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Bailout of local governments in Hungary: short- and long-term effects[2]

ABSTRACT

Kornai (2014) described the development of municipal indebtedness in Hungary and analysed the process of bailout carried out between 2011 and 2014. It was the first, really successful attempt to provide scientific evidence on the existence of soft budget constraint (SBC) in the Hungarian municipal sector. Nowadays, there is still an ongoing debate on the necessity of the bailout; however, the discussion often lacks scientific or factual grounds. This study aims to continue János Kornai's path and provides a scientific analysis and evaluation of the phenomenon. To start, the theoretical framework of SBC is introduced, for local governments in particular. Afterwards, the budget constraint on the Hungarian local governments is described briefly, followed by an assessment of the corresponding measures expected to offset the negative messages of the completed bailout. The study concludes that the centralisation measures taken and efforts made towards hardening the budget constraint resulted in the consolidation of municipal budgets; however, it was accompanied by a serious limitation of local autonomy, investments and borrowing. In spite of all these, the perception of SBC among municipal decision-makers is still alive and well.

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Introduction

The financial management of local governments in Hungary was ripe for a large-scale reform by the beginning of the decade. Renowned specialists and researchers have often pointed out that the local government system is under significant overpressure. Its perhaps most conspicuous sign was the very fast growth of municipal debt. The reasons are diverse. According to András Vigvári, central politics considered local governments to be 'conflict containers' up until 2010 and tried to delegate all issues involving political risks to these lower levels. The *relief valve* of the overpressure brought about by the simultaneously appearing operating deficit and the *expansion drive* was the outstanding freedom of local governments in money and capital markets even by European standards; this delayed the adjustment of budgetary expenditures to revenues and real capabilities. In addition, due to the weaknesses of regulations, fundraising from external sources by local governments was controlled only by the willingness of the banks to lend and take risks. This was further inflamed by the fact that local governments and later also the banks believed (in spite of the relevant clear legal rule) that the central government might not release the hands of large local governments. And so it happened: simultaneously with the transformation of the statutory foundations of the sector, the central government set about assuming municipal debt and simply deleting the memento of the *guilty* past. Apparently, there are only winners in the process: in the short term, the benefactor government saves the troubled local governments and, starting from a clean slate, the local governments can continue performing local public affairs. However, this simplified narrative conceals a number of effects/consequences. The municipal debt consolidation is undoubtedly the strongest indication in the past 20 years of the fact that the budget constraint on local governments is soft: the expectation of being bailed out may determine the decisions of local governments in the long term and may encourage them to continue overspending. The pronounced aims of the reforms implemented is to strengthen the budget constraint and to consolidate the financial management of local governments in order to avoid the reproduction of outstanding debt.

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However, now we can already see signs to the contrary: the local government of the city of Pécs needed another lifebelt at the end of 2017, but this time the help was not offered for free.

This study examines whether the legislation measures achieved the objectives set, and whether they were sufficient to ensure that they neutralise the long-term effects of debt consolidation. To verify this, the first part of the paper briefly reviews the literature on soft budget constraints, especially in respect of the local government system. The pillars of the new local government system are shown in the second part. In Chapter 3, the hypotheses set on the financial management of local governments are verified, then conclusions are drawn.

I. The soft budget constraint

The idea of soft budget constraints (SBC) was formulated for the first time by János Kornai in his study published in 1978 (*'Reproduction of Shortage'*), then in his book entitled *'Economics of Shortage'*, published in 1980, in relation to understanding the economic mechanisms of socialist regimes: contrary to classical capitalist companies subject to hard budget constraints, conventional socialist companies cannot expect bankruptcy or liquidation even in the event of loss-making operation; they will survive difficulties as a result of help from the central government. Kornai *et al.* (2003) and Kornai (2014) structure and summarise the problem of soft budget constraints and the research in the 25 and 35 years, respectively, since the ideas were formulated, which significantly widened the application of the conceptual framework of the SBC: today the bailout of privately owned companies (e.g. declining sectors) or certain operators in the financial sector no longer staggers anyone, especially in the knowledge of the events in the recent financial crisis. At the level of the national economy, bailing out non-profit organisations (e.g. hospitals, schools, universities) and debt-ridden, insolvent local governments is common. Our study focuses on the latter phenomenon, for which it is essential to describe the theory of the SBC in more detail.

In general, we can talk about the phenomenon of soft budget constraints if 'the behaviour of every organization concerned is affected by the expectation that it will be bailed out if it gets into serious financial trouble' (Kornai 2014:27). There are organisations subject to budget constraints, which have to cover their expenses from their initial assets and revenues. In our case, these organisations are local governments. The difference between revenues and expenses (deficit) may be covered by a 'support organisation', in the present case, the central government. The phenomenon of SBCs arises when the financial decisions of local governments are determined by the expectation that they will be bailed out if they get into *serious financial trouble*. In the case of local governments, the hardness of the budget constraint is related to the extent of fiscal decentralisation. In the course of fiscal decentralisation, the performance of public service tasks is divided between the central government and the levels of local government; in accordance with the principle of subsidiarity, decisions move closer to residents, and local needs become easier to meet, while locally elected representatives and bodies become more accountable. However, in addition to its advantages, this division of tasks also include challenges. The principle of economies of scale may be infringed, while it may be more difficult for the central government to look after its stabilisation tasks, and the performance of subnational levels of government may pose a risk to government deficit and debt; the latter are critical especially if the performance indicators set for the entire national economy, like the Maastricht criteria, are to be achieved (Dafflon 2010). An independent redistribution policy may generate competition among local governments, which may make residents and companies mobile.

The decisions of municipal leaders may be significantly influenced by the *expansion drive*, i.e. to be able to provide as good public services and as many projects to their residents as possible; this encourages them to overspend until they hit barriers. Kornai (2014) explains that in some of the cases cautiousness and self-control may also be limiting factors (fiscal discipline), but in most cases restrictions come from outside, e.g. withdrawal of market operators and closing of credit sources, while they may also include legislation or administrative tools restricting expenditures or borrowing. In decentralised countries, the reason for overspending by local governments is that they are more inclined to assign higher priority to their own local interests than to the interests of the country, the entire community. At the same time, Inman (2003) raises the point that passing through the costs can be interpreted not only in space, but also in time: if current expenditures are covered by credit, different generations enjoy the benefits and will bear the burdens.

In the case of local governments, we can talk about *serious financial trouble* when the state of insolvency is permanent and they have cumulative (operating) deficits for several years, are unable to make instalment payments or just cannot get another loan, because they have lost their creditworthiness. With regard to the frequency of financial trouble, bailouts can take place once, repeatedly or regularly. Bailout may mean the cancellation of a tax debt, the reduction of tax burdens, the easement of the terms of repayment, the cancellation/assumption of debt or even the provision of additional loans.

Rodden *et al.* (2003) shows the mechanism of the SBC as a three-step sequential game. In this, the central government can be of two types: it supports bailout or distances itself from it. Local governments individually evaluate the probability of commitment by the central government. In the first step, the central government sets a framework for the financing and financial management of local governments and also declares that there will be no bailout and emphasises the responsibility of local governments for their own financial management. In the second step, local governments analyse the authenticity of the declarations and commitment of the central government. Based on this, they may decide to manage their finances within the given framework and in accordance with the specific rules; in this case, the game is over. If, however, they decide to overspend, they may request that additional support be provided or their existing debts be assumed. In the final step, the central government decides on the basis of the costs and consequences whether to bail out the local government or distances itself from any bailout.

The key question is motivation: what can encourage the central government to bail out a local government? On the basis of the above, it is conceivable that the soft budget constraint is a question of commitment in the relationship between local governments and the central government: if a local government gets into financial trouble, will the central government provide it additional support or will it let the local government eliminate the problem itself? It makes the decision more difficult that the central government often does not have sufficient information about whether the local government managed its finances well and got into financial trouble through no fault of its own or it results from deliberate overspending. The bailout of local governments can be explained by a number of reasons: the bankruptcy of individual local governments may involve significant negative externalities in the performance of public service tasks and in the employment of public service employees. At the same time, the insolvency of a large local government may also affect the credit rating of the country, while the performance of local governments may worsen consolidated state budget indicators (deficit and debt). It may further strengthen the motivation of the central government for a bailout if the statutory framework does not protect private property and if credit agreements are not enforceable: in this case, the central government may compensate creditors with a bailout. If financial trouble appears in very large numbers, due to the intensification of social tensions, the political forces may lose their popularity at local and/or central government level: thus, a bailout may be justified by political survival and vote maximisation (Kornai 2014). Robinson and Torvik (2009) apply the premise that the SBC is not only one of the effects of fiscal decentralisation that politicians would get rid of (if they were credibly able to do so), but the central government consciously aims to maintain the softness of the budget constraint, because the SBC is suitable for building political clientelism: the recurrence of getting into trouble and bailout tightens the patron-client relationship. This is confirmed by Fink and Stratman's (2009) research, which shows in an example from Germany that budget constraints are not uniformly soft for every local government: the softness of the budget constraint depends on the bargaining power of individual local governments. As a result, influential local governments have a higher deficit and do not follow a tight fiscal policy.[3] Wildasin (1997) explains that the probability of bailouts increases in proportion to the size of municipalities, i.e. the budget constraints on smaller local governments are harder. The reason for this is that the external effects of larger local governments going bankrupt are larger and may significantly exceed the costs of a bailout (*'too big to fail'*). Therefore, Wildasin comes to the conclusion that the reason for soft budget constraints is not excessive decentralisation, but its low level: it would be desirable to break up larger municipal units into smaller ones in order to harden the budget constraint.

We could see that the soft budget constraint prevalent in the financial management of local governments is a very challenging feature arising from fiscal decentralisation, the main disadvantage of which is that it encourages wanton spending at the expense of others. Local governments may provide public services and launch projects irresponsibly, without those being covered by their budgets. If the expectation of the local government for a bailout is strong enough, it may lead to significant overspending, which makes it impossible to refuse a bailout. In an extreme case, a moral hazard also appears: if the local government knows that it can certainly count on being rescued by the state, it is not worth of making any effort to avoid losses or to repay a loan; in fact, it may even keep on increasing its expenditures (Kornai 1993). In addition, the SBC also affects the preference of decision-makers: the operation and development of the organisation may be relegated to the background, while the establishment of relations with potential bailout providers may receive more attention. At the same time, Besfamille and Lockwood (2007) explain that by contrast a hard budget constraint may cause a setback in projects; moreover, local governments have to make a disproportionate sacrifice to filter out bad projects, which leads to inefficiency.

What means can be used to decrease or even eliminate the effects of the SBC? According to Rodden and Eskeland's (2003) approach, a soft budget constraint develops if the central government proves to be too vulnerable to the financial processes or perhaps crisis arising at the municipal level, and at the same time it is too weak or deliberately does not take action to prevent overspending by administrative and regulatory tools. Besfamille and Lockwood (2007) see two ways to establish fiscal discipline: in the top-down approach, the central government establishes a hard budget constraint by *'hierarchical mechanisms'*. By contrast, according to the bottom-up approach ('*unconstrained decentralization')*, the fiscal discipline emerging as a result of (self-) assessment by local governments and the restrictive power of market mechanisms harden the budget constraint; to this end, the central government must successfully distance itself from the local government system and, at the same time, must also reduce its internal vulnerability (Table 1). These two methods are presented in detail.

Dimensions of intergovernmental relations[4]

Table 1

		Ability of the central government to regulate the financial management of local governments:	
		Weak	Strong
Did the central government authentically distance itself from the municipal sector?	no	**Bailouts and soft budget constraint**	Hierarchical mechanisms
	yes	Unconstrained decentralisation	

Source: Rodden and Eskeland (2003)

[3] Goodspeed's (2002) conclusions go further: for the central government, it would be worth bailing out opposition local governments in order to get votes and become re-elected. In this respect, Robinson-Torvik (2009) draws the conclusion that it is more rewarding for decision-makers to embrace bad projects, because this way they can provide funds to their supporters through a bailout. This is not true in the case of good projects, *'everyone can back them'*.
[4] The figure of Rodden-Eskeland (2003) also includes one additional dimension (the financial strength of the central government), which is omitted here: we presented only the case when the central government is fiscally strong. Otherwise weakness in this manner would mean sovereignty at municipal level.

Establishment of fiscal discipline

In order to strengthen the fiscal discipline, the central government may strengthen market mechanisms to enable them to control the financial management of local governments themselves. According to Kornai (1993), this requires the achievement of the following pillars: *(1) customer: pay for the goods purchased; (2) debtor: perform your credit agreement and repay your debt; (3) taxpayer: pay your tax; and (4) company/local government: cover your costs from your revenues.* If financial trouble occurs, this approach may also entail abandoning certain local governments. With this, the central government may demonstrate that it will not assume liability for municipal debts. Although this may lead to bankruptcy, it may encourage local governments and market operators to be cautious in the future.

Other institutions and laws can clarify *ex ante* what procedure is expected in the event of the insolvency of a local government. This goal is served by, e.g. setting clear rules for the settlement of bankruptcy and debts of local governments; these procedures take place independently of the central government, which may guarantee that market mechanisms will control the financial management of local governments in the long term. According to Ter-Minassian and Craig (1997), essential conditions for this are the free market and the fact that same or similar regulations should apply to local governments as to other market operators. It is necessary, furthermore, to ensure the availability of the necessary information for debtor rating (in particular, on outstanding debts and the ability to repay debts) and that local governments have guarantees that support a responsible budgetary policy (own control mechanisms). Last but not least, it is essential that market operators do not expect any bailout.

Administrative strengthening of the budget constraint

In order to strengthen the credibility and commitment of the central government, a number of administrative tools may be at its disposal in order to enable it to avoid overspending and concomitant excessive indebtedness. The use of these methods may make budget constraints harder; however, with this there is a risk that local governments will take a subordinate role. Rodden *et al.* (2003) classify and characterise the available means as follows:

- Prohibition of borrowing and central coordination of the allocation of external funds. Means for this may be the maximisation of municipal debt levels, the approval of loan applications or even the total centralisation of municipal borrowing. Its advantage is that the development of municipal debt will be brought into line with macroeconomic efforts and vulnerability will be reduced. However, with this, the central government may acquire excessive influence in the decisions taken by local governments. In addition, with the central approval of borrowing, local governments may think that responsibility now lies with the central government, so they may rightly expect help and a bailout in the event of financial trouble (Ter-Minassian and Craig 1997). This may undermine the politically neutral efforts of the central government refusing any bailout in the future. In the view of Rodden *et al.* (2003), credit allocation and loan restriction mechanisms are often politicised and, therefore, do not work in practice. However, this overrestricted condition, i.e. making the conditions of borrowing more stringent, may significantly set back projects, because they may be financed only from current surplus or savings (see also Besfamille and Lockwood 2007). The financing needs of projects appearing concentrated in time may unfairly burden the generations that finance their implementation or, without credit, the projects are postponed. This may be offset if the central government provides development funds or implements local projects itself; however, this may infringe the competence and autonomy of local governments (Dafflon 2010).

- Rules-based mechanisms may limit the purpose and extent of borrowing: e.g. long-term funds may finance only projects or if the indebtedness and the annual debt service may not exceed a certain level. This includes also budget regulations, e.g. no deficit may be planned in the budget. Such a widespread set of conditions is the *'golden rule'*, which allows debt financing: this increases the autonomy of local governments, allows more projects and ensures the fair distribution of financing burdens between generations (*pay-as-you-use*). The *golden rule* requires that (1) current expenditure may be covered only from current revenue (no operating deficit is allowed); (2) projects may be financed from loans; (3) the debt service may be covered by current income (no erosion of assets and debt spiral). Since the *golden rule* does not limit the allowable rate of borrowing, it may become necessary to apply separate rules for the rate of absolute or relative indebtedness (Dafflon 2010).

- If the central government decides to proceed with a bailout instead of releasing the hands of local governments, it may set certain conditions (at the municipal or sector level) in order to eliminate the root cause of the financial trouble. This allows institutional reform and may confirm that no bailout will take place in the future; thus, market operators and decision-makers can see that a new era sets in in the relationship between local governments and the central government. Dietrichson and Ellegard (2012) studied the short- and long-term effects of conditional bailouts carried out in connection with 36 local governments in Sweden between 2000 and 2004. It was found that financial assistance made subject to the fulfilment of conditions (cost reduction and operating budget balance) did not erode fiscal discipline, in fact, it even strengthened it. Based on the results, they also venture to propose that financial assistance made subject to conditions is more effective in strengthening fiscal discipline than the application of a hard(er) budget constraint. The Dutch model must also be mentioned (Allers 2014): in this case, the loss or debt of local governments is backed by the explicit guarantee of the central government: if necessary, local governments will be bailed out. Nevertheless, the number of bailouts per year is quite low (2 to 4 per year between 2001 and 2014, involving less than 1% of the local governments). The main reason for this is, according to the author, that autonomy of the local government is significantly curtailed during the 3 or 4-year period of bailouts. The financial situation of local governments typically improves after bailouts. Another textbook example of a conditional bailout could be seen to take place in Pécs, Hungary, which will be described in detail in Chapter 3.

Rodden and Eskeland (2003) draw attention to the fact that the application of the above tools is not at all simple if local governments can run into debt through a number of channels; therefore, careful planning is essential. Ter-Minassian and Craig (1997) also list such tricks: stating current expenditure as projects (reclassification), borrowing by municipal-owned companies, using instruments and techniques exempt from regulations (leaseback or repayment moratorium), or subordination of payments to trade creditors if not specifically covered by the regulations. It can be stated, however, that the efficiency of each tool greatly depends on the extent to which the central government genuinely enforces them.

II. Consolidation and the new local government system

The central government set to transform public administration in Hungary in 2011 at a great pace. Changes to the local government sector is presented in detail in the literature.[5] Therefore, this chapter covers only the changes in the sector budget constraint. The main features of the consolidation between 2011 and 2014, then the new local government system are presented briefly.

Municipal debt consolidation

There is a broad consensus that the budget constraint on local governments in Hungary was soft after the regime change. Notwithstanding that international studies (e.g. Wetzel and Papp 2003) published at the beginning of the 2000s also acknowledged the steps taken towards the establishment of fiscal discipline (e.g. enactment of debt settlement procedure, introduction of a borrowing limit), it increasingly became the general perception among local governments and financing banks towards the end of the first decade of the new millennium that the central government did not release the hands of local governments (Gál 2011). This was also strengthened by a number of independent things:[6] (1) the excessive and continuous decentralisation of public service tasks; (2) flexible budget boundaries (erosion of assets, operations financed from loans); (3) bond issues becoming widespread; (4) ineffective and unenforced borrowing limits; (5) an attempt to make the conditions of borrowing more stringent in 2007; (6) the (foreign exchange) credit boom; (7) the municipal leaders' moral responsibility (and the fact that the leadership of the majority of important local governments was in the opposition in national politics between 2006 and 2010); (8) the weaknesses of the debt settlement procedure; (9) the possibility of off-balance sheet indebtedness (e.g. PPP or sureties); and (10) last but not least the continuous *expansion drive*. However, Wildasin's (1997) findings were also confirmed under the conditions prevailing in Hungary: the smaller a local government, the harder the budget constraint. Later it will be shown that those who may have really needed help were the larger local governments; probably their expectations of a bailout were also higher.

Despite the promise of the law *('the consequences of the loss-making financial management of the local government shall be borne by the local government and the central budget shall not be responsible for its liabilities'),* there were signs that could strengthen the expectation by local governments of a bailout: the central government carried out small and large bailouts involving continuous additional support provided at system level and individual decisions even before the reform. On the one hand, it provided auxiliary support to distressed local governments through applications. Although the amount of this support was insignificant compared to the budget of the entire local government sector (just over 1% per year), but it is indicative that the number of additional support applicants has begun to increase again since 2010 (in 2012, 54% of local governments, 1,743 local governments in total). It is to be noted that the condition for local governments to submit applications for support from the largest funds, i.e. those placed at a disadvantage through no fault of their own (so called *ÖNHIKI*), was operating deficit. At the same time, the figures of the last year of the operation of the funds (2012) show that of the 1,743 supported local governments 58% continued to operate at a deficit despite the aid, 27% eliminated it, while 15% would have had a balanced budget even without aid. This reflects well that neither the amount nor the target of the funds was satisfactory, moreover, the aid did not have conditions encouraging the improvement of the balance. On the other hand, individual bailout actions also took place, e.g. in the autumn of 2011, the central government assumed the foreign exchange debt of seven municipalities due to lobbying by a mayor concerned.

[5] The workshop studies of the Institute for Legal Studies of HAS Centre for Social Sciences give a good review: Balázs (2014), Horváth (2014), Pálné (2014) and Szente (2014). In addition, the Congress of Local and Regional Authorities of the Council of Europe also evaluated the changes in Hungary in 2013.

[6] For a detailed explanation of the individual topics, see (1) Vigvári (2010); (2) Vasvári (2013b); (3) Vasvári (2009); (4) Homolya-Szigel (2008); (5) Jankovics (2016); (6) Schepp-Pitz (2016) and Vigvári (2009); (7) Kornai (2014) and Vasvári (2009); (8) Gál (2010); (9) Vigvári (2009); and (10) Kornai (1980).

However, an unprecedented large bailout began in 2011, which confirmed the preliminary expectations on SBC: the central government assumed all debts of all local governments generally in four phases. The process was completed by 2014. Kornai (2014) shows in detail the process of debt assumption and points out the signs of political clientelism.[7]

Main figures of the assumption of municipal debt between 2011 and 2014

Table 2

Rate of consolidation	Local governments concerned	Number of local governments concerned			Extent of consolidation (HUF billion)	Date	Extent of assumption
		Local govern-ments involved in debt assumption	Local governments without debt	∑			
Counties	All counties	19	0	19	196	30.12.2011	100%
Municipalities, Phase I	Municipalities under a population of 5,000*	1,700	1,181	2,881	74	28.12.2012	100%
	Municipalities over a population of 5,000	277	19	296	610	28.06.2013	40%–70%
Total municipalities, Phase I		**1,977**	**1,200**	**3,177**	**684**		
Municipalities, Phase II	All municipalities	509	2,668	3,177	457	28.02.2014	100%

Source: Based on figures from the Hungarian State Treasury and the Ministry of Interior

As expected, opinions were divided as to whether a bailout action of such a scale was warranted (HUF 1,337 billion in total). In my opinion, and this is also confirmed by several studies (e.g. Jankovics 2016; Horváth *et al.* 2014), the general and full debt consolidation that took place in Hungary had not been preceded by serious financial problems at the sector level. Thus, in fact, this bailout can be considered a national gift provided in a differentiated way; Kornai (2014) also quantifies this. A national gift from the local governments and their residents who had no debt (see Table 2) or had run into debt below average.[8] The importance of a 'sector level' indicator cannot be sufficiently stressed, because financial problems had arguably arisen among local governments. Almost all county governments became heavily indebted and, what is more, a large proportion of their long-term debt had financed operating expenses (Vasvári 2013a). In this case, the central government also assumed trade creditors. Local governments could also accumulate debt in a foreign currency; only transaction exchange losses resulted in an almost 15% (HUF 182 billion) increase in debt at the end of 2010 (which can be considered an unexpected external financial shock). However, even then the weight of the outstanding debt of local governments did not reach 5% of the GDP or 6% of government debt (the expenditure of the municipal sector amounted to approximately 12.8% of the GDP at that time); and as Kornai (2014) points out, 82.6% of this debt was accumulated by 150 local governments (4.7% of local governments). The municipal deficit also reached a record level in 2010, which thus increased the government deficit by 25%. However, cities of county rank and districts, i.e. fewer than 50 local governments, are responsible for almost half of this deficit. In addition, it is worth evaluating the bailout process also in the current economic policy space. During the bailout significant funds were withdrawn from the bank sector (e.g., transaction levy, bank tax). Although the proportion of non-performing loans owed by local governments was only 2.1% in mid-2011 (Jankovics 2016), the repayment of a significant part of the municipal debt would have only begun after 2011 (Vasvári 2013b). Therefore, the issue of municipal debt could easily become subject to bargaining in the *turbulent* relationship between the banking system and the central government. This confirms that the central government offered the last phase of the bailout of local governments first to the financing banks. In exchange for assuming the remaining debt, the creditor

[7] A clear example for this is the assumption of debt in 2013, under which the central government assumed just part (40% to 70%) of the debt of municipalities with a population of over 5,000. Although the central government had a preliminary, objectively defined idea of the proportions, deviations were allowed in several cases in the end. Kornai (2014) shows that this difference was considerably larger in the case of local governments affiliated with the ruling party.
[8] The central government provided a total of HUF 50 billion in aid through applications to local governments that did not have any debt, but did not provide any compensation to those the indebtedness of which did not reach the average level and consequently sustained detriment.

should have paid an amount corresponding to 7% of the debt part assumed to the state coffers. Although the idea was not implemented in the end, the concrete proposals to be put before the municipal councils were also drafted in some cases.

In the knowledge of the above, targeted assistance provided subject to conditions at the level of the individual local governments could seem to be justified. The decision-makers of the central government chose another path and, by cancelling municipal debt, also relieved local governments from the responsibility.

Financial cornerstones of the new local government system

Simultaneously with assuming debts at the sector level, the central government set to transform the local government system. Even the Fundamental Law contains significant changes in local self-governance. According to it, the law may make borrowing or other commitments by local governments subject to conditions of the consent of the Government in order to maintain budgetary balance.

The foundations of the new local government system are set out in the supermajority law on the local governments of Hungary. A significant trend of centralisation can be observed in the division of tasks: county governments essentially no longer perform public service tasks, while such tasks have been withdrawn from local governments to a significant extent (e.g. education, healthcare). In addition, the financial latitude of local governments has narrowed even further due to the introduction of a 'task financing system'.[9] As one of the most important changes, the Law declares that no externally financed operating deficit may be planned in budgets.

The new Act literally repeats the promise also included in the earlier Local Government Act, according to which the consequences of the loss-making financial management of the local government burden the same local government and the central budget is not responsible for its liabilities. However, in order to maintain their ability to operate or to avert another situation jeopardising the performance of their tasks, local governments may continue to apply for extraordinary financial aid. These amounts are still not significant: the total amount was HUF 11 billion in 2017, while local governments received HUF 8.2 billion in aid in 2016.

In line with the authorisation granted in the Fundamental Law, the Hungary's Economic Stability Act contains the rules for local government borrowing. It requires, above all, the fulfilment of the convergence criteria for government budget deficit and the government debt indicator; in connection with the latter, since the government debt indicator exceeds the required 60% (74.5% at the end of 2017), it requires that it be reduced. Since municipal debt is part of government debt, the latter requirement also provides a framework for the municipal borrowing. The most important change is that from 1 January 2012 local governments may validly conclude transactions giving rise to a debt[10] and may assume any surety or guarantee only with the prior consent of the central government. At the same time, the Act contains exemptions from the approval obligation, among which the most important are loans with a term of less than 1 year, loans for the pre-financing of the European Union aid (for development purposes), loans for development purposes below a certain value limit (specified by local government type) and reorganisation loans provided in the municipal debt settlement procedure.

[9] The essence of the funds-oriented financing system in place before 2013 is that the local government regulates the revenues at its disposal, with the proviso that it can also mobilise its own revenues. State aid is mostly untied, so local governments may be interested in increasing the efficiency of performing their tasks. Under the task financing scheme operated since 2013, the need for expenditure associated with the tasks is given, for which tied state aid is disbursed. The goal is to get and spend as much aid as possible and it does not encourage them to improve their services (Sivák *et al.* 2013).

[10] According to the law, transactions giving rise to a debt are borrowing; bond issue; issue of a bill of exchange; contract of sale and purchase concluded with the stipulation of the obligation of financial lease or repurchase; deferred payment for at least 365 days granted in a contract; and deposits placed as a result of differences from derivative transactions.

According to the Act, the central government consents to borrowing only if the following conditions are met jointly:

1. the transaction giving rise to a debt does not jeopardise the achievement of the general government debt ratio specified in the Central State Budget Act;

2. the transaction giving rise to a debt results in the establishment of a capacity required for performing the task of the local government specified by law, with the proviso that operating expenses are continuously covered;

3. it has introduced local business tax or at least one of the pecuniary taxes specified in the Local Tax Act or the communal taxes on private individuals;

4. the total payment obligation of the local government arising in the reference year from a transaction giving rise to a debt may not exceed 50% of the local government's own revenues in the given year in any of the years until the end of the term of the transaction giving rise to a debt. As the main rule, the local government may not start a new development if its total payment obligation in the reference year associated with its transaction giving rise to a debt reaches or exceeds this rate.

As it was mentioned in the previous chapter (see Rodden and Eskeland (2003)), local governments tend to avoid rule-based mechanisms. The amendments of the acts closed these *back doors* gradually. Such was the amendment of existing contracts (e.g. changing the term of loan or the terms of maturity or principal repayment grace period) or running into debt through municipally owned companies. Even contract amendments have become subject to authorisation by now. The growth of municipal debt through municipally owned companies was first limited by the assumption of sureties and guarantees by local governments, then from 2015 by making borrowing by municipally owned companies subject to authorisation. This was also justified by the fact that according to the Ministry of Interior the growth of municipal debt shifted to municipally owned or partially municipally owned companies, where an outstanding debt of more than HUF 1,000 billion was accumulated. This is an amount of the same magnitude as that assumed by the central government from local governments.

At the time of its original entry into force, the Act declared that local governments might only borrow loans with a term of less than 1 year for the purpose of operation, which did not require the approval of the central government. This has now been removed from the text of the Act: local governments may take out long-term operating loans with the consent of the central government if their purpose is to fulfil their payment obligations set out in a court decision or to provide their own contribution to a successful European Union tender for operation.

All transactions giving rise to a debt, which are planned in the given year, have to be included in their by-laws on the budget and the central government has to be informed about it in advance. Then the request for the consent of the central government has to be drawn up for each transaction during the year. The Government decides on approval on the basis of the joint proposal and recommendation of the Minister responsible for local governments and the Minister responsible for the state budget. The Government may also consent to part of the individual transactions or may even refuse them. In the light of the development goals, a decision may be made which contributes an amount lower than planned by the local government to the related transaction. Upon approval, the transaction giving rise to the debt or the suretyship agreement has to be concluded in the reference year.

Last but not least, it is necessary to mention that the transformation of the local government sector did not affect the review of the municipal debt settlement procedure, so the rules for the municipal debt settlement procedure set in 1996 and largely unchanged ever since did not change during the reform. This seems to be essential for the establishment of fiscal discipline, because under the current rules no procedure is launched against larger local governments (creditors and the local government have the right to do so, the latter against itself). This is because it requires too much sacrifice from all the parties concerned. On the one hand, only the mandatory tasks may be performed and no project may be launched during the procedure, which would have significant external effects on the local economy. On the other hand, the banks typically did not see guaranteed that they would achieve more in a long procedure, involving many additional creditors, than in bilateral negotiations. So a number of local governments could have already gone into *latent* bankruptcy; in their case, although the conditions for launching a debt settlement procedure exist, the procedure is still not initiated.

The new legislative environment continues not to deal with the issue of the internal indebtedness, i.e. depreciation not made up for. This is critical in the Hungarian local government system particularly because local governments inherited substantial assets at the time of the regime change, for the maintenance/replacement of which no funds were provided (in 2016 the portfolio of municipal real estate was worth more than HUF 10,000 billion, about two-thirds of which was unalienable national asset). On the positive side, in addition to a cash flow-based approach, local governments have performed accrual-based accounting since 2014, which, in addition to the fact that it may improve the evaluability of the economic processes of local governments and the assessment of their creditworthiness for external financiers, also states depreciation as a cost.

Evaluation

In order to eliminate the phenomenon of soft budget constraints, the central government chose a conditional bailout: in addition to a bailout, it hardened the budget constraint by administrative tools.[11] In accordance with the recommendations in the literature, local governments may no longer plan operating deficit; however, this only applies to externally financed deficits, as operating deficits financed from assets continue to be permitted. Task financing and the method of the calculation of central aid reduced the latitude of local governments, and last but not least their interest to improve efficiency. The current borrowing system is a very peculiar miscellany. On the one hand, certain rules have to be met in the course of borrowing. Due to the reform, these rules have become more modern (e.g. the requirement for operating expenses associated with the operation of projects), and mostly satisfy the conditions of the *golden rule.* Only the requirement for funds to repay the loan is missing. Consequently, running into debt may also be put on a more sustainable track. The new version of the borrowing limit described in Section 4 shows development compared to its predecessor in several points (e.g. it has to be met throughout the loan term, not only in the year of borrowing). It is a positive feature that the new regulations deal with the issue of off-balance sheet indebtedness and the increasing indebtedness of municipally owned companies. On the other hand, as the main rule, borrowing is approved by the central government or even the Government itself. Consequently, there may be local governments that forfeit the opportunity of borrowing notwithstanding that they have met the prescribed conditions.

This may significantly affect the level of municipal projects, and they may become defenceless to the intentions of the central government (see Rodden *et al.* (2003) and Dafflon (2010)). The exclusive authorisation right of the government may also be a problem: since the Government and its administration are not prepared to assess credit risks, they may reject good projects in the absence of knowledge and information, while they may authorise projects that are not financially justifiable. With this, the Government may assume excessive responsibility (Sivák *et al.* 2013); at the same time, the authorisation of the Government can also be interpreted as a kind of implicit guarantee. This is further reinforced by the communication factor that the position taken by the central government, which refuses bailout, is identical, word for word, with its previous promise – which it obviously failed to honour once. The continuing weaknesses of the maintenance of the system of exceptional aid and the debt settlement

[11] According to Horváth's (2014) opinion, cause and effect are inverted: in his opinion, the incorrect suggestion of a crisis and the inevitability of intervention are to serve the 'smoothness' of the transformation of the sector. So the withdrawal of the tasks appeared to be more justified with reference to the inevitability of crisis management. In fact, the centralisation efforts of the central government found their way easier between municipal decision-makers, without any resistance. As a result of all this, institution-based municipal autonomy, which was held responsible for everything, was eliminated.

procedure may strengthen the relationship with the previous financing system and the softness of the budget constraint.

On the whole, a system restricting the latitude of local governments (and thus their autonomy) by administrative means has been established; the budget constraint is seemingly hard, but may carry the possibility of a future bailout. No significant steps have been taken towards fiscal discipline based on self-restriction or the restrictive power of the market, except for the introduction of accrual-based accounting. The next chapter attempts to verify whether experience confirms these findings.

III. The new local government system in practice

The previous chapter showed what path the central government has chosen to mitigate or eliminate the effects of soft budget constraints. This chapter will analyse the practical experiences of the new legislative environment. During our study, four hypotheses set on the basis of the conclusions of the previous chapters are checked.

H1: The financial management of local governments was consolidated in the new legislative environment: the operating deficit essentially ceased and debt levels are low.

A significant increase can be observed between 2000 and 2010 in the levels of both municipal budgets and municipal debt; at the same time, the debt growth rate exceeded the increase in expenditure, in particular, after 2006. The budget balance of local governments ranged from a minor surplus to a deficit of 7% in this period. It can be stated about the period between 2013 and 2016, reflecting the operation of the new local government system that budgetary expenditures dropped to about two-thirds of the 2010 level, while the outstanding debt virtually disappeared by 2014 as a result of debt consolidation and shows only a slight increase. The positive news is that budgets also consolidated: after 2011 they became balanced (Figure 1). However, internal indebtedness continues to increase rapidly, as it did by HUF 182 billion between 2013 and 2016.

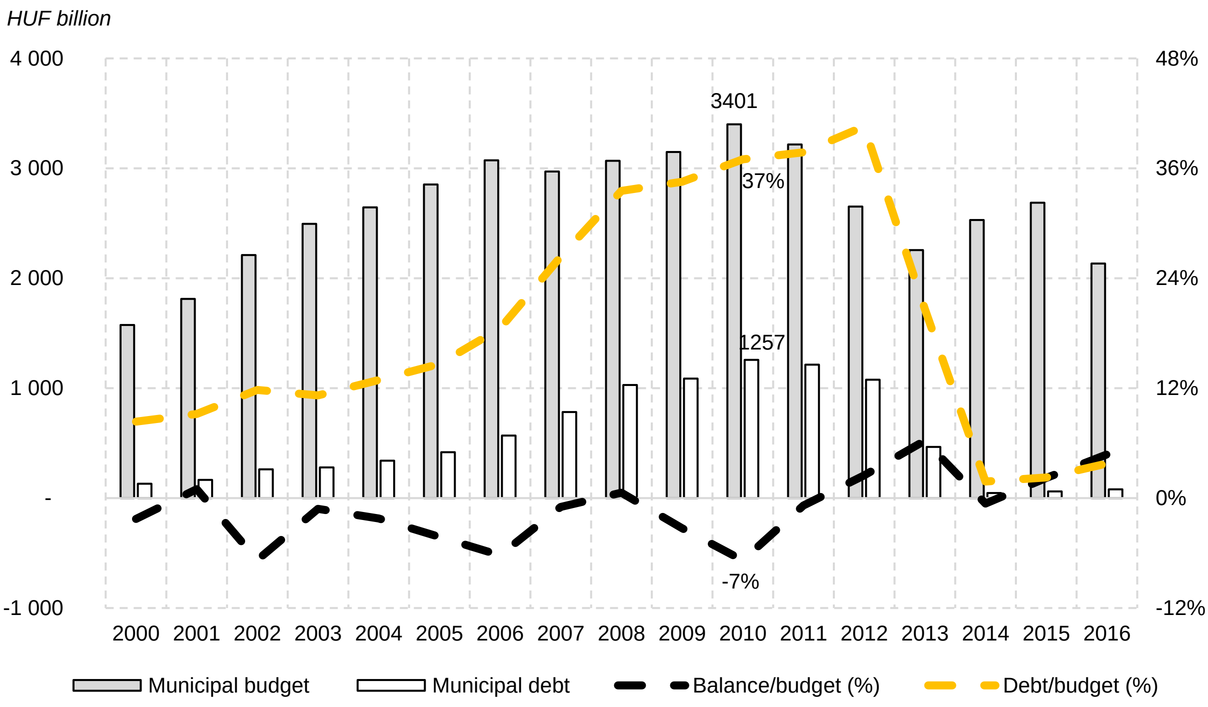

Figure 1. The budget, debt and deficit of local governments, 2000-2016
Source: Based on figures from the Central Statistical Office and the National Bank of Hungary

Municipal budgets comprise operating and accumulation activities. The first condition of the *golden rule*, which has also been transposed into the new legislative environment, is that current expenditure has to be covered always from current revenues, i.e. operating deficit has to be avoided. The Hungarian local government system, due to the significant differences in the size of local governments, has shown a significant surplus at the sector level since the regime change. However, digging down to the level of individual local governments, it can be established that a number of local governments struggled with operating deficits between 2007 and 2016 (Figure 2).

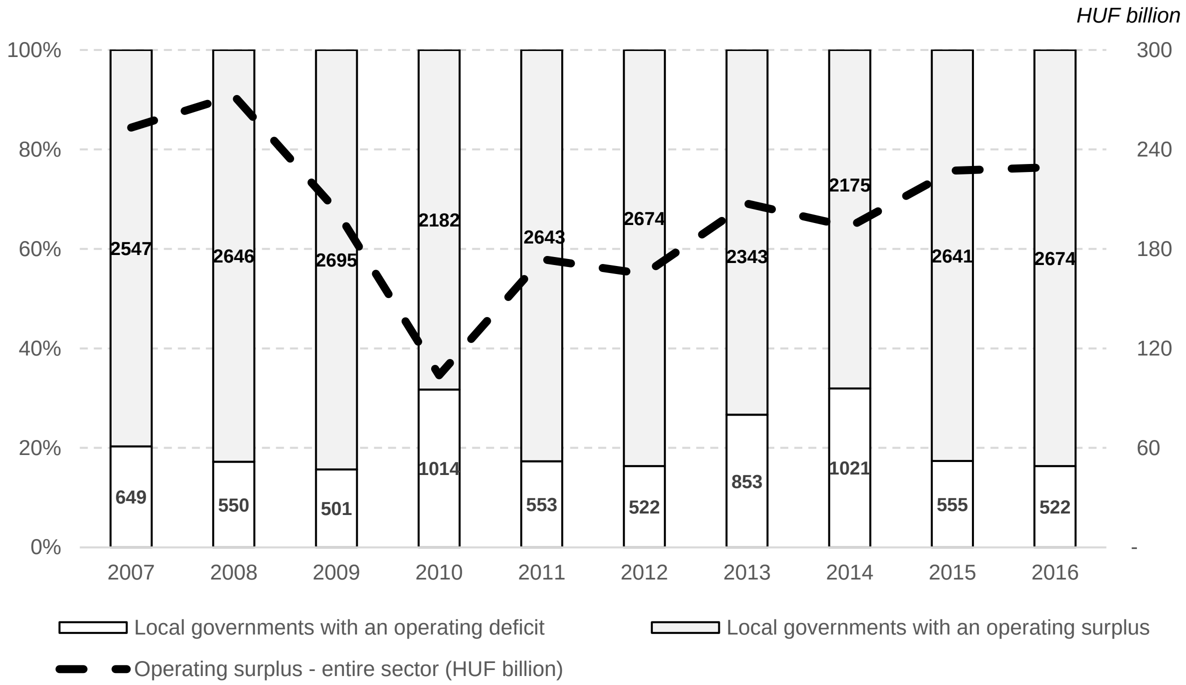

Figure 2. Number and proportion of local governments with an operating deficit and development of the operating balance at the sector level
Source: Based on figures from the Hungarian State Treasury

It can be said that after 2010 the operating balance was restored to the level of previous years. However, the number of local governments with an operating deficit did not decrease substantially. The legislation is, however, more permissive in terms of the calculation of operating deficits than the *golden rule*: only externally financed deficit is not allowed and any operating deficit may be covered from internal resources (assets). Taking into account the remaining funds from previous years carried forward and privatisation proceeds, the number of local governments struggling with an operating deficit significantly decreases: in 2016 the number of local governments struggling with an operating deficit (also) on the basis of legislation was hardly 1% of the entire sector (Table 3).

Number of local governments with an operating deficit, taking into account remaining funds and privatisation proceeds

Table 3

Local governments:	**2013**	**2014**	**2015**	**2016**
– With an operating deficit	853	1,021	555	522
– With an operating deficit, taking into account remaining funds from previous years	308	239	85	40
– With an operating deficit, taking into account remaining funds from previous years and privatisation proceeds	268	214	66	36

Source: Based on figures from the Hungarian State Treasury

On the basis of the above evaluation, hypothesis H1 is accepted: the budget of the municipal sector was balanced after the reform and, by legislative definition, the number of local governments struggling with an operating deficit also decreased. The fulfilment of the convergence criteria for budget deficit and indebtedness was not affected by the financial management of local governments.

H2: The administrative strengthening of the budget constraint has a negative effect on municipal projects.

According to Vigvári (2011), fiscal discipline and the borrowing activities of local governments are of special significance because the greater part of public projects are implemented by local governments. This is also justified by the principle of subsidiarity. In the majority of the EU-27 countries, including Hungary, the share of local governments in public projects was close to or over 50%. The latter is well illustrated in Figure 3. However, the trend seen between 2000 and 2010 was broken: the weight of local governments in public projects have dropped to a level lower by orders of magnitude from 2011, due to the significant increase of government projects. In 2016, local governments implemented less than a quarter of public projects. However, also the schedule of drawing down aid from the European Union has significant impact on the level of investments. In this respect, it can be said that between 2010 and 2015, the amounts drawn down increased by 75%, but a major (45%) decline took place in the last year. As a result, the total amount drawn down fell to the 2010 level. This means that the setback in municipal projects was caused between 2010 and 2016 by a decrease in projects financed not from EU aid but from the local government's own funds and credit sources.[12]

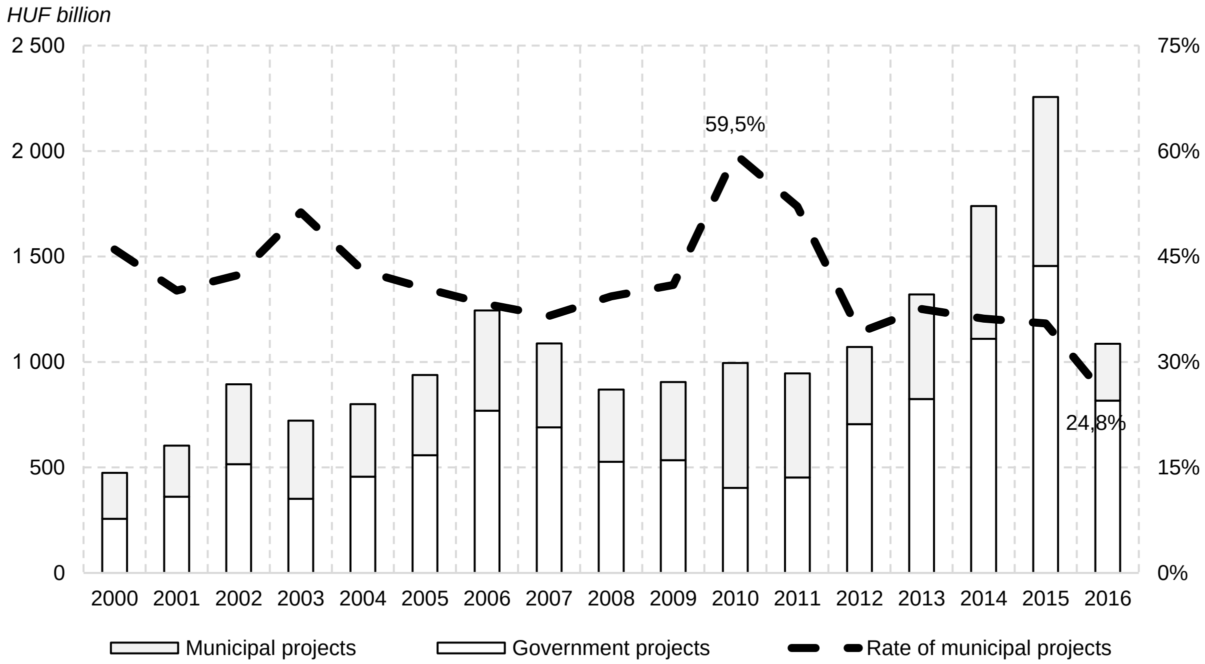

Figure 3. Accumulation of gross fixed assets by the central government and local governments, 2000-2016

Source: Based on figures from the Central Statistical Office

According to Rodden *et al.* (2003) and Dafflon (2010), with the decline in municipal projects, the influence of the central government on local projects may increase. This trend is confirmed in the example of Hungary: the central government has implemented and still implements to date a number of development programmes satisfying local interests.[13] This has three main consequences: firstly, the autonomy of local governments obviously decreases and they are at the mercy of central decisions.[14]

[12] Vasvári (2013a) shows that EU funds did not dominate yet in the funds of municipal projects until 2010.

[13] Such as the Modern Cities Programme, under which the central government entered into an agreement with the 23 largest cities in the provinces (cities of county rank) for the implementation of development objectives. The projects will be implemented by the central government by 2022 to the total value of HUF 3,388 billion. A minister without portfolio was appointed to coordinate the programme, which may imply that the approach of the central government will not change in this respect. In this regard, the football stadium and sports hall development programmes of the central government can also be mentioned.

[14] Examples related to two cities of county rank well illustrate the dependency formed between local governments and the central government. (1) The Mayor of Szombathely declared at the inauguration ceremony of the football

Secondly, there is a possibility that the central government makes its decisions on the basis of political sympathy or lobbying, which places the municipalities left out at a disadvantage. Thirdly, these projects do not require that the operating expenses of the capacities implemented with the project be ensured (which is incidentally required by the central government in projects implemented through borrowing by local governments). This can lead to conflict as to who should operate the new facilities established or from what funds their condition will be preserved.

On the basis of the above, hypothesis H2 is accepted: the number of municipal projects significantly decreased; at the same time, we are witnessing a significant increase in the role of the central government in local projects, which may cause the decline of municipal autonomy and discrimination against certain local governments.

H3: When borrowing is authorised, patterns may appear, showing that political sympathy plays a role in the individual decisions.

To verify this hypothesis, all decisions on borrowing by local governments issued between 2012 and 2017 were arranged in a database. A total of 50 government resolutions included 733 decisions, of which 716 were examined.[15] To check political affiliation, it was assigned to local governments in the database whether the mayor had been nominated by the ruling parties or an opposition party or entered the elections as an independent candidate of another party in the given government cycle. The database has an extensive potential for analysis; its comprehensive presentation would exceed the scope of this study. Therefore, only the relationships closely linked to the hypothesis are presented now.

National distribution of credit approval applications and mayors by political affiliation

Table 4

Political affiliation	Distribution of mayors (2014)		Distribution of the number of applications		Distribution of the amount stated in the application	
	local government	**%**	**pcs**	**%**	**HUF billion**	**%**
Governing party	627	19.8%	339	47.3%	341	85.6%
Opposition	51	1.6%	34	4.8%	17.5	4.4%
Independent/Other	2,485	78.6%	343	47.9%	40	10.0%
Total	**3,163**	**100.0%**	**716**	**100.0%**	**398,5**	**100.0%**

Source: Based on figures from government resolutions and the National Election Office

First, the distribution of applications for the central approval of borrowing is examined (Table 4). Based on this, it can be said that 47.3% of the applications were submitted by local governments led by mayors affiliated with the governing party; in respect of the loan amounts, this represents a weight over 85.6%. 4.8% of the applications can be associated with municipalities affiliated with the opposition, which is considerably lower than the figure observed for the ruling party, but is higher than the proportion of the local governments led by them (1.6%). 47.9% of the applications were submitted by independent local governments, but in terms of value this corresponds to only 10%. The reason for this is that the national political parties enter candidates typically in larger municipalities, the budget and borrowing capacity are much larger than those of smaller villages typically led by independent mayors. Table 4 essentially shows demand for municipal loans on the basis of political affiliation. The extent of the demand for loans before the reform and consolidation is simply estimated with the outstanding to be consolidated.

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stadium built in the city as a government project that they had obviously received this gift, *'because they had behaved properly'.* (2) An interim mayor election will be held in Hódmezővásárhely in February 2018. However, the Minister responsible for the Modern Cities Programme promised that funds might 'not be granted in the same way' under the programme if the independent candidate were elected as opposed to the candidate affiliated with the government. Seeing these examples, we can remember Kornai's (1980) words: *'The need for projects is not limited by fear from loss or failure. (…) Projects are gifts to the applicants.'*

[15] Two decisions were cancelled and in connection with 10 transactions the specific decision of the government is not included in the decision. Furthermore, borrowing by four associations and one national ethnic minority government was not taken into account in the analysis. In our analysis, we use the term 'borrowing' regardless of whether bonds were issued, sureties were assumed, or transactions involving deferred payment or financial leasing took place, or whether the application is aimed at debt renewal, contract amendment or new borrowing.

According to the order shown in Table 4, this is 71%, 7% and 22%, respectively (Kornai, 2014). Consequently, it can be established that the intention of independent-led local governments to borrow has declined significantly. This may mean a decline in borrowing by smaller towns and villages, which may be caused by these local governments not fulfilling the borrowing rules (see condition No 4), or these smaller local governments are not found creditworthy as a result of the more cautious lending policy of banks. The significant administrative burden of the procedure may be deterrent.

Approval rate of borrowing approval applications by political affiliation

Table 5

Political affiliation	Number of applications			Amount stated in the application (HUF bn)		
	Approved	**Rejected**	**Approval rate**	**Approved**	**Rejected**	**Approval rate**
Governing party	314	25	92.6%	324.8	16.2	95.2%
Opposition	23	11	67.6%	7.9	9.6	45.0%
Independent/Other	301	42	87.8%	28.8	11.2	71.9%
Total	638	78	89.1%	361.5	37.0	90.7%

Source: Based on figures from government resolutions and the National Election Office

Examining the decisions, it can be said that while the central government approves 89.1% of the applications, it approves less than 70% of the applications associated with opposition parties. The differences are even greater in the volume approved: in this respect, local governments affiliated with opposition parties received approval only for less than half of the loan amounts they wanted to borrow (Table 5). The reason for this, however, is not necessarily a political bias: it is conceivable that the opposition local governments are in a fundamentally worse budgetary situation (e.g. this can also justify the opposition leadership), and not even objective conditions are met during borrowing. Since the reason for rejection is not indicated in the government resolutions, it is attempted to evaluate the financial situation of local governments as a factor explaining rejection by checking the fulfilment of the objective conditions for borrowing. This is carried out by simple, descriptive statistical tools on the basis of data in municipal reports. To remind the reader, the relevant legislation sets the following four conditions for borrowing:

1. it does not jeopardise the level of government debt;[16]
2. it is related to the performance of a statutory task and the continuous payment for operating expenditure is ensured;
3. the local government has imposed the local taxes established by law;
4. the municipal debt rule is fulfilled.

We may conclude, that based on the government resolutions all transactions were related to the tasks of local governments (where indicated) and local governments did impose the taxes required for borrowing. The existence of the operating capacities was assumed in the case of local governments where the operating budget had been balanced (i.e. had a surplus). To verify compliance with the debt rule, the debt service of the new transaction was compared to the borrowing limit of the local governments concerned, which was calculated on the basis of the statutory revenues and the debt service in the given year (without taking into account the charges relating to the new transaction). It can be established that the transactions associated with the opposition perform better according to both considerations: there was an operating deficit in one case, while the debt rule was not fulfilled in four cases. The worse-than-average situation of independent local governments, as previously noted, may be caused by a smaller municipality size, which may also play a role in access to credit sources. (Table 6) Based on this, it can be assumed that the refusal of borrowing by local governments affiliated with the opposition is not affected by the financial situation of local governments. Consequently, hypothesis

[16] As the impact on government debt cannot be checked on its own, only on the basis of the financial management of local governments, we do not evaluate this criteria.

H3 is accepted: during the approval of borrowing between 2012 and 2017, the signs of political clientelism can be found in approvals by the central government. In addition, it was shown that access to credit sources by smaller municipalities was limited in the new legislative environment.

Fulfilment of the conditions for operating margin and the debt rule in borrowing approval applications by political affiliation

Table 6

Political affiliation	Operating balance			Fulfilment of debt rule		
	Deficit	Surplus	proportion of those with deficit	not fulfilled	fulfilled	proportion of those not fulfilling the rule
Governing party	65	274	19.2%	65	274	19.2%
Opposition	1	33	2.9%	4	30	11.8%
Independent/Other	94	249	27.4%	67	276	19.5%
Total	160	556	22.3%	136	580	19.0%

Source: Based on figures from government resolutions, the Hungarian State Treasury and the National Election Office

H4: The central government preserved several elements implying the softness of budget constraints from the former legislative environment and did not strengthen its efforts refusing any bailout, thus budget constraints remained essentially soft.

The previous chapter showed that the system of exceptional aid is still in place in the new legislative environment, and the weaknesses of the Debt Settlement Procedure Act were not reviewed as one of the pillars of fiscal discipline either. The approval of newly borrowed loans by the central government may strengthen the existence of an implicit government guarantee. In addition, the commitment of the central government in legislation to reject bailouts was not confirmed: the legislation includes the same promise, which the central government had already failed to honour once. Therefore, according to our hypothesis, the budget constraint on local governments remained soft. We cannot check the hypothesis at the sector level (it may be even impossible to do so), but we would present a point-like, textbook example.

The City of County Rank of Pécs is the county town of Baranya County, the fourth largest city after Budapest in Hungary. Its population is about 145,000. The city is one of the big winners of debt consolidation: before its debt was assumed (at the end of 2012), it had the largest debt owed to banks among cities in the provinces (more than HUF 42 billion, which is 91% of the budget of the local government). Its per capita debt (HUF 291,000) significantly exceeded the national figure (HUF 99,600). The central government assumed all bank liabilities of the local government by the spring of 2014. Three years after the debt was assumed, in the middle of the summer of 2017, the mayor of the city announced that the city had accumulated a deficit of HUF 5 billion, which might be up to HUF 9.5 billion together with the amounts owed by the companies owned by the local government. At the same time, he requested the assistance of the experts of the Hungarian State Treasury in investigating the problem and identifying the causes. One of the Members of Parliament of the city added that they expected the help of the central government in resolving the situation. A low-key response was received from the central government: *'The entity that made the trouble should also fix it.'*, while also adding that *'we are going to stand behind the people of Pécs'.* The assistance of the central government reflects this duality: it threw a lifebelt to it, but at the same time also set strict conditions (Government Resolution No 1943/2017 (XII. 12.)) As part of the bailout, the local government receives a repayable grant of HUF 6.5 billion for a 3-year term; if the local government meets the specified conditions, an additional repayable grant of HUF 3 billion may be disbursed. The bailout has the following conditions:

- the city and its institutions keep their payment accounts with the Hungarian State Treasury from 1 January 2018 until the repayment of the grant;[17]
- all assets of the city (except those the encumbrance of which is prohibited by law) is used as collateral for the repayment of the repayable grant and mortgages will be registered on all marketable properties with the Hungarian State as beneficiary;
- in addition to its transaction account, the collection order of the Hungarian State Treasury also extends to its local tax subaccount as cover for the repayable grant;
- the city continues to examine and carry out the measures aimed at savings, increasing its own revenues and implementing the structural changes commenced in 2017 also in 2018;
- the city is obliged to endure the continuous preliminary approval of and follow-up on the use of the repayable grant by the staff of the Hungarian State Treasury assigned to the task.

In addition, a three-member body, reportedly having been vested with decision-making power, was set up, which will assist the management of the city in the future. Its members include two Members of Parliament of the city and the Mayor himself. At the end of the year, the city submitted a loan application to the value of HUF 1.8 billion to the central government, which was rejected.

We started to present the situation of Pécs by stating that it was a textbook example. This is also true from two aspects: it shows how deeply bailouts are ingrained in the expectations of municipal decision-makers. The budget constraint on local governments has remained soft, and the long-term effects of debt consolidation could not be sufficiently offset by the legislative environment. However, in the case of Pécs, the central government, perhaps for the first time, demonstrated that if necessary it could impose strict conditions for a bailout. Consequently, the autonomy and opportunities of the city were significantly curtailed for the 3-year period of the bailout. Further analyses are needed to understand what led Pécs to get into such a vulnerable situation (off-balance sheet items, political reasons). However, this example, similarly to lessons drawn from the Dutch model (see Allers 2014), may be a warning sign for every city government.

Conclusions

One of the biggest questions of fiscal decentralization is the handling of the softening of budget constraints. This presents a challenge for both the central government and subnational stakeholders. This paper presented the conceptual framework of the soft budget constraint, in particular, as it relates to the financial management of local governments. With the help of the literature, it was pointed out that during the hardening of the budget constraint two main approaches could be applied: the restriction of financial management and access to external funds by administrative tools or the strengthening of the fiscal discipline of local governments. In the case of the former, the vulnerability of the central government may decrease and the financial management of local governments may become consolidated in the short term; at the same time, it may result in a significant curtailment of municipal autonomy. The establishment of fiscal discipline is a longer process, because it requires a change in the behaviour and deeply ingrained expectations of market operators.

The bailout process of local governments in Hungary between 2011 and 2014 was briefly reviewed. In our opinion, general and full bailout was not justified due to the concentrated nature of the problems. At the same time, it may provide a special interpretation of the events if they are evaluated in the relationship between the banking system and the central government. Simultaneously with the bailout,

[17] In Hungary, typically commercial banks keep the current accounts of local governments. Keeping accounts with the Hungarian State Treasury means a very strong control over the account turnover of local governments.

the central government decided to strengthen its control over local governments. A number of positive changes can be observed in the new statutory system (e.g. restrictions on operating balance, new borrowing limit, accrual-based accounting). However, the approval of loans by the central government (in fact, directly by the Government), projects a substantial reduction of access to external funds, which may also affect the level of projects, assuming, at the same time, an implicit guarantee for approved loans. The expectations for a bailout may be further inflamed by the fact that the central government kept a number of elements from the previous municipal system implying a soft budget constraint: the commitment to refuse of any bailout is not confirmed, the system of exceptional aid and the debt settlement procedure remain unchanged. The legislative environment continues to suggest the existence of central guarantees.

Practical experiences support our hypotheses. Following the reform, the financial management of local governments became consolidated, the fulfilment of the relevant convergence criteria was not jeopardised by the financial management of local governments and the vulnerability of the central government decreased. At the same time, there was a significant setback in municipal projects and projects promoted by the central government and serving local interests try to fill this void, which may inflict significant wounds on municipal autonomy. Furthermore, the new system significantly limits access to external funds mainly by smaller municipalities, which is aggravated by the fact that loan approval applications are not free from political affiliation. By giving up a significant part of their autonomy, local authorities paid a too high price for getting rid of their debt burdens. Nevertheless, the soft budget constraint remained in place: its textbook example at hand was the city of Pécs, which however provided additional lessons: the central government picked up the gauntlet and set strict conditions for another bailout. This deterrent example may represent a shift towards establishing fiscal discipline for local governments. However, for this, it is essential to review the debt settlement procedure. In the longer term, it may be recommended to delegate the approval of borrowing by the central government to lower levels, then to gradually eliminate it along with the establishment of fiscal discipline. Simultaneously, together with the restoration of the autonomy of local communities, it is necessary to return local projects to local governments.

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