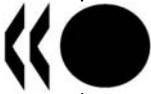


**Unclassified**

**ECO/WKP(2007)25**



Organisation de Coopération et de Développement Economiques  
Organisation for Economic Co-operation and Development

**04-Jul-2007**

**English text only**

**ECONOMICS DEPARTMENT**

**ECO/WKP(2007)25**  
**Unclassified**

**ENCOURAGING SUB-NATIONAL GOVERNMENT EFFICIENCY IN HUNGARY**

**ECONOMICS DEPARTMENT WORKING PAPERS No. 565**

by  
**Alessandro Goglio**

All OECD Economics Department Working Papers are available on the OECD Internet website at  
[www.oecd.org/eco/working\\_papers](http://www.oecd.org/eco/working_papers)

**JT0322966**

Document complet disponible sur OLIS dans son format d'origine  
Complete document available on OLIS in its original format

**English text only**

## ABSTRACT/RÉSUMÉ

### **Encouraging sub-national government efficiency in Hungary**

Hungary's counties and municipalities face difficult challenges. Participation in cost-cutting structural reforms initiated by the central government means cutbacks to administrative overheads and tough decisions in public services. At the same time, there are also challenges in modernising local infrastructures and in making full use of the EU funds for development projects. This paper first looks at how meeting these challenges can be helped by better budgeting, in particular regarding the transparency and oversight of accounts. Financing arrangements are also examined and this reveals a general problem of complexity. Assessment of spending responsibilities suggests room for improving the roles of counties and regions and a need for cutbacks in central-government influence on service provision and public-sector wages at the local level.

This Working Paper relates to the 2007 *OECD Economic Survey of Hungary* ([www.oecd.org/eco/surveys/hungary](http://www.oecd.org/eco/surveys/hungary)).

*JEL Classification:* H7

*Keywords:* Hungary; sub-national governments; budgetary rules; public services; auditing system; scale economies; public procurement; tax sharing; local taxes.

\* \* \* \* \*

### **Promouvoir l'efficience des administrations infranationales en Hongrie**

Les départements et les communes de la Hongrie se trouvent confrontés à une série de problèmes. Leur participation aux réformes structurelles lancées par l'administration centrale les oblige à trancher dans les dépenses administratives et à prendre des décisions délicates en ce qui concerne les services publics. Dans le même temps, il faut mener une action permanente de modernisation des infrastructures locales et tirer pleinement parti des financements de l'UE pour les projets de développement. On verra tout d'abord comment une meilleure budgétisation, surtout pour ce qui est de la transparence et du contrôle des comptes, faciliterait cette action. On examinera également les modalités de financement, qui posent un problème général, celui d'une trop grande complexité. Une évaluation des compétences en matière de dépenses montre qu'il serait possible de mieux définir les missions des comtés et des régions et que l'administration centrale devrait exercer moins d'influence sur la prestation des services et sur les rémunérations dans le secteur public.

Ce document de travail se rapporte à *l'Etude économique de la Hongrie 2007* ([www.oecd.org/eco/etudes/hongrie](http://www.oecd.org/eco/etudes/hongrie)).

*Classification JEL :* H7

*Mots clés :* Hongrie; autorités infranationales; budgétisation; services publics; contrôle des comptes; économies d'échelle; marchés publics; partage des impôts; fiscalité locale.

**Copyright, OECD, 2007**

**Application for permission to reproduce or translate all, or part of, this material should be made to: Head of Publications Service, OECD, 2 rue André-Pascal, 75775 Paris Cedex 16, France.**

## TABLE OF CONTENTS

ENCOURAGING SUB-NATIONAL GOVERNMENT EFFICIENCY IN HUNGARY .....	5
The sub-national government system.....	7
Budgeting issues.....	8
Making use of stronger budgeting rules .....	9
A need to widen the coverage of budgets.....	9
Better monitoring during the budget year is required.....	10
The deficit grant is unsuited to deal with cyclical pressures .....	10
Enhancing the effectiveness of the auditing system .....	10
Spending assignment issues .....	11
Costly co-ordination failures .....	11
Economies of scale .....	14
Lack of accountability vis-à-vis citizens and poor information sharing.....	19
Issues in wage setting and employment flexibility.....	21
Funding arrangements for local governments.....	21
An administratively costly grant system.....	22
The need for more performance-based funding.....	23
Fine tuning the allocation of personal income tax.....	23
Problems with local tax-raising capacity .....	25
Issues in investment funding .....	27
BIBLIOGRAPHY.....	29
ANNEX A1 THE BUDGET BALANCE RULES IN MUNICIPAL ACCOUNTS .....	32
ANNEX A2 EU TRANSFERS TO HUNGARY’S MUNICIPALITIES UNDER THE 2007-13 BUDGET .....	33
GLOSSARY .....	34

### Tables

3.1. The structure of public administration in Hungary .....	7
3.2. Gross public debt.....	8
3.3. The assignment of competences to the local governments.....	12
3.4. The size distribution of municipalities .....	15
3.5. Distribution of micro-regions by type of activity.....	18
3.6. Local taxes.....	26

### Figures

3.1. Local governments’ shares in general government expenditure .....	13
3.2. International comparison of the average number of inhabitants per municipality .....	15
3.3. Revenues of local governments by type.....	22
3.4. Taxes by level of governments.....	26

**Boxes**

Box 1. Policy recommendations for local government reforms.....	5
Box 2. Political developments in local government.....	8
Box 3. Consequences of the split between service provision and asset ownership.....	16
Box 4. OECD experiences with local government co-operation .....	17
Box 5. National approaches to information sharing.....	20

## ENCOURAGING SUB-NATIONAL GOVERNMENT EFFICIENCY IN HUNGARY

By

Alessandro Goglio<sup>1</sup>

Hungarian sub-national governments are facing difficult challenges. Many of the cost-cutting structural reforms to public services being initiated by central government involve the municipal and county governments through their responsibilities in providing services. In addition, these governments face ongoing investment challenges in raising the quality of local infrastructures to address social and economic issues. There are wide regional disparities in GDP *per capita* across Hungary, reflecting an uneven pace of economic development. Local governments in poorer areas in particular need to be successful in accessing EU-funds aimed at narrowing gaps in development through infrastructure investment.

This paper looks at how meeting these challenges can be helped by changes to budgeting systems, financing arrangements and spending responsibilities in the municipal and county governments. Policy recommendations are summed up in Box 1.

### Box 1. Policy recommendations for local government reforms

#### Budgeting issues

- The authorities should consider reinforcing budgetary rules: separate budget balance rules for current and capital items should be specified and, in parallel with developments in central-government practice, multi-year budgeting at the local level should be introduced.
- Hungary could follow the example of several OECD countries (Austria, some Canadian provinces, Poland and Spain) which have recently made local governments move “off-budget” items into their accounts.
- On budgetary transparency, efforts should be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards. One way of giving more teeth to sanctions would be *via* provisions requiring local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures they intend to implement in order to rectify the situation.
- The deficit grant is unfitted to deal with cyclical pressures. A good opportunity to remove it appears to be offered by the ongoing shift to the multi year budgeting framework in central government. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance.
- The audit powers of the State Audit Office should be bolstered by extending them to cover all local government accounts, rather than being restricted, as at present, to the use of transfers received from the central government.

1. This paper was originally prepared for the OECD’s 2007 *Economic Survey of Hungary*. Alessandro Goglio is an economist in the OECD’s Economics Department. The author is grateful to the experts from the Hungarian government and non-government bodies who provided information and comments, as well as to OECD colleagues for their suggestions, in particular Val Koromzay, Andrew Dean, Andreas Wörgötter, Philip Hemmings, and Roland Natran (now at the Hungarian Ministry of Finance). Thanks are also due to Margaret Morgan for technical assistance and to Sylvie Ricordeau and Josiane Gutierrez for assistance in preparing the document.

#### **Spending assignment issues**

- Efforts to find consensus on the issue of replacing the county-level of government with elected assemblies in the seven NUTS II Regions should continue. The replacement would help overcome problems of overlapping responsibilities and allow for savings in administrative overheads.
- Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper rather than encourage improvements in public services by sub-national governments.
- The regulations on passing over responsibilities for services from municipalities to counties would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure. Support from the municipalities for joint provision *via* the system of “micro regions” (*mikro-régió*) would be helped by stronger mechanisms for public comment on the decisions taken by the councils of mayors that run these services.
- On benchmarking, much faster progress is required in the development of comparable cost, output and performance indicators.
- Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better.

#### **Funding arrangements for local governments**

- The number of formula based earmarked grants should be further reduced as part of a broad re-assessment of the structure of the “basic package” of services covered by these grants.
- Steps are needed to eliminate problems in the PIT allocation. First, the link between the funding of a range of services to PIT revenue runs against principles of efficiency and flexibility in financing and should be severed. Second, if formula-based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services.
- Ongoing efforts to increase the role of service quality in funding represent good progress. However, the use of quality indicators remains limited and more work is needed to widen this approach.
- A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. Local “value maps” ought to be developed to ensure that the new property tax is levied on values that reflect market developments. The tax base should be broadened to include home owners.

## The sub-national government system

Hungary, a unitary state, has three layers of elected governments – central government (*központi kormányzat*), counties (*megyei önkormányzat*) and municipalities (*helyi önkormányzat*). There are 3 167 municipalities, 19 counties and 20 city-counties (including Budapest) which have a special dual status as a municipality and a county (Table 1, left column). Elections to the respective assemblies are held every four years and always (at least so far) in the same year as the general elections. Established in 1990, this structure replaced a centrally controlled system comprising three levels: communities, districts and counties.<sup>2</sup>

Unlike under the previous system, which granted significant powers on spending rights and funding allocations to the counties, the municipalities today benefit from a considerable degree of autonomy. Municipal governments are no longer subordinated to county governments; notably, a county cannot overrule the decisions of a municipality. The institutional foundations of the present framework are the

Constitution and the 1990 Act on Local Governments. Both legal instruments have *organic* law status, meaning that they can only be amended by a qualified parliamentary majority of two-thirds, rather than a simple majority.

Understandably, the qualified majority requirement is intended as a safeguard against the risk of excessively frequent and possibly disruptive changes. As in other countries, however, it may occasionally generate tensions and even hold back opportunities to introduce changes with a potential to raise the effectiveness of service delivery. This is particularly the case in Hungary at present, where following the recent local elections the opposition has a majority in most local governments (Box 2).

Table 1. The structure of public administration in Hungary

Elected bodies	Appointed Councils, notably on development, education and health
Parliament	<p><i>Councils in the national and regional level.</i></p> <p><i>There are three National Councils covering Development, Education and Healthcare, respectively. Most of their members are appointed by the central government. For example, the Development Council includes representatives from 9 Ministries, the presidents of the Regional Development Councils (see below) and the Mayor of Budapest.</i></p> <p><i>There are also 7 Regional Development Councils (NUTS II regions) and 7 Regional Healthcare Councils. Most of their members are appointed by the central government.</i></p>
19 County governments	<p><i>19 County Development Councils. These Councils include members appointed by the central government and county governments.</i></p>
3 167 Municipalities plus 20 cities with county status (including Budapest)	<p><i>Development Councils of micro-regions (166 in total) and other forms of local government associations. These Councils are appointed by the municipalities.</i></p>

Source: OECD, based on M. Kopány and D. Wetzel (2004).

2. For earlier discussions of Hungary's structure of governance see Wetzel and Papp (2003), OECD (2001a), OECD (2001b) and World Bank (2000).

### Box 2. Political developments in local government

The local government elections were held in October 2006, about six months after the general elections. The opposition Young Democratic Alliance - Hungarian Civic Union (FIDESZ-MPSZ) won 18 out of 19 counties and 15 out of 23 major cities (with the notable exception of Budapest), taking over almost all seats previously held by the Hungarian Socialist Party (MSZP), the leading government coalition partner. At the time of the local elections the public was still digesting the implications for household incomes of the government's fiscal austerity package. In addition, around the time of the local elections there was controversy over a leaked recording of a speech by the Prime Minister.

Following the local government elections some political analysts argued that Hungary was exposed to the risk of a dual government power, in which Fidesz-led local governments would attempt to block all of the central government's austerity and reform measures. However, this view may be exaggerated. First, access to the European budget allocations raises the motivation of the local governments to co-operate with the central government. Second, accelerated progress on some local government reforms might turn out to reinforce support for Fidesz. At present, every broad policy priority of Fidesz is on local government matters.

Many local activities, particularly in infrastructure development, education and healthcare, are initiated and co-ordinated *via* a system of local Councils and micro-regions (Table 1, right column). A National Development Council and 19 County Development Councils were created in 1996, along with seven Regional Development Councils for the 'NUTS II' regions which provide the interface with the EU's regional funding mechanism. However, the regions (*régiók*) not only play a policymaking role in development but also other areas of spending. For example, there are Regional Healthcare Councils that include representatives from counties and municipalities.

Since 2004, there are also 166 "NUTS IV" micro regions (*mikro-régiók*), comprising groups of municipalities that plan and implement various local activities, mainly with an aim to expand the provision of joint services. Most changes at the regional and micro region levels were initiated as part of Hungary's process towards joining the European Union (Temesi, 2000).

### Budgeting issues

There are several mechanisms that aim to make local governments deliver balanced budgets and these include the requirement for balanced budget submission and a "deficit grant" (Annex A1). As a result, the combined budget of sub-national governments has typically been close to balance or even in a slight surplus. Also, Hungary's local governments have not accumulated much debt (Table 2).

Table 2. **Gross public debt**  
End of year per cent of GDP

	2000	2001	2002	2003	2004	2005
Central government	54.3	52.0	55.0	57.1	58.4	60.3
Social security funds	0.9	0.4	0.8	2.0	2.1	2.2
Local governments' gross debt	1.0	1.1	1.5	1.5	1.6	1.9
<i>Consolidation within general government</i>	1.9	1.4	1.6	2.7	2.8	2.7
<i>General government consolidated gross debt</i>	54.2	52.1	55.6	58.0	59.4	61.7

Source: Magyar Nemzeti Bank (MNB).

However, it is hard to draw a firm conclusion about the quality of financial management from this. Given the strong reliance of the local system on central government transfers, these positive budgetary outcomes could reflect a tendency for central government to respond to local budgetary slippages with increased funding. The following sections look in more depth at various aspects of budgetary management.

### ***Making use of stronger budgeting rules***

Strategic prioritisation in sub-national government budgeting is rather weak. Indeed, local governments focus almost exclusively on ensuring the budget meets legal and procedural obligations, and medium- and long-term policy goals tend to take a back seat. Most municipalities only fulfil minimum presentation requirements which just require classification by spending units (salaries, goods and services, capital expenses). Only a few municipalities specify their spending objectives by services or programmes (education, child care, water, garbage collection and so on). The basic objectives of public spending are therefore not transparent in most municipalities' accounts. Various steps could be taken to rectify this:

- Specification of separate budget balance rules for current and capital items.<sup>3</sup> Local governments must present budget proposals that differentiate between capital and operating items, but there is only one budget balance requirement (which applies to the aggregate budget). The city of Budapest has taken a welcome lead with a self-imposed rule that any surplus on current spending can only be used to finance infrastructure investment.<sup>4</sup>
- Introduction of multi-year budgeting at the local level, in parallel with developments in central-government practice (see OECD (2007), Chapter 2). Several OECD countries (including Finland, Norway and Spain) have introduced multi-annual budgeting to both central and local government either simultaneously or following a defined timetable, rather than targeting the central budget alone.

### ***A need to widen the coverage of budgets***

Several OECD countries (Austria, some Canadian provinces, Poland and Spain) have recently made local governments move “off-budget” items into their accounts and Hungary could follow this example. The financial flows associated with certain important activities are not fully reflected in local-government accounts. The accounts of local public utility holdings (notably in transport) and non-profit foundations created to run housing and welfare assistance services are off-budget. In addition, the motivation for outsourcing some activities is questionable as this also can take accounts off-budget. Off-budget status makes it difficult to find out the amount being spent in these areas and obscures the true status of local-government debt given the likelihood of implicit guarantees. Both local holdings and non-profit foundations are governed by commercial law and are therefore free to finance themselves in the capital market. In addition, off-budget accounts widen the scope for circumventing fiscal rules through accountancy gimmickry. Reportedly, more than one third of the non-profit organisations receiving local financial support do not report the full extent of financial assistance (State Audit Office, 2006).

---

3. Sutherland *et al.* (2005). Drawing mainly on questionnaire responses, this paper gives a detailed picture of fiscal rules for sub-central governments in a number of OECD countries.

4. The City of Budapest's self-imposed rule on use of the current surplus has been in place since 1995 and surpluses on current spending have been recorded since then. For 2006, Budapest's gap between current revenue income and spending was 13%, with the plan being to widen the gap further to 20% before 2010.

### ***Better monitoring during the budget year is required***

Municipalities must submit annual and semi-annual budget updates to the Ministry of Finance but there are problems in the format of the reports. According to the State Audit Office (SAO), more than two thirds of the local governments implement registration systems that are unsuited to allowing precise assessment of liabilities (State Audit Office, 2006). Efforts should therefore be made to improve the quality of reporting, for example by regulations requiring local governments to re-submit when reports fail to meet standards.

In addition, the sanctions against municipalities that break budget rules are rather soft. At present the Ministry of Finance can only send out signals or make recommendations when it sees that a sub-central government is in breach of fiscal rules. One way of giving more teeth to sanctions would be to introduce provisions that require local governments to provide an explanation for breaching the budget rules and to submit a plan describing the measures to rectify the situation.

At the same time, in some respects too much budgetary information is demanded and a review of the budgetary information that municipalities have to provide to the central government should be carried out. A frequent complaint of municipal officers is that a great amount of unnecessary information must be attached to the budget documentation. Several hundreds of expenditure and revenue variables are collected annually by the central government. The level of detail is such that the Ministry of Finance lacks enough means to scrutinise that such expenditures cater effectively to their objectives. Not surprisingly, much of the information sent is incomplete or unreliable and is kept confidential at the national level.

### ***The deficit grant is unsuited to deal with cyclical pressures***

The deficit grant aims to provide relief to municipalities due to unforeseeable financial developments (see Annex A1). In 2007 the eligibility criteria of the deficit grant have been tightened. However, improving local budget management would probably require abolishing it. This grant has to date amounted to about three quarters of a percentage point of GDP per year and it has adverse incentive effects for local governments.

The introduction of multi-year budgeting at the local level, as suggested above, could be used as a vehicle for removing the deficit grant. Specifically, a municipality in difficulty could be allowed a temporary deficit as long as its multi-year budget remains in balance. In the Netherlands, where a similar mechanism is in place, if a municipality is unable to show a balance budget over the official multi-year budgetary period of three years it has to submit the budget to the higher level of government for approval.

### ***Enhancing the effectiveness of the auditing system***

The auditing system was reformed in 2003 and included a requirement that over each parliamentary cycle the SAO must audit each local government at least once. Though the new auditing framework also included changes intended to raise the visibility of the link between the budget and the quality of service delivery, little progress on this front has been achieved so far. Reportedly, this reflects the problem that many of the municipalities surveyed by the SAO have yet to implement internal audit systems or, when in place, the internal auditors are not independent of the local governments.

However the scope of the SAO's audits is narrow. The SAO's evaluations of local government are restricted to the use of transfers received from central government. These audits could be bolstered by extending them to cover all local government accounts.

## Spending assignment issues

Decentralisation of spending responsibilities to the municipalities and the counties in the early 1990s was significant. The municipalities were made responsible for several core services, most prominently primary education, water supply and various areas of healthcare including general practices, non-specialist hospitals and ambulatory services. The counties are notably responsible for secondary education, research hospitals and other specialised healthcare services. All in all, 20 key tasks are allocated to sub-national governments (Table 3), a fairly large number in the OECD context. Indeed, Hungary's municipalities perform broadly the same range of tasks as in the European Nordic countries, even though local systems are much less dispersed in these countries, based on the overall number of municipalities.<sup>5</sup> In terms of the share of total public spending, Hungary's sub-national governments are not exceptional. The counties and municipalities combined account for about a quarter of general government spending, a similar level to Poland, the Czech Republic and the UK (Figure 1).

The devolution of responsibilities for public services has been a broadly positive step but has also generated some challenges. The following sections look at problems in co-ordination, challenges in overcoming economies of scale and issues in wage setting for public-sector workers.

### *Costly co-ordination failures*

#### *Getting the "middle level" of government right: counties or regions?*

The middle level of government and administration (i.e. the level between the municipalities and the central government) has become rather complicated. Entry to the EU required the formation of the regions based on Eurostat NUTSII criteria as an administrative tool in EU funding. As mentioned above, the resulting system of seven regions has been used by central government to set up regional councils, which are made up of representatives from counties and municipalities and which cover issues in development, health and education. This has further narrowed the role of the counties which, as noted, was already significantly reduced by decentralisation in 1990.<sup>6</sup>

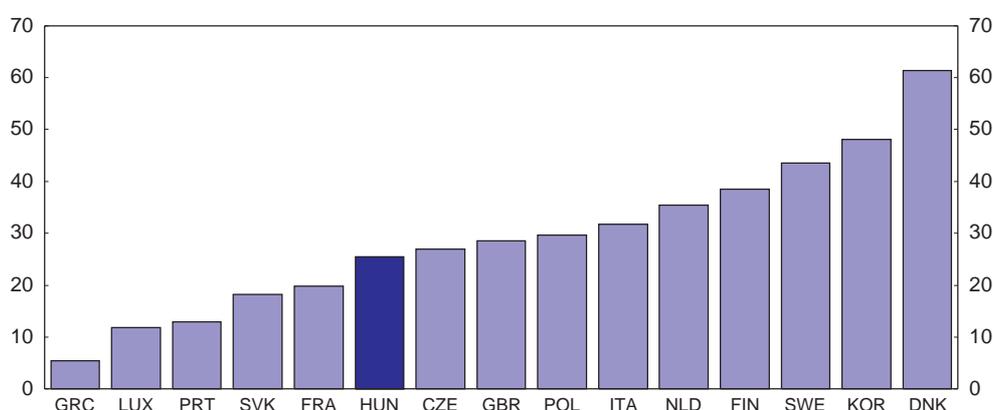
The co-existence of decision-making bodies at the regional level *via* the councils with county and municipal governments has generated overlapping responsibilities, especially between the councils and the large urban municipalities which also have county status. This is slowing decision making considerably, particularly in infrastructure development where it is difficult to agree upon the boundaries of a given project (e.g. road projects, water services and energy supply).

- 
5. In Finland, for example, a system of grants has provoked some mergers. In Denmark, the number of municipalities was cut quite dramatically from January 2007 from 271 to 98, with an average population of 55 000 compared with 20 000 previously. The 14 counties have been merged to five regions responsible for healthcare (OECD, 2006a). It should be noted, however, that compared with Hungary municipalities enjoy much less constitutional protection in Denmark.
  6. For further discussion about the role of counties, Vigvåri (2002), Fekete, *et al.* (2002) and Pálné Kovács (2005).

Table 3. The assignment of competences to the local governments

Functions	Municipalities	Counties/Urban governments	Local administrative units of the central state
<b>Education</b>			
Pre school and primary	X		
Secondary		X	
<b>Social welfare</b>			
Nurseries, kindergartens and welfare homes	X		
Social care services (elderly, disabled, special services for homeless and families in crisis)	X		
Social housing		X	
<b>Healthcare</b>			
Primary healthcare	X		
General hospitals		X	
Preventive care			X
<b>Leisure</b>			
Culture, leisure and sport		X	
Parks and cultural centres	X		
<b>Water and energy</b>			
Water supply and waste water treatment	X		
Gas supply and heating			X
Electricity supply			X
<b>Environment and public sanitation</b>			
Refuse collection and disposal	X		
Street cleaning		X	
Cemeteries	X		
Environmental protection	X		
<b>Roads and transports</b>			
Local roads and public lighting	X		
Secondary and national roads			X
Public transport services		X	X
<b>Urban planning and development</b>			
Town planning	X		
Regional planning		X	
Local economic development	X	X	
Tourism	X		X
<b>Administration and emergency services</b>			
Licences and administrative services	X		X
Law enforcement and emergency services (police, fire brigades, etc.)	X		X
Consumer protection			X

Source: OECD, Based on Temesi (2003).

Figure 1. Local governments' shares in general government expenditure<sup>1</sup>

1. Secretariat estimates based on the latest available national accounts figures (2005 for most countries) and excluding the transfers paid to other levels of government.

Source: OECD, National Accounts Database.

#### *Co-ordination failures between central government and sub-national government*

Hungary's constitutional law provides a large degree of autonomy to municipalities, but freedom in policymaking is affected by several other factors. A key role is played by the provision regulations laid down in sector specific laws, on which line ministries have strong influence. These laws have come under increasing criticism for going beyond the core mission of enforcing or supporting nationwide standards and priorities.<sup>7</sup> Compared with local government laws, sector-specific laws can be passed relatively quickly, namely by means of a simple parliamentary majority.

The Act on Public Education, for example, imposes overly restrictive rules on closing, or modifying the use of education facilities that restrain the room for adjusting the provision of services to local conditions. In particular, the Act confers special veto power to both providers and users of the service on any proposal to dissolve a public education institution.<sup>8</sup> The impact of the mechanisms encouraging joint provision in education (see below) is likely to be weakened in these circumstances.

In healthcare, most hospital workers are public-sector employees and have to be paid using central funding.<sup>9</sup> This framework considerably limits the scope for introducing performance management and performance-based compensation in the hospitals. Also, it exacerbates the problem of so called "gratitude money" (under-the-table compensation payments), which is widespread, though illegal. Other aspects of the legislation are also overly prescriptive on issues which should be at the discretion of local decision

7. The issue was originally raised in World Bank (2000). Peteri (2006) suggests that the power of line ministries may have led to less "objective" local grants, basically reflecting strong ministries' control of sector laws.

8. For example, the dissolution of a public education institution is conditional upon a consultation involving the staff of the institution, the school board, the parents and the school's student council, with all these players having veto rights.

9. The law allows local governments to contract out the operations of their hospitals but this does not happen very often. In this case, the hospital becomes a private company and the healthcare workers are no longer public employees.

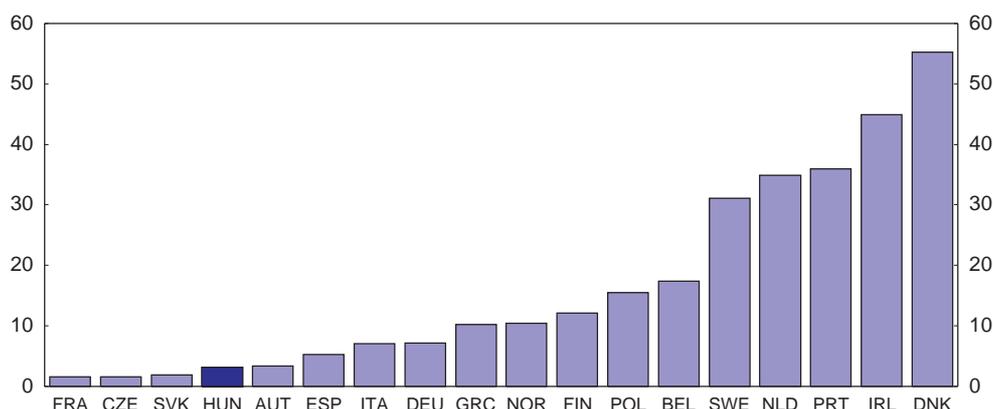
makers. For example, the sector specific act in healthcare states that patients must be able to access hospitals using regular public transport.

Reconsideration of central and sector specific laws is needed to cut back on regulations that hamper, rather than encourage improvements in public services by sub-national governments. Over-regulation generates inefficiencies in the sector they apply. It also creates a more general problem of weak incentives in local governments to initiate reform because they feel they are merely the executors of central-government policy, tightly bound by the provision rules and detailed formula-based grants (so-called “normative subsidies”).

### *Economies of scale*

The average size of Hungarian municipalities is one of the lowest of the European Union (Figure 2). The small size of many municipalities, especially given the wide range of responsibilities they have to cover, raises the question as to whether the scale of operation in administrative overheads and public services is efficient.

Figure 2. **International comparison of the average number of inhabitants per municipality**  
Thousands



Source: Denmark, Ministry of the Interior and Health website; Dexia Bank.

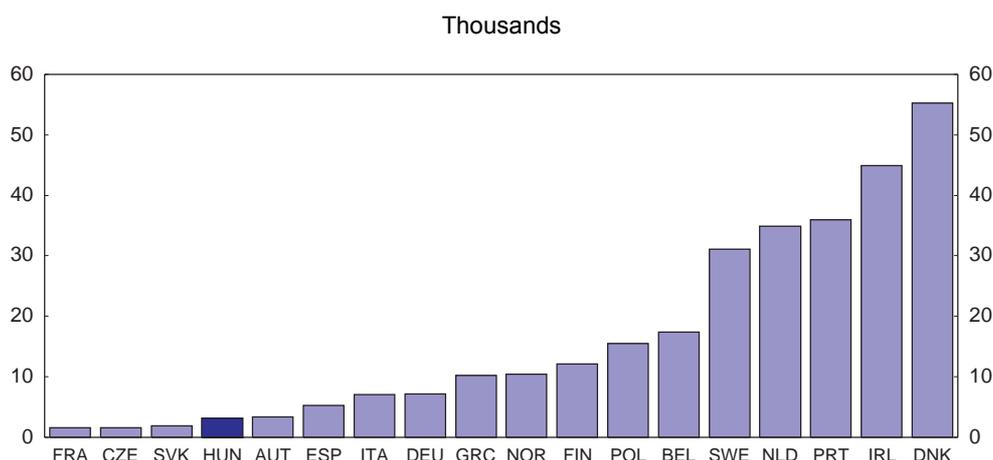
Though a precise picture of the relationship between size and efficiency in local government is difficult to establish, it seems that many Hungarian municipalities are relatively inefficient reflecting the small scale of their administrative capacities and client populations. Empirical studies broadly agree that efficiency begins to drop off significantly below 5 000 inhabitants.<sup>10</sup> Among them, Solé-Ollé and Bosch (2003) estimate that spending needs per head in Spain’s municipalities with 1 000 inhabitants are 23% higher than in municipalities with 5 000 inhabitants. Research on small local governments in Swiss cantons (a system often held up as a case where small-scale government works well) suggests that costs and quality are severely compromised below a population of 500 (Ladner and Steiner, 2003). Evaluated against these benchmarks, the number of municipalities below critical minimum sizes in terms of efficiency is relatively large in Hungary (Table 4).<sup>11</sup>

10. These estimates should be considered with caution, since larger municipalities tend to offer more services, resulting in higher average spending *per capita*. For recent surveys of economies of scale issues, see Fox and Gurley (2006) and Lotz (2006).

11. Excluding Budapest and the largest cities, Hungary’s municipalities average only 1 258 inhabitants. There are 1 020 municipalities with populations of less than 500 and 1 700 of less than 1 000. A number of papers have argued that although mergers and joint provision may allow scale economies to be exploited,

The most obvious solution to the Hungarian problem of economies of scale would be through mergers. However, this is easier said than done. Many argue that mergers will never get political support because the setting up of local democracy is one of the main achievements of transition.<sup>12</sup> Local democracy is indeed strongly protected; the constitution prohibits the central government from decreeing the merger of municipalities. Given this, policy has to work more indirectly so that joint provision is encouraged through suasion and incentive mechanisms.

Figure 2. International comparison of the average number of inhabitants per municipality



Source: Denmark, Ministry of the Interior and Health website; Dexia Bank.

Table 4. The size distribution of municipalities

Population range	Number of municipalities	Number of municipalities (cumulative)	Percentage of total municipalities (cumulative)	Total population	Total population (cumulative)	Percentage of total population (cumulative)
Below 200	312	312	9.9	38 030	38 030	0.4
201-499	705	1 017	32.1	241 942	279 972	2.7
500-999	682	1 699	53.6	497 662	777 634	7.6
1 000-4 999	1 157	2 856	90.2	2 445 773	3 223 407	31.6
5 000-10 000	146	3 002	94.8	1 012 533	4 235 940	41.6
Above 10 000	165	3 167	100.0	5 957 446	10 193 386	100.0

Source: Ministry of Finance.

such solutions are not without drawbacks. In France, for example, where joint provision is very common, concerns have been raised that they could lead to a failure of democratic control because joint bodies are not elected by the population and are often perceived as lacking transparency (Le Saout, 1998). Citizens may therefore be left with little influence over local services. However, these views apply only weakly to countries, such as Hungary, where citizens from small municipalities do not exert a strong voice with regard to local affairs (see below).

12. Before the transition there were 1 500 municipalities and Budapest, which counts as many as 23 districts, was considerably more centralised than at present.

A good feature of the local-government system is that it allows municipalities to transfer their service responsibilities to the county level on the grounds that they are unable to meet the related operating costs.<sup>13</sup> While this helps avoid costly duplications of specialised services, some regulatory fine tuning is required. At present, the ownership of the asset is not transferred along with the transfer of the utilisation rights. Transfer of ownership requires approval by the municipality following a request from the recipient county but this is rarely carried out. The municipalities are often reluctant to introduce changes in the use of their infrastructures and this limits the counties room for manoeuvre in reform (Box 3). The regulations on passing over responsibility for services would be more effective if municipalities were prevented from imposing rules on how the county uses the infrastructure.

**Box 3. Consequences of the split between service provision and asset ownership**

Reportedly, the split between service provision and asset ownership hampers healthcare reform, particularly regarding hospitals. There has been little progress in preventing uneconomic access to hospital services and hospital care remains overly dominant in the system (OECD, 2005a). Progress on this issue requires a significant degree of autonomous control and co-ordination of capital as well as current spending. For example, introducing lighter day-to-day care treatment means alterations to existing buildings or even a switch to new premises as well as the re-allocation of staff. The implementation of such reforms can however be held up because, for example, the county running the health services can find it difficult to persuade the municipalities (as owners of the hospitals) to consider such changes.

Changes in the regulations on the transfer of property rights when provision is passed over to the county level, would likely also favour restructuring in education. As in the Czech Republic, Poland and Slovakia, reflecting demographic developments Hungary faces the twin challenge of reducing numbers of primary and secondary schoolchildren but rising demand for tertiary and adult education. The transferability of property rights along with utilisation rights could, for example, facilitate the transformation of the primary schools into centres for adult education.

1. Useful background indicators illustrating the issue can be found in OECD (2006b) and specifically Table A1.31, p. 39.

In addition, the joint provision of services by municipalities is common.<sup>14</sup> There exist various legally recognised forms of associations. These allow for the joint delivery of services, the delivery of services by one of the member municipalities and the formation of joint administrative districts (e.g. covering local tax offices and internal audit). Box 4 provides a summary of OECD experiences with local government co-operation.

- 
13. The municipalities can only transfer duties that were passed on to them in 1990 as part of decentralisation. Over the past fifteen years many secondary schools as well as a number of hospitals were transferred from the municipalities to the counties by this means. Also, municipal governments have the right to take over the control of any county service as long as it can be proved that over at least the previous four years it has been mostly used by local residents.
14. Joint provision is covered by Act on Local Governments which permits the establishment of inter-communal partnerships on a voluntary basis. Adherence to a joint association requires approval by a qualified majority of the local council and the law does not impose any specific requirement with regard to the sectors the association is going to cover.

#### Box 4. OECD experiences with local government co-operation

Several approaches have been taken within the OECD to the problem of numerous small local governments. A number of member countries have encouraged amalgamation, while others have encouraged co-operation. Common themes have emerged about the potential returns of such policies:<sup>1</sup>

- The efficiency gains from merger or co-operation can require changes in work processes and municipal organisation that take a long time to materialise, while costs may rise in the short-run. For instance, the Japanese experience with mergers suggests it takes perhaps a decade for all the efficiency gains to work through.
- Incentive mechanisms need to avoid side-rules and “lock-in-effects” that alter the benefits of mergers or co-operation. For instance, in Finland merged municipalities cannot reduce the combined workforce for the first five years following amalgamation. Thus, the incentives themselves limit economies and efficiency gains.
- The boundaries of joint provision needs to be flexible to reflect that scale economies differ across public services.
- Mergers or joint provision need to be treated interactively and tailored to circumstances. Co-operation is likely to be more appealing in countries where the municipalities have wide responsibilities. The weakest or poorest municipalities have comparatively more to gain from the benefits of co-operation but may also find more difficult to find suitable partners. For a municipality located close to a big city it may be preferable to purchase services from the larger municipality, rather than establish a formal co-operation agreement. Also, co-operation and merger are not necessarily alternative solutions as decisions regarding mergers could be informed by knowledge gathered during co-operation.

1. For a broader discussion see OECD (2006), *Workshop Proceedings: The Efficiency of Sub-central Spending*.

The system of 166 “micro-regions” (based on Eurostat’s NUTS IV criteria) set up in 2004 has been used to bring more structured joint provision in key areas of public spending, including development projects. Central government is encouraging municipalities to use the micro-regions as a basis for joint provision. The broad aim is to encourage co-operation between small villages and larger settlements, something the former have often been reluctant to accept for fear of losing autonomy. Several incentive mechanisms have been introduced:

- *Progressively increasing grants.* Grants for some services are progressively increased with the population coverage of the associations of municipalities. For example, for sewage networks serving between 2 000 and 15 000 residents, the central-government grant covers 40% of total costs, this is increased to 50% if population exceeds 15 000.
- *Threshold requirements in investment grants.* Access to special investment grants is sometimes contingent upon meeting a minimum population or consumption threshold.
- *One-off and formula based compensations.* These are provided when associations are formed and later on to help cover operating and development costs. This compensation represents only about 2% of total central-government transfers to municipalities but the experience so far suggests that even this modest compensation can be enough to motivate small settlements to co-operate.
- *Deterrents.* From 2007 some penalties have been introduced. For example, the “deficit grant” will no longer be available to those municipalities that are not in an association for the joint provision of education services.

There is welcome flexibility in the micro-region system. Borders can be altered through legislation that allows municipalities to switch to an adjacent micro-region.<sup>15</sup> In addition, central government is taking a flexible approach in its application of the incentive mechanisms described above. Associations do not have to comprise all municipalities in a micro-region to be eligible for the incentives and the joint provision of public services can even span the boundaries of the micro-regions.

The general perception is that these mechanisms are indeed encouraging a more efficient scale of operations. Virtually all the micro regions are now being used for joint provision and are running at least three services. The most common joint provision is in education (Table 5). The government is carrying out case-studies of the micro-regions. Particularly revealing is the experience of the *Koppány* Valley Multi-purpose Sub-regional Partnership, which shows that network-wide gains can be quite substantial, measured in terms of expenditure savings.<sup>16</sup> Local government teaching expenditure per class is reported to have declined by an average of 30% following the establishment of the association and there has also been a 50% cut in administrative costs. Three schools have been closed without altering education levels for the inhabitants of the association taken as a whole.

Table 5. **Distribution of micro-regions by type of activity**  
As of February 2007

Purposes	Number of micro regions with joint provisions	In per cent
Educational	162	98
Social institutional	21	13
Social basic service	113	68
Children-protection service	2	1
Children-welfare basic service	136	82
Moving library	77	46
Inner audit	152	92
<b>Total number of micro regions with joint provision</b>	<b>165</b>	<b>99</b>
Total number of micro regions	166	100

Source: Ministry of Finance.

Though the micro-region system seems to be running well, there is some scope for improving governance. The micro regions are typically run by the association councils comprising only the mayors from the participating municipalities. Reportedly, in some instances this is leading to excessive marginalisation of the municipal assemblies. The law allows the establishment of a separate organisation - a joint municipal authority – to oversee joint services. However, very few have been created because their

- 
15. Notably, boundaries can be adjusted with a four year frequency, within 6 months from the general local government elections. During this period, local governments can opt to join an adjacent micro-region if this is seen as leading to better public services for their inhabitants.
16. The information about the experience of the *Koppány* Valley Multi-purpose Sub-regional Partnership have been made available to the OECD's Secretariat by the Ministry of Local Government and Regional Development.

powers are vaguely defined. Oversight of the association councils could be strengthened by provisions allowing for comment on preliminary council decisions from all stakeholders. This however would also require allowing local stakeholders access to the relevant details of the councils' work.

Additional mechanisms for encouraging joint provision should be explored. Adjustment of tax allocation formula is one candidate. For example, the Czech Republic is considering adjustment of its tax allocation formula to reward joint provision (OECD, 2006c). However, the returns to both existing and new schemes need to be carefully evaluated. It can be prove tricky to ensure that co-operation agreements result in concrete economies in service provision and not just superficial organisational changes to fulfil eligibility criteria. Also, the returns from a fiscal perspective may be limited if efficiency gains emerge in improved service quality rather than cost savings.

### ***Lack of accountability vis-à-vis citizens and poor information sharing***

Effective and efficient local government requires not only incentives from central government but also strong oversight by local citizens. This can be helped by regulations ensuring transparency in actions and outcomes of local government and participation in decision making (Box 5). Unfortunately, these are arguably inadequate in Hungary. Regulations stipulate that only one public hearing per year must be held, while virtually all municipalities comply, only a small fraction of them exceed this obligation. There are no strict rules for the organisation of such public hearings, meaning that meeting agendas can be set out in such a way to avoid sensitive issues (Soós, 2003). Moreover, public hearings are often poorly advertised and, as a result, meeting attendance can be low. Although there are some *ad hoc*, bilateral discussions between municipalities, local government officials find the sharing of good and bad experiences at the sub-national level is too limited and informal.<sup>17</sup>

More benchmarking would help. Experience from a number of OECD countries suggests that information sharing enhances competitive pressures on sub-national governments (Box 5). But in Hungary this is poorly developed. For instance, there are no standardised measures for elderly care facilities or for school performance. While there are plans to bring in indicators, for example there is intention to publish adjusted mortality rates by region, progress is slow. EU funding may provide one way of speeding up this process. Central government should also step up its support, for instance with subsidies to cover the initial costs of participation.

Local governments carry out a significant share of public procurement, so ensuring the legal and administrative frameworks to allow small administrations sufficient flexibility while safeguarding against abuse is important. Hungary scores fairly well in OECD indicators of procurement policy.<sup>18</sup> It has been one of the first countries to set-up an independent Public Procurement Council and there is also an independent body handling appeals and complaints on procurement (the Public Procurement Arbitration Board, PPAB). A recent report by the SAO concludes that most local public procurements follow the rules of open tendering procedures (SAO, 2006). However, it also points out that half of these local governments have yet to comply with the obligation to establish an internal code of conduct. Public procurement practices

---

17. One would expect that residents of small municipalities can take advantage of proximity to approach local leaders. In practice, at least in Hungary, this does not seem to be a significant advantage. Indeed, a survey data reveals that face-to-face contacts between local representatives and citizens are less frequent than in the larger municipalities. In addition, unlike their larger peers, small municipalities cannot benefit from other oversight mechanisms (*e.g.* stronger competition between political parties, associations of local citizens and media coverage). See Soós (2002 and 2003) for discussions of citizens' participation in Hungary based on survey data.

18. For assessment details of Hungary's position in OECD policy indicators in procurement see (see OECD, 2005b; Gjersem *et al.*, 2004).

also feature among the complaints of foreign investors along with other aspects of red-tape and administrative procedures (OECD, 2005b). Although PPAB has been applying its sanctioning powers more strongly, increased monitoring of these practices is needed.<sup>19</sup>

#### Box 5. National approaches to information sharing

OECD countries have been paying increasing attention to stimulating competitive pressures and cross-learning at the local level through information sharing.<sup>1</sup>

##### Examples of information sharing

- Australia regularly collects a comprehensive set of information and statistics on government services (such as in education, justice, emergency management, healthcare, community services and housing) for each state and local territory, as well as the national level.
- Denmark, Norway and Turkey collect comparative statistics on a variety of municipal data and this is available online. The data published by Denmark, for example, describe social conditions, economic background, local financial data, and output measures, such as students per teacher.
- The Association of Netherlands Municipalities launched in 2006 a pilot website – *What is your municipality doing?* –, to enable citizens to compare municipal services. The site aims to increase transparency, quality and uniformity of a variety of services. One problem encountered is that data available on the internet can be too technical to digest by the general public.
- Finally, Italy uses performance based indicators to promote regional institutional capacity. The main feature of this system, which was launched in 1998 in the context of the reform of regional development policies, is that it uses the indicators to reward or sanction the regions.

##### Policy challenges

The effectiveness of performance indicators is contingent on establishing clearly defined and quantifiable targets – itself a difficult issue. A key issue is *who chooses* the indicators. Local participation is important for building commitments, not least because the financial and administrative burdens of data collection fall upon the local administrations. The leverage of the central government to require data submission is generally lower in cases such as Spain, Austria and Canada where regional governments are highly autonomous. Leverage is also low where a relatively high proportion of central government transfers come in the form of non-earmarked grants, with Hungary falling into this category. The national government can play a constructive role by tackling co-ordination failures, for example, where there is no standard presentation of municipal budgets, again a situation that applies to Hungary. In addition, national government's oversight can be necessary to ensure the validity, reliability and comparability of data. National government can also help by setting standards for the presentation of information to the public.

1. The Box draws from discussions held at a recent workshop on the efficiency of sub-national spending jointly organised by the OECD Network on Fiscal Relations across Levels of Government and the French Budget Directorate of the Ministry of Economy and Finance. For further information, see OECD (2006), *Workshop Proceedings: The Efficiency of Sub-central Spending*.

19. For example, in early 2007 the PPAB sanctioned Budapest's District XXIII for failing to call a tender for renovating its buildings. The renovations had been carried out by the same company, which for 2005 alone was given 34 separate procurement projects. In its explanation the PPAB reaffirmed that the law requires local councils to call public procurement tenders for any project whose cost is estimated to exceed HUF 10 million. The amount of the fine equalled roughly 6 per cent the combined cost of the 34 renovation projects.

### *Issues in wage setting and employment flexibility*

Wage setting and employment conditions for public-sector employees are strongly centralised. The central government imposes a limit on the increase in the number of permanent employees at the sub-national level and sets salary scales and wage adjustments. Thus, most sub-national government wage scales factor in educational and seniority levels in the same way as wages in central government. And, for instance, the 50% public-sector pay increase over 2002-03 was agreed at central level and applied to most local-government employees. Only a small share (less than 10%) of total local government employees are currently hired under the standard labour code that applies to the business sector. However, there has been some increase in outsourcing which has indirectly meant increased use of more flexible work arrangements. Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better. In line with developments in other OECD countries, reliance on life-long job contracts should be lowered and barriers to mobility within the public sector scrapped. Central government is moving ahead with reforms to remuneration and management for civil-service employees (see OECD (2007), Chapter 2) and similar systems should be adopted by sub-national governments.

### **Funding arrangements for local governments**

Aside from the structure of spending assignments, *de facto* levels of self-determination in the municipalities and the counties are influenced by the system of intergovernmental financing. Most sub-national government funding goes to the municipalities, reflecting the much wider range of responsibilities compared with the counties. The key features of the system are as follows (Figure 3):

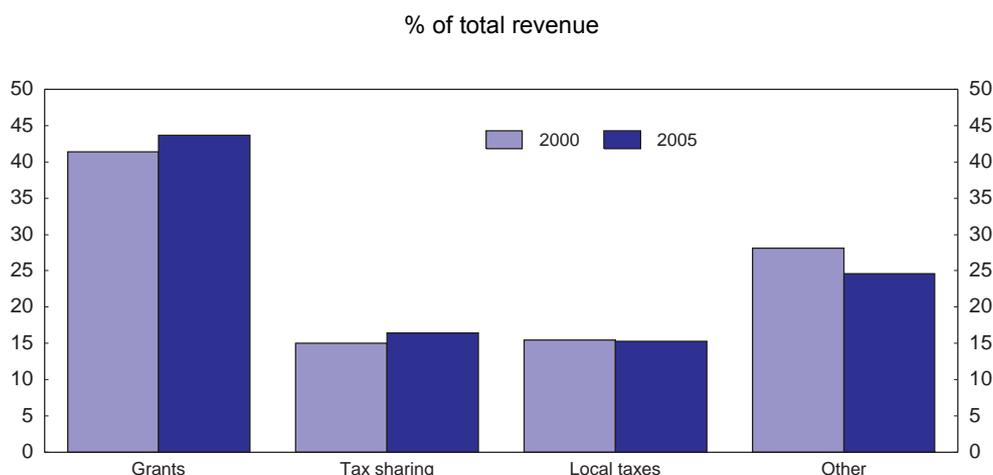
- *Grants from central government.* Grants are by far the most important source of revenues for sub-national governments. These are the sole source of revenue for counties and account for a large share of municipal funding. Grants account for roughly 45% of the aggregate revenues of municipalities, equivalent to about 6% of GDP.
- *Tax sharing.* About 40% of revenues from personal-income tax (PIT) are distributed to the municipalities. These account for 15% of total sub-national government revenues (some 2% of GDP).
- *Local taxes.* Local taxes make for roughly another 15% of total revenues, though there is considerable variation across sub-national governments. Particularly important is a tax on business turnover which totals approximately 80% of overall local tax revenues at the sub national level (this is discussed further below).
- *Other revenue sources.* The remainder (roughly 25% of total revenue) comes from various items, in particular asset sales, revenues from local fees and fines, and the reimbursement of value added taxes (for instance that paid on the purchase of inputs used for services).<sup>20</sup>

In broad terms, the system of financing is overly complex. This problem has been recognised by the government, particularly regarding the grant system (see, for example, Government of Hungary, 2006b). This is discussed in detail below along with the use of performance indicators in financing, the PIT tax allocation, local business taxes and the funding of investment.

---

20. These VAT revenues are to be initially paid to the State Tax Authority, implying that also the expenditure-side of the sub national government balance sheet contains this item.

Figure 3. Revenues of local governments by type



Source: Ministry of Finance.

### ***An administratively costly grant system***

The largest grant transfers are so-called normative subsidies, *i.e.* they are formula based grants. Around 40% of these transfers are for primary education. A large share of grants are not-earmarked (*i.e.* they go into general sub-national government revenues). Recent OECD work (Blöchliger and King, 2006) calculates that 43% of total grant transfers are non-earmarked, a share roughly in line with the OECD countries' average (45%).

Some important grants are however earmarked (*i.e.* the local authority must spend the allocation on the designated activity) and stipulate matching funding (*i.e.* the local authority has to make a contribution to the funding of the activity). The largest earmarked grant is the social security transfer for healthcare which is paid directly to the healthcare institutions. Supplementary funding allotted to education (*e.g.* special programmes for Roma children) and grants for large infrastructure projects are also earmarked. This is the case, at present, with the Budapest's fourth Metro line.

A major source of concern in the grant system is with the large number of detailed financial norms applied. It is usual for grant systems to be complex because of the need to tailor the grants to suit the services being funded. However, excessive complexity and administrative costs are added to the Hungarian system due to the large number of specific characteristics and sector requirements. This is exemplified by the numerous formula based grants, of which there are over 200.<sup>21</sup> The education grant alone results from the aggregation of some 30 norms, each one associated to a mandatory service.<sup>22</sup>

21. "Only" 50 norms are presented in a special annex attached to the draft budget. See Fox (2004) for more details on this issue.

22. As an illustration of the practical difficulties the system may create, Fox (2004) reports the case of a school that had to follow 23 norms. Because the primary education norms are based on the average number of students each day, counts had to be run on a daily basis. Moreover, since the academic year is affected by two budgetary years, schools and local governments are forced to follow two different sets of definitions and normative values in the same school year.

The government is taking some steps to cut back on the number of formula based grants. The latest Convergence Programme of Hungary (Government of Hungary, 2006b), contains a commitment to reforms, beginning with education. From September 2007 (the beginning of the school year), kindergartens and primary schools will be financed using a single normative subsidy instead of the ten normatives used to-date. Unlike the present system, where the normative is calculated on a per-child basis, the new formula will be based on organisational parameters with the objective of increasing the number of classes taught per-teacher and the number of pupils per-class. The government expects that, once fully implemented, the uniform grant will replace 70% of all state grants in public education.

Further to these measures, the current OECD assessment of good practices with grant management (Bergvall *et al.*, 2006) suggests that other options should be considered:

- Further reducing the number of earmarked grants as part of a broad re-assessment of the structure of the “basic package” of services covered by these grants. Switzerland, for instance, has had some success in removing perverse incentives by replacing earmarked grants with non-earmarked general purpose grants. In the Netherlands a more selective approach has been taken: switches from earmarked to non-earmarked grants are only made in areas where municipalities are unlikely to cut back services drastically.
- Simplifying the system of obligations and minimum standards. Reducing the number of normative subsidies can be facilitated if detailed and superfluous standard requirements are eliminated. It also facilitates the calculation of the aggregate non-earmarked grant.

### ***The need for more performance-based funding***

Progress in introducing measures of output in funding formulae has been modest so far. Indeed, the largest subsidies put a very strong emphasis on the *per capita* component and items reflecting outcomes or quality carry little, or no, weight. For example, grants for secondary education remain largely based on the number of students in the classroom with no penalties or rewards based, for example, on student performance in national tests or on the number of successful students who have access to higher education. In addition, central government authorities like the Ministry of Finance or the Ministry of the Interior do not verify outcomes. As a result, quality standards are not enforceable, even when they are set in the sector specific laws.

The government sees the fiscal adjustment programme as providing opportunity to make grant transfers more conditional on performance. For example, since 2007 funding of local social welfare services has made half of the grant dependent on the fulfilment of provision standards. Similar quality-focussed incentives have been introduced in education, notably affecting the numerous secondary art schools.

The ongoing efforts to increase the role of quality and output in determining funding for mandatory services are welcome. This is a positive feature because these are services that contribute to established central government objectives. However, the use of quality indicators remains limited and more work is needed to widen this approach.

### ***Fine tuning the allocation of personal income tax***

The share of PIT revenues allocated to the municipalities has declined and is now roughly 40% of total PIT revenue. The allocation mechanism is complex. The calculation is based on total PIT revenue collected two years previously and has several components:

- *Own-base component.* The “cessation level”, *i.e.* the share allocated according to the PIT collected within the municipality (own-based revenues), will equal 8% of overall PIT revenues in 2007.
- *Equalisation component.* Another part of PIT is spent on an equalisation mechanism. In this process, the annual state budget law sets averages of *per capita* tax revenues according to several size-classes of municipality (the calculations factor in revenues from PIT as well as the local business tax). Municipalities with per capita revenues below the average for their size-class receive a supplement that fully covers the shortfall. Those with per capita revenues above the average have to contribute to the equalisation scheme according to a schedule in which the share of the difference with the average that is retained increases with the size of the gap. For 2007, the equalisation will cost the equivalent of 8.3% of total PIT revenue.
- *Formula based (normative) component.* The remainder of the municipalities’ share of the PIT is used to fully fund a range of administrative services and to top-up funding in some other areas (*e.g.* welfare services). The allocation uses formulae similar to those used in the grant system. This component is relatively important; for the 2007 budget it will amount to 23.7% of total PIT revenues and for the past fifteen years it has never been below 20%.

The formula based component of the PIT allocation should be reconsidered. First, the link between the funding of a range of services to PIT revenue runs against principles of efficiency and flexibility in financing and should be severed. For instance, the link to PIT means strong exposure in funding for these activities to fluctuations that are unlikely to relate to cost or output variation. One way forward would be to drop this indirect allocation of PIT to municipalities and to fund these services from general government revenues (as is the case for other formula based funding for municipalities). Another approach would be to re-direct the allocation into the own-base and equalisation components and to drop the specific funding for these activities. The need for simplification in this area of municipality financing is echoed in a recent World Bank report on local-government financing in central and Eastern Europe (World Bank, 2006).<sup>23</sup> Indeed, of the eight countries surveyed, only Hungary has a two-tier system in which revenue redistribution on an origin basis and general purpose grant transfers are combined together.

Second, if formula based funding is retained for those areas currently funded (at least partly) by the PIT allocation, a review of the formulae should be conducted because at least some of them appear to run counter to encouraging the joint provision of services. For example, under the 2007 budget each municipality with less than 500 inhabitants is entitled to receive a PIT-related normative for “administrative, communal, and sport-related tasks” that is twice the value of larger municipalities, which weakens the objective of municipal co-operation. Similar adverse signalling mechanisms are contained in the grants allocated for the issuance of official documents (passports, identity cards, car plates, birth certificates, etc.).<sup>24</sup>

---

23. Notably the World Bank report concludes that Hungary has the most complex system among the eight countries surveyed (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). Lithuania, for example, which has the simplest system in the region according to the World Bank study, targets a fixed level of equalisation using a single parameter. Specifically, the PIT is distributed entirely on an origin basis, with the richer jurisdictions then being required to share part of their revenues with the poorer ones. See World Bank (2006, p. 68).

24. In this case, the 2007 budget law states that the grant is evaluated at 513 HUF per document processed (roughly equivalent to 2 euros), but at the same time it requires that the total grant value cannot be less than HF 6 million which implies funding for processing 12 000 documents. It seems unlikely that municipalities with only a few hundred inhabitants require processing on this scale.

### *Problems with local tax-raising capacity*

Local government own tax revenues are well below the average of the sample of unitary OECD countries (Figure 4). In addition, the most important local tax is a local business tax, rather than a property tax (Table 6). Hungary has a local property tax, based on the size of plots or buildings, but its contribution is negligible, as is the case with the tourist tax. Under the current legal framework the local authorities have a relatively wide margin of discretion about how to shape their local taxes.<sup>25</sup>

There are a number of problems with the business tax:

- It erodes the local tax base as it is imposed on mobile assets and increases pressure on tax competition. This is visible in the trend increase in the number of local municipalities that choose to set the level of the local business tax rate below the statutory maximum ceiling of 2%.
- Since it applies to business operations that can last for short periods – such as construction – the basis of the tax is subject to variability.
- To the extent that the regional disparity in the local business tax basis broadly matches that of wealth, the strong reliance on local business taxation aggravates regional income disparities. At present Budapest and surrounding municipalities collect most of the local business tax and, indeed, four districts within Budapest alone account for 30% of total business tax revenues.<sup>26</sup>
- The base is questionable. Because the tax is based on turnover it runs counter to the principle of taxing incomes or profits. Furthermore, the legality of the local business tax in the context of European Union rules has been challenged.<sup>27</sup> The argument is that the base could overlap with that of the value added tax and as such contravenes a principle of EU tax regulation that countries cannot impose more than one turnover based tax. While a final decision remains pending, the European Court of Justice has nevertheless ruled in a recent resolution that bears some resemblance with the Hungarian situation that Italy's turnover-based local business tax is in compliance with EU regulations.<sup>28</sup>

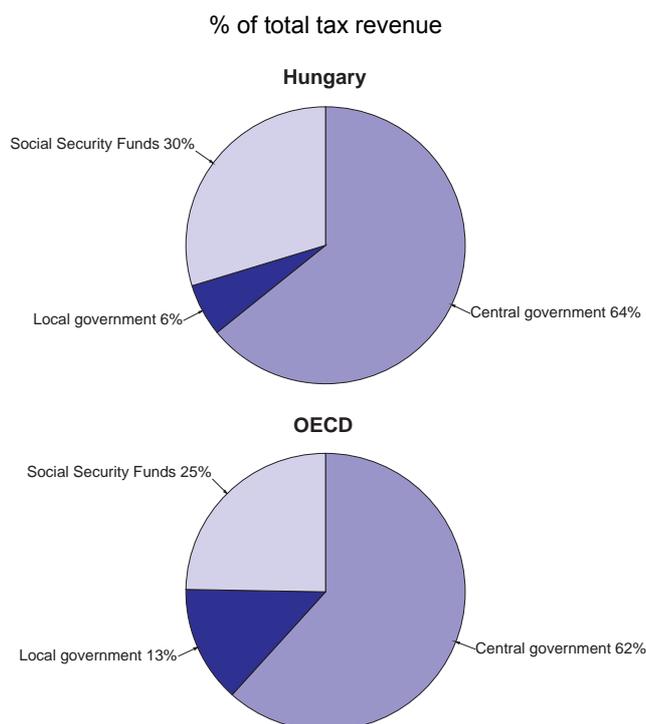
---

25. The institutional setting is defined by the Act on Local Taxes under which the central government defines the ceiling but not the floor of local taxes. As a result, the local governments have the right but not the obligation to introduce certain taxes (OECD, 2006e).

26. It should be noted that the local business tax is not subject to horizontal equalisation.

27. The Budapest city hall received 79 letters of complaint during the spring of 2006. Many were from big companies such as German energy provider E.ON, the French supermarket chain Auchan, Hungary's largest bank OTP and more recently the mobile telecom group Vodafone Hungary and the medical group Innomed Medical. In a number of cases, companies brought legal action before national courts against the tax authorities claiming the reimbursement of past payments.

28. However, it is difficult to assess the extent to which this resolution amounts to a precedent since there are also differences between the two taxes. For example, the Italian local business tax also takes into account changes in the value of assets, rather than being solely turnover-based like in Hungary. These differences could lead to a different ruling. In April 2007, responding to a request for an expert opinion from the European Court of Justice, the European Commission suggested that the local business tax is not in breach of the EU rule prohibiting more than one turnover based tax.

Figure 4. Taxes by level of governments<sup>1</sup>

1. Estimates for 2004. Central government includes supranational taxes (attribution less than 0.5%) collected on behalf of the European Union by its member states. OECD is an unweighted average of unitary countries. The figures do not take into account the transfer of revenue from central to local government which in Hungary's case is partly derived from the local government's tax base.

Source: OECD (2006), Revenue Statistics 1965-2005.

Table 6. Local taxes

As of 2005

Type of tax	Number of municipalities levying the tax	Number of municipalities levying the tax as a percentage of total number of municipalities levying at least one tax	Amount of revenues raised as a percentage of total local revenues
Building tax	734	23.6	11.2
Land tax	402	12.9	1.3
Communal tax for private individuals	2190	70.5	2.0
Communal tax for business	703	22.6	0.3
Tourism tax	519	16.7	1.3
Local business tax	2639	85.0	84.0
Total number of municipalities having at least one tax	3106	100.0	100.0

Source: Ministry of Finance.

Acknowledging these problems, the government announced in 2005 that firms would be able to fully deduct the local-business tax in the calculation of corporate income tax in 2006 and that the local business tax would be completely eliminated in 2008. However, only the first step has been implemented so far, while the elimination of the local business tax has been suspended as part of the government's measures to rein in the fiscal deficit.

A system more focussed on the local property tax would ultimately be better. Property taxes have low avoidance and relatively stable and predictable revenues. In addition, the "benefit principle" is more strongly adhered to since the local property tax is imposed directly on the local taxpayers and is difficult to avoid. A broadening of property taxation is under discussion as part of reform on the local revenue system. The reform should also include removal of the local business tax. The following issues should be considered in the proposals:

- Development of up-to-date local "value maps" to ensure that the new property tax is levied on values that reflect market developments. At present, properties are valued using arbitrary point values, such as per-square metre and location in the case of land, or in the case of buildings, per-square metre and according to use (whether office or residential). Such values were deliberately set low in the early 1990s when Hungary lacked a properly functioning property market and have never been re-evaluated since.
- Broaden the tax to include home owners. A broader tax base would more closely align the tax with the local electorate, thus bringing it more in accordance with the benefit principle. It would entail corresponding widening of valuation to include residential premises. Much of the framework necessary to do this is already in place. The cadastral mapping and the legal property registry are unified and all land and real estate properties in the country have been registered. One source of possible problems is that while the information-technology systems in the land offices are operational, the national network of registries is yet to be connected. An ongoing programme to produce digital cadastral maps is expected to be finalised by 2008, though putting digital maps in a fully harmonised format should take longer.

### ***Issues in investment funding***

Hungary's sub-national governments initiate a lot of investment and local development is one of the main pillars of the new government strategy to use EU funding (Annex A2). Assessments by the government and the World Bank conclude however that the system is highly fragmented and somewhat un-coordinated (Government of Hungary, 2006a; World Bank, 2000). While the allocation process stimulates competition among municipalities, engaging in local investment funding requires substantial administrative costs and local priorities are not always well identified.

In response to these issues, the latest Development Plan of Hungary (Government of Hungary, 2006a) sets out clearer local objectives and brings in new approaches to manage funding. Investment activities will not only focus on traditional "hard" infrastructures (*e.g.* roads and railways), but also on boosting local human resources and skills (*e.g.* education and training). In transport, there is the intention to widen the scope beyond motorways and to invest more in local roads, the expectation being that, by helping local labour mobility, this will support employability. Local policymakers will have to submit development

strategies that involve more co-operation and close ties between local governments, the business community and local institutions, such as universities. According to the Development Plan, several large municipalities will act as “hubs” for development.<sup>29</sup>

To improve co-ordination, the allocation of EU funding will become more centralised. So far, programmes have been divided up between line Ministries. Under the new approach, the Ministries’ role will be more that of intermediary bodies, both during the planning stage and as executors of programmes. Otherwise, any funding decisions will be taken centrally.

---

29. For example, Győr and its surroundings, which make for the automotive centre of Hungary, will focus on the engineering industry and renewable energies. Miskolc, where many chemical companies are already located, will act as an R&D pole in the area of nano-technologies and alternative energies.

## BIBLIOGRAPHY

- Bergvall, D., C. Charbit, D.J. Kraan and O. Merk, (2006), “Intergovernmental transfers and decentralised public spending”, *OECD Journal of Budgeting*, Vol. 5, Number 4.
- Blöchliger, H. and D. King, “Fiscal autonomy of sub-central governments”, *OECD Journal of Budgeting*, Vol. 5, Number 4.
- Dusek, T. (2006), “Regional income differences in Hungary”, paper submitted at the 46<sup>th</sup> Congress of the European Regional Science Association.
- Fekete, É.G., M. Lados, E. Pfeil, Z. Szoboszlai, (2002), “Size of Local Governments, Local Democracy and Local Service Delivery in Hungary”, in P. Swianiewicz, *Consolidation or Fragmentation? The Size of Local Governments in Central and Eastern Europe*, The Local Government and Public Service Reform Initiative, Budapest.
- Fox, W.F, (2004), “Intergovernmental Finance: Summary and Evaluation”, in Kopányi M., Wetzels, D., and El Daher S., *Intergovernmental Finance in Hungary*, a co-publication of the World Bank and Open Society Institute, Budapest, Hungary.
- Fox, W.F. and T. Gurley (2006), “Will consolidation improve sub-national governments?”, *World Bank Policy Research Working Paper 3913*, World Bank, Washington.
- Gjersem, C., P. Hemmings and A. Reindl, (2004), “Product market competition and economic performance in Hungary”, *OECD Economics Department Working Papers*, No. 381, Paris.
- Government of Hungary (2006a), *The New Hungary Development Plan 2007-13*, Budapest.
- Government of Hungary (2006b), *Convergence Programme of Hungary 2006-2010*, Budapest.
- Hegedüs, J. (2002), *Decentralisation and structural adjustment in Hungary*, paper presented at the 2<sup>nd</sup> International Conference on Decentralisation, Metropolitan Research Institute, Manila.
- Kopányi, M. and D. Wetzels (2004), “Hungary’s macroeconomic and Sub-national Context”, in , Kopányi M., Wetzels, D., and El Daher S. (eds.), *Intergovernmental Finance in Hungary*, a co-publication of the World Bank and Open Society Institute, Budapest, Hungary
- Ladner, A. and R. Steiner (2003), “Die Schweizer Gemeinden im Wandel: Konvergenz oder divergenz?”, *Swiss Political Science Review* 9(1), 233-259.
- Le Saout, R. (1998), *Les enjeux de l’intercommunalité*, La documentation française, Paris.
- Lotz, J. (2006), “Municipal amalgamations and economies of scale”, Draft paper for OECD Workshop on Efficiency of sub-central public spending, May, Paris.
- OECD (2001a), *OECD Territorial Reviews: Hungary*, OECD, Paris.

OECD (2001b), *Fiscal Design Across Levels of Government: Hungary*, OECD, Paris.

OECD (2005a), *OECD Economic Surveys: Hungary*, OECD, Paris.

OECD (2005b), *Hungary: Phase 2, Report on the application of the convention on combating bribery of foreign public officials in international business transactions*, OECD, Paris.

OECD (2006a), *Education at a Glance*, OECD, Paris.

OECD(2006c), *OECD Economic Surveys: Czech Republic*, OECD, Paris.

OECD (2006d), *Fiscal Equalisation in OECD Countries*, mimeo, OECD, Paris.

OECD (2006e), *Budgeting in Hungary*, OECD, Paris.

OECD (2007), *OECD Economic Surveys: Hungary*, OECD, Paris.

Pálné Kovács, I. (2004), "The Legal and regulatory Framework of Fiscal Decentralisation", in Kopányi M., Wetzels, D., and El Daher S., *Intergovernmental Finance in Hungary*, a co-publication of the World Bank and Open Society Institute, Budapest, Hungary.

Pálné Kovács, I. (2005), "Shaping regional governance in Hungary", presentation at Open Days workshop, Brussel.

Péteri, G. (2006), "Decentralisation under fiscal pressure, local government finances in Hungary", in Sevic Z. (Editor), *Local government finance in Central and Eastern European Transitional Countries*, forthcoming, Edward Elgar, Cheltenham, UK.

Solé-Ollé, A. and N. Bosch (2003), "On the Relationship between Local Authority Size and Expenditure: Lessons for the Design of Intergovernmental Transfers in Spain", in G. Färber and N. Otter (eds.), *Reforms of Local Fiscal Equalization in Europe*, Speyerer Forschungsberichte, No. 232, Forschungsinstitut für Öffentliche Verwaltung, Speyer am Rhein.

Soòs, G. (2002), *Local Government reforms and the Capacity for Local Governance in Hungary*, Tocqueville Research Centre, Budapest.

Soòs, G. (2003), *Local Participation and Participatory Institutions*, Tocqueville Research Centre, Budapest.

State Audit Office (2006), *Report on the activities of the State Audit Office of Hungary in 2005*, Budapest, May.

Sutherland, D., R. Price and I. Joumard (2005), "Fiscal rules for sub-central governments: design and impact", *Economics Department Working Papers*, No. 465, OECD, Paris.

Szalai, Á., F. Zay, M. Hőgye, I. Barati, Á. Berczik (2002), *Local Government Budgeting in Hungary*, The Local Government and Public Service Reform Initiative, Budapest.

Temesi, I., (2000), Local Government in Hungary, in T. Horváth (ed.), *Decentralisation: Experiments and Reforms*, The Local Government and Public Service Reform Initiative, Budapest.

Temesi, I. (2003), "Transfer of Municipal Property in Hungary", in G. Péteri (editor), *From Usage to Ownership, Transfer of Public Property to Local Governments in Central Europe* , Local Government and Public Service Reform Initiative, Budapest.

Wetzel, D. and A. Papp (2003), "Strengthening Hard Budget Constraints in Hungary", in J. Rodden *et al.*, *Fiscal Decentralisation and the Challenge of Hard Budget Constraints*, The MIT Press, Cambridge.

World Bank (2000), *Hungary, Modernising the Subnational Government System*, World Bank Discussion paper, No. 417, The World Bank, Washington, D.C.

World Bank (2006), *Current issues in Fiscal Reform in Central Europe and the Baltic States*, The World Bank, Poland, Warsaw Office.

## ANNEX A1

### THE BUDGET BALANCE RULES IN MUNICIPAL ACCOUNTS

By law sub-national governments have to submit a balanced budget. In addition, there is a “deficit grant”, that provides immediate relief to municipalities experiencing temporary financial pressures because of unforeseeable developments.

Moreover, there are strict regulations limiting the amount of debt sub-national governments can carry. Annual debt service is limited to “corrected own revenues”, namely 70% of own source revenues (defined to exclude revenue sharing) after subtracting the amount of short-term liabilities. The legal framework imposes limitations on the assets and revenue sources that can be used as collaterals and loan guarantees.

Municipal bankruptcy is subject to special legislation under which the creditor or the local government can initiate a bankruptcy proceeding each time a debt is 60 or more days overdue (World Bank, 2006). Cases are examined by a court which can:

- Order the start of debt settlement procedures and designate a financial trustee; or alternatively,
- Determine that the local government can meet its obligations from existing cash flows and assets and establish the conditions for the reimbursement.

The legislation mainly works as a deterrent and has been used relatively sparingly so far. Since the end of the 1990s, there have been eleven municipal bankruptcy cases approved by court decision. Nine cases resulted in a voluntary debt settlement agreement between the parties. In two cases the court followed the recommendation of the trustee and ordered the liquidation of the assets. Interestingly, procedures have never been initiated by the creditors. All were launched by the local governments themselves, most of which were small municipalities with a population below 5 000 inhabitants.

## ANNEX A2

### EU TRANSFERS TO HUNGARY'S MUNICIPALITIES UNDER THE 2007-13 BUDGET

Within the 2007-13 EU budget, the most important funds for local governments are the Structural Funds (SF) and the Cohesion Fund (CF), which together sum to € 22.4 billion, (roughly equivalent to 25% of GDP in 2006). These funds are allocated as follows:

- Thematic Operational Programmes (€ 16.2 billion) notably covering enterprise development, transport, human capital, environment and energy. These programmes are funded by a mix of the Structural and Cohesion Funds, plus national contributions.
- Regional Operational Programmes (€ 5.2 billion) that provide funds directly for local development. Only the EU's Structural Funds (plus national contributions) are used here.
- Reserves as well as funds for technical assistance purposes and European Territorial Co-operation (€ 0.9 billion in total).

Municipalities are allowed to apply for both Thematic and Regional Operational Programmes. While for priority projects funding will be decided following a more centralised process, other SF projects will be allocated via open tender procedures. For open-to-tender projects, local government will not only compete with other municipalities, but also with non-governmental organisations (*e.g.* universities, civil associations or private business entities).

It is difficult to predict how much EU development funds will finally be allocated to the municipalities, largely because of the length of the budgetary period and uncertainties about the results of tender procedures. Municipalities received about one quarter of the SF in the 2004-06 EU budget. However, this will probably be higher in the new budgetary period because the municipalities are now more experienced with application procedures and there are greater opportunities opened up by the focus on Regional Operational Programmes. Officials in the Ministry of Finance expect that municipalities will qualify for 30% of all the SFs and 50% of all CF available, roughly equal to 12% of GDP in 2006.

The national contribution comprises a statutory 15% matching grant ("co-financing") to the EU funds (*i.e.* nearly € 4 billion during the seven year period). In addition for some projects additional funds are required to fully finance projects ("own resources of the beneficiary"). The role that municipalities will play in providing co-financing has not yet been finalised, though it is likely that at least as large a share of co-financing will be provided by central government funds. For "own resources" a fund has been in place since 2004 to help poorer municipalities and micro-regions. Municipalities applying jointly can also be eligible for assistance from this fund. For 2007, HUF 10.1 billion is allocated to this fund.

**GLOSSARY**

CF	Cohesion Fund
FIDESZ-MPSZ	Young Democratic Alliance-Hungarian Civic Union
MSZP	Hungarian Socialist Party
PIT	Personal Income Tax
SAO	State Audit Office
SF	Structural Funds
VAT	Value Added Tax

## WORKING PAPERS

*The full series of Economics Department Working Papers can be consulted at [www.oecd.org/eco/Working\\_Papers/](http://www.oecd.org/eco/Working_Papers/)*

- 564. *Integration of immigrants in OECD countries: do policies matter?*  
(July 2007) Orsetta Causa and Sébastien Jean
- 563. *The unemployment impact of immigration in OECD countries*  
(July 2007) Sébastien Jean and Miguel Jiménez
- 562. *Migration in OECD countries: labour market impact and integration issues*  
(July 2007) Sébastien Jean, Orsetta Causa, Miguel Jiminez and Isabelle Wanner
- 561. *The internationalisation of production, international outsourcing and employment in the OECD*  
(June 2007) Margit Molnar, Nigel Pain and Daria Taglioni
- 560. *Why has Swedish inflation been persistently low?*  
(June 2007) Felix Hüefner
- 559. *The Swedish housing market – better allocation via less regulation*  
(June 2007) Felix Hüefner and Jens Lundsgaard
- 558. *Linkages between performance and institutions in the primary and secondary education sector*  
(June 2007) Douglas Sutherland and Robert Price
- 557. *Toward a more efficient taxation system in New Zealand*  
(June 2007) Annabelle Mourougane
- 556. *Income inequality, poverty and social spending in Japan*  
(June 2007) Randall Jones
- 555. *Improving the efficiency of health care spending: selected evidence on hospital performance*  
(May 2007) Espen Erlandsen
- 554. *Cross-country analysis of efficiency in OECD health care sectors: options for research*  
(May 2007) Unto Häkkinen and Isabelle Joumard
- 553. *What promotes fiscal consolidation: OECD country experience*  
(May 2007) Stéphanie Guichard, Mike Kennedy, Eckhard Wurzel and Christophe André
- 552. *Globalisation and the macroeconomic policy environment*  
(April 2007) Karine Hervé, Isabell Koske, Nigel Pain, Franck Sédillot
- 551. *Why has core inflation remained so muted in the face of the oil shock?*  
(April 2007) Paul van den Noord and Christophe André
- 550. *Housing markets and adjustments in monetary union*  
(April 2007) Peter Hoeller and David Rae
- 549. *Financial markets in Iceland*  
(March 2007) Peter Tulip
- 548. *The political economy of delaying fiscal consolidation*  
(March 2007) Boris Cournède

547. *The impact on growth of higher efficiency of public spending on schools*  
(March 2007) Frédéric Gonand
546. *Performance indicators for public spending efficiency in primary and secondary education*  
(February 2007) Douglas Sutherland, Robert Price, Isabelle Joumard and Chantal Nicq
545. *Monetary policy and macroeconomic stability in Latin America: the cases of Brazil, Chile, Colombia and Mexico*  
(February 2007) Luiz de Mello and Diego Moccero
544. *The Brazilian "tax war": the case of value-added tax competition among the states*  
(February 2007) Luiz de Mello
543. *Public spending efficiency: institutional indicators in primary and secondary education*  
(January 2007) Frédéric Gonand, Isabelle Joumard and Robert Price
542. *Enhancing turkey's growth prospects by improving formal sector business conditions*  
(January 2007) Rauf Gönenç, Willi Leibfritz, Gökhan Yilmaz
541. *Fiscal relations across levels of government in Australia*  
(January 2007) Vassiliki Koutsogeorgopoulou
540. *Russian manufacturing and the threat of 'Dutch Disease': A comparison of competitiveness developments in Russia and Ukrainian industry*  
(January 2007) Rudiger Ahrend, Donato de Rosa and William Tompson
539. *Stimulating innovation in Russia: The role of institutions and policies*  
(January 2007) Christian Gianella and William Tompson
538. *Healthcare reform in Russia: problems and prospects*  
(January 2007) William Tompson
537. *A golden rule for Russia? How a rule-based fiscal policy can allow a smooth adjustment to the new terms of trade*  
(January 2007) Christian Gianella
536. *From "clientelism" to a "client-centred orientation"? The challenge of public administration reform in Russia*  
(January 2007) William Tompson
535. *Has the rise in debt made households more vulnerable?*  
(December 2006) Nathalie Girouard, Mike Kennedy and Christophe André
534. *Social security reform in Brazil: Achievements and remaining challenges*  
(December 2006) Fabio Giambiagi and Luiz de Mello
533. *Improving labour utilisation in Brazil*  
(December 2006) Luiz de Mello, Naércio Menezes Filho and Luiz G. Scorzafave
532. *Boosting innovation performance in Brazil*  
(December 2006) Carlos H. de Brito Cruz and Luiz de Mello
531. *Consolidating macroeconomic adjustment in Brazil*  
(December 2006) Luiz de Mello and Diego Moccero
530. *Product market regulation in the non-manufacturing sectors of OECD countries: Measurement and highlights*  
(December 2006) Paul Conway and Giuseppe Nicoletti