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Strengthening Local Management Capacity: Institutional Development in Transition

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Decentralization of the state was interpreted and used in various ways during the past two decades of Hungary's transition. First, the economic and political aspects were emphasized. Later, reformers focused on the creation of a better public sector. As a result, fiscal and administrative issues became more important. Local organizational and management practices, as part of the broad institutional environment, were rarely the focus of reforms, and without sufficient local control decentralization will not visibly improve allocative, fiscal, and economic efficiency; transparency; and accountability in service delivery.

This chapter summarizes the institutional and organizational transition of Hungary's subnational system in public administration, human and physical services, regional development, and fiscal management. This analysis is an institutional one of the emergence, gradual rationalization, and parallel top-down and bottom-up evolution of a multifaceted decentralization. Empirical evidence supports the conclusions that: (a) in the Hungarian circumstances, starting the process by introducing a highly decentralized local government system was justified, and (b) the legal and regulatory steps in the previous restrictive fiscal environment have reached their limits in establishing a modern local government system. The national government should now focus on supporting local governments in increasing their institutional capacity in realizing the full advantages of decentralization.

* This chapter is based on Péteri 1999.

Decentralization and New Institutions at the Local Level

Without sufficient institutional development, the benefits of decentralization will never be achieved, even if all other necessary political and fiscal conditions were fulfilled (Litvack, Ahmad, and Bird 1998). The past period of economic decline and social reconstruction would have not been manageable had decentralization not started with the introduction of a decentralized local government system. Local governments successfully developed responsive local welfare measures in a restrictive economic environment by crossing the traditional political divide between left and right. Local governments not only follow top-down rules and initiatives, but also very often develop new methods and policies, which are later espoused at the national level or built into regulations. Local innovations and incentives push changes in the public sector from below (Clark and Ferguson 1974).

Another example of locally initiated changes is the local governments' intense cooperation with nongovernmental organizations for service delivery. This cooperation later forced the introduction of uniform normative current grant schemes accessible to all kinds of public service delivery organizations. In addition, various local economic development arrangements raised issues related to changing the regulations on planning urban land use. Performance-based budgeting and fiscal information efforts were also implemented first at the local level.

Despite these changes, local institutional development has remained insufficient and lagged behind the overall decentralization process, primarily because fiscal pressure on the economy was so high that austerity measures had to be taken. The fiscal deficit and the weight of general government expenditures on the economy had precedence as the focus of fiscal policy—a priority justified in a period of distress and need for economic restructuring. In the public sector, austerity measures were rather successful: the central budget deficit dropped to a manageable level (3–4 percent of gross domestic product) and general government spending decreased significantly to 40 percent of gross domestic product. Local government expenditures dropped by 21 percent in real terms, and employment in local governments was cut back by 13 percent between 1993 and 1997 (László 1998).

Reformers intentionally postponed local institutional development and used high inflation as the primary technique for managing the austerity program. According to the Ministry of Finance, the driving force of economic transition, major cutbacks had to be implemented through reductions in the real value of wages and services. “Had inflation been small,” comments László (1998 p.173), “it would have been impossible to carry out nominal reduction in public wage.... The significant rearrangement of the structure of the budget was definitely facilitated by inflation. The issue is what the next steps should be now that fiscal austerity programs have fulfilled their goals and economic growth seems to have stabilized.”

To keep the achieved development sustainable and realize the benefits of past efforts, local governments must take one further step: they must develop their institutional environment. Decentralized adjustment has to be supported through various development

activities, otherwise the desired macroeconomic stabilization cannot be achieved (Shah 1998).

The Development of Institutions and Organizations

The present municipal system is based on very liberal principles set forth initially in the Hungarian Constitution and the Act on Local Government. The first declared in 1989 the rights of any local community to establish independent local self-government. The 1990 Act on Local Government provided full sovereignty for local governments in fulfilling virtually all local administrative, legislative, regulatory, and management functions, and made them responsible for providing all kinds of local public services. Hence, conceptually, the national government had no need to impose any further regulation on local governments.

The major steps in the central regulation of local: (a) public administration, (b) human services, (c) public utilities (including communal services), (d) regional development, and (e) intergovernmental fiscal relations (see table 18.1), suggest that the general framework of the local government system was established before any changes were made in the centralized system of public service delivery. As a result, the liberal values of the local government system came into play and soon combined with the demand for sectoral laws based on such arguments as the need to provide equal access to services, to impose hierarchical control, and to support professional standards. Moreover, basic local government institutions were gradually operating in line with sectoral laws, sometimes in contradiction with the original concept of decentralization. These conflicts were even more intense with fiscal issues, because many of the new sectoral obligations had to be financed subsequently by municipalities without respective increases in local revenues.

The first general characteristic, which is rooted in the French–German tradition of public sector management, is that legal regulatory factors now dominate local management. This narrow interpretation of regulatory environment is based on the belief that local governments, being subject to laws and government decrees, are able to follow the rules and intend to do so. Otherwise, central control mechanisms will force compliance. Local governments' capabilities, organizational and management capacity, and staff conditions are not taken into account in this central regulatory approach. Without supporting local government operations in developing the required conditions, the effectiveness of the most sophisticated legal regulations would remain low.

The second general characteristic is the strong influence of sectoral legal regulations. Briefly summarizing the regulatory actions in the five major areas, the most active component seems to be fiscal management. This activity does not mean that other areas are less regulated. In all other sectors, the allocation of functions, competencies, and mechanisms of regulation and control are even more complex—for example, allocation of intergovernmental competencies in public education (Balázs 1998).

Table 18.1 *The Emergence of the Institutional and Organizational Framework of Local Governments*

<i>Public administration</i>	<i>Human services</i>	<i>Utility services</i>	<i>Regional development</i>	<i>Fiscal management</i>
Constitutional changes, functions, and competencies (1991)	New sectoral laws: social policy (1993), public education (1993), vocational training (1993), culture (1997)	Eliminated tariff subsidies, control transferred to local level (1990)	Municipal ownership after privatization of state-owned enterprises	State Audit Office (1989)
Regulations on civic and public employees (1992)	Limited own revenue raising, enterprise activities	Concession (1991)	Limiting local participation in enterprise activities.	Government information network (County Treasury and Information Service Office 1991)
Public administration offices: legal control and coordination (1991, 1994, 1997)	Centralized cash management practices (optional local treasury 1997)	Utilities in municipal hands (1991–)	Local economic development: employment through investments.	Unified accounting (1991)
Minority local governments (1993)	Postponed reconstruction, capital investment	Commercial entities in communal services	Local tax exemptions.	Matching and addressed grants (1992)
Urban authority: child protection (1996), building permits (1997)	Education: demographic wave (decline)	Privatization with foreign involvement: solid waste, water, and wastewater companies	Infrastructure deals with investors.	Budgeting procedures (1992, 1995)
Forms of municipal cooperation and associations (1990, 1997)	Health care: failed rationalization, selective bailouts	Public procurement (1995)	National regional development network: -county based -corporatist -decentralized grant allocation (1996)	Budgetary institutions (1996)
	Welfare policy: decentralized adjustment	Limited compulsory competitive tendering (1995)	Structure plan and regulatory plan (1997)	Property registration: physical indicators (1992)
		Law on Environmental Protection (1995)	Elimination of extra-budgetary funds (1999)	Certified local audit (1994)
		Increasing social consciousness (high arrears)		Bankruptcy regulations (1996)
				Coordination of appropriations, extra-budgetary funds (1997)
				Compulsory feasibility studies of capital investments (1998)
				Weak interest representation (lobbying)

Source: Péteri 1999.

Laws, government decrees, and ministerial bylaws now regulate the functions and competencies of local governments (including the council, committees, mayor, chief executive, and municipal employees). The paramount number of regulations reflects that these detailed rules are self-reinforcing toolkits for unnecessary micromanagement by sectoral ministries (table 18.2). Furthermore, the overlapping between the legal rules and the large number of regulations shows that various, and sometimes divergent, concepts and legislative policies affect local governments, motivating them to act as agents of the central organizations rather than to be self-cautious local agents who primarily respond to the local citizens.

Table 18.2 Number of Legal Regulations by Local Functions, 1999

<i>Sector</i>	<i>Number of regulations</i>
Health care and social services	58
Administration (interior)	42
Agriculture	42
Industry, commerce, tourism, price setting	35
Administrative (justice)	34
Transportation, water, and telecommunication management	33
Finance, fiscal management	31
Environmental protection, regional development	30
Labor	27
Culture and public education	21
Local government and minority self-government operation	8
Defense	3
Total	364

Source: Line ministries' data.

Public Administration

Public administration at the local level requires unified and similar practices. Lawful procedures and professionalism of decisions should be ensured both for general administration matters and discretionary cases. Various attempts were made to improve the professional level of local actions and guarantee a standardized treatment of local public administration employees (for example, on employment, childcare, and building licensing by urban authorities). Administrative expenditures are on average 15 percent of local budgets, but miscellaneous expenditures also are usually accounted under this function. This accounting happens often in small municipalities, where the cost of administration is often the largest expenditure item, representing more than 30 percent of local expenditures.

The public administration offices of the government went through a transformation in this period. Their main function has always been the legal control over local government decisions, but their role slowly moved toward coordination, government information system development, and training. First, a few regional public administration offices were established, but later these offices opened in every county under the control of the Ministry of Interior. After 1997 they became deconcentrated county offices of the central government, and plans are under way to reestablish regional public administration offices.

Human Services

Human services represent the largest municipal expenditures. Public education, health care, social services, culture, and sports together absorb almost two-thirds of local government budgets. These functions have always been local services, but the economic and regulatory environment substantially changed in the early 1990s. Design and approval of the sectoral laws on these activities took two to three years, because lawmakers had to achieve a sensitive balance of central control on service quality and allocation of functions to municipal and county local governments.

At the end of the 1990s evidence is clear that sectoral legislation on human services is not in harmony with the principles laid down in the initial legal local government framework. Allocation of service institutions to certain types of local governments, control of service performance, employment and salary regulations, introduction and regular changes in normative current grants (for example, in education) all have a strong impact on local government structure and behavior. In the period of fiscal austerity, the minimum level of service provision was always a higher priority compared to the decentralization principles in the early legislation.

The fiscal management regulations and the forms of organization and management developed in the traditional budgetary sector of human services supported unified and controlled service provision. Budgetary organizations had limited own-revenue raising capacity, and their business activities were scaled down by law. This attitude was somewhat different from the general one developed in the 1980s. At that time, the entrepreneurial spirit of public service entities was supported. The positive consequences of those changes were that local government units have learned both autonomy in their daily practices and how to counterbalance cutbacks in grants. The negative side of the entrepreneurial character was that sometimes a shift from the main activities of the service organizations toward revenue raising was too radical.

Parallel to these nationally initiated changes, local governments also developed new forms of fiscal management. Consolidated cash management of local budgetary institutions was introduced as municipal treasuries began adopting the design of the national treasury system. Local treasuries proved to be very successful in decreasing idle cash, introducing more precise planning rules, and using appropriations (see chapter 22). In parallel with

the efficiency gains at municipal level, the autonomy of budgetary service institutions is no longer as wide.

Public Utilities

Public utilities and other communal services, including housing, also went through a major reorganization. The first steps were the immediate elimination of the national charge and rental subsidies and the transfer of price- (rent-) setting authority to local governments, with two exceptions, however: a flat-rate subsidy remained for water and sewer charges above a certain level and for the collection of liquid waste from septic tanks.

Local governments became owners of public utility networks and service companies. The water, sewage pipes, and wells became, by law, core assets of local governments and restrictedly marketable properties that could be sold only by a council's decision. The service companies and the operating assets were often privatized. The former state-owned water companies and the county water companies were transferred to local governments, which owned the network, and they have created more than 250 new service organizations and operating companies.

These changes forced local governments to develop new organizational and management forms in the field of public utilities. The concession law was one of the early regulations in this area, but later local governments developed contractual relationships with various service organizations. My survey in 1994 showed different arrangements of various services (Péteri 1996). In-house (budgetary) organizations were used mostly for housing management, and public services were financed by general budget revenues. External service providers or contract-based service management by in-house units were more frequently used in fee-based services (see chapter 17). Now, foreign companies are involved mainly in the municipal solid waste sector, but investment also extended to large cities in water management.

The lack of comprehensive, detailed information on public utilities, communal services, and contracts is a matter of concern (see chapter 21). Even the arms-length companies are not reported in the public finance information system. Model contracts and comparative information on service performance are not available. Ministries do not feel responsibility for these tasks, and professional and local government associations are not capable of collecting and managing this information and do not have the technical assistance that may be required.

The legislature made limited attempts in 1995, when solid and liquid waste collection and disposal and chimney sweeping were declared mandatory local services, and a reporting system was established. At the same time, the national government introduced compulsory competitive tendering. This legislation was misinterpreted by some ministries and also by several local governments. The Ministry of Interior sent out a circular in which only the new (and not the extended) contracts were subjects to tendering. Local governments'

argument was that they have a constitutional right to define how a municipal service is provided, so tendering is unnecessary. The lack of administrative capacity to manage competitive tendering and insider transactions was often behind the reluctant behavior of local governments.

Regional Development

Regional development has always been regarded as a high-priority local government function. Mayors often see it as a more significant local task than providing some traditional local public services. Surveys show that local economic development, as a component of regional development, was especially important in towns (2,000–10,000 inhabitants) and in large cities (more than 50,000 inhabitants).

Local government involvement in business activities is partly inherited from the Soviet-type local government system, in which local authorities had direct responsibilities not only for public services but also for production. This attitude was reinforced in the modern local governments for two reasons: (a) because they became minority owners of former state-owned companies through the privatization process, and (b) fiscal austerity measures forced them to increase their own sources through business-related revenues. Local taxes, especially business taxes and capital revenues from the sale of assets, became increasing and important discretionary local revenues in the late 1990s.

Local government participation in enterprise activities is subject to constraints. They are allowed to take ownership only in commercial entities that have limited liability and financial investments only in state securities. Even those constraints could not prevent losses. During the recent period of stock market decline, some brokerage companies mishandled the municipal portfolios, and local governments did not exercise proper oversight over their contracts.

The goals of local economic development are different in major groups of municipalities. In cities that have more favorable conditions for domestic or international investors, inward investment is the primary aim. In villages that have been hit by unemployment job creation is the primary goal. In Budapest attracting investments into public and market services is a key development factor. The most frequently used methods for supporting inward investment are building public utilities, roads, contacting future partners, and lobbying at the central government level. Industrial parks (for example, in Győr) have proved to be a very successful means of local and regional development.

Parallel to local efforts, the national network of regional development councils was established in 1996. Through this channel, the national government intends to manage regional development in a coordinated way and in partnership with the national funds. A system of subcounty, county, regional (NUTS2), and national regional development councils was created. All the important players in regional development are represented in these councils: local governments, national government, chambers of commerce, and labor offices. The county development councils have a crucial role, because they manage

and reallocate the decentralized appropriations for capital investments. In short, rather than being the driving force for local and regional development, the regional development councils still focus on allocating minor (0.5 percent of gross domestic product) funds primarily for equalization purposes. This focus has proven to be insufficient in building local capacity for absorbing European Union structural funds.

Fiscal Management

Changes in local government finances and fiscal management started in the legislative modernization process in the late 1980s. The goals were to increase own revenues, launch a unified and nondiscretionary capital investment grants scheme, and establish joint fiscal management units for fragmented budgetary organizations. The legislature introduced a significant transformation of intergovernmental transfers, however, just before the political and administrative changes.

Audit

Municipalities and their governing bodies were initially assumed to enjoy a degree of sovereignty, because no organization beyond Parliament had authority to issue binding regulations or exercise any direct control over local decisions. The State Audit Office (SAO), responsible to Parliament, was established in 1989 to monitor the operation of all kinds of government and budgetary organizations, including the flows of state funds (for example, treasury). As part of the overall government system, SAO monitors the operation of municipalities, though only to control legal compliance and the use of national funds, not to review the substance of local decisions. In principle, all other governmental or general overseeing organizations (for example, line ministries or Constitutional Court) exercise monitoring within the boundaries of their functional competency.

SAO carries out comprehensive annual audits of 30–50 municipalities' reports and reviews their use of state funds; it also runs investigations on selected issues across municipalities (approximately 1,000 local governments were included in these investigations). SAO audits were focused on national budget connections (30 percent), comprehensive audits (26 percent), and sectoral audits (19 percent). The rest of SAO's efforts addressed issues such as property management, budgeting, and financial reporting (Kusztosné 1998).

SAO reports and recommendations are presented to Parliament and submitted to the local governments concerned; however, presenting local findings to the local council or the general public of the municipality is not compulsory.

SAO has regional units by county, but their capacity is not sufficient to audit local governments properly. Some reformers attempted to establish a separate local government audit office, but it turned out to be too expensive. Since 1994 larger municipalities that have over Ft 100 million (US\$ 0.5 million) in the budget and that have loans must be audited by an independent external auditor. As a result, 559 local governments contracted with auditors in 1997 (SAO 1997).

External audits focus on the validity of information and analyze the municipal financial position. The minimum requirement is to review municipal budgets, financial reports, and balance sheets. The auditor's report is presented to the local government, and the auditor has the right to call for an extraordinary council meeting if any serious illegal actions are found. If the mayor does not call the meeting, then an appeal process is also stipulated.

The external auditor must be a member of the chamber of auditors and hold a special qualification in public finances. Often the heads of large city finance departments or employees of the County Treasury and Information Service Office are qualified external auditors (for third-party municipalities). The auditor is appointed through a competitive tendering process, and that process sets conditions regarding disclosure of conflict of interests. The local auditors are experts regarding up-to-date analysis of municipal finances and preventive actions to provide support for local governments.

Local governments establish their own internal audit systems. The finance audit committee, to be set up by law, gives its opinion on the budget and the reports and examines the financial process, focusing on own-source revenues, changes in municipal assets, and changes in local borrowing. This audit also covers public service institutions. The committee's reports should be presented to the council, and in case of disagreement, the committee reports would be subject to SAO review.

Cities and major towns have an internal financial auditor who provides management support and prepares the organization for the external audit. Service organizations are also subject to internal audits, even if they are separate budgetary entities of the local government. The methods for internal audits are slowly developing and spreading among practitioners.

The present local government audit system has two major problems: (a) lack of capacity at the SAO for running the external audit efficiently, and (b) undeveloped methods of supportive and preventive audits as a tool of management in all types of audit. In small local governments, joint audit offices should be used. An audit should be developed further into a supportive, professional advisory activity.

The only way to increase the quality of local government audits is to develop the professional capabilities of the internal and external auditors and to establish transparent processes for selecting independent and qualified auditors. This technical assistance might be provided through the chambers of auditors and local government organizations. The Loan Administrative Change Initiative (LACI) of the World Bank should be used as a model in a flexible way, as local auditors' capacity and professional standards are being developed.

Budgeting and Financial Reporting

Preparation of local budgets and development of financial reporting rules are two important elements of fiscal management. All major components of local budgeting and reporting have strictly regulated, unified rules. This unified system is based primarily on the

information needs of the national budget, though local governments typically follow these planning rules and presentation forms even if they do not serve local budgeting purposes.

Several types of fiscal plans are mandatory at the local level. According to the spatial planning regulations, local governments must design a long-term urban development strategy. This strategy might be a basis for the four-year-term economic plan, which must be approved right after the inauguration of a new local government. The Act on General Government Finances also specifies that a rolling plan should be elaborated and approved, together with the annual budget, for an additional two-year-period.

Those medium- and long-term plans are not widely used by local governments. Some analysts have serious doubts about the practical use of the strategies and forecasts in the present local government finance system. First, such a strategy depends heavily on grants; second, recent experiences have shown that intergovernmental transfers and national regulations on local own revenues cannot be forecast. The fiscal austerity programs of the past years did not help design valid and stable medium-term local prognoses.

Annual budgeting procedures, contents, forms of presentation, and reporting are strictly regulated by law and government decrees. Fixed deadlines exist for preparing local budget concepts (November 30), presentation of budget proposals (February 15), approval of budgets (within 30 days after presentation), and semiannual (September 15) and annual reports (within four months). The form of budget classification is also unified: budgets are approved by organizational units and, within each unit, by groups of expenditures (such as salaries, operating expenses, welfare payments, and capital expenditures).

Local government current and capital expenditures and revenues should be presented in two separate balance sheets. This separation serves only presentation purposes, because cross-financing among current and capital budgets is allowed. This separation of current and capital budgets provides useful information for the councilors on general trends in local government finances and use of assets. According to aggregate data on local government capital and current budgets, current revenues are often used for capital expenditures.

Annual financial reports follow general principles of reporting on economic activities. Local government budgetary organizations follow double-entry bookkeeping and cash-based accounting. Gross accounting principle is used for main (public service, budgetary) activities and for enterprise activities. Special rates of depreciation are used in the public sector for tangible assets.

Financial reports include local government balance sheets, cash-based budget reports, reports on cash reserves or savings, statements on profits and losses, and the supplementary annexes. This supplementary annex focuses on performance indicators of municipal functions and services. Local government fiscal information is based on the chart of accounts for budgetary organizations, supplemented by analytical registers. Details of the system of accounts are defined by the local governments within the general legal framework.

Information on local budgets, budgetary organizations, balance sheets, and property registers are collected by the County Treasury and Information Service Offices. These are

deconcentrated units of the Ministry of Finance and Ministry of Interior. Information collection is highly computerized, and limited comparative information is disseminated among local governments.

Analysts cite three basic problems regarding local government budgeting and reporting systems: (a) confused expectations about budgeting, (b) lack of modern planning methods, and (c) limited access to comparative information on municipal finances and service performance. Most of these problems cannot be solved simply through new regulations, but require that innovative techniques and methods be disseminated among and learned by professionals and practitioners.

First, local governments do not define long-term goals and strategies for their major services and functions, and they do not build their plans on a hierarchy of decisions on general mission statements, local values, and general sectoral plans. Lacking this strategic view (and being strongly dependent on transfers), local governments use plans as a simple vehicle to allocate funds among service organizations. In practice, local budgets serve primarily as tools of control over public spending rather than for implementing *ex ante* strategies.

Second, this planning concept is supported by methods for designing expenditure and revenue appropriations. Line-item budgeting is used for planning expenditures by organizational units to calculate inputs of service. This traditional method prevents local governments from having a general view on service areas (such as functions and programs). Inputs are weakly connected to the level of services and performance of the service organization.

These two sets of problems are mutually reinforcing: because no clear strategy for services exists, output criteria (performances) cannot be identified. The lack of performance indicators prevents quantification of measurable service goals and standards. To solve this problem, any move away from the present organization-oriented, input-based planning could improve local budgeting methods (Kassó 1997). One step in the right direction would be to develop and introduce more detailed service performance indicators, which would support output-oriented budgeting under the present system, focusing on organizations. Another step could be to support planning by functions and programs. Experiments to develop zero-based budgeting methods, which help design inputs by functions or programs, are underway.

Third, access to information by the general public and the local governments is a problem. Several hundred expenditure and revenue items are collected by the fiscal information system from each municipality's budget and financial reports. This information is public at the local level, but confidential at the national level after being collected. Only the two ministries that control the County Treasury and Information Service Offices have access to detailed information by municipalities. Some comparative average data by several clusters of municipalities are returned in printouts to local governments, but these data are not sufficient to allow local government associations and think tanks to conduct analyses or evaluate alternative policies.

Capital Budgeting and Investment Process

The present capital budgeting practices and the capital investment management capacity have been strongly influenced by the changes in the financial environment. In the 1990s local government capital expenditures declined from 18 to 13 percent of total local budgets. In this period covering current expenditures was the highest priority for local governments. A restrictive fiscal policy has reduced funds for both regional and sectoral investments and raised local needs for own-capital budgets. Now only urban municipalities might have capital budgets, and no significant capital investment is made in the rest of 2,800 municipalities in the countryside.

The sectoral composition of capital expenditures has changed significantly. In 1991 almost half of local capital investments were in the area of human services (that is, education, health care, and culture). By the end of the 1990s this share has declined to 30 percent, but capital investments in physical infrastructure, housing, and market services account for 50 percent of total capital budgets. This trend was explained by the decrease in education needs and the lack of national budget grants in the health sector.

Parallel to the sectoral changes, the financing schemes of capital investments also changed. The traditional form of grant financing of human services did not work: in the period 1991–1998, only Ft 155 billion were used for matching grants and an additional Ft 128 billion as targeted grants. Among matching grants, public utility services had the largest share, because no grants were allocated for educational purposes after 1996; instead, water, wastewater treatment, and solid waste landfills had a high priority at the national level. The targeted grants (non-matching for large projects above Ft 200 million) were used mostly for reconstruction of large hospitals, homes for the elderly, and theaters. In addition, extrabudgetary funds of line ministries also served local capital investments in water, environmental, and road funds (Jókay, Kálmán, and Kopányi 1998).

The change in the structure of local capital investments has modified the methods and techniques of investment management. The former line department units rarely operated as implementing agencies for local government investments. Their function was to prepare investment plans and control the process of tendering out, contracting, and activating the object. Local government decrees on capital investments also define value limits for the decision competencies of various elected bodies (such as the council, committee, and mayor).

These changes were greatly needed in this period, when the national government financed most of the local capital investments in partnership with the private sector. No information is available on the scale of private involvement in financing local public services, but major projects (such as landfills, sewage plants, and public transportation) always needed financial contributions from the private sector. No estimates are available on private capital investments under urban development deals (such as building roads, water, and sewage networks in exchange, for example, for land or tax exemption).

The second half of the 1990s saw significant changes in the local management of capital investments. The most important one was to set the rules and value limits for public

procurement (that is, the purchase of goods and services). Conditions, types, procedures, timing, and appeal processes were defined by law. Minimum value limits for using the legislation on public procurement are defined by the annual budgets. These limits are rather low (US\$ 140,000 for capital investments in 1999). The new legislation on public procurement followed European Union regulations on competitive tendering. Public procurement rules are often bypassed by issuing the tenders through independent municipal enterprises (see chapter 15).

Another requirement is to prepare a feasibility study on capital projects if they are to be supported by national funds. Changing rules of urban planning will also modify the relationship between the public and private sectors because local governments have more bargaining power as far as construction plans are concerned.

In a market environment, public servants and elected officials must learn new techniques in planning, negotiating, and implementing capital investments. Because more and more local investments are revenue producing by private or privately operated facilities, new financial planning methods are called for. Local governments and their arms-length companies must establish funds for future reconstruction and capital investments. This long-term thinking, however, is not part of the typical operation at local governments so far.

Cash flow project financing will modify the relationship between the local governments, the operating companies, and the financing institutions (generally, banks). National budget grants will still have a strong influence on investments, but because other sources are also needed, local behavior will change. Concession agreements and build-operate-transfer schemes require developed contracting techniques between local governments as clients and the operating companies. Local governments usually want to keep the ownership of the utility network, site for the landfill, and so forth.

The lead bank of a municipality is often the major lender for investments. In this case, the fiscal information is easily available. For many decades, the lead bank for local governments used a very simple rule-of-thumb for evaluating a local government's borrowing capacity: if the ratio of capital expenditures in the total budget was below a specified limit, then it had access to loans. The high level of grants and transfers guaranteed the repayment. Now that Hungary has several domestic and international banks, public information on local governments' borrowing capacity is needed.

Local Debt Management

Municipal fiscal strategies have significantly changed as the economic conditions and financial regulations substantially changed, and local governments learned new methods during the 1990s. My survey showed that the newly elected mayors' first attempts were to cut back expenditures (Péteri 1998). Expectations were high (and so perhaps were reserves) in spending and service management. Later, by the end of their first terms, mayors' preferences had changed. On the expenditure side, local governments made more radical

steps: they canceled programs or transferred functions to county governments. At the same time, more local governments used new revenue, raising options, such as introducing local taxes, borrowing, and selling local assets.

This shift in local fiscal strategies resulted in a more businesslike operation at the local government level. The entrepreneurial approach was always present in local governments, because the lack of public revenues coupled with the transfer of state property provided good conditions for ventures. The rules of the public and private sectors were mixed in the decisions of many councils and local officials. After the new fiscal austerity program was launched in 1996, however, a regulated procedure of municipal debt management and limitations on local borrowing were introduced.

The purpose of these regulations was to separate local governments' financial responsibilities from the national budget. Though the Act on Local Government already declared that insolvency of local governments was subject to court resolution on the request of creditors, the legislature did not define detailed procedures until 1996. New procedures decentralized the management of municipalities in fiscal crisis and defined the conditions for applying for deficit grants only in ultimate situations. The limitation on local borrowing served similar decentralization purposes.

According to the legislation on local government debt management, the mayor has the main responsibility to start the legal process. In principle, after 60 days of overdue invoices, the local government or the creditor can initiate the debt resolution court process. Local governments are responsible for their budgetary institutions, too, but not for independent municipal companies (except when guarantees are involved). In 1998 the hospitals became part of the local bankruptcy procedures, despite the fact that they are financed by the national health care fund.

In practice, the local bankruptcy law was used only in the cases of nine small local governments. These cases were typically locally initiated procedures and closed mostly under an agreed settlement. The main causes for bankruptcy were typically unrealistic plans for capital investments. Although most of these investments were in the public sector (such as schools or sport halls), some also were in the private sector (for example, to promote local tourism). In these cases, lending banks had accepted core (nontransferable) property as collateral, which also caused problems (see chapter 30).

Debt management procedures were introduced together with limitations on local borrowing. The limit on municipal borrowing is 70 percent of net own revenues. The fiscal information system, however, does not present proper data on local government debt service limits. Since the limit is in place, the debt to net own-source revenue ratios were never higher than 15 percent, a level quite low when compared to the allowed limit of 70 percent of total budgets. In this respect, therefore, the aggregate local government borrowing capacity has high reserves.

What to Do?

During the 1990s local government management has been developed mostly through regulatory actions. This brief analysis of the four major service areas and some components of fiscal management showed that administrative measures supported decentralization. This legal framework was necessary for the development of local management. Many failed attempts, however, show that this legal-regulatory approach is not in itself sufficient. Several areas of the decentralization process can be characterized as unfinished business because the legislative steps did not provide the anticipated results in service delivery or the efficient operation of local governments. New institutions require several other conditions, management skills, and knowledge to reach satisfactory outcomes.

Future actions should focus on the following areas:

- Support and advice to local governments to develop new organizational forms and procedures (for example, model contracts, formula-based user charges, and capital investment financing schemes)
- Training and development of sector-specific and general management technical expertise at the local administration and in policymaking both for staff and for the politicians
- Development of locally available information systems with data relevant to municipal operation and management (for example, performance indicators, service standards, public fiscal data, and public information on contracts)
- Support to increase the professional level of local governments by independent policy institutes, think tanks, professional associations, consulting capacity, and information exchange systems among local governments.

The Role of Central Government in Further Decentralization

Most policymakers do not support further decentralization in the local government context. In their views, decentralization is simply equal to a transfer of public functions to lower levels of government. Obviously, several arguments against such an interpretation arise: differentiation of local public services, unmanageable allocation of transfers in a fragmented urban structure, and the present behavior of local governments geared to seeking central grants. The national fiscal policy, however, always relied on local governments' adjustment to economic realities, ability to increase the quality and level of services, revenue-raising capacity, and development of effective forms of service delivery.

The crisis situation—when the basic local government regulatory environment was established and experimented with at both levels of governments—is over in many respects. First, the economic transformation has reached the level at which private ownership has become dominant in the economy. Second, after a long period of economic decline economic growth has picked up in the second half of 1990s. Third, the tight fiscal policy

was successful in significantly reducing the share of general government expenditures. Parallel to these changes, however, local governments are faced with new challenges, including growing needs and membership in the European Union.

Under these new conditions, decentralization efforts should be based more on consensus building than on crisis management. This responsibility is a new one for the national government, which should make local governments capable of realizing all the benefits of decentralization. National policies should support local adjustment not by simple fiscal means only (for example, tightening or reallocation of revenues) but also by other techniques of public administration and public service management. The entire public sector will benefit from a consensus-based decentralization.

Such decentralization requires significant changes in national government's organizations, operation, and management. A broad interpretation of public administration means include: (a) legal and legislative actions, (b) public service management methods, (c) finances and fiscal management, (d) information and monitoring, and (d) support to raise public awareness and publicity. In the main areas of local government functions (see table 18.1), these public administration means should be developed in different ways.

Elements of Public Administration Means

Municipal solid waste management is a good example to highlight the elements of public administration means that are needed in a decentralized system (Péteri 1998). In general, environmental protection is well regulated, although some important components of legal regulations are still missing. This lack causes several problems for local governments: for example, waste is not defined by law, landfills' technical minimums are not detailed, no clear regulations on unauthorized landfills are specified, and legal sanctions on user-charge collection are not built into general regulations on minor offenses.

Public service management can be supported by various national government actions. To develop a decentralized control mechanism, the use of ecomanagement and audit schemes should be advertised, information and professional expertise are needed for environmental planning, and regional planning should be based on market coordination. Tendering and contract practices and information on bids should be provided to local governments and service organizations.

In the field of finances two corrections might indirectly increase the local government's sources allocated to this service: availability of specific grants for major stages of large capital investments and grants for buying equipment and vehicles. Technical assistance is needed for local governments to define general methods for setting user charges and to establish typical forms of cooperation among local governments. Supporting competition among hazardous waste treatment units to decrease management costs and using obligatory cash deposits for contractors are also useful means.

The present information system on communal waste management does not help local governments. A limited set of data is available only at the Ministry of Environment. No comparative information on finances of solid waste services or on tendering and contracting is available. Decentralized decision-making can be supported by increasing public awareness and publicity on waste problems. Regular professional information channels should be developed, and environmental nongovernmental organizations should be encouraged to increase their capacity to participate in local decision-making.

These examples show that in a decentralized environment national governments must develop new techniques. They are all indirect means to increase local governments' autonomy and capacity to respond to local needs.

Legal Framework with Basic Rules and Service Standards

Organizational forms and models meeting local service delivery needs might be developed on a trial-and-error basis, like the “free commune” experiments in the Nordic countries. Sometimes national support is also needed (for example, support of the national tax administration to introduce value-based local property taxation).

Training, knowledge transfer, and guidance to develop local service management capability should be regularly available at an affordable price for local governments. National government projects and coordinated technical assistance programs must be developed for local governments.

Information sharing on service management is greatly needed both for policymaking and for local decisions. More detailed information and easier access to data would support decentralization of services. Standards, performance levels, cost, and efficiency indicators help comparison, which is the basis of decision-making in a decentralized environment.

Finally development of negotiating mechanisms is the basis of consensus building in decentralized political and public service systems. Organizations representing local governments, municipal professionals, or service providers must be involved in the national decision-making process. They could protect the needs of the local government sector against other lobbying groups. By contrast, well-functioning local government associations might help decentralization by keeping the problems within their own circles. Fiscal policy coordination can be supported by intergovernmental committees (Shah 1998).

Summing up, the legal and regulatory steps in the restrictive fiscal environment have reached their limits as far as establishing a modern local government system. A new interpretation of the decentralization of public administration and public service delivery is needed. Indirect support should be provided to local governments to increase their institutional capacity and obtain the full advantages of decentralization. The national government has the main responsibility in creating responsive, efficient, and transparent local governments.

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