Chapter 29

Eastern and Central Europe Hungary

Rapid decentralization, early over-extensions, and a slow economy lead to tighter controls and reduced borrowing.

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Lessons

Hungary's experience illustrates how myriad institutional and macroeconomic issues can converge to confound early efforts to make local governments more accountable and self-supporting. After a decade of adjustment, prospects for subnational borrowing in private capital markets are improving, but for most local governments the capacity to raise capital remains uncertain.

In the euphoria of the early transition from a command to a market economy, Hungary created a highly decentralized and fragmented government structure. Decentralization appeared to give local governments significant potential to raise own-source revenues. However, a high-tax central government and a slow-growth environment left them with little will to raise local taxes and dependent on central transfers. After an early burst of activity, municipal infrastructure spending declined through the 1990s.

The effects of delayed infrastructure spending became increasingly evident in the mid-1990s—as a result of urban population pressures and the emergence of the criteria for accession to the European Union (EU)—even as tight fiscal policy constrained transfers. Matters were complicated by the burdensome (and often conflicting) national mandates and extensive rules and regulations for local services, which absorb about two-thirds of local spending. Under economic stress, harnessed by restrictions, and lacking incentives to raise own revenues, local governments saw their revenues fall by 20 percent in real terms between 1993 and 1998.

Although sales of the substantial capital assets inherited by Hungary's local governments have helped to meet capital spending needs, the supply of saleable assets has dwindled. Moreover, after the unfettered ability of local governments to borrow led some to overextend, possibly threatening future stability, the government began tightening borrowing laws in 1995 and put a municipal bankruptcy law into effect. These laws are generally viewed as consonant with the development of private capital markets. But the shaky financial condition of local governments and the ease of entering bankruptcy have dampened private lending. The rapid growth in local government debt in the early 1990s was reversed in the late 1990s as local authorities began to pay it off.

Only one Hungarian city, Budapest, has entered the international capital market. Development of local credit markets is seen as essential to meet the growing capital needs related to EU accession. While EU grants and loans are forthcoming, matching funds will be required at the local level. To raise these funds will require improvements in local financial management and reporting as well as operational and lending vehicles that can serve the needs of the many fragmented localities.

Hungary was the first socialist country in Central and Eastern Europe to embark on the path of economic and political liberalization. As several features of the economy had been reformed earlier, many considered it better placed than its nearby peers, such as Poland and the former Czechoslovakia, to respond to the shocks of the transition from socialism to a market economy in 1989. Hungary had higher foreign direct investment than its neighbors, better export performance, and a vibrant domestic private sector.

However, Hungary also had problems. Unsustainable foreign debt combined with a propensity to favor present consumption over investment led to a foreign exchange crisis and forced the government to implement a stabilization program in late 1989. By 1997, after a long and costly period of adjustment, the macroeconomic and structural policies put in place by Hungary had created better conditions for sustainable growth. While the process of fiscal consolidation and convergence toward the European Union—particularly in controlling inflation—is far from over, the basic macroeconomic conditions for stability and growth are clearly in place (World Bank 2000).

Transition in the formerly socialist states in Central and Eastern Europe has been marked both by the move from a command economy to liberalized markets and by decentralization of government. For a highly centralized, state-dominated economy, adjusting to a market-based system is complicated. So is decentralization. Once political decentralization was introduced, however, it proceeded very quickly in many transitioning economies.

For every country in the region, legislation on local self-government represented a significant departure from the past. Subnational governments had existed in most of the formerly socialist economies, but they acted primarily as administrative arms of the central government, with no independent fiscal or legislative responsibilities. New legislation affirmed decentralization and local financial autonomy, freeing subnational governments from central control and allowing local democracy to flourish. However, while the trappings of democracy were quickly accepted, true fiscal decentralization—uniting local accountability for service delivery with local revenue raising power—has been slower to materialize. Fiscal decentralization has occurred in fits and starts, with more than a few accidents along the way.

Decentralization and the Local Government System

Hungary was the first of the Central European countries to start developing and implementing municipal decentralization. Launching a series of legal reforms in 1990 with the Law on Local Self-Government, the country decentralized the state administration, reestablished the autonomy of local governments, devolved greater responsibilities for public service provision to these governments, and ultimately tightened local budget constraints, in part by regulating municipal bankruptcy (Kopányi and others 2000).

Until 1990 the government in Hungary had been organized in a multitier system in which the central government controlled more than 1,523 local councils through 19 county councils. Hungary was a unitary socialist state, and the local councils had no separate legal identity. Under the old regime local units performed a wide range of expenditure functions but only in the capacity of agents of the central government. Local governments had little independent revenue, and even though they were charged with some spending responsibilities, few of these were independent spending functions. Some fees and duties were collected locally, but the rates were fixed by the central government. In the event of revenue shortfalls the funding needed to cover expenditures was negotiated with the central government and channeled from the central budget, mostly through the counties.

The passage of the Law on Local Self-Government in 1990 eliminated the middle tier of government—the 1,523 local councils that had served as the agents of the central government, carrying out its fiscal orders through the 19 county councils (the regional bodies).[1] The law not only abolished the local councils; it also scaled back the responsibilities of the regional bodies. Hungary was left with effectively two levels—the national state and a host of local units. At the same time the number of local governments increased dramatically—to 3,148 in 1993—as many of the former local councils broke up into discrete units along historical lines of community. For agglomerations with populations of 50,000 or more, 22 cities of county rank were established, with Budapest given the status of an autonomous municipality. The existence of so many small units has been identified as a major problem in rationalizing municipal services (see Davey 1990 and Peteri and Wright 1994).

The Law on Local Self-Government also redefined the rights and responsibilities of the two remaining levels of local government. Local governments (localities) now are directly responsible for most traditional local government functions. Some taxing authority has been devolved to these

local governments, but most expenditure responsibilities are still met through grants from the central government. The grants, though largely unconditional, are related in part to spending norms linked to expenditure responsibilities. Localities can own, borrow, and dispose of property and establish, manage, and sell public enterprises.

The Law on Local Self-Government was the first of several laws that now frame the Hungarian intergovernmental system and lay out the terms of autonomy for local governments.[2] Broadly speaking, these laws accomplished the following:

- Established that local governments are no longer agents of the center and its ministries.
- Adopted the principle that local governments should be public service entities with assigned tasks and local taxing powers.
- Accepted the principle of subsidiarity as embodied in the European Charter.[3]
- Established sets of mandatory and voluntary service activities to be carried out by municipalities.
- Accepted the principle that municipalities can be legally obligated to perform certain tasks, but that mandates should be accompanied by fiscal or other assistance.
- Defined performance standards for voluntary tasks that are the responsibility of local citizens.
- Allowed local taxing authority.
- Established that local governments have ownership rights.
- Allowed and encouraged local governments to enter into associations with one another.
- Detailed a process for municipal bankruptcy proceedings, including the authority for workouts to avoid potential bankruptcy.

Under the Law on Local Self-Government towns, cities, the capital region and its districts, and counties have equal local government rights. In principle, this has created a system of equality among local governments, but it is one in which resources and responsibilities vary considerably.

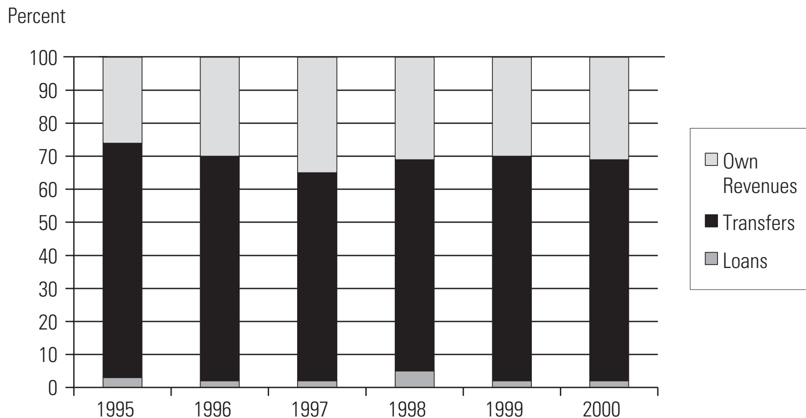
Decentralization and Subnational Finance

Hungary has a large public sector compared with those in other European countries. General government expenditure (including social security) was

about 51 percent of GDP in 1995. It declined to 43 percent in 2000, and the plan was to reduce it further to 40 percent by 2003. Correspondingly, local government expenditure fell from 16.5 percent of GDP in 1993 to 12.8 percent in 2000 (real expenditure fell by 20 percent).

The 1990 Law on Local Self-Government devolved many expenditure responsibilities to subnational governments, but it defined the tasks of local governments vaguely. The tasks are basically shared responsibilities. The central government heavily influences the legal requirements for service provision. Despite the devolution of some taxing authority to local governments, most expenditure responsibilities are still financed through grants from the central government. These grants, though unconditional, are linked to expenditure responsibilities.

The Law on Local Self-Government provided for a range of revenue sources to finance local government functions. These include five major local taxes (taxes on business, land, buildings, communal services, and tourism), user charges, revenues from entrepreneurial activities, and receipts from the disposition of rental and commercial properties. Local revenue accounted for 26 to 35 percent of total local government revenue in the late 1990s. Central government fiscal transfers accounted for most of the rest, with receipts from loans contributing 3 to 5 percent (figure 29.1).



Source: Hegedus 1999.

Figure 29.1. Sources of Local Government Revenue, Hungary, 1995–2000

Between 1990 and 1998, as general government expenditure declined by 31 percent, local revenues and receipts fell by 33 percent. Locally generated revenues and borrowing proceeds could not offset the reduction in general government transfers.

As increasing responsibilities for financing and providing services and growing investment needs for local infrastructure coincided with tight fiscal policies and smaller budgetary transfers, local governments had to respond to the mounting fiscal pressure on both the expenditure and the revenue side. On the expenditure side, they improved the cost efficiency of local services. However, they also cut costs by reducing capital investments below replacement levels, adversely affecting both the quantity and the quality of many public services. By the end of the 1990s municipal investment in infrastructure fell significantly short of the rate that would be required to meet EU standards for investment.

On the revenue side, local governments made little effort to generate more own-source revenues. Local governments also faced structural problems. Most municipalities are too small to undertake investments in projects on an economically viable scale. Moreover, the specialized financial instruments and financial intermediaries needed to meet the investment demand of municipalities are lacking.

As investment rates increase as part of the EU integration strategy and as asset sales decline as a source of investment finance, local governments will have to turn increasingly to private capital to meet the growing demand for public infrastructure and upgrade the quality of service to the levels required for accession to the EU (World Bank 2000).

Evolution of Domestic Capital Markets

Capital markets in transitioning economies generally are still in the early stages of development. This is reflected in the number and variety of institutional investors (insurance companies, pension funds, mutual funds) and the resulting depth of markets. It is also reflected in the still-immature market infrastructure (primary and secondary markets, rating agencies, analysts) and market regulation (disclosure requirements) and in the markets' small capitalization, turnover, and range of products (table 29.1).

Hungary's capital markets, though put in place before the postsocialist reforms of the early 1990s, got off to a slow start. Capitalization was low as a result of several factors—the gradual approach to privatization (until late 1995), the lack of development of the institutional investment sector, and

Table 29.1. Equity and Debt Markets, Selected Countries in Central and Eastern Europe, End-1995
(millions of U.S. dollars, except where otherwise specified)

	Czech Republic	Hungary[a]	Poland[b]	Slovak Republic	Slovenia
Equities market					
Market capitalization	17,992	2,850	4,564	5,329	306
Market capitalization as a percentage of GDP	40.3	7.1	3.9	30.6	1.7
Annual trading volume	4,713	764	4,861	840	341
Number of listed shares	86	42	65	21	18
Average daily turnover	20	3	20	3	1
Bond market					
Market capitalization	3,302	1,135	5,235	6,091[c]	338
Market capitalization as a percentage of GDP	7.4	15.1	4.4	6.5	1.9
Annual turnover	2,617	1,276	1,654	521	176
Number of listed bonds	23	38	13	32	16
Average daily turnover	11	5	7	2	1

Note: Figures refer to trading at the stock exchanges and exclude the Czech and Slovak securities exchanges and the Bratislava Options Exchange.

a. Equities turnover and capitalization include shares, investment fund certificates, and compensation vouchers. Bond turnover and capitalization include government and corporate bonds and treasury bills.

b. The Poland Stock Exchange replaced the listing system with a three-market division in 1995. The shares shown as listed here trade in the main and secondary market.

c. In September 1995.

Source: Bokros and Dethier 1998.

a burdensome tax structure due to the large government sector. Capital market development also was constrained by a preference for corporate placements without the issuance of new equity shares, large foreign direct investment flows that favored joint ventures, and the bond market's focus on meeting the national government's large fiscal needs, crowding out private investment.

Nonetheless, Hungary had started out ahead of its neighbors. The government began money market and capital market reforms as early as 1983, when it allowed the reintroduction of corporate bonds. Indeed, Hungary was more effective at developing its bond (debt) markets than its equities markets. While the equities market capitalization was only $2.9 billion, or 6 percent of GDP, at the end of 1995, the bond and treasury bill market had a capitalization of about $6.5 billion in March 1996. The total debt turnover on the Budapest Stock Exchange was $1.2 billion in 1995. Over-the-counter trading accounted for another $12 billion in 1995, with

turnover values in government bonds and bills 6 to 12 times those on the stock exchange.

The government dominated the debt markets. In 1995 corporate bonds accounted for less than 1 percent of bond capitalization and turnover in the Budapest Stock Exchange and 5 percent of bond turnover in over-the-counter trading. Driving the government's dominance were its large fiscal deficits and debt payments.[4] Deterioration in Hungary's macroeconomic fundamentals prompted a decline in Hungary's international credit ratings in early 1995.[5]

Local Government and the Capital Market: The Early Phase

The evolution of the municipal credit framework in Hungary can be divided into two general phases. In the first, from 1990 to 1995, controls on subnational borrowing were essentially based on market discipline. Local governments had little experience with this concept of market access, nor had they needed to worry about it. Before decentralization, the large number and amount of grants available from the central government led most municipalities to behave in ways aimed at maximizing grants. Moreover, the large receipts from the privatization of municipal assets meant that local governments had no need to access capital markets to finance their development spending. Accordingly, constraints on the demand side were the main factors in the limited use of capital markets to finance capital spending.

In 1990, however, local governments in Hungary acquired new financing needs as they became responsible for capital expenditures in the service areas assigned to them. These new expenditure responsibilities, compounded by the requirements for meeting the standards relating to EU accession conditions, brought with them huge financial needs.

The main sources of financing for local government investments in Hungary are receipts from property (sale of assets), grants from the central government, loans, and operating surpluses. In 1995–97 receipts from local government asset sales accounted for about 70 percent of total investment funds. Since 1997 this share has declined, however. The second most important source of funds is capital grants, which account for 20 percent of investment funds.

The Law on Local Self-Government granted municipalities the authority to borrow freely for capital investment projects, without approval from or registration with a higher level of government. Thus from 1990 until March 1995 municipal governments faced no absolute or formula-based limit on borrowing and could borrow for whatever purpose and on whatev-

er terms the city council approved. (Short-term borrowing for liquidity management can be initiated by the local mayor, while long-term borrowing to finance infrastructure investments and property improvements requires the approval of the local assembly.) There were, however, restrictions against using shared revenue, transfer payments, normative grants (such as equalization grants), and infrastructure grants from the central government for repaying loans (implicitly, the central government would not finance a local government's debt). In addition, the Law on Local Self-Government stipulated that the central government would not assume responsibility for local debt.

From the outset, bank loans have been the largest source of credit. The national government provides some subsidized loans, but most funds are borrowed from banks, carry market interest rates, and have medium-term (five- to eight-year) maturities. While private banks are free to lend, state-owned banks dominate lending (as well as other intermediation services). The National Savings Bank (OTP) early on had a near monopoly of loans to local governments, accounting for 99 percent of lending to municipalities in 2001. The bank's portfolio of loans to municipalities, which has been increasing continuously since the end of 2001, grew by 35.6 percent in 2002, reaching 63.3 billion forint (Ft). However, while the total volume increased, the bank's share of the municipal loan market fell to 55 percent (OTP Bank 2003).

In obtaining loans, localities may pledge as collateral properties they own, except for vital core properties such as streets, public parks, and common areas. County guarantees for local borrowing, common in the past, remain legally possible but are not a promising security, mainly because the counties no longer have secure revenue sources. The counties' role as guarantor has diminished accordingly.

In the early 1990s some localities had strikingly high levels of debt, stemming from local councils' borrowings for projects under earlier regimes and carried over into the new framework. Under the earlier system repayments due on any borrowings approved under the national credit plan were guaranteed by the national government. After the reforms this debt became the responsibility of the new local governments, and for some it was a major burden. Moreover, given the loose regulation, it was seen as a potential threat to the national treasury.

After enactment of the Law on Local Self-Government, municipal borrowing grew quickly. In 1991 local governments took Ft 4.5 billion in credit, and in 1992, Ft 7.5 billion. Still, the amount in 1992 constituted only

1.5 percent of total local budget receipts. In 1993 the share of borrowing rose to 4 percent.

Most localities used their borrowing authority cautiously. However, the changes in—and uncertainty about—the revenue system and the abolition of credit planning and central guarantees for local investment put municipalities in a new position. By the mid-1990s some municipalities had begun to borrow long term to finance short-term operating deficits, a practice that at the time was not prohibited. Other borrowing was largely to finance investments in nonmandatory infrastructure (activities not mandated by the state).

As a result of the unfettered freedom of local governments to manage their assets and budgets, the central government faced the possibility of dealing with hundreds of cases of contingent liabilities and directly carrying out mandatory local tasks if local governments failed. Indeed, localities began to default, and both creditors and debtors began to lobby for large-scale state bailouts. Representatives of several commercial banks explicitly stated that loans to these localities were for the public benefit and therefore ought to be bailed out by the state.

In late 1994 and 1995 the Hungarian government had several policy options for controlling municipal borrowing and protecting the solvency of the state budget. One was to declare "no responsibility" for borrowings by local governments. A second was to impose restrictions under existing legislation and create a monitoring and enforcement mechanism. A third option was to rely on an informal agreement with the major financial institutions involved with local governments, asking them to enforce debt limits and restrain excessive borrowing. A fourth option was to rely on market discipline and transparency to screen out risky clients and penalize bad decisions by borrowers and lenders.

Municipal Debt Financing: The Post-1995 Phase

In the second phase of municipal borrowing, following 1995, the central government instituted regulation of local government borrowing and dealt with the consequences of impending municipal defaults. New laws, along with the tight fiscal conditions in the country, placed curbs on the growth in subnational borrowing and began to rein in its use. The government enacted three key measures: a limit on debt service for local governments in 1995, the Municipal Debt Adjustment Act in 1996, and the Securities Act in 1997 (which included rules on issuing municipal bonds).

With the Law on Local Self-Government of 1990, Hungary's local governments had become independent entities subject only to the supervision of

the Parliament, with no intermediate layer of government or administration to approve, monitor, or intervene in their financial activities. Nonetheless, some national oversight continued. The State Audit Office monitors the technical, accounting, and reporting aspects of the use of state funds by local governments. However, while it issues opinions on the use of funds, it cannot punish violations. The Public Administration Offices issue opinions about the formal compliance of local government decisions with the Constitution and other laws but do not comment on the effectiveness, content, or reasonableness of local government actions (Jókay, Szepesi, and Szmetana 2000).

Without the political will or the ability to tightly control local government borrowing and business practices by constitutional and legislative fiat, the Hungarian government decided to propose a municipal debt adjustment (bankruptcy) law that would be invoked if prudence and other preemptive measures failed. Hungary's corporate bankruptcy law, in force since the late 1980s, did not entirely apply to municipal borrowers, since they could not be liquidated unless the state took over their duties. Because every citizen has a constitutional right to representation at the local level, local government cannot be liquidated like a commercial enterprise. Accordingly, a coherent policy geared to governments was needed to define debt adjustment procedures.

The state's aim was to avoid having to take on the contingent liabilities of local governments and to ensure the continuance of vital public services without additional strain on the national budget. Thus its approach was to regulate the process wherever possible and to allow market actors to assume risk. The debt adjustment law would protect debtors, creditors, and the state budget while making it entirely clear what would happen in the case of municipal default. Rather than the tight allocation regulations known in Europe, the Hungarian government decided that both lenders and borrowers should be held responsible for their decisions, while it put in place mechanisms for ultimately protecting mandatory services.

The Municipal Debt Adjustment Act of 1996, in effect since mid-1996, is the centerpiece of the new municipal borrowing framework. The law defines a debt adjustment process aimed at allowing local governments to regain their financial health while also protecting the rights of creditors. Its provisions, which impose definite costs on local governments that default on debt or other payments, also lend protections to debtors and limit the powers of creditors. There is strong evidence that the law has prevented bankruptcy filings by encouraging both creditors and debtors to seek redress outside the court system and take steps to ensure solvency and operational efficiency.

Under the new legal framework, municipalities stopped borrowing beyond their capacity to service debt (Kópanyi and others 2000). Debt service as a share of own-source revenue has been well below the limit of 70 percent authorized in the 1996 amendment.[6] In 1998 local government debt service as a whole was well under 30 percent of own-source revenue.[7] By early 2000 there had been only 9 court filings for bankruptcy and about 60 bankruptcy threats that resulted in out-of-court agreements between the local government and its creditors.

Nonetheless, the municipal bankruptcy law is not without its drawbacks. It has been criticized, for example, for essentially eliminating municipal capital borrowing. Since 1995 municipal medium- and long-term borrowing has been limited largely to a few big cities. Recent experience with municipal finance shows that the bankruptcy act has prompted even the smallest communities to put in place effective preventive measures to avoid the risk of asset liquidation. Moreover, financial institutions have been more prudent in lending to municipalities (particularly for gas and wastewater projects). The municipal bankruptcy framework has performed effectively in Hungary's market-oriented legislative and institutional environment.

Bond Issue by the Municipality of Budapest

Budapest, the capital of Hungary, is home to 2 million inhabitants and a consumer market of around 5 million. With more than 90 percent of the nation's service industry and 60 percent of its research and development capacity, Budapest produces more than a third of Hungary's GDP. In Budapest services account for a large share of income and employment—a share nearly 20 percent larger than the national average—and the unemployment rate is much lower (Pallai 2000).

The challenge for Budapest, as for other municipalities, was to use the framework created by the Law on Local Self-Government of 1990 to transform the financial and administrative system it had inherited from the socialist era. Since only fiscal stability and independence could provide the basis for political independence and greater fiscal autonomy, it was clear that own-source revenues would have to be increased. Greater own-source revenues were needed to ensure not only financial independence but also the long-term security of services for which municipalities were now responsible.

While Hungary faced serious macroeconomic and fiscal problems in the mid-1990s, Budapest also confronted a structural deficit. Part of the strategy to remedy the situation was to focus on increasing its own revenues

through taxes and charges rather than fighting to restore earlier levels of central transfers. The new financial strategy was aimed at shifting to an active borrowing policy, entering the capital markets as a fully autonomous entity, and building a loan portfolio that spread financing risk. To adopt an active borrowing policy, Budapest had to increase its financial reserves to the equivalent of at least one year's debt service obligations.

Until 1996 the municipality borrowed primarily from domestic banks (domestic currency loans) and from two international financial institutions, the European Bank for Reconstruction and Development (in 1993) and the World Bank (in 1995).[8] The loans were raised on the principle of negative pledge; only the assets created through the project financing were pledged, not tax revenue or assets of the municipality.

In 1996–97, with a relatively small debt burden, a large investment portfolio, a well-regarded privatization process, and growing confidence in the country, Budapest appeared ready to enter the international bond market to raise finance. In 1996 the city decided to issue its first bonds in the eurobond market, targeting public investors. Budapest also decided to issue bonds without a rating because the city could not get a higher credit rating than the country. A two-round tender was conducted to select the lead manager. Ultimately, however, the issue had to be postponed because of a change in the national tax law.

In 1998, after amendment of the tax law, Budapest decided to launch its eurobond issue (table 29.2). In the meantime Hungary's sovereign rating had improved from speculative to investment grade (Moody's Baa2), and the city's financial status had strengthened. The municipality did not seek a rating of its own, but it compiled an information memorandum for the sale. The five-year bonds were issued at a 57–basis point "surcharge" over the Bundesbank bond of the same term and obtained a 35–basis point premium over the London interbank offered rate (LIBOR). The Hungarian National Bank issue in February 1998 had a 31– to 33–basis point premium over LIBOR. Thus the market assessed the risk of the municipality's bond as similar to the country risk. Institutional investors subscribed to 20 percent of the bond issue, and private investors, mainly on the German and Austrian money markets, to the remaining 80 percent (Pallai 2000).

Bond Issue by the Municipality of Pecs

With a population of about 160,000, Pecs is the fifth largest city in Hungary. It is situated in the south of the country, close to the Croatian border.

Table 29.2. Terms of the Bond Issue by the Municipality of Budapest

Amount	DM 150 million	**Paying agent**	Deutsche Genossenschaft Bank
Type of bond	Fixed rate		
Form or denomination	Global bearer bond	**Debt service**	0.37 percent of 1999 budget
Issue date	23 July 1998	**Authorization**	General assembly, mayor's office
Maturity	Five years	**Supervision**	Capital Market Supervisory Board
Amortization	None; bullet		
Interest rate	4.75 percent	**Purpose**	General funding purposes
Interest payment	Annual	**Use of proceeds**	Infrastructure and financial reserves
Rating	None		
Security	Unsecured	**Performance**	Punctual
Cross-default	Capital market obligation	**Other debt (as of 1 January 2000)**	Ft 4,093 million
Law	German		
Listing	Frankfurt Stock Exchange	*Long term (more than one year)*	1.63 percent of total budget
Lead manager	Deutsche Genossenschaft Bank	**Other debt service**	0.13 percent of total budget

Source: Pallai 2000.

Since coal and uranium mining were discontinued in the early 1990s, light industry and the service sector have grown, complementing the traditional food, tobacco, and leather industries.

Pecs floated its first bond issue of Ft 150 million in 1997, using the proceeds for general purposes (table 29.3). The bond issue amounted to only 1 percent of its 1997 budget and therefore had no material impact on its financial situation. Of the municipality's total revenue in 1997, 40 percent came from central government subsidies, 16 percent from local taxes and fees, 16 percent from privatization receipts and other capital revenues, 14 percent from municipal services and other operating income, and 13 percent from personal income taxes. Of its total expenditure, 34 percent went to salaries and wages, 26 percent to maintenance, 16 percent to social security, 12 percent to investments and associated costs, and 10 percent to operating expenses. At the time of the bond issue the municipality had more than Ft 1.5 billion in outstanding debt.

No credit rating was contemplated for the issue because of its small size, its private placement, and the fact that it was guaranteed. Moreover, as a private placement, the issue required only the standard minimal documentation and limited due diligence and was fully underwritten by the manager.[9] Because there were only a few potential investors for this unlisted issue

Table 29.3. Terms of the Bond Issue by the Municipality of Pecs

Issue date	6 February 1997
Issue	Ft 150 million in bonds at 16.4 percent annual interest, fixed rate, at par
Purpose	General funding purposes
Status and security	General obligation and guarantee
Form and denomination	Registered notes; Ft 10 million
Guarantor	Raiffeisen Unicbank Rt.
Market	Hungarian domestic market, direct placement
Maturity	Five years (6 February 2002)
Amortization	Bullet due at term
Rating	None
Law	Hungarian
Listing	None
Lead manager	RSI Hungary Securities Ltd.
Paying agent	Raiffeisen Unicbank Rt.
Performance	Punctual
Public participation	None
Other debt at 1 January 1999	Short term (less than one year)
Total amount	Ft 908 million
Total amount as a percentage of the 1999 budget	6.3 percent

Source: Municipality of Pecs [http://www.fornax.hu/].

(primarily insurance companies), no public marketing took place. Indeed, the issue was a "bought deal"—that is, it was placed with one insurance company as the sole investor. The offered price was considered competitive and therefore was accepted by the city. Since the investor planned to hold the issue until maturity, no trading and no secondary market could develop. The size of the transaction (less than $1 million) made an international placement infeasible.

When Pecs had considered its funding alternatives in mid-1997, market conditions favored bonds over loans. Short-term rates were slightly above 20 percent, and the benchmark five-year forint government bond was trading at about 16 percent. The bond offer, including the guarantee fee, was considered to be at least 75 basis points cheaper than a bank loan with a similar maturity.[10] The lead manager offered a five-year fixed rate bond issue—the standard for the municipal private placement market. The municipality had received bond offers at even more advantageous terms relative to loans. Since the fixed rate bond seemed substantially cheaper than floating rate notes, it accepted the offer.

The Pecs issue was guaranteed by a commercial bank, and both the guarantor and the lead manager are subsidiaries of a foreign bank. Like all domestic, privately placed municipal debt issues until then, the Pecs issue carried a bank guarantee. The bond issue for Budapest that followed in 1998 was placed without such a guarantee.

Prospects for a Larger Municipal Credit Market

Local government finance in Hungary remains in transition, and much still needs to be done to ensure that the decentralization of government activities is economically efficient and politically sustainable. Under the Law on Local Self-Government localities assumed far greater spending responsibilities. With local own-source revenues inadequate and the sale of assets coming to an end, new sources are needed to pay for these responsibilities. While local governments, needing to catch up on deferred investments and anxious to meet EU accession requirements, have looked to domestic capital markets to meet their investment needs, private investors' interest in supporting these needs remains unclear.

Several trends have had powerful effects on municipalities in Hungary. These include the declining contributions to municipal budgets from the central government, the drop in income from the one-time sale of public assets, and the growing needs for project and infrastructure development. Strapped for funds to meet operating needs and unable or unwilling to raise local taxes, localities have seen investment in infrastructure shrink as a share of GDP, from 3 percent in 1991 to about 2 percent in 1997. Hungary's municipal debt market remains embryonic. There have been few bond sales, and bank loans have remained the dominant source of borrowing for local governments.

However, a growing number of factors, on both the supply and the demand side, may encourage a larger municipal credit market in the near future. Hungary has taken steps toward regulation that leaves capital markets relatively untrammeled and has sought to clarify the allocation of risk. Such regulation is part of the legal, regulatory, and institutional framework critical to the development of an efficient subnational capital market—a framework that provides the foundations for a market in which private investors and financial intermediaries compete to mobilize financial resources from savers. The goal is to correctly price the extension of credit and efficiently allocate capital among subnational government investments.

Several pieces remain to be fitted into this mosaic, however. At the national level the burden of excessive regulation and a costly central government needs to be eased to give local governments greater fiscal flexibility. The excessive fragmentation of local government, which inhibits economies of scale and the efficient delivery of services, needs to be cured. At the subnational level the capacities of local governments to finance projects, program investments, manage financial policy, and manage revenue and debt must be strengthened.

Notes

1. Budapest enjoyed special status as a county and municipality and was directly represented in the central government planning process.

2. The others include the laws on Local Taxes (1990), Elections of Self-Governments (1990), Property Transfer (1991), Tasks and Authorities Competencies (1991), the Capital City and Its Districts (1991), Municipal Bankruptcy (1996), and Debt Management (1996). See Ebel, Varfalvi, and Varga 1998.

3. The principle of subsidiarity calls for examining two criteria when considering which governing body should have jurisdiction over a problem. First is the size of the problem: if an issue encompasses many local communities or extends over a large geographic area, the involvement of a higher level of government may be necessary. Second is the resources or political will of a local community: if they are inadequate for addressing the problem, a higher level of government may intervene.

4. To provide incentives to investors to purchase government securities, the government provided two tax breaks: up to 30 percent of income on government bonds held for more than three years and a 10 percent tax on government paper (as compared with the 10 to 20 percent tax applied to equities).

5. Hungary has a positive reputation for debt service in international capital markets. Standard and Poor's has given it a BB+ rating with a stable outlook. Moody's has rated Hungary's sovereign unsecure rating A1 rating for both local and exchange currency issues.

6. Debt is defined as including loans, bonds, guarantees issued on behalf of third parties, and lease agreements. Own current revenues are defined as including local taxes, duties, interest revenues, environmental fines, and other own revenues. This definition excludes the revenues of institutions (rent, user fees), although these are also included in local government bud-

get tables as part of own local revenues. Own local revenues are "corrected" by subtracting short-term liabilities (not including cash flow credits, which are used to ensure funding of local government operations).

7. These data do not include guarantees and leases, so the available borrowing capacity is lower than can be directly estimated (Pigey 1999).

8. These initial loans from the European Bank for Reconstruction and Development and the World Bank were for investments in public transport.

9. The manager's commission and the annual guarantee fee are part of the overall pricing but were not disclosed.

10. This figure is an estimate, since the precise size of the guarantee fee was not disclosed.