

Municipal Finance in Transitional Countries

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Geçiş Ekonomilerinde Yerel Yönetimlerin Finansmanı

Abstract

This paper looks at how municipalities are financed in transitional and non-traditional economies. Transitional economies are moving from a traditional, planned or regulated economy to a free market economy. Transitional economies are also undergoing economic liberation by letting market forces set prices. These economies undergo restructuring and privatization by moving from the public to the private ownership of resources. The transition process leads to private property rights which are the basic element of a free market economy. Transitional economies are found in Asia, Central and Eastern Europe, Africa and Central and South America.

Key Words : Municipal Public Finance, Traditional Countries.

JEL Classification Codes : R51.

Özet

Bu çalışma geçiş ekonomileri ve geleneksel olmayan ekonomilerde yerel yönetimlerin finansmanının nasıl olduğunu ele almaktadır. Geçiş ekonomileri geleneksel, planlı ve merkezden düzenlenen bir yapıdan piyasa ekonomisine geçmeye çalışan ekonomileri ifade etmektedir. Bu ekonomilerde piyasa güçlerince fiyatların belirlendiği bir ekonomik serbestlik hedeflenmektedir. Yine bu ekonomilerde izlenen yeniden yapılanma politikaları ve özelleştirme uygulamaları ile ekonomik kaynakların mülkiyeti kamu kesiminden özel kesime aktarılmaya çalışılmaktadır. Geçiş ekonomileri Asya, Orta ve Doğu Avrupa, Asya ile Orta ve Güney Amerika'da yer almaktadır.

Anahtar Sözcükler : Yerel Yönetimlerin Kamusal Finansmanı, Geleneksel Ülkeler.

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Beyan

Kırgızistan-Türkiye MANAS Üniversitesi, İ.İ.B.F. Maliye Bölümü tarafından 24–27 Ekim 2007 tarihleri arasında Bişkek’te düzenlenen 2. Uluslararası Kamu Maliyesi Sempozyumunda sunulan aynı başlıklı çalışmanın özeti “The Proceedings” kitabında ayrıca basılmıştır.

1. Introduction: How Municipalities are financed in Transitional Countries

This paper looks at how municipalities are financed in two countries: Canada (a non-transitional country) and Hungary (a transitional country). The purpose of this paper is to compare the differences between the two countries and to show how far Hungary has moved away from being a transitional country. The Hungarian Government has stated that its goal is to achieve a quality of life enjoyed by the most developed Western European economies by achieving a growth rate higher than the European Union's average rate of growth. The high rate of growth is based on increasing employment and productivity. The main challenge for economic policy is to provide the required macroeconomic conditions to obtain these goals. (Government of Hungary, web site) Unlike Hungary, Canadian municipalities are financed in different ways in each province.

2. The Role of Municipalities in Canada

Canada is a federal state that includes three levels of government; federal, provincial-territorial and local. Local governments are creatures of the provinces. Under the Canadian constitution, the municipalities are the responsibility of the provinces. The provinces have the right to create, modify and disband their municipalities. They can also determine the powers and responsibilities of the municipalities and the revenue sources that the municipalities can use to finance its expenditures.

Each province has a Municipal Act that governs the creation, the powers and the responsibilities of their municipalities. The provinces also have planning acts that determine how land can be used. The assessment acts empower most provincial agencies to assess property for municipal property taxation.

2.1. Urban Issues

The concentration of people in large urban areas has created a set of benefits and costs that the municipalities and other levels of government have to deal with. Large urban areas have become the economic drivers of the Canadian economy. However, many Canadian cities have found that their revenues have not kept up with their financial responsibilities. These include caring for the increasing numbers of homeless people, the demand for additional low-cost social housing, the concerns about the level of police and fire protection, and the problem of waste disposal.

2.2. The Financial Position of Canadian Cities

2.2.1. Problems of Funding Operating Cost Budget

In many Canadian municipalities their operating cost budgets must be financed from the city's own revenue sources: the property tax, user fees and intergovernmental transfers. In most provinces municipalities are not allowed to run deficits on their operating cost budget. (City of Toronto, 2005a, 2)

2.2.2. Problems of Funding the Capital Cost Budget

Canadian cities face significant problems in financing their capital budget. They have a large backlog of capital expenditures for the maintenance of their existing capital assets, especially for public transit and new capital assets. In most provinces, the province subsidizes the municipality's capital cost.

In municipalities in the European Union are eligible to receive infrastructure funding from the European Regional Development Fund. This fund has a budget of U.S. \$260 billion to be spent over seven years. This amount is about one-third of the total European Union budget and it is financed by contributions from the governments of the European Union, from private sector contributions and from lotteries among other sources. Within the G-7 countries, except for Canada, national governments fund 15% to 30% of all operating costs and 30-100% of all capital costs for public transit. (Brittain, 2002, 559-560)

2.3. Revenue Sources Open to Canadian Cities

2.3.1. Property Taxes

All Canadian cities levy a property tax. In 1970, Ontario transferred the assessment function from the municipalities to the province. (Kitchen, 1989, p.23) The government introduced a new assessment system in 1998: market value assessment based on 1996 property values. The change came about when the government passed The Fair Municipal Finance Act on Jan. 1, 1998. Other Canadian provinces have similar legislation.

The Canadian cities use a number of user fees. City agencies impose fares on those who use its buses, subways and streetcars. The local power utilities charge fees for the use of electricity. Fees are also charged for water consumed by households. Other user fees included recreation fees, parking fees, and library fees. The fees are intended to help cover the costs of providing the services.

Canadian cities need a more efficient user fee programme. A programme that collects more of the cost of providing a service through increased user fees would make a substantial contribution to reduce the operating cost budget deficit.

Economists prefer user fees to pay for services because if the prices charged are set equal to marginal cost this would lead to an efficient use of resources (allocative efficiency). Prices equal to marginal cost also reduces consumption and lead to rationing efficiency. These prices also produce the cost-efficient method of production for the service. (Deweese, 2002).

2.3.2. Intergovernmental Transfers

Canadian municipalities receive revenue from higher levels of government through unconditional or conditional transfers. Unconditional grants can be spent by the municipalities in any way they feel is important. Conditional grants require certain conditions to be met when the grant is received. Open-ended grants specify an upper dollar limit on the amount of funds that are provided. Closed-end grants set out the operating or capital cost on which the grant is to be spent. They also set an upper limit on the size of the grant.

The federal government currently exempts all municipalities from the GST (VAT) that they would have paid on their purchases from the private sector. (City of Toronto, 2004)

2.4. Problems with the Use of MVA as a Way of Financing City Expenditures

There are two major problems with the current property tax system used in many Canadian municipalities. City officials and taxpayers argue that it is a regressive tax. A regressive tax takes a larger share of a low-income taxpayer's income than that of a high-income taxpayer's income. Kitchen argues that this is not true. (Kitchen, 2005, Chapter 10) A property tax can have its regressiveness reduced by measures that provide tax relief to low-income taxpayers. Also, a person's income does not measure their wealth. A taxpayer's wealth includes the value of the property that is being taxed.

Kitchen also argues that the property tax is a good tax because it is very visible to the taxpayer. Taxpayers can tie what they pay in property taxes to what they receive in services.

If a problem exists, they can complain to the city officials. Despite Kitchen's argument, the view that the property tax is a regressive tax and that it does not reflect a taxpayer's ability to pay has led to the use of other taxes, such as income and sales taxes.

3. Municipal Government in Hungary

Hungary has come a long way since it began moving to a non-transitional country. The central government has been actively pursuing computerized applications. This has been a national goal in order to integrate Hungary into the European Union. Combined with strong leadership, these efforts have brought results within a short period of time. (OECD, 1)

Hungary was one of the first countries, among the Central European transitional countries, to reform its municipal system and introduce rules accelerating the decentralization process. (Stec, 4) The legislation supporting the reforms was the Act on Local Self Government passed in 1990. The Act eliminated 1523 local councils that had acted for the central government in a system of 19 County Councils. (Tassonyi, 219) Many local governments were amalgamated into larger municipalities.

Hungary is a parliamentary republic and a unitary state with three levels of government. It has the central government, 19 counties and 3,167 municipalities, including 20 cities. Budapest is the capital, with nearly 2 million residents. Elections to the various assemblies are held every four years in the same year as the national elections. There are also 7 Regional Development Councils and 7 Regional Health Councils. Most of the members are appointed by the Central Government. The local municipalities have 166 development councils and other forms of government associations appointed by the municipalities.

Municipalities have a considerable amount of power over their spending and in running their own affairs. They are no longer subordinate to the county councils. A county can no longer over rule the decisions of the municipalities. The legal foundation for the system is the Constitution and the 1990 ACT ON LOCAL Governments.

In 2006 Hungary's GDP was U.S \$113.2 billion. The economy has been growing quickly. In 2006 its growth rate was 3.8%. Based on World Bank data, the Hungarian economy is now a 66.2% free market economy. Hungary is ranked 25th out of 41 countries in the European region. (World Bank website) Both foreign ownership and foreign investment is wide- spread. Hungary has a large budget deficit. It needs to reduce government spending and further reform its economy in order to meet the 2010 target date for accession into the Euro zone.

The 1990 Self-Government Act sets out the provisions for county and local governments and determines the basic principles of central and local affairs. The Act gives the local governments wider powers than they had before. Local governments not only provide local services but they are now responsible for local education.

Local governments are legal entities that may pass by-laws. Their tasks and functions are the responsibility of a representative body that is governed by an elected mayor and a council. Their decisions are subject to revision by the Constitutional Court if there is a breach of the law. If there is no breach of the law, their decisions are subject to revision by the local courts. State bodies have only normative control over the local governments. They set standards for service delivery. The Hungarian Parliament regulates the legal status and the tasks and functions of local governments. It also guarantees the operation, the financial means and the basic rules of management for local governments.

Local governments are responsible for providing many government services. The OECD survey suggests that the joint-provision of public services should be encouraged to capture economies of scale. The financing of sub-national governments needs to be simplified and made more transparent. The OECD suggests that the reform of local taxation should include a widening of the property tax and the removal of the local business tax. (Ibid)

Effective and efficient local government requires incentives from the central government and a strong awareness by the local citizens of what their local governments is doing.

This can be helped by regulations requiring transparency in the actions and of local government and by participation of local citizens in the decision-making process. The basic problem is that these are not practiced in Hungary. The regulations stipulate that municipalities only have to hold one public hearing per year. All municipalities comply with the regulation but only a small fraction of them exceed this requirement. There are no rules for the organization of these meetings and local officials can set out the agenda to avoid discussion of sensitive issues. Public meetings are poorly advertised and only a small fraction of local citizens attended the meetings.

Information sharing among local municipalities is not well developed in Hungary. Information from a number of OECD countries (Australia, Denmark and the Netherlands among others) suggests that information sharing is important and that it enhances competitive pressures on sub-national governments to improve their efficiency. (OECD 2007, 86) Hungary should introduce performance indicators to measure the efficiency of the service they provide. The major problem is who chooses the performance indicators? Local government participation is important because the financial and administrative burdens fall on them. Leverage is also low because a large share of central government transfers to the municipalities comes from non-earmarked grants.

The national government can play a constructive role by imposing and suggesting benchmarks. In Hungary there is no standard format for the presentation of municipal budgets. Also, national government oversight is necessary to ensure the validity, the reliability and the comparability of local government budgets. The central government can also help by setting standards for public meetings.

Local governments undertake a significant share of public purchases. Local government administrative standards are important to help safeguard against abuse of their spending. Hungary is one of the first countries to set up an independent board to handle complaints on procurement. The central government has set up the Public Procurement Arbitration Board to hear complaints about procurement.

Wage setting and employment conditions for public sector employment are strongly centralized in Hungary. The central government imposes a limit on the increase in permanent employees at the sub-national level. It also sets salary and wage adjustments.

3.1. The Problems Facing Local Governments

Hungary's counties and municipalities face difficult problems. Their participation in budget cutting by the central government means that they face cutbacks in their administrative overheads. At the same time, they face the problems of modernizing local government infrastructure and of making full use of the E.U. funds for development projects. There are wide disparities in GDP per capita among the regions. This reflects the uneven economic development among the regions which could be remedied by infrastructure spending to attract firms and workers to the regions.

The OECD has suggested a number of policy changes to help remedy these problems. These include separate budgets for current and capital expenditures and the use of multi-year budgets so that every municipality can plan their expenditures for more than one year. Efforts should also be made to improve the quality of municipal government reporting to the central government.

Municipal deficits are financed by the central government. If municipalities used multi-year budgets, they could be allowed to run a deficit on its current-year budgets providing that the multi-year budgets are in balance. A reconsideration of central government and sector specific laws are needed to allow all levels of governments to reduce the regulations that hamper rather than encourage improvements in public service at the local level. Local governments should be given more power to design contracts for their employees and in setting wage levels to reflect local conditions. A broadening of the property tax is under consideration as part of a reform of local government revenue system. The OECD has suggested that the reforms should include the removal of the local business tax. They also suggest that market value assessment be used as the base for the residential property tax. (OECD 2007, 75)

There are several mechanisms that make municipalities deliver balanced budgets. These include the requirement that the municipalities submit balanced budget to the central government. A deficient grant from the central government is available if the municipalities can not achieve a balanced budget. As a result, the combined budget of sub-

national governments has typically been close to balance or in surplus. Also Hungary's local governments do not have much debt. In 2005, local governments' debt was 1.9% of GDP. This compares to the central government debt of 60.3% of GDP. The data do not reflect the fact that the central government often provides grants to the local government to cover their deficits. Therefore, there is not much need for local governments to borrow. (OECD 2007, 77)

A deficit grant provides relief to the municipalities due to unforeseen financial developments. The eligibility for these grants has been tightened. Improving local government budget management would require abolishing these grants. Local governments should finance their expenditures from the taxes they impose. The introduction of multi-year budgeting may reduce the need for these grants.

Decentralization of spending responsibilities to the municipalities and the counties took place in the early 1990's. Local governments are responsible for primary education, the water supply and various areas of healthcare including general practices, non-specialized hospitals and ambulatory services. The counties are responsible for secondary education, research hospitals and other specialized services. Health care workers are public employees and they are paid from central government funds. Local government's share of total government spending is about 25%.

The average size of Hungarian municipalities is one of the smallest in Europe. A good feature of the local government system is that small municipalities are able to transfer their service requirements to the counties on the grounds that they are unable to meet their operating costs. This helps avoid costly duplication of specialized services. But some regulatory fine tuning is required. In particular, combining the services offered at the county level may help achieve lower costs and more efficient production of the service because of economies of scale. In 2007 there were 166 micro regions looking after education, social institutional, child-protection services and other services of this kind.

3.2. The Current Tax System

Hungary's accession into the European Union on May 1, 2004 did not lead to any significant changes in the tax system. The Hungarian VAT tax is based on the Hungarian VAT System (LXXIV) of 1992. In 2007, the VAT tax is 20%. There are reduced rates for food (15%) and textbooks and medicines (5%). (Hungary Government web site, V.A.T. Rates) The continuous harmonization has made Hungary's tax system compatible with the EU regulations by the time that Hungary entered the European Union in 2004. (Hungary Government web site) The framework for local taxes is based on the Act on Local Taxes of 1990.

Municipalities have the power to decide which of the available taxes they will use. Local governments are entitled to introduce the rates on property, communal taxes and local business taxes. When Hungary entered the European Union in 2004, Hungary had to adjust its tax system to comply with the requirements of the European Union. The major problems arose in local taxation.

There is excessive decentralization of local government. A proposal has been put forward to move to regional forms of local government. Experiences in other countries show that making municipalities bigger, does not necessarily reduce operating costs. Among the impediments to the implementation of a local property tax is the fact that the current local government does not have the capacity to administer such a tax. Local governments get their funding from grants from the central government. These are the most important source of revenue for local governments. The grants account for about 45% of the budgets of municipalities. Most of the grants come from the central government's income tax. These taxes make up 15% of municipal government revenues. Local taxes make up about 15% of total local government revenue. Of particular importance is a tax on business turnover which accounts for about 80% of local government revenue.

Other revenue makes up 25% of local government revenue and they include asset sales, revenue from local fees and fines and the reimbursement of the VAT tax from the central government. Most of the grants from the central government are formula-based and earmarked for specific local government expenditures. Others are cost-share grants where the municipalities have to match the grant from the central government. The system is complex and the central government is taking steps to simplify the system. Local government revenue is well below the average for a sample of unitary OECD countries. The most important tax is the business tax rather than the property tax. This tax is based on turnover and it runs counter to the principle of taxing incomes or profits. The legality of the tax in the E.U. has been challenged. The central government is aware of these problems and it will allow business to deduct the tax when they calculate their corporate income tax in 2006. In 2008 the local business tax will be completely eliminated.

Hungary has a property tax based on the size of the buildings (site- value assessment). Its contribution to local revenue is small. What is needed is an effective market-value property tax. This will require a substantial reform of the current local taxation system. An effective property tax system requires three components.

- The definition of the tax liability (who pays the tax, on what basis and with what rates),
- The assessment method, and
- The mitigation issues.

All of these issues have to be dealt with if a property tax is to be used. In Central and Eastern Europe, the Hungarian system of local government is considered to be well developed. Among the Central-European transitional economies, Hungary was the first country to reform its municipal system and introduce a decentralization process. (Stec, 4.) In 1990, the state administration was decentralized leaving a lot of autonomy to the local self-governments.

Act LXV (1990) created a new form of public administration for local governments. The Act gave the population of a municipality the right to form its own local government and to elect representatives to make decisions independently of the central authorities. (Stec, 4)

In Hungary, the public and private sectors are not yet separated. Hungary took the first steps towards creating a democratic administration and moved away from a centrally-planned economy to a free-market economy. (Jenei, 2000)

The municipal base also changed. Because of increasing deficits caused by the disappearance of central government subsidies, the state and municipalities have been forced to involve the private sector in their investments. The major problems in the coming years are whether municipalities will be able to meet the requirements set by the private sector and whether the state can speed up the reform that will make the municipalities creditworthy. (Stec, 4)

3.3. Problems with the Government Budget

In the 2006 and 2007 budget considerations dominated the Hungarian economy. In 2006 the Hungarian economy had a budget deficit of 9.6% of GDP. (OECD 2007, 8) To achieve a balanced budget, the central government increased taxes and cut expenditures.

The tax increases involve an increase in employee social contributions, the Vat tax, and business taxation. Other major reforms include reduced spending on health care, a reduction in the gas-price subsidies, a freeze in civil service salaries, a reform of the unemployment benefits, early-retirement pensions, the old age pension and disability benefits. The government also plans to reform the disability benefits and the old age pensions. Other spending reforms are underway or being considered by the central government. Tax increases and expenditure cuts will reduce economic growth in the short-run. This will bring future dividends in the form of lower inflation rates and higher rates of economic growth. The payoff depends on discipline of the budgetary process. This includes a system of binding medium-term spending limits. Budgetary reform should also be extended to the sub-national governments.

Budget reform should include the counties and municipal governments. There are potential savings in administrative overheads. Sub-national governments are responsible for providing many government services. The joint-provision of public services should be encouraged to capture the economies of scale. Financing of sub-national governments needs to be simplified and made more transparent. Reform of local taxation should include a widening of the property tax and the removal of the local business tax. (Ibid)

3.4. Local Governments

In Hungary, the local budget is constrained by only very broad centrally defined limits. Many restrictions that are found in other countries do not exist in Hungary. In Hungary, there is a requirement that the central government must approve any part of a local government budget that is financed by borrowing. The most important restriction is the limit placed on local government loans based on the amount of their own revenue sources.

The local government sector is well developed. Local governments are responsible for a large share of public services. They also have full decision making powers, compared with the many constraints found in other countries. (Szalia, 333)

It is important to have the motivation and the tools to make efficiency improvements. The sub-national governments are bound by tight rules to deliver balanced budgets. But this does not guarantee either financing or spending efficiency. Sub-national units lack a long-term perspective. They currently operate on a year-by-year budgets. Longer term budgets are a useful reform. Also, there is plenty of room to introduce increasing accounting transparency.

The introduction of a property tax based on market value assessment would help increase local government financing to meet their expenditure and the removal of the tax on business. In 1997-1998 municipal revenue were about 28% of the revenues of all governments and 11% of GDP. Expenditures by local governments made up 23% of general government expenditures and 11% of GDP. (Ibid.). Municipal spending on public education accounted for 65% of total government spending. (OECD, 2000) The municipal share from public sector investment was also high at 70-80% (OECD, 1999).

3.5. The Investment of the Municipal Sector

To meet the requirements of European Union, Hungary has agreed to improve its infrastructure and its environmental conditions. Conservative calculations of the expenditures in the environmental sector alone will require 6.8-7.6 billion Euros. (Kerkes-Kiss, 23)

Hungary infrastructure expenditures were neglected in the past. At the top of the list are the water and sewer systems because of decaying pipes. Sewage collection and treatment also needs significant investment. (Stec, 5) This is also true of garbage collection and disposal. The underinvestment in the past has caused serious water and soil contamination. Another problem area is district heating. The current meter system does not provide an incentive to consume less. Hungary needs to install new meters and to modernize its district heating generators.

3.6. How Infrastructure Investments are financed

Financing can come from three sources, the municipalities, the central government and from borrowing on the capital markets. Until recently Hungarian cities did not need to obtain external funds. The revenue came from selling state enterprises to the private sector and from central government subsidies. The local governments are now facing a situation where their assets have been sold and where the state is reducing its subsidies. As a result, the municipalities have been borrowing from local banks.

The Act on Local Government lays down the main responsibilities and financing sources for local government borrowing. The Act does not set out what share of infrastructure can come from borrowed funds. Hungarian municipalities are not totally prepared for accessing credit markets in order to meet the EU standards. The central government has passed legislation that sets out the main responsibilities for the local government financing of infrastructure internally. Local governments can also rely on the European Union for funding. (Canadian Urban Institute 7-12).

4. Summary and Conclusions

Hungary has come a long way since it began to move to a non-transitional country. It was one of the first Central Europe countries to reform its municipal system and to introduce measures to deregulate its economy to move to a free market economy. The goal of moving to a free market economy was undertaken for two reasons. To become a member of the European Union and to achieve a quality of life for its citizens that is enjoyed by the most developed Western European economies. These goals were to be achieved by raising the growth rate, increasing employment, and improving the productivity of the economy. The evidence indicates that Hungary has been successful in achieving its goals. Its growth rate has been higher than that of most other Central European countries. Its standard of living has improved, but it is still below the most developed western European countries. In 2004, Hungary archived its goal of becoming a member of the European Union. The next stage is to prepare its economy to allow it to enter the Euro currency system.

In Hungary, municipal budgets contain only one unified fund. There is no separate capital and operating budgets. The evidence indicates that the Hungarian municipal budget system is a well-functioning system which meets the requirements of compliance and expenditure control. The municipal budget process would be improved if the municipalities had separate operating and capital budgets. The use of multi-year budgeting would improve local government planning of their capital expenditures. Municipalities should raise more of their revenue from their own revenue sources. The current property tax is a site-value assessment system tax that raises little revenue. If the municipalities used a market-value assessment system, their revenues would increase even at low rates of assessment. The major problem with market value assessment is who does the assessments and what data they will use to make the assessments.

Municipality costs could be cut if the municipalities shared information and cooperated in the joint-purchasing of goods and services to achieve economies of scale. The municipalities receive most of their revenue from the central government. The rest of their revenue comes from a wide variety of local taxes such as property taxes and user fees. Hungarian municipalities also have access to the to the European Union's Regional Development Fund to finance their funding on infrastructure. The central government grants to municipalities would improve their performance if they used more ear-marked grants along with performance indicators to measure the effectiveness of the grant.

The central government introduced a new form of public administration for local governments when it passed ACT LXV in 1990. This Act allowed the local governments to have more autonomy than before. Local governments became responsible for many of the same functions as local governments in Canada. The prime difference is that the Hungarian local governments receive most of their revenue for the central government.

Canada is a federal state with three levels of government. The municipalities are the responsibility of the provinces. Each province has a municipal act which sets out the powers and the responsibilities of the municipalities. The municipalities raise most of their revenue from the property tax. Major Canadian cities are growing quickly and their revenues have not kept pace with their responsibilities. In most provinces, the municipalities are not allowed to run deficits on their operating cost budget and they are seeking other sources of revenue other than the property tax. The major problem faced by Canadian municipalities is how to raise enough revenue to finance their capital cost budgets. Canadian municipalities are seeking help from the provinces and the federal government.

Hungary and Canada are different in terms of their governmental structures. The municipalities have different responsibilities and revenue sources. But they both face the same problems in financing their operating and capital budgets.

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