

## A Model of Centralizing Local Government Finances

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**Abstract** This paper explains how the Hungarian Government tried to overcome and manage the economic problems and deficits of local governments (LGs) which accumulated between 1990 and 2010. The model has been used as a case study for teaching about the fiscal reform of local governance; i.e., measures of decentralization and centralization. The aim of the model was to reform the management of local finances to help solve some real financial problems of LGs while preserving the principles of local democracy and satisfying the requirements the Hungarian Act on Local Governments. The model can be applied in other countries where the operation of local public services is beset by financial difficulties and the central government possesses sufficient resources to intervene. The paper presents a model of the consolidation of local governance involving the parallel and harmonized reform of the institutional arrangements of local finances, the economy, public services, elections and administration. The paper also contains observations about the near future of Hungarian local governments and gives some recommendations.

**Keywords:** • centralization • local governments • reforms • Hungary

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## 1 The financial position of local governments by 2011

The system of local governance, with its freely elected local representatives, was introduced in post-communist Hungary in 1990. By 2011, the total debt of Hungarian local governments amounted to 4.3 billion USD, an amount which could no longer be adequately handled. The accumulation of the debts of LGs was due to a lack of financial expertise and inexperience in dealing with economic activities. Most of the loans given to local governments, which were disbursed in order to finance the development of settlements, were instead spent on financing the ongoing operation of local public services. Local governments were no longer creditworthy for banks. Also, the system did not motivate elected local representatives to support the development of the local economy. Therefore, the reform and transformation of the local governance system could no longer be delayed.

## 2 The legal and financial transformation of local governance

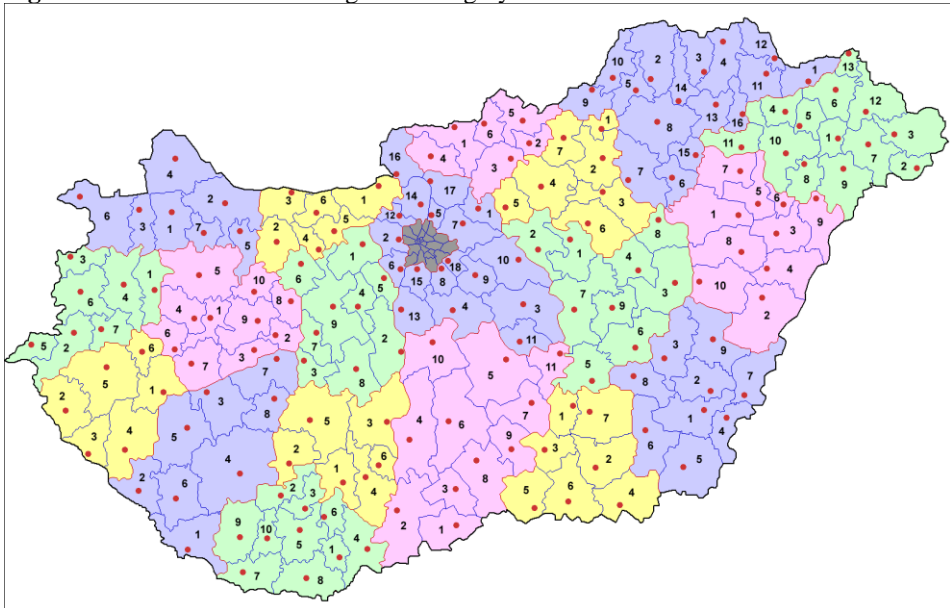
The transformation of local governance according to new principles began in 2010. First, the legal status of the local governments was modified in the Constitution, according to which loan applications of local governments could be approved only for local or regional development investment projects with a clearly defined financial basis. Local governments were prohibited from taking up loans for the purpose of financing the ongoing operations of their institutions. Also, the law on national property was changed and a kind of nationalization was introduced: a wide range of properties formerly owned and operated by local governments became state-owned properties.

The new *Law 189/2011 on Local Governments*<sup>1</sup> restructured the administrative tasks of local governments: some 40% of these tasks were transferred to the central government. These local tasks included the maintenance of official inventories, registries, public education, personal document management and, with the exception of social care, all kinds of duties that authorities performed. The central government was able to manage these tasks through the reintroduction of the so-called borough system of territorial administration. By force of the above-mentioned Law, 175 boroughs were established around the country in 2013, preserving the preexisting system of 19 counties and 7 regions.

To understand the change that was bought about by the reintroduction of the borough system, let us revisit the history of Hungarian public administration. Boroughs existed from the early days of governance; each royal county was divided into four or eight boroughs depending on the size of the county. A borough (in some cases named a “riding”) spanned the distance that citizens could cover on foot from their places of habitation to the administrative centre of the borough and back within one day. In the years 1972–1975 the borough system was replaced by a system in which the administrative centers were concentrated in large and medium-sized towns. In 1990, when local governments were established to replace the previous system of local

councils, each of the local governments was permitted to maintain an administrative office, providing they could afford it. At that time, from the 3188 Hungarian local governments 1514 had to share administrative units with neighbouring settlements, since they could not afford to perform administrative services on their own.

**Figure 1:** Counties and boroughs of Hungary



\* Note: New Law 189/2011 on Local Governments  
 Boroughs (175) reintroduced from 2013  
 Source: Wikipedia (2019).<sup>2</sup>

Due to the bankruptcy of the majority of local governments, it became necessary to undertake economic consolidation. This took place in four phases between 2012 and 2014 according to the following schedule:

- In 2012 the government spent 700 million USD on consolidating those LGs in which problems were the most urgent.
- In 2013 the government disbursed 300 million USD to cover the full debt of settlements with a population of less than 5000.
- In 2014 the government spent 3300 million USD on supporting the capital Budapest and its districts<sup>3</sup> and several major towns in Hungary by financing their debts to a level of 40–100%, the level of debt financing depending on the particular LG.

The new concept behind the legislation was that the eligibility for the economic support of local governments had changed. Previously, support was given on a so-called normative basis, i.e., it was proportional to the size of the population. However, according

to the new principle, LGs received support according to so-called duty-based, service-based, or task-based calculations. In other words, the amount of support depended on the local income capacity rate, on the amount of locally collected tax, and on the number and volume of services operated or managed by the local government.

### **3 A new concept for reshaping local services**

As mentioned above, the idea of the reform was to put a stop to mere institution-financing (i.e. normative support) by replacing it with service, duty or task-based support. The new aim is thus to develop towns as a whole, together with all their functions, but the provision of – for example – good urban transportation or health care should not be narrowed down to support for the operation of a transport company, or a hospital; i.e., of individual institutions.

Hospitals and schools were especially sensitive and problematic institutions because LGs lacked sufficient expertise to run them, and there were insufficient resources to finance them. As a rule, the smaller the town, the more difficult it was to afford the maintenance of educational and health services. Accordingly, hospitals and special health care units were taken over by the central government, as were schools. In the case of towns with a population of over 3000, a mixed system of school management was introduced, whereby both the central and local governments contributed to their maintenance. This implied a complicated bureaucracy which has faced difficulties with operating educational institutions and has occasionally turned teachers and pupils against the political leadership. Moreover, analogous processes unfortunately took place in the field of health care, where the operation of hospitals faced difficulties, including a lack of doctors and nurses.

The operation of the social care sector has remained in the hands of local governments. Previously, local governments distributed social benefits according to norms which were defined under 52 so-called “pretences” (titles). The complexity of the system led to administrative difficulties and slow working processes. According to the new regulation, citizens may now apply for social benefits from local social care administration using only one of eight different pretences.

Other services, such as waste management, a chimney sweeping service, water supply, and distance heating were provided by many contributors, some of them owned by the LGs, others by private enterprises. It was found difficult to engage these actors in fruitful discussion and to agree with the representatives of these stakeholders. Therefore, the reshaping of these services and markets and the amendment of the respective regulations were deferred to a later date.

#### **4 New principles for financing local governments**

As mentioned earlier, the former normative financing of local governments was replaced by task-based financial support from the central government. Instead of the size of the population remaining the basis for financing local public service tasks, the new financial system stimulates LGs to provide the services required by the respective regulations according to economic data supplied by the local governments themselves, who take into consideration the amount of local tax and duty revenues. Thus, the new financing system is based on the financial capacity of the governments, while their professional expertise in providing the related services is also taken into consideration. The financing system encourages LGs to develop their professional expertise and decision-making capacity in order to improve public services.

There are, however, some service fields that are closely monitored by the central government and financed according to specific principles. This approach affects the provision of school meals, the provision of kindergarten services, the enlargement of local kindergartens, and the management of public transportation. Some 2.3 billion USD in annual support is awarded for the development and operation of these services.

As mentioned earlier, local governments can no longer apply for loans to finance ongoing public service operations, but there are opportunities for loans for development and investment. In parallel, the repayment conditions for loans have been tightened up. In the case of emergencies, the respective law permits the disbursement of operational loans, but only within a one-year repayment deadline.

The government agency responsible for local governments is a state secretariat located in the Ministry of the Interior (Home Office). This agency encourages local governments to apply for development loans, especially those devoted to developing public sport service infrastructure such as swimming pools and football fields. Likewise, preferential credit is offered for improving public transportation. European Union subsidies are available for improving environmental quality, especially the development of waste water treatment and waste management; such support schemes encourage LGs to apply for complementary loans and grants.

#### **5 Reforming the administration of local governments**

Reform of local governance included the rationalization of administration, too. Only settlements with a population exceeding 2000 are entitled to run their own local government offices. In 2015, for example, from the approximately 3200 Hungarian local governments, some 1400 operated their offices on their own, while 1800 local communities had to share offices with neighbouring settlements. Before 2010 the number of LGs sharing offices with neighbouring settlements was only some 500, which means that rationalization raised the number of joint local government offices

by a factor of 3.6. On average, eight settlements share common offices and 17 civil servants work for a single office. The staff of such joint offices totals 25,000 clerks.

## **6 The economics of the self-reliance of local governments**

The 198/2011 Law<sup>4</sup> focused on the most important features of the institutional arrangement of LGs. However, for reshaping the economic environment of LGs, new reforms were needed. The main focus of interest of the government shifted to the responsibility of local bodies in attracting working capital, investment, and jobs to their territory. The implementation of these tasks required better urban marketing, an enhanced local identity, image building and urban branding.

Another law of 2011 legally underpinned the institution of public employment. This enabled LGs and other organizations such as NGOs and churches to apply for government funds to employ workers to carry out local public tasks in a non-profit arrangement. This has led to a considerable decrease in local unemployment. The mainly unskilled labour force hired in this way has been used not only for cleaning public spaces, but also as the staff of local establishments, among them new investments. Also, so-called social cooperatives were introduced to create new jobs in agriculture, predominantly in the area of growing fruit and vegetables, and in manufacturing, predominantly in the creation of alimentary products. Local governments were encouraged to open local marketplaces: i.e., premises for marketing and selling the products of local social cooperatives and mobilizing private agricultural producers, thereby serving the needs of traditional, licensed small-scale producers of agricultural goods and food. These products help to sustain traditional agricultural activities and contribute to preserving the identity of local consumers and producers, and even of the whole population.

## **7 Reforming local elections and institutional arrangements**

According to new regulation, the date and frequency of local elections is defined differently to the date and frequency of general elections. Previously, these two types of elections coincided, as both were held on the same day every fourth year in the springtime. Under the new regime, elections for local governments are held every fifth year in the fall. Additionally, members of the national parliament are not allowed to run for mayoral posts at the local level because this practice previously resulted in some conflicts of interest.

Under the new regime, elected representatives of local government bodies are required to take part in a life-long learning process. Civil officers and clerks must attend post-graduate training courses offered by the National University of Public Service. Every third year the clerks employed in public administration are obliged to collect a defined sum of credits from these post-graduate courses, some of which are based on e-learning.

Law 198/2011<sup>5</sup> establishes a platform whereby associations representing local governments can cooperate with the representatives of the central government by mutually sharing and exchanging their views. Also, a Local Government Research Institute has been established as part of the national University of Public Services.

A Government Decree of 2015 provides that those ministries which have jurisprudence or competence in terms of influencing local governments are obliged to establish the division of labour between their respective ministerial departments and the affected local governments.

## **8 The future of local governance**

The government is prepared to centralize the administration of certain public services in the centers of the seven regions. Significant steps towards regional centralization have already taken place in the administration of public health care and education. Another example is chimney sweeping, which in the future will be administered at the regional level in order to meet the challenges of fire protection, security, environmental protection, and energy management.

LGs in Hungary must have compatible information systems. A nationwide application service that supports an ASP (application service provider) system must be introduced to local government offices in order to decrease their risks and financial burdens. This will facilitate the introduction of uniform practices of book keeping and the regular provision of statistical data from every local government office.

As for the financing of local governments in the future, it is important that an inventory of debts and loans that are disbursed to them is constructed. Regulating loan conditions, together with compiling an inventory of local tax levies, will increase the transparency of the financial arrangements of local governments.

Public transportation is also a crucial function. Further steps are needed to harmonize railway and road transportation timetables around the country.

The incentives for the development of local economies require an inclusive type of local government decision-making that incorporates the active part of the local population.

It is additionally necessary to spread know-how about urban and regional marketing among LGs. Awareness must be raised of the fact that urban marketing involves the accomplishment of certain tasks that are additional to those of tourism marketing.

The establishment of inventories of local tax levies, loans and debts will enable stronger legal control over the financing and economies of local governments in the future.

**Notes:**

<sup>1</sup> Available at (in Hungarian): <https://net.jogtar.hu/jogszabaly?docid=A1100189.TV> (15 March, 2019).

<sup>2</sup> Available at: [https://commons.wikimedia.org/wiki/File:Townships\\_\(districts\)\\_of\\_Hungary.png](https://commons.wikimedia.org/wiki/File:Townships_(districts)_of_Hungary.png) (15 March, 2019).

<sup>3</sup> The 23 districts of Budapest are governed by autonomous local governments.

<sup>4</sup> Available at (in Hungarian): <https://net.jogtar.hu/jogszabaly?docid=99700081.TV&celpara=> (15 March, 2019).

<sup>5</sup> Available at (in Hungarian): <https://net.jogtar.hu/jogszabaly?docid=99700081.TV&celpara=> (15 March, 2019).

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Wikipedia (2019) *Townships (districts) of Hungary*, available at: [https://commons.wikimedia.org/wiki/File:Townships\\_\(districts\)\\_of\\_Hungary.png](https://commons.wikimedia.org/wiki/File:Townships_(districts)_of_Hungary.png) (15 March, 2019).