Public Services and Changes in Financing System of Local Governments in Hungary*

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The financial legal status of local governments varies widely in time and space, as this system of governance is continuously changing and developing. The realization of financial independence needs a number of public financing instruments which can be present in various forms depending on the nature of the system. It is obvious that we cannot separate the municipal financial issues from the central government's budget given that these are closely linked to each other through the financial connections between the layers of governance. Thanks to the changes in this dynamic, this topic is always current in financial legal circles and among economists, public finance specialists and experts dealing with this problematic issue. This is even more the case during periods of time when cross-border effects produce important reform processes.

This paper focuses on several fundamental issues. What is the reason for providing certain types of public services at the local level? What are the financial sources that the local management of public services should consist of? Who should finance them? To what extent should the central government intervene in these issues? What are the effects of the new system introduced in Hungary in the early 2010s?

The detailed description of fiscal federalism and its first-generation theories enables us to see that the units of local government have an important role in providing public services. Thus, the financial decentralization is constantly a current issue.[2] I tried to classify the relevant theories to be able to demonstrate the pros and cons of financial decentralization.

Local interests, the concept of a more direct democracy, the problems related to information and data, Tiebout's hypothesis, Oates' decentralization theorem, the cost-effectiveness and the Leviathan hypothesis favor decentralisation[3]. But there are a lot of arguments against decentralisation: for example, the spill over effects, economies of scale, the fiscal illusion, the so-called club goods, the flypaper effect, as well as critiques of Tiebout's hypothesis.[4] After having studied these aspects[5], it has become obvious that the conclusions drawn on financial federalism are not limited to federal states: instead,

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[2] Henning, C. Randhall – Kessler, Martin: *Fiscal federalism: US history architects of Europe's fiscal union.* Bruegel essay and lecture series, Bruegel, 2012, 28-31.

[3] Fred Thompson, Mark T. Green (eds.): *Handbook of Public Finance*. Marcel Dekker, New York, 1998, 389.

[4] Bailey, J. Stephen: *Local Government Economics: Principles and Practice*. MACMILLAN Press, Houndmills, 1999.

[5] Begg, Iain: *Fiscal Federalism, Subsidiarity and the EU Budget Reviem.* Swedish Institute for European Policy Studies, Stockholm, 2009, 19-28, 32.; Musso, Juliet Ann.: *Fiscal federalism as a Framework of Governance Reform.* In: Fred Thompson, Mark T. Green (eds.): *Handbook of Public Finance*. Marcel Dekker, New York, 1998, 350.

they can prove useful and applicable on the different layers of governance in unitary states too.

It is worth examining how different systems of local governance have changed throughout the last decade, especially in reaction to the financial crisis.

Table 1

Subnational Government Structure and Finance in Europe (2015)

Measure / Country		Expenditure as a percentage of GDP	Revenue as a percentage of GDP	Debt as a percentage of GDP	Local tax revenue as a percentage of GDP
Federations and quasi-federations	Austria	17,9	18	12,7	1,7
	Belgium	26,6	25,3	20,9	5,7
	Germany	20,8	21,1	28	11,8
	Spain	21,9	20,6	32,2	8,1
Unitary countries	Czech Republic	11,4	12	4,1	5
	Denmark	34,9	35,2	11,1	12,3
	Estonia	9,5	9,7	4,4	0,3
	Finland	23	23	12,7	10,4
	France	11,4	11,5	11,1	5,7
	Greece	3,4	3,7	1,2	0,9
	Hungary	7,9	8,1	0,6	2,3
	Iceland	13	12,4	13,2	9,4
	Ireland	2,2	2,5	2,1	0,5
	Italy	14,5	14,8	11,4	6,4
	Latvia	9,3	9,6	7,6	5,6
	Luxembourg	4,6	5	2,6	1,3
	Netherlands	14,5	14,1	11,5	1,4
	Norway	16,1	15,7	17,1	5,9
	Poland	12,8	12,8	5,5	4,2
	Portugal	5,9	6,4	7,8	2,5
	Slovak Republic	7,5	7,6	3	0,5
	Slovenia	9	9,3	3,2	3,5
	Sweden	25	24,8	16,1	13,3
	United Kingdom	10,9	10,6	10,3	1,6
OECD Total		16,4	16	24,4	7
EU28 Total		15,7	15,6	15,6	6,2

Source: Author compiled, based on the data of the OECD

Analysing the development of these systems (of local governance), it may be established that the Anglo-Saxon and continental methods of governance serving as models can, in their pure form, only exist in theory. They cannot exist in practice because they have been subject to important changes affecting primarily their financial autonomy and the provision of local services. Regarding the data collected by the OECD in 2015, I can conclude that the ratio of local expenses to GDP stagnated or increased in the majority of the examined countries (see Table 1). There are two exceptions: Hungary and Ireland, where we can witness a considerable fall as the expenses of local governments decreased by 75%.

It must be mentioned – as emphasized by a 2010 report of the European Commission – that local governments were faced with the necessity of layoffs, structural reorganization and borrowing in the wake of the financial difficulties (and especially the decrease in income) caused by the crisis.[6]

In my opinion, the sub-national levels of government, the public services provided at these levels and the trends in the organization and financing of public services (e.g.: decentralization and centralization) all show a cyclical process, even in the context of diverse and differing international practices.

In Hungary, the system of local and regional authorities established during the democratic transition has been working, changing and developing for more than 20 years until it has undergone a process of significant transformation in the early 2010s. This change affected the scope of local public services as well as the main character of local governments. A certain number of services that were formerly provided locally have been centralized. Regulations on local management have been changed. Numerous checks and limits have been installed in the system. The revenue structure has been transformed and the system of intergovernmental grants and transfers has been reshaped.

We can clearly see that the solution was not entirely effective given that several other factors contributed to the aforementioned errors. For example, the tasks conferred to local levels were not accompanied by changes in the financing system. The system could not cope with the difficulty resulting from the fact that the resources of individual local governments varied widely but they all had the same legal status. The revised system of revenue assignment is a good example of the new approach called "task-based" financing (an expenditure-oriented system replacing the previous resource-based financing) – including its negative aspects.

The evaluation and assessment of these changes is controversial. We are faced with a large number of arguments and counterarguments concerning the considerations of experts in the fields of administrative law, financial law and public finances. This is precisely the reason why we cannot disregard the exemplary practices and achievements of the previous revenue assignment system, even if there are a lot of negative aspects.

I could conclude that the original objective of the preparation of this revised concept was not to introduce the current system but to provide a much-needed correction to the system of financing of public services based on the calculations on expenditure needs

[6] Council of European Municipalities and Regions: *The economic and financial crisis. Impact on local and regional authorities*. Brussels, 2010. http://www.ccre.org/docs/Economic_and_Financial_Crisis_(CEMR_2009).pdf

detailed above. In the end, it is clear that while the terminology remains unchanged, the contents of the system have been transformed completely after the adoption of the new Local Government Act in 2011 and its amendment. The reason for the divergence from the original objective could be that some key issues with the proposed solution were obvious from the beginning. For example, it is very time consuming, difficult and expensive to determine the expenditure requirements of local municipalities. From these observations, it can be concluded that this approach to the financing of public services is not the same solution as similarly named approaches in international literature.[7]

The role and the financing of local governments across Europe has changed due to the economic crisis, meaning that the relationship between local and central governance needed to be rethought. This is not exclusively a Hungarian trend. In the background of the reorganization of the provision of public services among the different layers of governance, there is a sort of centralisation as a desired objective to achieve. This is present also in the financing of public services.

The impact of the new approaches is detectable in the financial system. Local expenditures have decreased by 7.9% relative to GDP because of the centralisation of providing public services (see Table 1).[8] This is due to the fact that primary education, personal social benefits and health care have been handed over to the central government. The central management of local services has also resulted in the reduction of local autonomy. Together with the change in financing, the scope of powers delegated to the different levels of government, as laid down by law, has also changed in Hungary. Interestingly, in practice, this division of powers shows a very different picture. Therefore, there are several services that are traditionally considered “local government-related” which can also be provided in a centralized way without them losing their local character.

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During the transition period, the objective was the decentralization of centralized power in order to put local administrative units in a more powerful position.

In the 2010s a sort of reversal process has begun unfolding which enhances the centralization of local public services according to a concept of the state as a “good owner”. Due to the changes in the financing of local authorities and the regulation of local governments there are a number of new limits, checks and instruments for stabilization curtailing the extent of locally administered functions. This process leads us to question whether the local government is actually independent.[9]

Numerous local taxes have become earmarked after 2010. As local taxation is of the most important elements of local financial autonomy, this intervention in their free use can cause harm to local interests. By the same logic, in the case of support by the central government, the use of non-earmarked subsidies can reinforce local financial autonomy. As formulated by József Hegedűs and Gábor Péteri, this transformation process was

[7] Dahlby, Bev (1998): Fiscal Externalities and the Design of Intergovernmental Grants. *International Tax and Public Finance,* 3(3), 1998, 398.
[8] In 2005, this number was 12,59 %.
[9] Act CLXXXIX of 2011 on Local Governments in Hungary (2011. évi CLXXXIX. törvény)

entirely contrary to the logic of the functioning of local financing and local public services, eliminating the positive results achieved during the past few decades.[10]

On one hand, overregulated financial solutions make the system more inflexible and on the other hand, they decrease the need of savings on a local level. In my viewpoint, local governance is a democratic value. It represents more than the local dimension of public services. It is the representation of local interests and it is one of the cornerstones of the development of communities.

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[10] Hegedüs József - Péteri Gábor: *Közszolgáltatási reformok és a helyi önkormányzatiság*. Szociológiai Szemle, 2015/2, 90.