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**Risks arising from local governments'
financial status and assets in Hungary**

Thesis

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1. Introduction

It is widely accepted and discussed that an organization has to face many risks and uncertainties. The phenomenon is to be interpreted as a flow of many factors. First, we shall mention the changes in the economic environment. Second, the global sharing of work or the use of more and more developed technologies may also contribute to increase operational risks. However, we must not even forget that market coordination that is being extended by liberalism and deregulation is also a source risks and uncertainties. It is a common mistake not to distinguish between these two notions. Risks refer to information on the structured and planned nature and knowledge on possible outcomes of an event. As opposed to this, uncertainties refer to lack of basic information of an event (Vigvári 2004).

All public bodies – including local governments – face risks and uncertainties. But in what context can we speak of risks affecting local government? The research that was supposed to answer this question has been started 3 years ago. During my research in local government borrowing it became clear to me that the operation of local governments is a complex process that can not be understood simply from creditability. Thus, I started to analyse operational risks from systematic aspect.

Many OECD countries have been concerned with the the theoretical problems of financial help of local governments for decades which is partly due to previous reckless local borrowings (Council of Europe 2002a). As theoretical researches have pointed out there can be cases when local governments shall financially be helped by the central government because of the interest of local citizens. Experiencing reckless borrowing of local governments in the early 1990s the government has introduced an outstanding local bankruptcy regulation. Local governments' bankruptcy regulation made it clear that local government do not cease to exist. Local assembly shall only calculate with dismissal as opposed to the bankruptcy regulation of companies that usually cease to exist. It is important to emphasize that the analysis of financial status and local assets is only a concern for creditors. The investigation of local government bankruptcies (Jókay 2004) has revealed the contravention and misinterpretation of laws that may lead to serious conflicts in society. This makes financial help of central government necessary even if the central government becomes uncreditworthy.

Beside unwise local borrowings, the case of Orange County local government in the USA made local government risks to be an actual problem in 1994. In this case, due to the reckless speculation of local politicians the local government had to moderate the quality of local public services and delayed paying wages of public servants. Although the local government should have fulfilled its financial commitments arising from contracts it decided on an ad-hoc basis which payments to make. The lack of „willingness to pay” has become a brand new risks (Jókay, 1997).

Since the macroeconomic status of Hungary has been worsened in recent years the regulation of local governments has become stricter. Beside traditional analysis certain evaluation methods of the corporate sector have come forward. It is however a question, to which extent these expressions and methods can be used in case of local governments (see Virág, 2003).

2. Aim and structure of the research

As a starting point I have studied theories and experiences on local government finances. Based on this, we can declare that the theory of fiscal federalism is in many aspects actual. Due to the vivid professional interest, shed light on new aspects of the classical problems of task and revenue centralization versus decentralization. In the theory of Tiebout, tax payers declare their satisfaction with local decisions by „voting by feet” (meaning moving to the jurisdiction of another local government). Theoreticians of „public choice” have, however, raised concerns on government failures. These theories gain a new understanding when capital, labour, products and services can move freely and local citizens are more and more aware of transparent use of local revenues and assets.

During my research I have concentrated on the following targets:

- analysing the adaptability of theoretical researches for Hungary;
- summarizing uptodate researches from the aspect of risks.

I have seen that there were significant changes in the fiscal system of OECD countries in the last decades to which local governments managed to adjust with different levels of success.

The direction of adjustment pointed towards the growing use of credits and raising transparency of operation. The role of credit in local governments' budget differs from country to country which calls for a country-specific regulation of borrowing and indebtedness. The variety of local government systems requires the revealing of financial and asset risks stemming from laws, the structuring of national legislations on local budget equilibrium, borrowing and indebtedness and the analysis of similar and diverse characteristics of regulation from the viewpoint of risks.

International experiences are very important also from the aspect of modernizing the Hungarian local government system. First, we can learn from the mistakes of other countries. Second, Hungarian literature lacks methods and analysis of managing local government risks. Our starting point is thus the methodology of international rating companies and the Hungarian State Audit Office. These documents suggest the more accurate analysis of single cases and developing new, subjective evaluation and measuring methods. Risks shall be this analysed by taking place and time as dimensions into consideration. This requires a thorough analysis of theories, methodologies and information before risk evaluation. Analysis of risks shall be carried out very cautiously because of the imbeddedness of into the state's hierarchy and the overflowing effect of changes in the macroeconomy. During my research I was able to rely also on the survey performed by Marketing Centrum in 2006. In this survey, data on interviews with 405 mayors strengthened the necessity of gathering further information but also marked some starting points of research in the future. My work came to the conclusion that there is no enough information of revealing the clear situation certin signs however forecast serious conflicts and consequences.

3. Structure of the dissertation

The dissertation starts with a theoretical overview in which I summarize debates on fiscal federalism theories launched in North-America.

The second chapter covers the summary of local borrowing regulation highlighting its theoretical and practical boundries, the lack of transparency and the use institutional risk management technniques.

The third chapter traces the birth and advent of risks in the past 17 years along with changes in regulation of tasks and revenues.

The fourth and fifth chapters aim to separate risks of financial status and assets of local governments. In this chapter, I make attempt to underpin the analysis of each and every risks by objective and subjective elements.

The aim of chapter six is to give a summary on risk management techniques of local governments and provide central and local decision makers with an early warning system which:

- central level decision makers can detect risks hiding under the surface and of which we usually lack of information;
- local government decision makers may be able to perform an assessment of operation;
- the empirical analysis of localities' risks becomes a reality.

The seventh chapter of the dissertation is supposed to test the model set up in the previous chapter based upon the operation of Szeged county-right town between 2000 and 2007. In this chapter I search for financial status and asset risks and investigate the necessity of further evaluation and analysing methods.

4. Main achievements of the dissertation

Researches in local public finances have been extremely vivid due to the researches of Keynes, the theoreticians of „public choice” in the 20th century. Researches discussed the subordination of state functions (allocation, redistribution and stabilization) to government levels, the problem of centralizing and decentralizing public services and the efficiency state institutions. These researches gained new power from the critics of the „public choice” theory. Second generation fiscal federalism theories emerging in the 1990s made previous thesis more accurate and called for the consideration of economic integration in theories.

The strengthening of economic integration raises many new questions on local government financing. Studying second generation fiscal federalism theories has so brought me to my first thesis:

Hypothesis 1.: National redistribution can hardly cease income disparities among regions in a globalised context. In order to moderate growing local financial conflicts, sub- and supranational governments shall cooperate by making a decent revenue centralization.

The existence of integration zones resulted in the birth of new type of public goods. Programs financed by the European Union serve the interest of many countries (trans-continental highways, establishment of the Single European Market, etc.). The Community Budget that can be planned up to 1,24% of GNI can not be considered in order to strengthen and develop integration, strengthen social and economic cohesion and improve competitiveness in Europe.

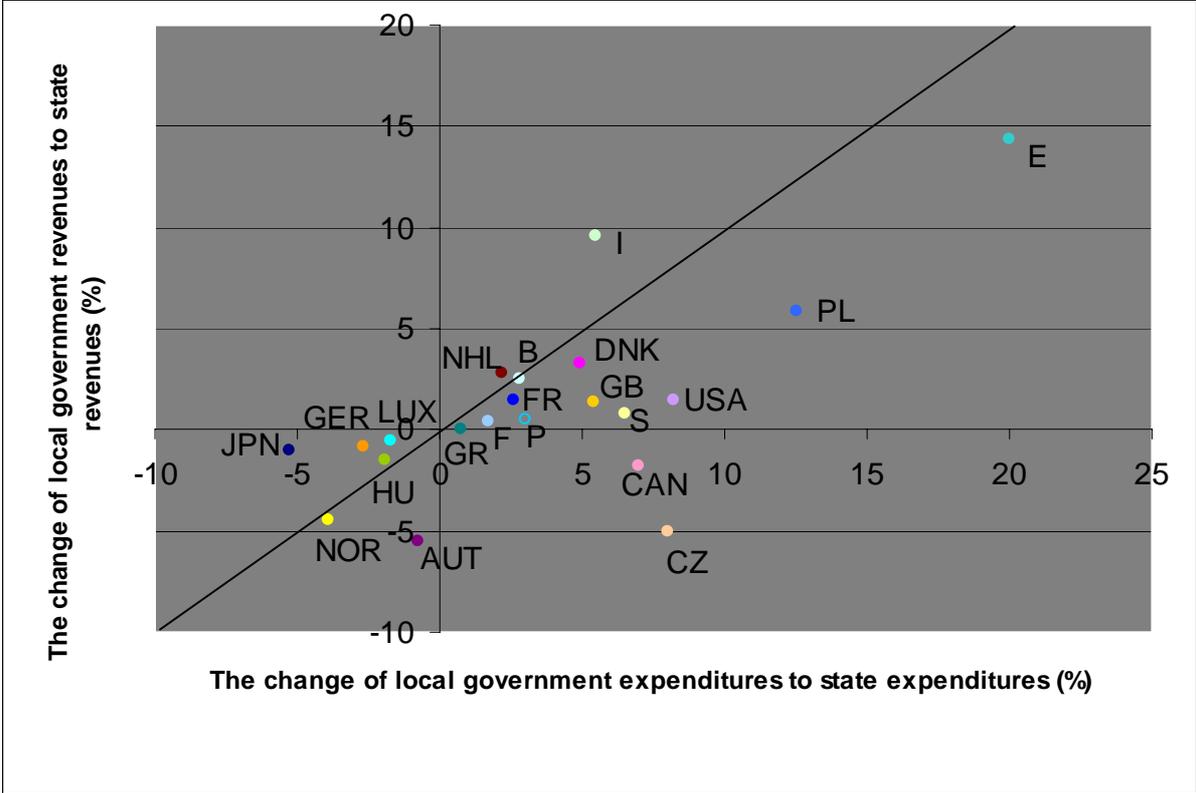
It is also a problem that tasks and revenues of the community is decided by the member states. The wide-scale tasks require a comprehensive institutional background and the introduction of standards. Since the Community Budget contains less money than it would be needed and member states face with financial problems of state institutions, excess redistribution relating to global pulic goods will definitely rely as a burden on local governments' budget.

Central governments shall trace down to which extent local governments relying on different revenues can meet local citizens' requirements. The difference in the role of certain revenue sources can be explained by the difference in local citizens' income and real estate status, the process of public service centralization versus decentralization and experiences on local government borrowings:

Hypothesis 2.: the role of borrowing in local government financing is diferent in all country because of the deflection of financial architecture. Huge and unwise local borrowing brought country-specific features into legislation because of the fear from social consequences.

Although borrowing and credit is supposed to compensate for the lack of other revenues the slow speed of revenue decentralization as opposed to the speed of tasks decentralization called for a flexible financing tool:

Figure 1.: The change of task and revenue decentralization in certain OECD countries between 1987 and 2005



Source: Sutherland et al., 2005 and own construction

The change of local revenues to state revenues remained under the change of local expenditures to state expenditures. This contradiction was only to be overcome by a flexible daily operation.

The safety of operation required the supplement of revenues by external sources. The regulation of local government borrowing had been rather liberal and normative regulation in certain countries during the 1960s and 1970s. International financial market events in the 1970s resulted in a strict but country-specific regulation (Dafflon, 2002). Concerns on the financial status highlighted transparency and commitments adjusted to local financial ability. As the survey of the Council of Europe (2002) has pointed it out, however, variegation of local borrowing often lacks transparency. Although indebtedness of local governments can

also be prevented by calculating local governments' ability to finance such commitments, tools applied in OECD countries (e.g. financial capacity, per capita debt, etc.) can not be considered as effective methods. Attention has so been directed to institutional solutions (e.g. rating, debt register) that allow financial market participants decide whether the operation is performed in a sustainable way. Since the use of these risk management solutions is in different phases in all countries, the role of loans and credits in local government financing can only be understood by studying the special features of local government systems.

The Hungarian local government system has revived by 65/1990 Act on Local Governments. Rules that have been established at the time of establishment of the new system were a result of political compromises hiding serious contradictions. These contradictions have manifested in different forms during the last 17 years. The bad fiscal status was to be traced by the concentration of more and more severe risks:

Hypothesis 3.: The root of local government risks can be traced in the inconsistency of acts prescribing local public tasks that may have resulted in further irresponsible decisions at both national and local levels.

Legal contradictions have already been incorporated in the Act on Local Governments. Discrepancies that have been exacerbated by further legislations¹ made local decision makers face dilemmas. Though the Act – in accordance with the European Charter of Local Government – declared that localities are eligible for revenues proportional to their tasks, it is too early to be satisfied because the tasks of local governments are not made clear (see Article 1 of Paragraph 8 of the Act in which tasks are enumerated by using the expression “... the task is especially to”). The unclear distinction between compulsory and voluntary tasks or the status of county governments shall also make us worry.

The fact that all local tasks could not be codified into the Act on Local Governments because of the length of content of sectoral responsibilities has resulted in further perverse situations. The central government usually devolved tasks on localities without changing the Act on Local Government (Pálné, 2004) since government and ministerial decrees enabled task decentralization without decent revenue decentralization. This was justified by the bad

¹ The only exception is the 1/1988 Act on Public Roads that declared local responsibility but it came before the Act on Local Governments.

macroeconomic status of the country. According to Ágh (2005), the central government handled local governments as „conflict containers” problems causing conflicts on central level have been devolved to local level.

Annual budget acts made attempts to support local public service financing by increasing the number of normative titles but this and the decreasing proportion of local subsidies resulted in the worsening of local public services. The problems of exhaustion of revenues from privatization and the moderate increase of local tax revenues has been aggravated by local bankruptcy regulation that was supposed to stop further irresponsible borrowing.

Hypothesis 4.: At the dawn of increasing local borrowing the financial architecture of local governments shall be modified.

Creditors considered the state will stand up for local debts before the 25/1996 Act on Local Government Bankruptcy Regulation came into effect. The excessive credit supply has been very useful in the early 1990s as well. Creditors managed to realize only a very small proportion of their claims after the Act into effect due to which localities were able to get only few loans until the end of 2003. The sector was so not able to exploit its borrowing ability provided by the Act on Local Governments (70% of adjusted own revenues). However, looking at data of years from 2004 we will experience that total commitments exceed the level set for local borrowing in the Act on Local Governments. It may also concern us that the number of localities requiring operational loans has increased significantly since 2000. The total debt of the sector had been 1.4% of state debt in 2000 while 2.6% in 2005 and 3.0% in 2006. This embodies a 28% average annual growth rate.

According to a survey performed by Marketing Centrum in the summer of 2006, local governments tend to increase local borrowing in to next 4 years. Though the survey is suitable for our investigation to a restricted manner, certain statements shall make us think things over. 405 respondent majors as first line leaders of local governments plan to borrow more even if a SWOT analysis reveals serious dangers. Among the weaknesses we shall mention (Vigvári 2003b and own opinion):

- the incalculable risk of central normative support system (see ÖNHIKI) may decrease creditability of the sector;

- the high proportion of small localities does not support the optimization of the costs relating to external financial tools;
- rating is almost completely unknown.

Among the threats we shall mention:

- the insufficient level of private investment may result in a net financing position relative to the Community Budget of the EU;
- the decrease of the value of local assets and amortization may hinder local public service provision;
- reckless local borrowing may cause further loss of assets;
- local governments do not calculate the financial sustainability of local borrowing;
- localities receive support from the EU after the project has been finished. This may cause liquidity problems.

The acceleration of local indebtedness will bring loss of local assets so many local governments are rolling debts ahead since they are insolvent. The report of the State Audit Office issued in 2006 has pointed out that the increase of local debt reveals severe risks. A study issued in 2007 by the Research and Development Institute of the State Audit Office however refers to local governments' debts as „significant fiscal risks”.

As Jókay (2007) has highlighted the proportion of „adjusted own revenues” which is the difference between own revenues and short term commitments leads to misinterpretation or false conclusions or even the evasion of local borrowing limit. According to his calculation, 1 county right town, 11 towns and 363 other localities had a negative „adjusted own revenues” in 2006. The research has also revealed that 1965 localities did not have any short term commitment in 2006. This calls for a stricter control of the reality of the financial statements of local governments. The analysis of the financial statements, task and revenue decentralization shall be paid more attention. During the reforms public service provision shall be rationalized and retain tasks at the local level that really serve local interests. Besides, the normative support system shall be simplified and local revenues shall be increased. Increasing local revenues will however only bring a step forward if risks are disclosed.

Hypothesis 5.: The current state information system does not reveal local governments' risks. The information gap is responsible for the increase of the sector to a large extent.

Data stored in the information system shall be suitable to provide locality-specific information on the structure of the budget, the level of local debts. Further data shall however be gathered on „off-budget” risks. These incorporate traditional off-budget activities of local governments (e.g. tax reliefs, exchange rate risks relating to foreign borrowing, leasing commitments, guarantees, warrants) and off-budget activities of local governments' firms (e.g. guarantees, warrants to third companies, risk of these public service providing companies). According to Polackova (1998) and Hegedűs and Tönkö (2006) central government shall gather information on local tax policies, deterioration of local assets, local PPP agreements and warrants and guarantees offered to local public service companies in order to get a clear picture on local governments' operational risks. As Hegedűs (2004) has revealed, both central and local politicians are unaware of local private companies operation that are involved in public service provision.

Hypothesis 6.: The measuring of local governments' risks requires the grouping of risks. This is effectively supported by the methodology of rating companies.

The methodology of rating companies with a local government evaluation system (Standard and Poors, Fitchratings) shall be studied since they have piled up significant experiences in the last more than 80 years. The analysis of North-American localities has many country-specific features, certain aspects are of universal validity. The involvement of space and time into analysis may help express the extent of local public services and its importance to the local economy. Since the Act on Local Governments contained a wide range of local public tasks that had been widened further by sectoral laws in the 1990s, the evaluation and measurement of risks shall take single cases into consideration. A very important element of the methodology of rating companies is that the same extent of difference in an index measuring a risk will not necessarily lead to the same conclusion when comparing two local governments. A per capita increase of local revenue of a local government in a declining region does not mean the same as of a local government in an advanced region.

The expression of „expectable controll” by Vigvári (2002b) suggests that local governments shall build out controll mechanisms considering their own status by which the total level of

risks can be mitigated. We shall however remember that local governments' lack of revenues get in a contradictory situation: in order to survive on the long run they have to make decisions averse to short term interest (e.g. political survival). It is advised thus to extend the notion of „expectable controll” to „expectable behaviour”. As opposed to the normative nature of „expectable controll” the notion „expectable behaviour” means the exploitation of alternatives provided by laws by which local governments can do much more to moderate risks.

There are many traditional methodologies to manage local governments' risks. The main difference is the extent to which they rely on calculable (objective) and qualitative (subjective) risk management elements. The methodology of rating companies call for the use of subjective elements. Since the Hungarian banking sector relies to an excessive extent on calculabe methods, the use of qualitative elements is more than sensible.

The new local government risk evaluation can be performed by identifying the signs referring to the changing of risks, setting the way of analysing deflection and defining „expectable behaviour” elements. These conditions may differ both in significance and content among different sizes of localities. Thus, I was only able to define the most important fields in the dissertation. The model set up in the pervious chapter has been tested at Szeged county-right town local governments' data of 2000–2006 gathered from an interview the head of Department of Finance and local end of year financial statements. Although the sphere of information did not support a full-scale revealing of risk information they have reflected lack of concepts regarding local asset management (e.g. the huge increase in the value of assets by a compulsory reevaluation in 2003 delivered to off-budget companies) and financial dangers (e.g. the lack of control on local governments' companies, the increase of sale of soils and real estates, lack of control of sustainability of local borrowing and debt).

5. Possible directions of future research

There is a need for a change in both local and central regulation in order to avoid further unwise local borrowing and the loss of valuable local assets that have been calculated on a market value. Local government decision makers shall strengthen planning capacities, establish control mechanisms that support the transparency of operation while central

government decision makers shall provide enough financial resources to recover deteriorated assets. As far as the whole local government system is concerned, tasks are rather complicated. On the basis of the results presented in the dissertation local financial management shall be modernized and decent answers have to be given to fiscal challenges. In my opinion, sensible fiscal decentralization will definitely improve the operation of the whole public sector significantly. I also believe that the modernization of local public management apart from the significant change of the public status of local governments will bring new solutions that allow a more successful and more effective local public service provision. The main task is the simplification of revenue decentralization², reregulation of local borrowing but this also necessitates the cease of the „conflict container” role and – probably – a one-time consolidation of the system. I would like to investigate these questions in the future. I can rely on a wide-scale of literature but the laying of new proposals requires a multi-aspect analysis of risks and effects. The use of this preparatory methods means a big challenge to professionals.

² According to the reports of the State Audit Office, current revenue regulation of local governments is an important root of other risks.

6. Major publications and conference attendances of the author

6.1. Articles in professional newspapers

1. Halmosi Péter (2005): Az önkormányzati hitelfelvétel szabályozásának motivációja az Európai Unió országában. *Hitelintézeti Szemle*, 2005/1. pp. 68-77.
2. Halmosi Péter (2006): Félúton. Tanulmányok a helyi önkormányzatok finanszírozási rendszerének továbbfejlesztési lehetőségeiről. *Könyvrecenzió, Magyar Közigazgatás*, 2006. június pp. 377-380.
3. Halmosi Péter (2007): Az önkormányzati költségvetési szabályok nemzetközi összehasonlításban. *Commitatus Önkormányzati Szemle* 2007/9. Megjelenés alatt.
4. Halmosi Péter (2008): Az önkormányzati rendszer kockázatai a stakeholderek nézőpontjából. *Pénzügyi Szemle* 2008/1. Közlésre elfogadva.

6.2. Reviewed articles

1. Halmosi Péter (2004): Az adórendszer nemzetközi kihívásai és lehetséges válaszai az Európai Unióban. In: Botos Katalin (szerk.): *Pénzügyek a globalizációban*, JATEPress Szeged, 2004, pp. 18-29. ISBN: 963 482 694 6
2. Halmosi Péter (2004): Problems with the finance of local governments in Hungary. *Economics and Management of Transformation International Symposium*, May 7-8. 2004, Temesvár, Románia. CD-book.
3. Botos Katalin – Halmosi Péter (2004): A tudathasadásos kisvállalkozó. In: Czagány László – Garai László (szerk.): *A szociális identitás, a vállalkozó és a piac*, JATEPress, Szeged, 2004, pp. 245-256.

4. Halmosi Péter (2006): Az önkormányzati önértékelés szükségessége és szempontjai. Tanulmány a Belügyminisztérium Önkormányzati Finanszírozási Munkacsoport részére. Szerkesztő: Vigvári András.
5. Halmosi Péter (2006): A hazai önkormányzatok kockázatainak értékelése. In: A magyar gazdaság versenyképessége. Budapesti Műszaki és Gazdaságtudományi Egyetem. ISBN 963 420 859 2
6. Halmosi Péter (2006): Az önkormányzatok, mint kockázatos banki ügyfelek. In: Botos Katalin (szerk.): A bankszektor és stakeholderei. Generál Nyomda, 2006.

6.3. Chapters in professional books

1. Halmosi Péter (2004): Karitatív szervezetek működési problémái a magyarországi leó klubok példáján. In: Dinya - Farkas - Hetesi - Veres (szerk.): Nonbusiness marketing és menedzsment, pp. 285-295. KJK Kerszöv. Budapest. ISBN 963 224 787 6.

6.4. Conference attendances

1. Halmosi Péter: „A helyi önkormányzati hitelfelvétel lehetőségei és korlátai az Európai Unió országaiban”. Elhangzott a „Pénzügyek és globalizáció” című konferencián Szeged, 2004. november 9.
2. Halmosi Péter: „Challenges of local government finance in Europe”. Elhangzott: „The Impact of European Integration on the National Economy International Symposium”. 2005. Október 28-29., Kolozsvár, Románia.
3. Halmosi Péter: „Az önkormányzati hitelfelvétel szabályozásának kihívásai Európában”. Elhangzott a XXVII. Országos Tudományos Diákköri Konferencia Közgazdaságtudományi Doktorandusz Szekciójában. Sopron, 2005. április 29.

4. Botos Katalin – Halmosi Péter: „SMEs in the viewpoint of economic policy”. Elhangzott: „The Impact of European Integration on the National Economy International Symposium”. 2005. Október 28-29., Kolozsvár, Románia.
5. Halmosi Péter: „Local governments as risky bank-clients”. Elhangzott: „Management of Organizations in the Context of Globalization and European Integration International Symposium. 2005. november 11-12., Temesvár, Románia.
6. Halmosi Péter: „Az önkormányzatok megváltozott finanszírozási helyzete”. Elhangzott a Verseny és versenyképesség c. konferencián a Pázmány Péter Katolikus Egyetemen. Budapest, 2007. november 5.
7. Katalin BOTOS – Peter HALMOSI: Ageing societies and insurance policy – An international comparison. Uniwersytet Ekonomiczny W Krakowie. Konferencia 2007. december 6-7.