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**FINANCING STRATEGY FOR THE BUDAPEST  
MUNICIPAL GOVERNMENT PROGRAM  
1995-2000**

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## **Introduction: method for designing the financial program for the city**

Following the elections in 1990 one of the Parliament's first decisions was the Law on Local-Self Government, which placed the local governments on completely new grounds, including their management. The local governments, in order to cover their tasks, dispose of central grants (normative grants, addressed and targeted grants, etc.), split revenues (personal income tax, motor vehicle tax) and own-source revenues (institutional incomes, local taxes and other incomes) and were given substantial properties (public works and enterprises, public rental housing, etc.) for the same purpose. Regarding the financial regulation of the local governments, the former "expenditure regulation " has been succeeded by "resource regulation", that is *in its intention* based on normatives.

23 local governments of equal rights have been formed in Budapest, where the basic local government licenses have been transferred to the 22 districts<sup>1</sup>, and the Municipal Government's task is the provision of the services that concern the whole of the city and the exercise of the right of regulation in certain fields. A unique feature of the budgets of the city and district governments is the *split of resources*: from among the split revenues the personal income tax, the per capita normative grants and the local industrial tax revenues are annually reallocated based on the division of tasks set by the Capital Act.

In 1993. there has been a resolution taken to work out the program of Budapest for the years 1995-2000. Metropolitan Research Institute has got the task to coordinate this work, together with one of the special counselor of the Cabinet Office of the Mayor of Budapest. The main aim of this project was to analyze sector programs (based on the work of experts of the given fields), put together their financial requirements and work out the financial projection of the capital city budget comparing the requirements with the projected revenues. In this paper we try to give an overview of the possible direction of the future financial management of the Budapest Municipal Government.. The elaboration of the financing strategies is done in five major phases:

1. Reviewing the Municipal Government's revenues we are focusing on the possibilities to have an increase in the individual revenue elements;
2. Reviewing the costs related to the service sectors controlled by the municipality (public works, education, culture, etc.);
3. Projection for the financial possibilities for the Municipality based on the revenues and the operating costs

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<sup>1</sup>Budapest has a two tier system, where each district has its own mayor, local assembly and local budget.

4. Establishing a prognosis about the magnitude of developments and renovations to be completed by 2000, based on alternative forecasts of revenues and expenses.

5. Projection for the financial gap the city is going to face in the period of 1995-2000.

These elements together constitute the fiscal background of the program, and mark the scope of the sectors programs.

**Table 1 Revenues of Municipality of Budapest 1991-1994 (in million HUF)**

	1991		1992		1993		1994	
<b>1. Total central sources</b>	<b>40.605</b>	<b>71,9%</b>	<b>46.971</b>	<b>70,1%</b>	<b>46.604</b>	<b>64,7%</b>	<b>55.190</b>	<b>62,3%</b>
Intergov. trans.	15.677	27,8%	17.305	25,8%	20.018	27,8%	21.759	24,5%
Personal Income	9.403	16,7%	12.140	18,1%	9.339	13,0%	11.683	13,2%
<b>Tax</b>								
Social security	15.525	27,5%	17.526	26,1%	17.247	24,0%	21.748	24,5%
<b>contr.</b>								
<b>2. Own sources revenues</b>	<b>11.142</b>	<b>19,7%</b>	<b>16.371</b>	<b>24,4%</b>	<b>20.153</b>	<b>28,0%</b>	<b>28.618</b>	<b>32,3%</b>
Current revenues	8.156	14,5%	14.322	21,4%	17.312	24,1%	17.479	19,7%
Capital revenues	2.986	5,3%	2.049	3,1%	2.841	3,9%	11.139	12,6%
<b>3. VAT Income</b>	<b>1.084</b>	<b>1,9%</b>	<b>949</b>	<b>1,4%</b>	<b>1.498</b>	<b>2,1%</b>	<b>1.932</b>	<b>2,2%</b>
<b>4. Residual Fund</b>	<b>2.539</b>	<b>4,5%</b>	<b>1.962</b>	<b>2,9%</b>	<b>3.696</b>	<b>5,1%</b>	<b>2.391</b>	<b>2,7%</b>
<b>5. Other Revenues</b>	<b>1.066</b>	<b>1,9%</b>	<b>784</b>	<b>1,2%</b>	<b>31</b>	<b>0,0%</b>	<b>524</b>	<b>0,6%</b>
<b>Total Revenues</b>	<b>56.436</b>	<b>100,0%</b>	<b>67.037</b>	<b>100,0%</b>	<b>71.982</b>	<b>100,0%</b>	<b>88.655</b>	<b>100,0%</b>
<b>Loan</b>	<b>579</b>	<b>1,0%</b>	<b>547</b>	<b>0,8%</b>	<b>6.321</b>	<b>8,8 %</b>	<b>6.733</b>	<b>7,6 %</b>

## 1. The revenues of the capital's budget

The analyses of the 1991-93 budgets clearly proved the appearance of a regional policy disadvantageous for the capital. The positions of the Budapest local governments (municipal and districts) have severely deteriorated in 1991, and their share from the municipal incomes hardly exceeded the proportional part of the population (22.5% in 1992), whereas in earlier decades it was around 30% (even in 1989 it was 29%). The financial situation of the city was further hampered, when the personal income tax share of local governments was reduced from 50 to 30% by the parliament in 1993. (In 1990 local governments received 100% of the personal income taxes.) The capital disposed of funds of decreasing real value: revenues without the social security allowance increased by 21% in 1992, and by 34% in 1993 compared to 1991, whereas prices had increased by 34% in 1992 and by 66% in 1993 compared to 1991. In 1993 the Municipal Government had to take substantial amounts of loan. The planned 1994 budget renders taking further loans unavoidable for covering the basic operational and development tasks.

The data of Table 1 show that the centrally regulated revenues form a decreasing proportion of the total budget revenues: from 72% in 1991 it decreased to 62% in 1994. This means that the city had to try to counterweight the decreasing central transfers by increasing its own-source revenues. The own revenues compared to the

national figures is high and increasing: in 1992 they increased from 11 to 16, in 1993 from 16 to 20 billion HUF in a much higher pace than the total revenues of the budget.. These are the signs of the increasing fiscal autonomy of the Municipality.<sup>2</sup> (Ebel-Simon, 1994) The budget of 1994 shows the effect of politics, namely the canceling the 1996 World Expo, which eased the financial burden of the city.

### *1.1 The central revenues*

The possibilities to increase the central revenues are determined by two factors: on the one hand the trends in the general economic situation of the country and within that the modifications of the budget's positions; on the other the redistribution between Budapest and the other settlements in Hungary.

The revenues depending on the central budget (government) are the following: revenue from the shared taxes (most important is the personal income tax), normative grants, addressed and targeted grants, and the centralized funds. Different central (partly off-budget) funds may significantly contribute to the investments by the municipality.

The capital's special situation among local governments is determined by two factors: the role Budapest plays in the country's economic, political and cultural life, and its relation with the agglomeration settlements. The effects of the services ranging from education to culture provided by the municipality's institutions go way beyond Budapest's administrative boundaries. The Law on Local-Self Government and the Capital Act do not acknowledge these facts, and make the degree of compensation for the extra expenditures of the capital and the district governments related to these functions subject to individual political decisions. Due to Budapest's peculiar situation (direct and indirect) central resources are set as a result of political bargaining and a negotiation process.

#### *1.1.1 Personal income tax revenues*

Significant part of the Municipal Government's budget revenues comes from the personal income tax. The PIT calculation are always based on the taxes paid by the residents two years before. Between 1988 and 1992 even the real value of the personal income tax payments of the residents increased (in average by 4% annually). This increase is connected to the fact that the tax margins were not adjusted to the inflation rate, but it could also be explained by improving the supervision of the tax returns (much less by an increase in the real value of the households' incomes). Nevertheless, the decrease in the municipalities' share from the personal income tax from 100 to 50 and then to 30% was a substantial loss in the capital's case. It caused a total loss of 11,4 billion HUF to the municipalities in Budapest. With the new central government in 1994 the share of the local government has been increased to 35 %. (see Table 2)

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2R. Ebel and P. Simon: Financing a Large Municipality: Budapest, manuscript, 1994

**Table 2 Personal income tax revenues of the Municipal Government between 1990 and 1994**

	1990	1991	1992	1993	1994
<b>Total PIT* (in billion HUF)</b>	117	147,6	185,5	248,8	283,1
<b>PIT in Budapest (in billion HUF)</b>	24,9	33,5	43,3	57,0	71,6
<b>Share of Budapest</b>	21,3%	22,7%	23,3%	22,9%	25,3%
<b>Local Governments Share</b>	100%	50%	50%	30%	30%
<b>Total PIT tax revenues for Budapest LGs</b>	24,9	16,8	21,7	17,1	21,5
<b>PIT in Municipal Government</b>	12,5	9,4	12,1	9,3	11,7
<b>Real value of PIT at 1990 prices</b>	24,9	25,0	26,5	28,7	29,5

\*two years earlier data

### 1.1.2 Normative grants

The normative grants are unconditional transfers, the aims of which is to cover the major portion of the cost of certain services. In the last four years the individual normatives had been annually modified in the budgeting process. Whereas in 1992 and 1993 as a result of a modification "counter weighting" the decrease in the personal income tax revenue the Budapest local governments (district and municipal) got similar amounts in real value compared to the previous year, the real value of the grants decreased in 1994 by 4,5 billion HUF.

**Table 3 Normative grants (1991-1994)**

	1991	1992	1993	1994 (planned)
<b>Total for LG sector (m HUF)</b>	146.990	172.711	210.067	212.203
<b>LGs in Budapest (m HUF)</b>	25.455	29.533	36.029	35.990
<b>Share of Budapest</b>	17,3%	17,1%	17,2%	17,0%
<b>Municipal Government Budapest</b>	12.522	13.830	15.632	15.890
<b>Share of Municipal Government</b>	8,5%	8,0%	7,4%	7,5%
<b>LGs in Budapest (at 1991 prices m HUF)</b>	25.455	24.212	24.286	19.885

Source: Budget reports (1991-1992), proposal for the budget and for the split of the resources (1991-1994)

For the assessment of the changes in the normatives, one must consider that the local government's responsibilities have undergone some modifications, having increasing tasks and decreasing resources.

### 1.1.3 Other budgetary grants (addressed and targeted grants, earmarked state funds, centralized estimates)

These resources of the budget are practically centralized, and despite the need for normative (as it was originally included in the targeted construction<sup>3</sup>) are increasingly subjects to individual decisions. The capital is linked to these financial resources in two ways. *First*, investments financed from central funds are realized in or in relation with

<sup>3</sup> The system of the targeted grants needs a restructuring, as the applications arrived outnumber many times the available funds, therefore are destined to be put on the shelf for years. The proportion of newly starting projects is reduced to 10%. Thus access for the local governments to targeted grants -for new projects- is practically unprojectable.

Budapest, thus improving the capital's infrastructure even if the investment/development is not administered through the city (e.g. Expo, M0 motorway ring, construction of a new bridge, etc.)<sup>4</sup>. *Second*, the capital does actually receive grants from central resources for certain developments.

**Table 4 Other centralized funds open for all LGs in 1993 (in billion HUF)**

	1993	Note
<b>Targeted and earmarked grants</b>	<b>28,7</b>	<b>investment on normative basis</b>
<b>Centralised fund</b>	<b>15,4</b>	<b>for special targets mostly social policy</b>
<b>PIT supplement</b>	<b>6,5</b>	<b>general revenue</b>
<b>Grants for LGs with financial troubles</b>	<b>1,5</b>	<b>general revenue</b>
<b>Investments Funds controlled by ministries</b>	<b>63,9</b>	<b>Road Fund, Environment Fund, Water Fund, etc.</b>
<b>Total</b>	<b>116,0</b>	

The magnitude of the funds of the central budget and the Municipal Government's investment data indicate that the Capital receives much less from central resources than earlier.

**Table 5 Central investment grants in the Municipal budget 1991-1993 (million HUF)**

	1991	1992	1993
<b>Earmarked grants</b>	<b>1.635</b>	<b>998</b>	<b>1.096</b>
<b>Targeted grants</b>	<b>288</b>	<b>952</b>	<b>676</b>
<b>Other grants</b>	<b>1.232</b>	<b>1.525</b>	<b>2.614</b>

The analysis of the Municipal Governments' developments indicate that in 1992 for development worth 9.4 billion HUF the addressed and targeted grants were 2 billion HUF (almost 21%), in 1993 for development worth 12.4 billion the grants constituted 1.8 billion HUF (15%). 8% of the approved and used allocation for targeted and addressed funds was received by the Municipal government in 1992, and 12% in 1993.

## 1.2 Own revenues<sup>5</sup>

### 1.2.1 Local taxes

A decree of the Municipality (1991) set the rules for levying the local taxes by the Municipality and the Districts. According this rule, the district has the right to levy the

<sup>4</sup> It is an important issue, whether it would be more effective and advantageous from the entire city's aspect if the city had a chance for substantial interference. If the track of the M0 for instance was set closer to downtown Budapest, it could be much busier than the one planned, more outside in the city.

<sup>5</sup> One special and quite complicated element in local government finance issue of Budapest is the split of certain central revenues between the Municipal Government and the district governments, the share is around 55 % for the Municipal Government..

property tax, communal (poll) tax on households and the tourism tax. The only local tax the Municipality levied is the local business tax, which is an important source of revenue, the share of which has increased to 8,4 % in the budget.(This tax is levied and collected at the municipal level, and split with the districts afterwards.)

**Table 6 Local Taxes in Municipal budget 1991-1994**

	1991	1992	1993	1994
<b>Local Tax Revenues (million HUF)</b>	<b>281</b>	<b>3.930</b>	<b>6.527</b>	<b>7,425</b>
<b>As % of the total revenues</b>	<b>0,5%</b>	<b>5,9%</b>	<b>9,1%</b>	<b>8,4%</b>

### *1.2.2 Revenues from real estate and asset management*

The Municipal Government basically control three types of assets:

- The assets of the public works, and other companies. The estimated value is 150-250 billion HUF.
- Shares, mostly from the privatization with a value of 8-10 billion HUF.
- Real estate (land building) partly unused, partly used by organizations providing public services (education, social care etc.). the estimated value of this asset is 50 billion HUF.

The expectation as revenue sources from selling real estate was always higher than the reality, because the real estate market recession.

**Table 7 Revenues from selling real estate (million HUF)**

	1991		1992		1993		1994	
	planned	actual	planned	actual	planned	actual	planned	actual
<b>Real estate sold</b>	<b>260</b>	<b>386</b>	<b>4.862</b>	<b>232</b>	<b>3.000</b>	<b>523</b>	<b>4.000</b>	<b>1270</b>

### *1.2.3 Local Government borrowing*

In the beginning of the period Budapest Municipality had very little debt to manage, as the typical way of the investment follow the “pay as you go” scheme, where the total cost of the investment is paid by the LGs revenue, and was quite rare to use resources raised by borrowing.

From 1993 Budapest municipality took quite substantial loan from a bank consortium with (as it can be judged) quite favorable term, which shows the creditworthiness of the Budapest.

The borrowing by the local government is still in an initial phase, nowadays the significant parts of the loans are still handled by OTP bank. In the last few years some new loan constructions have appeared (consortium loans, bonds) and it is expected that newer banks will step into the loan business for the local government. Reliable methods for analyzing if a local government creditworthiness do not exist yet under the

Hungarian conditions. Good example for this fact is that the EBRD and a CLF (Credit Local de France) had been seeking for a partner to set up a local development bank, and they decided in 1994 for to postpone the program, because of the risk the sector could have. <sup>6</sup>In the traditional cash flow analysis for the loan taking, we have to take into consideration that the local government can only satisfy the loan payment conditions with their general incomes or by selling their properties.

The capital city government reached very good positions and it is trying to keep it this way. Until know all the base for all the loan applications was the so-called character loan. It is basically an unsecured (good faith loan) made on the basis of the borrowers reputation. The essence of this is that instead of a positive loan guarantee (pledge conditions), a negative guarantee is set, which means that the loan provider does not ask for guarantee with the condition that the loan applicant does not apply for a loan from another loan provider with guarantees (positive loan guarantee). The rest of the conditions are related to the exact payments of the loan and to a guarantee from the loan applicant to commit itself to a reasonable management of its resources. These conditions are reflected in the contract, which also states the obligation of both halves to inform each other continuously about the matter. The local government generally works with short -or medium-term loans and bonds. In the case of the city government the medium and long-term loans are the typical, and in the future this will remain this way.

The importance of Municipal government in local government borrowing is shown by the fact that a very substantial part of all LG borrowing in Hungary, which can be illustrated by the fact that National Saving Bank (OTP), which is in a position of “natural monopoly” issued in 1993 16 billion HUF loan for the whole LG sector.

**Table 8 Borrowing and debt service of Municipal Government of Budapest.**

	1992	1993	1994	1995 (planned)
<b>Borrowing (million HUF)</b>	<b>547</b>	<b>6321</b>	<b>6733</b>	<b>20009</b>
<b>Capital expenditures</b>	<b>11541</b>	<b>15274</b>	<b>22905</b>	<b>29802</b>
<b>Debt service</b>	<b>N/A.</b>	<b>380</b>	<b>2569</b>	<b>4689</b>
<b>borrowing as % capital expenditure</b>	<b>4,7 %</b>	<b>41,4</b>	<b>29,4</b>	<b>67,1 %</b>
<b>debt service as a % of current revenue</b>	<b>N/A</b>	<b>0,5</b>	<b>2,9</b>	<b>4,6</b>
<b>debt service as a % of own revenues</b>		<b>1,4</b>	<b>9,0</b>	<b>17,9</b>

In budget plan for 1994 the Municipal Government decided to take 14 billion loan in 1994, but after canceling the World Expo plan, the municipality could save some investment and could make an agreement with the government.

## **2. Financing the public services**

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<sup>6</sup>In these days several local government bankrupted, and it is open how the central government will solve this problem.

Another important element of the financial situation of the Municipal Government is how efficiently it operates services responsible for. In the Table 9 it is given the amounts earmarked to different sectors from the general budget of the municipality. These amounts represent the net municipal budget support, that is the revenues of the institutions (user charges, etc.) are deducted. The two very important sectors are education and public transport, which are responsible for more than half of the subsidies. These data refer to the operation, there is no reference to developmental issues. Developmental issues should be discussed separately.

**Table 9 Local government operating subsidies in different sectors (billion HUF)**

	1991	1992	1993	1994 (plan)
<b>Public Works</b>	2,5	3,1	3,8	3,6
<b>Roads</b>	1,0	1,4	1,7	1,7
<b>Public transportation</b>	9,6	11,2	11,6	9,2
<b>Education</b>	7,1	8,3	9,6	10,1
<b>Culture</b>	1,6	2,0	3,5	3,2
<b>Health care</b>	0,9	0,8	0,8	0,7
<b>Social care</b>	1,2	1,5	1,7	1,6
<b>Office of mayor</b>	0,8	1,3	2,0	2,9
<b>Other</b>	0,3	0,4	2,1	0,8
<b>Total</b>	<b>26,8</b>	<b>32,5</b>	<b>38,6</b>	<b>40,0</b>

The provision of the public municipal services shows the anomalies of the previous economic system. (The management, pricing, cost efficiency, quality control etc.). The program defines five areas where possible changes can be implemented:

1. It should be revised whether the quality, the quantity of the municipal services can be financed taken the possibilities of the Municipal Government and the households willingness and capacity to pay.
2. The services provided directly by the municipality or by its company, can be replaced by indirect provision (provided by non municipal entities, the private sector, non-profit corporations or foundations). One such form can be privatization.
3. It should be revised what is the extent of the organizational and structural changes that would be needed to improve the efficiency of the given service providing entity.
4. It should be revised whether the real estate used by the entity is well utilized, maintained and its operation is happening according to the original intentions.
5. It should be revised whether the user charges could be increased (in parallel with the implementation of the allowance system) and what would be the impact of this on the accessibility of the service and whether the equal chances can further be assured.

### *2.1. Decrease in the Quantity and/or Quality of Services*

The quantity and quality of the services of the Metropolitan Municipality are closely related to the subsidies that support the given sector. There is more and more financial pressure on the capital, the lack of resources can be felt immediately here. In the long

run this leads to the deterioration of the service network, of the real estates and -as a general phenomenon-, to the decrease of the quantity and quality of the tenders. This already can be sensed in the sector of public transport or in the deterioration of the building stock of health sector (hospitals), and in the area of certain public services, e.g. baths. This is mainly happening when neither the fees nor the amount of the subsidy can be increased, and there are no further chances for restructuring the institutions or privatization

In some cases there are no other alternatives that to reduce the level of the services, and if it is the case, a planned, conscious withdrawal coordinated with the NGOs and other civil organizations and groups is much more successful than just the spontaneous cutbacks. When considering the decrease of the level of a service quality, it should be reminded that it can result in the increase in the cost per unit (referring to the output of the units).

### *2.2. Providing Municipal Services Through the Private Sector (Non profit Corporations, Privatization)*

There is a wide specter of how to organize municipal services with cost reduction and quality improvement. Various sectors require different considerations and naturally the legal alternatives are also diverse. Some of the possibilities are summarized in . The data here are tentative. Priorities and targets may alter in practical life. By all means, applying these methods can happen in a cost effective way. Cost savings can be redistributed within the same sector. We do not consider it a wise thing to redistribute the contingent savings to other sectors - not even if it would seem to enjoy priority from political reasons.

**Table 10 Alternative methods for assuring municipal sector services**

<b>Sector</b>	<b>Alternative way of service provision</b>
<b>Public transport</b>	<b>Due to the critical condition of the public transport, the privatisation of the basic service is not advised. ( The relationship between the City and BKV needs restructuring )</b>
<b>Public works</b>	<b>Contracts, concessions or privatisation are the possibilities, but first and foremost is the pricing issue and implementing a well operating regulation system</b>
<b>Social policy</b>	<b>Expansion of contractual services, financing foundations</b>
<b>Education</b>	<b>Supporting non-profit organisation for providing services</b>
<b>Health care</b>	<b>Regrouping the excess capacities in hospitals, entrepreneurial contracts in the basic health services</b>
<b>Culture</b>	<b>Additional activities of maintained institutions (buffet, workshops, booking office) in the contractual form or as a concession.</b>

### *2.3. Restructuring the Service Providing Institutions*

Due to the financial pressure, many institutions have formed their own "survival strategy", without an active city policy intervention. One important element of this is the cut down on renewals, maintenance costs ( e.g. public transport, residential house maintenance). Another possibility is the hidden increase in the user charges and fees ( e.g. education). Again another possibility is the re utilisation of the proceeds gained

from rents or better utilisation of property. There is an obstacle in the efficient utilisation of municipal subsidies, namely that the advantages and disadvantages are not very clear. and are distributed among the institutions (sectors) randomly.

The restructuring policy is facing into an opposition on the side of the institution, who are not interested in disclosing the excess capacity and inefficiency they inherited.. These excess capacities can be utilised only through a longer period and with the assistance of an efficient regulatory technique. One of the reasons of why it would be advantageous for public utility companies to turn into enterprises is that this way, the operation could be rationalised and an enterprise could be stripped of all activities which do not belong to its basic activity.

A further problem is that the structural changes of the public utility companies demand investment and there is lack of resources experienced everywhere (e.g. in public transport there is big possibility for cost effectiveness, but for the sake of cheap operation e.g. the purchase of modern buses, that is serious investments would be needed ).

There is a general agreement that the efficiency of the Metropolitan public utility companies could be raised in many different ways. The segmentation into different small units or enterprises is not an applicable solution (should it happen on an area or a functional basis ) due to an argument which is called the economies of scale.

**Table 11 Real estate assets used by the institutions providing public services (million HUF)**

Sectors	Book value of the real estate
health	7.400
social care	1.260
education	5.525
culture	1.200
other	2.083
<b>Total</b>	<b>17.468</b>

Source: Municipal Asset Inventory, 1992

Certain experts say that the direct supervision of the huge metropolitan enterprises can not be executed even with an enormous staff. What could be done is that the enterprises themselves can be made interested in operating in an efficient way.

#### *2.4. A more efficient management of the real assets*

Real assets policy should mostly concentrate on the utilization, operation and maintenance of the existing property. It is a target that the value of the property is preserved and the costs are reasonable in the long run. Real estate management should foresee two main conditions.

1. The optimal utilization of the real estates is restrained by the quick changes in the service requirements.. Those mechanisms has to be provided with the help of which the institutions owning the property are induced to make more profit of the property and lead to a more efficient use of the asset they control.

2. Another important characteristic feature of the real estate management is that the maintenance of the real estate should be assured on the necessary level. Otherwise municipalities can suffer serious losses.

*The organizational system* of the real estate management requires some modifications, as well; real assets policy should be clear, decisions of strategic importance should be brought about by a committee ( Real Estate Management Committee). Basically there are three priority areas which should be monitored by the Committee:

- Assessment and assets valuation of the property portfolio. A means to this, can be the categorization of the asset at the very beginning and the technical survey of the condition of the asset.
- With respect to the profit producing capacity of the asset which can be used for investment purposes or can be leased, there should be a survey on the market value of the empty lands.
- Setting/concluding the actual operational costs of the real estate portfolio, bases for budgetary support and settlement.

#### *2.5. Increasing the user charges and fees*

One means of solving the financial crisis of municipal services is the increase of the user charges and fees) to a level where the fees would actually cover the service costs. The above mentioned principle can be justified firstly in the case of public utilities. The utilization fees in this area almost reach the cost effectiveness level. This is where the city can most successfully increase its revenues from the households sector (it is much easier than e.g. collecting the local taxes). The increase of fees in public transport is politically a more difficult task, but still has to be carried out. In this case however, utilization fee increase does not mean the increase of transport fare, but the introduction of zone system in the transportation and the introduction of settlement tariff (this will happen together with the solution of problems now existing in connection with the conurbation areas). The control system of fares is also a problem to be solved in a strict manner.

In other sectors - where the municipality provides substantial subsidy -, as well, the possibility for increasing fees should be revised. A certain level of subsidies is justified only if the service provides city policy targets (public transport, education, libraries). Another case can be if fee increase would involve drastic drop in the utilization of the service. Subsidies not necessarily mean institutional support, in many cases it is much better if the consumer is supported on the basis of some criteria, e.g. income. Thus the municipality does not have the single choice of whether to decrease the subsidies (increases the fees), but it is also a matter of choice and decision, what should be the form of subsidy (it is issued to the power company so that the fees should remain on a low level or issued to the consumer ).

A well prepared subsidy system neutralizes the general argument that: The fees can not be increased because the households will not be able to pay, there will be receivable or an intolerable drop might happen in the service utilization. It is also possible that the municipality takes into consideration the support application in connection with more than just one sector.

Fee increase is a complex problem both from professional and political aspect. Each sector should be considered separately and in a detailed manner in order to establish the acceptable proportion of fees and subsidies.

The increase of fees of housing related utility costs (gas, water, sewerage, heating, refuse) which would be viable for the development of municipal services, is restrained by the solvency of the residents. Increasing the fees to an appropriate level seems to be a political issue. It would mitigate the problem if the political and trade aspects of fee increase could be separated. This is the aim of the suggestion which is called mean tested housing allowances.

**Table 12 Simulations on housing allowances for the different option for increasing user charges**

Public services	Present user charges	Proposed increase - minimum	Proposed increase - maximum
Water (HUF/m3)	24.6	-	+100 %
Sewage (HUF/m3)	20.0	+100 %	+200 %
District heating	64-83	+ 50 %	+100 %
Gas (HUF/m3)	9.00	+100 %	+100 %
Garbage collection (HUF/hh/year)	-	2.000	4.000
<b>Total one year user charges</b>	<b>19 bn HUF</b>	<b>33 bn HUF</b>	<b>41 bn HUF</b>
<b>Cost of housing allowances</b>	<b>1 bn HUF</b>	<b>5 bn HUF</b>	<b>8 bn HUF</b>

According to the data of the table, the increased fee collections will cover the costs of the subsidy. However, these results were shown only with an illustrative purpose, since there are other aspects which are at present when a major fee increase is being implemented ( like the increasing amount of arrears, the deterioration of the situation of the middle layer since its members are left out of the subsidy system). These are the issues that should be dealt with, when a suggestion of such type is being considered.

### **3. Projecting the revenue side of the municipal budget for the years of 1995-2000**

In the projection on the revenue side we used the following assumptions:

1. There is a constant estimate for the amount of normative grants (16 billion HUF) for the Municipal Government's prognosis model of fiscal possibilities. The reason for that is that it is extremely difficult to give estimates of the normative grants, and this entry is not independent from other central distribution (e.g. share from the personal income tax, etc.).
2. The general economic situation is presented through the **PIT**, we used two options: (a) stagnation (0 %), and (b) 2 % real increase.

The amount of the future tax revenues depend on the economic situation, but the effect of increasing the severity of the taxing morale and tax return supervision should not be neglected. When calculating the models we presumed two alternatives for the real value of the PIT: the current level (0%) and a mild increase (2% annually); furthermore we are calculating with the prices of 1994,

that is the inflation effect is not taken into consideration. The other factor influencing the local governments' revenues from the personal income tax is the proportion of the municipality's share where we calculated with four versions. The difference between the best and the worst alternatives in the period between 1995 and 2000 is 86 billion HUF (0% increase in the real income) and 92 billion HUF (2% increase in the real income).

3. In respect of local taxes we used two options: (a) to keep the tax revenue at the present level, which would mean 7,4 billion revenue in the period of 1995-2000 (b) to increase it by introducing the property tax<sup>7</sup>, which means 11,9 billion HUF revenue..

4. We used two options for the projection of real estate selling, an optimistic one, when the local government could sell 4,7 billion, and a pessimistic one, when the local government can sell only 1,8 billion HUF in the period of 1955-2000.

5. For the sharing the PIT we used three options (30-70; 35-65; 40-60).

When calculating the model we examined the influence of three possibilities: 1. 0% increase in the real income and 30% share from the PIT; 2. 0% increase in the real income and 35% share from the PIT; 3. 2% increase in the real income and 40% share from the PIT. (In the end of 1994, the new central government changed the LG share from 30% to 35%.)

6. For the state grants for developments we used again two options (a) 7 %; (b) 8 %.

For the model we were obviously using approximate figures, that compare the total central funds to the total central revenues. We estimate the total central resources over the normative state grants to be 7.5 % of the budget.

On the expenditures side we had a simple assumption that level of expenditures without new investment will be maintained, and the possible expenditure saving will be spend inside the sector for fixing the deferred maintenance problems or in other way.

In the projection model we calculated with debt service for the loan taken up to 1995, and because the debt service were given in nominal terms we deflated by 15 % inflation rates.

Using this assumptions we set up three scenarios, which are shown in Table 13.

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<sup>7</sup>We proposed to levy the property tax by the municipality, and we made a simulation of the expected revenues, with different options.

**Table 13 The scenarios used in the projections**

	PIT		Local Taxes		Asset selling	Government contribution to investments as % of the budget revenues without Social Security contribution
	Real increase	Share of the LGs	Real increase of local tax	Property tax		
Scenario I.	0%	30%	0 %	no	low	7 %
Scenario II.	0%	35%	5 %	no	high	7%
Scenario III.	2%	40%	5 %	levied	high	8%

**Table 14 The budget resources for investments 1994-2000 in the three scenarios<sup>8</sup>**

	1994	1995	1996	1997	1998	1999	2000	Total
scenario I.	2.328	1.367	1.550	1.168	2.268	3.032	3.236	14.951
scenario II.	5.820	5.015	5.372	5.348	6.850	8.036	8.713	45.154
scenario III.	6.473	5.961	7.781	8.359	10.542	12.505	14.081	65.701

For 1994 estimated values

#### **4. The investment needs in the different sectors and the financial gap**

On the basis of the need assessment in the different sectors (prepared by special consultants) the investment needs were formulated in three alternatives: A. minimal, B. medium; C. maximum. (See Table 15.) These investment needs have to be corrected by the factor, that the different centralized fund could cover a part of the investment costs. We estimate this as 15 % of the cost. The next step is to face the future need assessment with the possibilities projected in the previous point. (See Table 16.) The gap between the revenues and expenditures could be bridged by (a) increasing the user charge for the services (b) increasing the state contribution. The user charge can be increased by a limited magnitude, which is 38 billion in our estimates. (We calculated by 73 % average increase with a subsidy element of 25 %, which could end up to a revenue of 9 billion HUF per year. The new source could be altogether 38 billion HUF.)

<sup>8</sup> The data for 1994 in the Table 14 is an estimated figure.

**Table 15 Investment needs in different sectors for 1995-2000 in three alternatives (billion HUF)**

	A minimum	B medium	C maximum
<b>1. Transportation</b>			
reconstruction of public transportation	8	54	108
reconstruction of roads/bridges	10	19	28
developments	22	36	49
<b>2. Public works</b>			
2.1 Water	0	5	10
2.2 Sewage	11	42	87
2.3 Bath	0	0,7	5
2.4 Flood protection	0	0	0
2.5 Gas service	0	0	0
2.6 Public lighting	0	0,1	0,3
2.7 District heating	3	6	9
2.8 Garbage collection and treatment	13,6	14,8	35,3
2.9 Road cleaning	0	0,6	0,75
2.10 Chimney cleaning	0	0	0,1
2.11 Cemetery	0	0	1,3
<b>3. Environment protection</b>			
3.1 Natural environment	3	6,6	12
3.2 Built environment	0	0,6	1,2
<b>4. Housing and rehabilitation</b>	0	1	2
<b>5. Social care</b>	6	7,2	9
<b>6. Education</b>	3,6	4,1	4,1
<b>7. Health</b>	6	6	6
<b>8. Culture</b>	6	6,9	12
<b>Total</b>	<b>92,2</b>	<b>210,6</b>	<b>380,05</b>

**Table 16 The projected investment deficit for 1995-2000 in different options**

Revenue scenarios	Investment options		
	A (92 billion HUF)	B (211 billion HUF)	C (380 billion HUF)
I. scenario (15,0 billion. HUF)	77 billion. HUF	196 billion. HUF	365 billion. HUF
II. scenario (45,2 billion. HUF)	46,8 billion. HUF	165,8 billion. HUF	334,8 billion. HUF
III. scenario (65,7 billion. HUF)	26,3 billion. HUF	145.3 billion. HUF	314.3 billion. HUF

## 5. Conclusion and summary: financial management of Budapest

*5.1 Preconditions of the well functioning city: managing the conflicts between the government and the municipality; and between the districts and the municipality.*

One of the main conditions for the implementation of the metropolitan policy program is to solve the conflict between the government and the municipality. The developing and financial necessities calculated on the basis of the sector projects undoubtedly prove, that the city's resources are not enough for fulfilling those tasks, which are

considered to be out of the boundaries of the regular tasks the city's authorities carry out according to the laws. This fact has been admitted by the government, but the solution of this problem has been set to daily deals and negotiation, therefore it has excluded the possibility for the city's authorities to work out a foreseeing financially stable development policy program. One of the criteria in the solution of the conflict is that the Capital should take part in the decision-making mechanisms of the developments related to itself and therefore of national importance, to avoid bad decisions for its matters.

The city-district conflict hinders the comprehensive urban policy in two ways: on one hand the local services task/responsibility sharing in some areas reduces the rational and efficient organization of the public services, on the other hand the independence of some districts in certain areas makes it impossible to solve the tasks related to the whole city.

When planning the greater developments in the city, all the positive and negative issues that affect the plan must be shown in the most accurate way, and then on this basis come to an agreement with the districts. The environmental expenses of the developments must be paid and the city must guarantee the funds for it. In this way the Capital would be acting as "the higher level government" up to certain degrees.

A comprehensive, years ahead foreseeing city policy can only be set if the conflicts between the central government and Budapest, and between the city government and the districts are solved. Naturally the city can be run even with these conflicts (but if there are political differences between the local district governments and the city government as it is the case since December 1994, then these conflicts may result in a crisis), but with less efficiency and more errors and with higher expenses.

## *5.2 Financial strategies of the city's program*

The financial problems of the city government are not only caused by the lack of resources to implement the technical projects (this is typical of all the local government), but they are also caused by the lack of convenient information, which makes more difficult the preparation of the political and technical decisions concerning the real priorities of the sector.

### *5.2.1 Developing and increasing the capacity of control and monitoring in the city*

In almost all the public services areas there is a lack of resources for developments and maintenance accumulated but it's almost impossible to compare the degree and the gravity of this among the different sectors. These issues are not only related with the lack of information system but with they are also related with the public services sector structure.

The reason for this is that the companies and institutions that belong to the city government are starting to be more independent and in the majority of cases they work in a system that is very difficult to monitor and to regulate. The two main conditions for the efficient control of the financial demands are the above mentioned monitoring of the activities of the companies and institutions and the other is their controllability. The next step of the city policy program is to guarantee that the city government board

will be able to execute the monitoring and the organization of the public services. The administrative capacity of the taxation structure is a task that belongs to this point. The introduction of the property tax suggested in the program can be accepted as an “investment” which will be refunded by the incomes and the flexibility of the financial situation of the city government.

### *5.2.2 Course of the reorganization of the sectors*

The public services belonging to the city local government have very different contents and financial characteristics. The financial strategy related to the sectors with areas lacking resources can be based on the following options:

- Increasing the role of non-profit and the private sector, one of the possibilities would be to privatize the property (ex. Public utilities companies) and/or reducing the direct role of the local government.
- Increasing the public services fee (where it is economically and legally possible) and taking loans for the projects related to this.
- A better utilization of the properties that belong to these sectors
- Adjusting the level and quantity of the services to the financial possibilities
- Rationalization of the organizations

One of the important suggestions in the cultural, educational, social policy, child-care and health-care sector is to separate the activities for maintaining the building sites from the technical tasks related to the activity, and the different way for financing them. This would create the motivation to manage reasonably the fortune of the activity. The important principles for the elaboration of the policy of the sector are the following:

- The user charge paid by the population or the end-users should, in most of the public services, cover the expenses of the services, unless a considerable amount of people is left out from the usage of the services. The appropriate user fee must be considered an efficient instrument politically and economically, the social problems that may rise concerning the payment of these services must be managed by a personal income dependent compensation system.
- The efficiency of the sector should be increased by letting non-profit companies and other entrepreneurs take part in the management of the public services. We would like to stress that we do not only mean privatization, we are also thinking of concession in public services, contracts in the social policy sector and task financing in culture.

The program does not count in a short-term on having significant monetary savings in the strategic sectors until the year 2000, so a real aim to achieve would be to increase the efficiency of the financial tools used in the different sectors.

### *5.2.3 Choosing among the different revenue raising alternatives*

The difference among the revenue raising alternatives is in the source of the surplus incomes. The developments have two sources: the local population and institutions and

the central budget. Whatever financing techniques we may choose we have to face this fact. Nevertheless it is important how we distribute the expenses and other charges caused by the developments especially in case of a high inflation rate. In this case it seems justified to apply a construction, that distributes the charges better. We have to increase the usage fee, where is possible, among the local population and the institutions, and where it is not, then there the general taxes should be increased.

In the places where the decision is to charge higher usage fees to the population, we must consider that this fee increase is in “competition” with other fees and taxes, for example the traffic, public services, housing fee, education and culture are not only competing with each other but also with the local taxes, the property taxes, and the country’s central government personal tax increase etc., which means that the sooner one of them is introduced the less possibility there is to introduce one of the others. We also must be aware of the negative events that may come with the alternatives (increasing the taxes may lead to the denying or hiding of personal incomes, increasing of the usage fees may lead to a reduction of the number of persons using these service, or the number of customers with arrears will increase, if the privatization is not well prepared then that can lead to a loss of control over the privatized public service, and, as a result of it, the price of the service may rise).

Choosing between the different options for increasing the incomes is a political issue, therefore the decision must be taken only with the appropriate knowledge of the strategic sectors and only after consulting with the organization safeguarding the interests of the other halves.

#### *5.2.4 Investment demands and possibilities*

The estimated expenses calculated and based on the programs for the different sectors will be about 92 to 380 billion HUF. Among the sectors the transportation is the most determining one, taking away 50 % of the expenses, and within this sector public sector needs the majority of the expenses. In the public-utilities work sector the main issues requiring expenses are the cleaning of the sewage and the waste-handling problem. According to the present sector structure, the expenses required for the rest of the sectors are about 10-15 % of all the expenses, which shows the contradictions in the present task-sharing system among the district local governments.

If we compare the revenue prognosis with the expense requirements (see Table 17, we can see that taking into consideration the minimum for the expenses (92 billion Ft) and if we choose the second optimistic income scenario (45,2 billion Ft), furthermore we suppose an increase of the usage fees (which can be politically risky) and its financing form can be solved by privatization or project loans, then in spite of it all, we would still have a deficit of 8,8 billion HUF. If we think about the second level of investment then the deficit in all the scenarios would be more than 100 billion. This means that to execute these city projects, the city would need a support of 15-20 billion a year for six years.

**Table 17 The financial gap between the development needs and the possibilities, 1995-2000 (with an increase of user charge of 38 billion HUF)**

Scenarios	Investment options		
	A (92 billion HUF)	B (211 billion HUF)	C (380 billion HUF)
I. scenario (15,0 billion HUF)	39 billion HUF	158 billion. HUF	327 billion HUF
II. scenario (45,2 billion HUF)	8,8 billion HUF	127,8 billion HUF	296,8 billion HUF
III. scenario (65,7 billion HUF)	-	107,3 billion HUF	276,3 billion HUF

After comparing the city's income perspectives and the expenses, the degree of the financial problem becomes quite clear. In this situation the city must determine clearly its strategy in all the sectors concerning their needs.

The city must execute a structure transformation, described in the sector programs, in some parts of the sectors (social policy, education, culture, public health-care, environmental protection), the city must play a controlling and initiative role in this. For the execution of all this no more than today's material tools would be needed, but the necessary resources must be guaranteed for the organization of new institutions and for starting new processes.

In the other group of the sectors (public utilities, housing, city-renovation), the aim is to create the conditions for the market-based functioning of these sectors. The financial problems of these sectors can be solved or at least mitigated by increasing the efficiency, using better the financial sources and rationalizing the public consumption. The main issue here is how to guarantee a solvent demand in the basic infrastructure on a market basis. In other words, how can we achieve to introduce an increase of the usage fees, so that they can cover their expenses and even leave a margin for developing and at the same time guarantee that the people can still afford to pay them. The solution suggested in the program is that depending on the personal incomes of the citizens, the city will support its citizen to make them solvent payers of the increasing fees. After this solution the city development and the public utilities can be set to a more market basis, so after this, the city can deal with the basic investments and then it can directly intervene in the non-market services.

Finally there is one sector, public transportation, where we would have to apply both methods, but they cannot be achieved completely (it is impossible to have fees introduced in public transport that cover completely the expenses), on the other hand the problem is of such a magnitude, that the city cannot solve it by its own. Therefore, this is the sector where the city - apart from the reorganization of the Budapest Public Transportation Company (BKV) structure and the increasing of the fees-, must try to bargain a better deal with the central budget. So transportation is the sector, where the low financing consequences appear the most. At the same time this is the sector, where the consequences must be shown in the most obvious and clear way, and if there is no solution then this is the first sector where certain public services must be cut down or restricted.