decision. To my mind, it draws the teeth of the soft budget constraint syndrome. This connecting link between the bailout and the active control makes the Hungarian case special.

V. Active control since 2012

The rules on active control are laid down by the ESHA Sec 10–Sec 10/E. This regime has been amended many times since 2012. The provisions became even more elaborated and lengthy. The rules described are those in force on 1st August 2017.

The regime on limiting local borrowing consists of a general and a special set of rules. Both cover the credit liabilities that are defined by an exhaustive list.[18] The most important ones are credit contracts, loan contracts, the issuance of bonds and promissory notes and financial lease contracts. Furthermore, both refer to guarantee contracts and contracts of suretyship.[19]

According to the general set of rules, the Hungarian Government's prior approval of local credit liabilities, guarantee contracts and contracts of suretyship is required to conclude valid agreements. There are four conditions to the approval of credit liabilities. 1) The credit liability does not risk the debt target envisaged in the act on central budget.[20] 2) The credit liability is for investment purpose attached to one or

15 LGA 2011 Sec 111 Para 4.

16 According to this concept, local governments are not allowed to take out a loan to finance current expenditures except short term loans, redeemed within a year. The short term loan in the current budget is for treasury purpose, namely for managing the temporal discrepancy between local revenues and expenditures. The outcome of the golden rule is that the current budget has to be balanced without long term loans. B. Dafflon, The requirement of a balanced budget and borrowing limits in local public finance…, 28–29. It shall be noted that according to the European Charter of Local Self-Government, for the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law. European Charter of Local Self-Government, Article 9 Section 8.

17 The relevant rules are discussed in point V. of this paper.

18 ESHA Sec 3 Para 1.

19 It has to be noted that this paper does not henceforth deal with guarantee contracts and contracts of suretyship.

20 This condition is in connection with the public debt brake rules in Fundamental Basic Law of Hungary. In essence, Parliament shall adopt the act on central budget, the consequence of which is

more mandatory local task and the maintenance of the new property is provided in the long run. 3) The debt-service-to-own-revenue ratio does not exceed 50%. 4) A minimum of one local tax out of four[21] is imposed by the municipality.

According to the special set of rules, local governments can conclude credit liabilities without approval in two cases. 1) Those that mature within the fiscal year and 2) small amount credit liabilities that are defined precisely by the ESHA. Local governments shall comply with the 50% ratio in these two cases too. It has to be noted that the special set of rules belongs to the model of passive control, since there are rules that are extra to the market mechanisms, but no direct control of central government exists. As such, the Hungarian regime blends the models; however, active control prevails.

VI. Conclusion

Local public services have been centralized in Hungary after 2010. It is enough to emphasise that extensive and expensive services to the people were given to bodies of the central government. The most important examples are education and health care excluding primary health care. Bailout, active control and centralisation concern the substance of Hungarian localism. Under these circumstances, one can argue that local governments have less functional autonomy due to the centralization. One can argue that they have more financial autonomy, because they no longer have enormous debt service, even if active control was introduced. One can argue that less functional autonomy means more real autonomy, as local governments are prudent.

As far as I am concerned, uniform judgement is difficult to make, because the balance of the pros and cons of the changes depend on the starting financial position of local governments around 2010, and their starting position were diverse.[22] Some of them were in trouble and had comprehensive functional autonomy only their accounts. Some of them were prudent and exercised comprehensive functional autonomy. Smaller municipalities with a lot of debt and with small tax capacity seem to be the winners in the reforms. Cities with affordable debt and high tax capacity lost more than they won. Without a doubt, the framework of local governments made by the reformers in 1989/90 is still massive, but their substance transformed.

that the public-debt-to-GDP ratio declines from fiscal year to fiscal year. The sum of the public debt for the end of the fiscal year is planned in the act on central budget. This is the debt target that has to be respected by local credit liabilities.

21 There are five local taxes in Hungary according to Act C of 1990 on Local Taxes. These are: building tax, plot tax, tourist tax, local business tax, and communal tax. The imposition of the latter one, however, does not fulfil the criteria of the ESHA rule. That is why the condition as to the approval is to impose at least one local tax out of four (not five).

22 Vigvári, *Pénzügyi kockázatok az önkormányzati rendszerben,* 10–28.