# Case Study – The Financial Management Reform in the Municipality of Budapest, 1990-1999

by Pallai, Katalin

This paper will give you a short overview of the financial management reform of the Municipality of Budapest accomplished during the first decade of its existence. (1990-1999). To set the stage for the discussion first the starting condition for the reforms will be given, then, the goals and the process of the financial management reform will be described and finally, the cornerstones of the current financial strategy, will be discussed.

This paper has a special focus both in the description and in the analysis. The emphasis will be put on answering two major questions:

1) How could the municipality, through the financial management reform, create a stable basis for strategic planning of the wide range of activities comprised in urban development and urban management?
2) What are the implications of the financial strategy on the general policy formulation?

According to the goals set for the paper by these two questions, the description and explanation of the financial management reform and of the actual system of financial management strategy will neglect the financial type technical analysis and will concentrate more on the general policy dimension, i.e. to the question of what made the local financial system capable to create stability and security for policy planning and implementation.

As this case study was written for educational purpose, as part of the course material of the World Bank Institute Urban Management course, only the first decade, i.e. the positive story of the financial management restructuring is included in it. (In another case study of the same course material – written on The Strategic Planning and Management in the Municipality of Budapest - the whole history of the Budapest reforms after 1999 will be also included.) As the course participants use the case of Budapest as an extensive exercise running parallel to the course and so will have substantial information on the conditions of the city and the Hungarian Local Government system, basic data and description of the local government law and intergovernmental context are included only as an appendix here.

## THE STARTING CONDITIONS

During the communist regime the public administration in Hungary had a clearly monolithic and hierarchical system. The public sector was relatively large (60% of GDP), decision-making and resource allocation was strongly centralized and different fields of local activities were vertically connected to line ministries. Till the end of the 1990s resource allocation was mostly discretionary and local finance had soft constraints. In this system operation and capital finance were nearly independent. In the operation the un-transparent and un-effective base financing prevailed and local development planning had to function more as a tool of lobbying for central subsidies, than a comprehensive policy activity. In this vertical and discretional system "local plans" were practically huge "wish lists" of different projects, as only this technique could maximize the chance of obtaining subsidies for local development. Operational consequences of new projects were nearly never calculated. Consequently, local financial activities resembled more to a simple accounting exercise than to real financial planning and management.

The new decentralized system, that offered to local governments a large extent of decision making power, clearly defined tasks, allocated resources on a mostly normative basis and gave the possibility for real local planning, i.e. offered wide discretion for the local aggregation of policies for better synergy of activities and for improved developmental outcomes. At the same time, by setting hard budget constraints, it gave the responsibility of longer term planning and adjustment of both operational and capital side of the budget. In this situation the challenge facing the new local governments was to implement a comprehensive process of interior reforms so as to make the local government capable to independently plan, elaborate and implement strategies. In this context the reliability and transparency of local financial management became important and the local financial policy became a crucial element of local policy implementation.

Besides the above mentioned challenge and the favorable conditions supplied by the strongly decentralized Hungarian system there were two major conditions that rendered the financial reform process difficult. One difficulty was the inherited oversized public sector that made it obvious that functions should be reconsidered both at the central and local level. The other difficulty was the uncertainty of the intergovernmental fiscal system. In Hungary the major public administration reform started in 1988 introducing a tax reform based on PIT and VAT, normative financing of local governments and many new elements whose outcome was difficult to forecast in the early 1990s. At the same time the central government had the right to decide about the allocation of local transfers on a yearly basis within the rules of the national budgets. In these conditions it was a logical tendency of the central government strategy that attempted to decrease the total of public expenditure through the considerable decrease of local resources. These conditions made it obvious that intergovernmental fiscal relations would rapidly change according to the central revenues receipts and central budget needs. In consequence of all these conditions, we can summarize the situation: at the start of the Transition an un-experienced local leadership was thrown into an uncertain intergovernmental framework.

## THE GOAL OF FINANCIAL MANAGEMENT REFORM

The general goals of the reforms were clear from the beginning: (1) financial independence had to be strengthened by the increase of own revenues to create the basis for decision making independence, (2) the service delivery and management had to be reorganized to create a sustainable and planable system and (3) the administrative and decision making procedures had to be renewed to create a system conducive to the elaboration and implementation of coordinated, strategic policies.

The first step of reforms had to establish a comprehensive and transparent system of planning and budgeting that reached to more than one year both with its forecasts and plans. At this point comprehensiveness meant that all plans elaborated in separate sectors had to be aggregated into one budget document, the total of obligations and consequences had to be summarized and compared with the foreseeable resources.

The crucial step for transparency had to be the reorganization of the old-type line item budget into operational and capital budget[1]. The separation of recurrent and capital revenues and of operational and capital expenditure respectively can give the basic transparency of structural proportions of the budget. The forecast of these elements and the survey of the consequences of interventions and new projects can envision the expectable structural surplus or deficit that is a major indicator of financial health.

It is an obvious principle of prudent financial management that recurrent revenues must be higher than operational expenditure, so as no capital revenue is spent on operation. The amount of the recurrent revenues exceeding the operational expenditure is called the operational surplus. Operational surplus is the most important source of capital investments during the long run. For sustainability of the financial balance it should also be secured that forecasted expenditure do not increase faster than revenues, i.e. no structural deficit is forecasted.

By the analysis executed in the first half of the 1990s in Budapest it was obvious that the operational surplus was close to zero and there was a forecasted structural deficit in the budget. (Ebel- Simon: 1995) Within these conditions it was obvious that the recurrent revenue base had to be increased and the operational expenditure decreased so as the operational surplus could increase, the structural deficit could be eliminated and the conditions of a sustainable balance of the budget could be established.

Considerable increase of the recurrent revenues was foreseeable only by the increase of own revenues that in turn could strengthened financial independence of the local government and together with the increasing operational surplus could build the foundation of creditworthiness. Finally, the achievable creditworthiness could offer the possibility of "cheap"[2], efficient[3] and equitable financing[4] of capital projects[5].

[1] Capital budget is an expression used in budgeting for the part of the budget that includes the larger , often multi-year, development projects.
[2] Cheap, as better creditworthiness offers the access to loans with better conditions, e.g. lower interest rates

## THE STRATEGY

In 1995 the seven-years financial forecasting model of Credit Local de France was adapted for Budapest. The model simply reorganized all budget figures previously calculated only on the basis of the Hungarian budgeting regulations. All budget items were reorganized into a clear and strict structure of operating and capital revenues and expenditure. In the reorganized structure the budgeted figures of previous years were introduced and the model calculated the operational surplus. Besides the analysis of the budget history the model was also capable to accommodate any hypothesis for future revenue and expenditure trends and calculate the resulting operational surplus forecasts.

The use of the model could clearly communicate a disturbing fact: with the input of any set of plausible hypothesis on future revenue and expenditure trends within the actual financial management system no operational surplus would be achieved and the structural deficit of the budget could not be eliminated. This also meant that after the drying out of privatization revenues no resources would be available for capital investments so the gradual degradation of the infrastructure would be unavoidable. The message was clear: Serious structural reforms had to be initiated.

The strategy had to be twofold: parallel increase of operational revenue and decrease of operational expenditure. The increase of operational revenues had to mean the increase of local taxes and user charges. The decrease of the expenditure was more complicated. For this a huge transition challenge had to be faced: the reconsideration of the functions supplied by the municipality and the reorganization and rationalization of service delivery. With limited resources available the city had to concentrate to the most important tasks. Decisions had to be made on what functions had to be dropped, kept or reinforced from the old, inherited list of tasks. Decisions on tasks had to be based both on concepts on the desirable role of the local government and on the predictable financial constraints of the Municipality. At the same time the inherited base financing system of operation had to be changed to task financing for better planability and more efficiency of institution financing.

Restructuring of the service delivery was targeting cost savings in the long run, but it was obvious that it was costly in the short run. Closing of institutions was possible only with adequate compensations and rationalization often necessitated investment into the cost saving solutions. So an important strategic decision had to be made: revenues from privatization and simple asset sale were all turned into the capital costs of up grading and rationalization of the infrastructure.

---

[3] efficient financing of development means here that better contracting conditions can be reached with constructors when timing of payments can be flexible and not dependent on the revenue receipt cycle of the local government.

[4] Equitable financing means here that through borrowing the financing burden of projects can be debited to the beneficiaries, i.e. not financed by citizens who pay their taxes and charges at the time of the construction, but through the long repayment parallel to the active life of the project the actual users of it pay.

[5] I.e. development projects

For the long term-security of service delivery two other tasks had to be accomplished, as well. On the basis of the financial forecasting a system of multi-year planning was introduced. The cornerstone of the planning is that a balanced budget means not only evading deficit, but also realizing an operational surplus for renovations and investments that are needed for the future security of operation. The target of the Municipality was a 20% surplus of operational revenues over operational expenditure to have a secure budget for capital expenses even after the drying out of privatization revenues. The forecasting and planning system introduced in 1996 secured not only the reliable financial management but also the necessary transparency and accountability. The sustainable task structure, that made a sustainable balance of the budget possible and the reorganization of the financial management, in turn, created security and established the creditworthiness of the Municipality, and on the longer run, allowed a shift to an active borrowing policy to facilitate better project financing.[6]

In summary the strategy targeted two general goals: with a sustainable balanced budget to secure the operation and service delivery, and with creditworthiness to create the possibility of optimal and equitable financing of development projects.

## THE ACTORS AND CONDITIONS

The financial reform strategy was elaborated by the liberal political leadership of the city who was in office since 1990. For them the necessary steps of the strategy were mostly obvious. They considered the restrictions of tasks acceptable and in accordance with their concept of a relatively lean public sector. The targeted cost coverage of user charges, with subsidies applied only on social considerations, the privatization, the contracting out and task based financing of functions all fitted well into their political ideology. The only element taken as a sacrifice was the maximum rate of the local business tax. Still, this was unavoidable, as it supplied around 20% of local the revenues. (i.e. the revenue from it was roughly equal to the targeted operational surplus)

The liberals lead the city in coalition with the socialist party. Socialists, who were partly descendents of the old communist party and partly left oriented social democrats, could much less accept the underlying political principles of the reform strategy. For them privatization, the dropping of functions, the closing of institutions, the strictly social equity base of subsidies were all unacceptable.

The rest of the Assembly[7] consisted of the right wing, conservative opposition, who by political principle could accept some of the reforms, but as being in opposition were not willing to share the political costs of the targeted reform program.

[6] All the elements of the financial reform, that are mentioned here only shortly, are explained in details in the paper of the same author listed in the reference list.
[7] The Assembly is the decision making body of the Municipality

With these political players it was difficult to see how, in normal conditions, the reform strategy could have been implemented. It was obvious that the reform agenda could get through the Assembly only in conditions where its acceptance was unavoidable.

The conducive conditions were the following:

1) The socialist-liberal coalition of the central government introduced the so called "Bokros package", a seriously restrictive financial policy, in 1995 to lead the Hungarian economy out of the financial crisis caused by the socialist regime and the inadequate government policy during the first election term (1990-94).

2) During the early 1990s the central government planned the organization of a World Exhibition in Budapest in 1994. The Municipality of Budapest has always been against the EXPO projects as it did not consider the city neither financially nor infrastructurally capable to handle it. The new government, elected in 1994, cancelled the EXPO, but at the same time delayed the payments of subsidies for the already running investments of the Municipality. Till 1995 this delay in transfers caused a short-term financial crisis for Budapest.

The Bokros package on the national level made the political atmosphere more accepting to the strategy of serious restrictions for fast restructuring and the short-term local financial crisis made the reforms unavoidable. It is still the merit of the liberal leadership that a the right time had already in hand a comprehensive reform strategy that could be presented to decision in the adequate historical minute. It is an interesting game of historical psychology that has been proved again: it is often easier to get political sacrifices through the decision making system when less resources are available, but the steps are unavoidable than in conditions when resources would make it easy but not unavoidable.

## THE PROCESS OF FINANCIAL REFORMS

The table below lists the most important features and steps listed by election periods and further goals compared to the date of 1998. The reform process can be best followed by the changing goals. In the three periods discussed in this paper the Municipality could define different targets: the first election term (1990-1994) was the time of the consolidation and the first simple steps of reforms. In these early years the city could target only the setting up of the major framework of the new functioning, maintain balance and operational capacity, while introducing some new tools of financial management. The second election term (1994-1998) was the time of the elaboration and initiation of the major reforms of financial management, while till the end of the second election term and in the first years of the third one sustainable balance was achieved and the Municipality stabilized its prudent financial management.

**Table 1: The Reform of Financial Management in Budapest**

| 1990 – 1994 | 1994 – 1998 | Further Targets |
|---|---|---|
| **Situation** | | |
| Fiscal pressure<br>Fiscal uncertainty | macroeconomic problems<br>improving fiscal certainty | starting economic growth<br>public finance reform |
| **General goal** | | |
| Consolidation | Reform strategy accepted and started | Prudent financial management |
| **Reform objectives** | | |
| Renewal of decision processes and procedures<br>Start of comprehensive planning | Strategy for institutional restructuring<br>Implementation of medium term planning | Maintenance of sustainable financial management and balance |
| **New tools** | | |
| First two years comprehensive capital investment plan | Increase of own revenues (Tax, user charge increase and privatisation)<br>Seven-years forecasting model and four-years planning of capital budget<br>Reform of operation elaborated and started | Rationalization of operation<br>Task financing of operation<br>Seven-years forecasting and planning<br>Active borrowing policy |
| **Results** | | |
| Coexistence of old and new elements<br>"base financing" of operation<br>new decision procedure for capital projects | operation surplus increase<br>better fiscal balance till the end of term<br>creditworthiness | system of sustainable financial balance<br>flexible/optimal project financing<br>sound base for strategic planning |

In 1990 the start of Hungarian local governments was very promising. In the first year of the new system local governments received the whole personal income revenue and some other central transfers to fulfill the wide range of tasks assigned to them.

One major weakness of the Hungarian system could already be seen in the early years. As in Hungary the intergovernmental finance decisions are made within the frame of the annual national budgets, the central transfers could be significantly modified from one year to the other, while the capacity to own revenues could be built up only slowly by the newly elected bodies. This caused fiscal uncertainty. At the same time the obvious strategy of the central government in its effort to decrease public expenditure was twofold: it passed further service responsibilities to local governments and it eased the pressure on the central budget by decreasing the transfers to local governments. The two processes together caused a considerable fiscal pressure on localities.

During the first election term (1990-1994) the fiscal pressure was pressing so the leadership of the Municipality made great efforts to maintain its financial balance and the operational capacity, and struggled for regaining at least a part of the resources withdrawn by the central government. At the same time the elaboration of the reform strategy for the fiscal and operational management of the city has also started. As a result, some new elements have been introduced into the system, which for the time being were coexisting with some surviving old elements and practices.

Financing operation tasks remained within the frame of the traditional "base financing system", as the elaboration of a new task financing system needed more time and was

surely not mature then. In the first years no change occurred in the process of capital budgeting either. Capital budgets — as in the old system — were accepted only for the given year, and decision on projects could be made at any time of the year based on the one-time costs, so the process was much softer than later. For a more transparent system plans elaborated in separate sectors had to be aggregated into one budget document, the total of obligations and consequences had to be summarized and compared with the planned activities. The first comprehensive list of developmental projects was elaborated in 1993 in Budapest in the form of a two years capital budget that compared project lists with revenue forecasts. The result of this exercise was the canceling of some 80 large project form the list of the inherited "development plans" during one historic local Assembly meeting.

At the same time, the rules of decision procedures were also reformed, creating a bit more transparent and accountable system. This first improvement of financial planning was obviously effective only on the capital side of the budget, and could not adequately handle the operational consequences yet.

During the second election period (1994-1998) there were good and bad news for Budapest: the country faced serious macro-economic problems, but the intergovernmental relations were not only better, but more predictable as well, which seriously helped the proceeding of the reforms in Budapest. The strategy could go further: not only "survival" and some small steps were on the agenda, but the introduction of major structural reforms could be planned.

It was clear at the beginning of the term that Budapest had a structural deficit, but at the same time the central government had its serious fiscal problems, as well, so increase of transfers could not be expected. (Ebel-Simon: 1995) In this situation one element of the strategy had to be the increase of own revenues. This meant a clear shift in the local financial policy as instead of focusing on the fruitless fight for regaining the earlier level of central transfers, the increase of taxes, charges and capital revenues, i.e. real fiscal autonomy was put into the focus.

In 1995 the seven years financial forecasting model of the French Credit Local International was adapted and introduced in Budapest and gradually became an accepted tool for financial forecasting and planning. The obvious consequence of the seven years forecasting of revenues was that the multi year planning of capital expenses could be established. From 1997 the Municipality established seven years forecasting of revenues and four years planning – then from 1999 seven years planning - of capital budgets.

The Credit Local model besides helping establish multi year planning had an even more important consequence on financial policies. As the projection of any set of plausible hypothesis into the model proved that, without important changes in service delivery, the structural deficit could not be eliminated only by the possible increase of own revenues, but a decrease of operational expenditure was also necessary, it proved the need for structural changes.

The financial projection model seems to be a simple tool, but it was a decisive element in the political process. It helped many politicians — who had earlier been insensitive to financial questions — to capture the notion of the structural deficit, and in

consequence it could help to bring about a coalition supporting the reform and willing to undertake its political costs.

The Municipality had to reckon with the fact that the increase of current revenues has serious limits and the revenue flow from asset utilization (privatization, sale of real property and portfolio assets) will necessarily dry up. Under such circumstances, maintaining the operating expenses at real value would result in the exhaustion of accumulation resources, and eventually even the financing of operation would become impossible.

The alternative approach was the drastic increase of own revenues and the decrease of operational expenditure. As a result of the new revenue policy local taxes increased from 9.9 billion HUF in 1995 to 29.4 billion HUF in 1998, and other types of recurrent own revenues were also increasing dynamically. Shares of three major public utility companies were sold in the following three years, yielding 300 million USD capital revenue for the Municipality.

At the same time the major restructuring also started. The decreasing of operational expenditure rested on three pillars. One pillar was the elaboration of concepts for each sector, defining the core functions to be undertaken and the strategies to get rid of other non-public functions, whose expenses could not be covered on the long term. The other two pillars aimed the reduction of unit operating costs by the introduction of the more effective task financing system of operation and by one-time, accumulation type and non-recurrent operational expenses. It was clear that the revenues from asset utilization had to be used for the financing of the rationalization process and structural reform.

At the same time, it was also targeted that by the time of the drying up of the accumulation and capital type revenues, the Municipality was to achieve significant operating surplus (meaning the surplus of current revenues over current expenses) in order to bring about the only significant source for a long-term balance of budget. The targeted ratio of operating surplus to current revenues — necessary to finance future investments — was 20%, to be reached in five years.

The strategy was professionally well elaborated, still at the beggining it was hard to see how could adequate coalition be built along the restrictive policy with high political costs. Firm reform steps became plausible only when in 1995 a large amount (8.5 billion HUF) government guaranteed grant remained floating for months. The short-term financial crisis of the Municipality could be exploited by the financial leadership to win wide political acceptance for the first privatization transactions, for the more dynamic revenue raising and for the seriously restrictive expenditure policies foreseen in the new financial strategy.

This reform meant simultaneous institutional and financial reform. On the one hand the tasks were (and are) reconsidered, to achieve a sustainable structure of services, and creating adequate conditions for the supplying institutions, on the other hand the financing system of the institutions had to be changed from the basis type financing to task financing. It was clear at the beginning that the change to the new method requires at least 3 to 4 years. The capital budgeting reform was easier, but the introduction of the operating budget reform is only at the first step. In 1999 and 2000

so-called "shadow budgets" were prepared beside the traditional type budget, on the basis of which refinements could be made for the process to get closer to exclusive use.

The budget reform aimed to establish a predictable fiscal planning system for the goal of better transparency and to create better incentive to efficiency and some protection against institutional "slack". It was also the necessary condition for creditworthiness and to implement the strategy on borrowing for improving efficiency and equity of capital project finances.

The goal was to shift to active borrowing policy, and enter the capital markets as a fully autonomous entity and to be able to achieve a loan portfolio in which financing risk is spread. For adopting an active borrowing policy, the Municipality had to increase its financial reserves. It defined their volume equivalent to at least one year's debt service obligations.

The first important borrowing transactions were the loans contracted with EBRD (1993) and World Bank (1995) for public transportation investments. The Municipality negotiated these loans independently, later it appeared on the syndicated capital markets, and finally, in 1998 — after having swapped existing loans — the Municipality issued bonds at the value of 150 million DEM on the international bond market.

As a good debtor, the Municipality of Budapest raised its loans through the so-called name financing from the very beginning, on the principle of negative pledge, without letting the assets to be encumbered financially in any way, except for assets created through project financing.

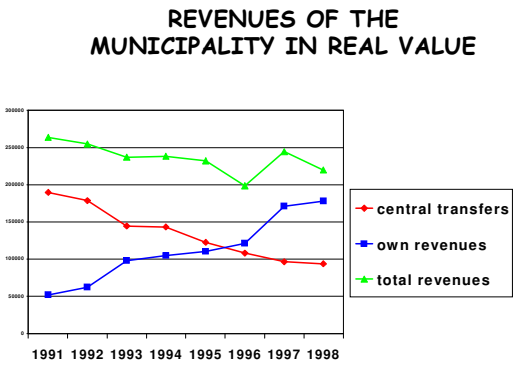
Active borrowing policy is either not *per se*. Financing infrastructure investments partly from borrowing ensured that the amount of annual investment outlays remained roughly equal. Had this practice not been pursued by the City, investments would have been implemented with delay, on the one hand, and great fluctuations would have characterized development activities on the other hand, as they should have been subject to the actual receipt of privatization revenues.

## THE OUTCOME AND IMPACT

The outcome of reforms can be surveyed first through the tendency of change of the budget figures.

During the 1990s Hungarian local governments had to accomplish their reforms with permanently decreasing central government transfers but also with increasing mandates. As it can be seen on the diagrams during the 1990s, the real value of central government transfers to Budapest decreased by half. To maintain the real value of total revenues, the Municipality had to increase its own revenues. As it can be seen on the diagram the strategy of own revenue increase was successful. It amounted to the double - in some years nearly triple – of previous revenues. As a consequence the proportion of the central government transfers has become completely reversed,

reinforcing fiscal independence, yet painfully decreasing the total revenues of the city budget.



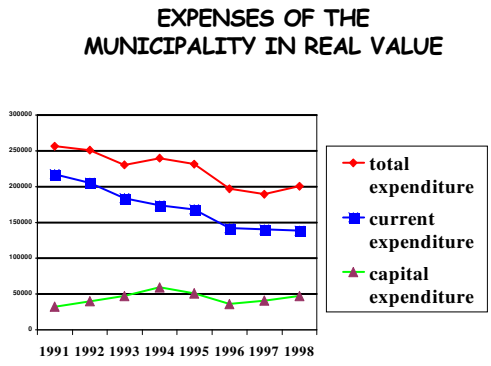




**Diagram 1: Real value of revenues, 1990-2000** **Diagram 2: Real value of expenditure, 1990-2000**

Due to decrease of total revenues the Municipality had to change the expenditure side of its budget considerably: the operational expenditures decreased from 85% to 47% in 1998. Parallel to this, capital expenditures were increased from 13% to 24 %.

The figures contest the successful implementation of the fiscal strategy discussed above. The most important indicator of the improving balance is the operational surplus. The operational surplus was practically zero in 1996, while it approached the targeted 20 % by 1998.

The result of the reforms is that even in 2000, after two years of serious decrease in intergovernmental transfers, the budget figures of the Municipality demonstrate financial health and balance. Debt service is fairly low and the proportions of expenditures are good: 47% operating and 42% of capital expenditures.

**Table 2: Major budget figures in the year 2000**

| **REVENUES** | | **EXPENDITURE** | |
|---|---|---|---|
| Central transfers | 75 billion HUF | Operating expenditure | 130 billion HUF |
| Own revenues | 137 billion HUF | Reconstruction | 9,5 billion HUF |
| | | Capital expenditure | 115 billion HUF |
| Borrowing | 19 million HUF | Debt service | 0,5 billion HUF |
| Securities | 43 billion HUF | Securities bought | 19 billion HUF |
| TOTAL | 274 billion HUF | TOTAL | 274 billion HUF |

## The strategy of prudent financial management

The goal of financial management in the Municipality of Budapest is to maintain the sustainable balance, stability and transparency. For this the current financial strategy continues the process introduced by the reforms. Every year in the autumn, when the concept for the budget is prepared the seven years forecasting model is updated. Based on the financial forecast and analysis, the targeted proportion of the operating and capital budgets are set. As it has already been mentioned, the operating surplus is a crucial element of the budgeting. In each year – even when serious fiscal stress presents – there is an effort to keep the operating surplus at 20%. If needed for the balance the current expenditure has to be decreased as a sacrifice for the sake of long-term sustainability.

From November, when the Concept for the Budget is accepted till March, when the budget has to be accepted, the most agitated debate in the City Hall is often around this issue. The financial management fights for the operating surplus, i.e. for pegging operating expenditure to operating revenues. This approach resists the short-term temptation to evade cutbacks on expenses and increasing own revenues for the long-term stability and for the possibility of continuing capital investments and strategic development. Other political forces focus on the pressing needs in the operation of services. For the advocates of the "operational needs" the operational surplus is a good target, as the 20% seems to be an arbitrary number. It is easier for this party to communicate to the electorate its good will to improve services, as it is for the other to share the notion and importance of the operating surplus. Until 2000 the financial leadership proved to be stronger each year, it accepted the short-term political costs of restrictions and after serious conflicts in the leading coalition the proposed financial strategy was kept, defining operating and capital expenditure items on the basis of the pre-set proportions of the budget, continuing the multi year planning of capital budgets and keeping financial reserves necessary to maintain the active borrowing policy.

### CAPITAL BUDGET PLANNING PROCESS

In 1990 the Municipality inherited the institutions and development plans of the socialist council. Most sectors had development concepts but they were elaborated with a strong supply side orientation. In consequence the development concepts were mostly individual sector plans with extensive lists of all possible interventions, but interventions of different sectors were hardly coordinated. The council discussed new projects when elaborated and after approval the new project could be added to the existing list. This procedure was logical during the old communist regime, as a larger local "whish list" could increase the possibility to get financing form different parts of the centralized budget.

In the new situation aggregation and decision had to happen at the local level. For this a comprehensive budget and its comparison to forecasted financial capacities had to be elaborated. The first Two-Years Capital Investment Plan (CIP) was elaborated in 1993 after long negotiations and revisions on earlier sector plans.

In 1996, after the introduction of the seven-years forecasting model a four-years capital investment plan was established. The first project lists for the new CIP were prepared by the sectoral leaderships. These lists proved to be much longer and costlier than the possible capacity of the Municipality, so negotiation started on the prioritization of projects and elimination of those projects that were far beyond the local capacities. In sectors where accepted development concepts existed, the selection could clearly be based on the plans, in others the negotiation of the sectoral and financial leadership tried to finalize the lists.

The financial constraint of sector planning was established so that for the given year all the forecasted capital budget resources could be planned for projects, but for the next years only a decreasing percentage of the forecasted expenditure capacity. This method established a rolling system of planning. If no big financial crisis presents, in each year new projects can be included into the CIP, as the financial burden caused by the older projects consume only part of the given capital budget. Within the year changes can be made, or new projects ca be proposed, but only in case decision is made on the new project and on the dropping of other projects with the same expenditure need at the same time.

Since 1998 the CIP is planned for seven-years already. Today still the first draft of CIP proposals are prepared by the departments of the administration, they are finalized through negotiation with the financial leadership and accepted by the Assembly.

The capital budget planning method of the Municipality is a clearly administrative solution. Capital budgets are prepared by the local government and they become public in the budget document. The elaboration is still not arbitrary as the project lists are based on the priorities established in the development concepts and strategies of the municipality. The CIP only finalizes the timing of different development projects envisioned by the development strategy and prepared for implementation by the departments.

## EVALUATION

The goal of the financial reforms was twofold: with a sustainable balanced budget to secure the operation and service delivery, and with creditworthiness to create the possibility of optimal and equitable financing of development projects.

The case of the Municipality of Budapest clearly contests that for accomplishing reforms not only vision and consistence, but adequate external and internal conditions for the implementation are also needed. The elaboration of the strategy is only one part of the success. The other part is the timing of the introduction of the elements of the reform. Timing means assessment of the maturity of the system for the implementation of the more sophisticated tools and the assessment of the political arena for the possibility of the coalition building for the reforms. In consequence in the analysis both the construction of the reform strategy and the effect of the changing political context are equally important.

On the basis of the stability and transparency of the financial management, the Municipality has become a reliable partner for banks, investors and other private and public partners. And here is the crucial message of the Budapest story for the urban management course: interior financial mechanism of local governments must be established on a way that not only own resources are available for capital investment (i.e. development projects), but the financial health of the local government has also to be secured for keeping the possibility to introduce external resources into the development projects. The local government alone can never be strong enough to increase the competitiveness and improve the quality of life of its city. It can only be a facilitator and partner in the development process that must be a cooperative game of various players.

Financial planning is a complex activity. Urban planners and managers do not have to be aware of its technicalities, but at least they should understand the logic of the system. They should understand how decisions on operation of services are connected to the margin of maneauvre of the financing of development projects and how decisions on revenues affect the financing possibilities of new investments.

In Budapest the leading force of the whole reform process was the financial reform. It was the restructuring of financing that lead the reorganization of procedures and supplied better understanding of the capabilities of the Municipality. Results of the financial forecasting and planning and the realization of the limited margin of maneuverability was twofold: (1) it helped to clarify public roles and focus local government activities to these roles; (2) it pushed sectoral and development thinking towards strategic policies and towards more active and demand oriented policies. This part of the story also brings a message to urban managers on the rational dimension of policy making and the possible constructive influence of constraints if handled by skill and expertise.

## References:

Ebel – Simon (1995): *Financing a large municipality: Budapest,* in: Decentralization of the Socialist State, ed: Bird - Ebel – Wallich, The World Bank

Ebel – Várfalvi – Varga (1998): *Sorting Out Intergovrnmental Roles and Responsibilities,* in: Bokros – Dethier: Public Finance Reform During the Transition: The Experience of Hungary, The World Bank

Pallai (2001): *"Local financial management reform: The case of the Municipality of Budapest",* In: Kopanyi- Wetzel ed.: Sub-national Modernization Challenges, The World Bank, 2001, (in print)

# APPENDIX 1: BASIC DATA ON BUDAPEST

## The geo-political position of the city

The position of Budapest on the economic, geographical and political map of Europe offers excellent opportunities for the city. The city is an important center of one of the most developed economic regions of Eastern and Central Europe, a major junction of transcontinental transport routes. It is the most important gateway city of the region, which does not only adopt influential effects coming from Western Europe and other parts of the world and transfer them to a wider region but also operates as the site of exchange between the West and the East. Especially during the Yugoslavian crisis, it became an important connection point towards the Balkans as well.

## The position of Hungary in CEE

Hungary has political stability and its economy is one of the strongest in the CEE region. In consequence of the decisive and fast transition at the beginning of the 1990s, and the thorough political and economic restructuring, the decline of the first years of the decade ended in 1994. Since the middle of the decade the economy is steadily growing and Hungary became the major target of foreign direct investment. As economic growth stagnated for a few years in the mid 1990s, the country stepped back to second in CEE after Poland. In this year – if the 5-5,3% forecast of GDP growth will be realized - it can regain the leading position both in economic growth and FDI/capita.

## The Hungarian economy

The Hungarian economy is steadily improving since 1997.

**Table 3: Major general indicators of Hungary**

| HUNGARY | 1995 | 1996 | 1997 | 1998 | 1999 est. | 2000 est. |
|---|---|---|---|---|---|---|
| real GDP growth % | 1,5 | 1,3 | 4,4 | 4,8 | 3,8 | 4 |
| GDP ($ bn) | 44,7 | 48,8 | 45 | 47 | 50,5 | 53 |
| CPI (%) | 28,2 | 23,6 | 18,3 | 14,3 | 9,5 | 7 |
| Unemployment (%) | 10,4 | 10,5 | 10,4 | 9,5 | 9 | 8,8 |
| FDI ($ bn, cumulative) | 8,8 | 13,3 | 16,3 | 18,5 | 20,5 | 22,5 |

Source: Equity Central Europe, 1999

## The position of Budapest

Budapest, the capital of Hungary, is not only a political center of decision making and control but, as the largest city in the region, plays also a key part as a center of innovation, business management and services.

**Table 4: Major general indicators of Budapest**

| | Hungary | Budapest | Bp as % of HU |
|---|---|---|---|
| Size | 93.000 $km^2$ | 525 $km^2$ | 0,5% |
| Population | 10 million | 1,9 million | 19 % |
| GDP in1997, billion HUF (USD) | 8,541 (45) | 2,950 (16) | 35% |
| GDP/ capita in1997, HUF (USD) | 841,000 (4,504) | 1,552.631(8,315) | 185% |
| Average wage 1998 (HUF) | 70,450 | 89,402 | 127 % |
| Investments by businesses in 1996 (billion HUF) | 1057 | 333 | 31,5 % |
| FDI (billion USD, cumulative by 2000 est.) | 22,5 | 13,5 | 60 % |

Source: National and Budapest Statistical Yearbooks, 1999

More than one-third of the country's GDP is generated in Budapest. The city excels in terms of the value of per capita GDP (HUF 1,858,000), which exceeds the national average by about 85% (HUF 1,007,000). (1998)

The economic recession in the years just after the change in the political system was not so strong in the capital as it was in the provinces. The expansion in service capacities in the capital could partially offset some of the consequences of the recession, first of all the major decline in industrial output.

The proliferation of enterprises, which took off at the end of the 1980s and accelerated during the 1990s, was most intense in Budapest. The number of businesses established as a legal entity in Budapest rose from 13,000 in 1990 to 64,000 in 1999, representing 43–45% of all similar businesses across the country. The capital's percentage share of businesses without legal entity, inclusive of private entrepreneurs, was 27%. With respect to the number of businesses actually operating, the number of businesses per 1,000 of population is approximately 75% higher in Budapest than in the provinces.

In 1998, foreign capital took a 10% share in the number of the corporations in Budapest. In this respect, Budapest plays an outstanding role as more than half of all businesses with foreign capital in the country and 54% of equity capital is bound to Budapest.

## Economic sectors and condition

Thanks to its traditional central role, human resources are of a high standard, services, innovation, strategic functions and R+D activities are concentrated here, all of which ensure the synergy needed to obtain a central position in a strong hierarchy of cities that is arising as a result of globalization.

**Table 5: Composition of economic sectors in Budapest (1997)**

| SECTOR | GDP share | EPLOYMENT | INVESTMENT |
|---|---|---|---|
| Agriculture | 0,5 % | 0,6 % | 0,3 % |

| | | | |
|---|---|---|---|
| Industry | 18,7% | 16,9 % | 20,4 % |
| Construction | 4,4 % | 3,1 % | 10,1 % |
| Services | 76,6 % | 79,4 % | 69,2 % |

Source: Hungarian and Budapest Statistical Yearbooks

Economic growth and productivity is higher in Budapest than the country average. Here is the largest economic concentration in Hungary. 735 thousand employees work in 230 thousand economic units, producing 35 % of the GDP. Budapest concentrates 60% of foreign investments.

Modernization and the restructuring of the economy is extremely fast in Budapest. Modernization results in 1,5 times higher productivity than in other parts of the country, and the economic change resulted in the increase from 51 % to 79 % share of local GDP of the tercier sector between 1980 and 1998.

Budapest is one of the most attractive destinations in Hungary for tourists; 27% of all guest nights and 37–38% of all guest nights by foreigners are spent here. 27% of all hotel accommodation capacity of the country is provided in Budapest.

The relative density of the network of retail outlets is linked partly to the role of the capital in tourism: in 1998 17% of all retail outlets and 14% of catering establishments within Hungary operated within the administrative city boundaries of Budapest. (Due to changes in statistical categories the figures are not comparable to previous ones.) This network comprising of approximately 31,000 outlets provides services to the population as well as foreign and Hungarian tourists and partly meets the demand created by neighbouring settlements.

For the first time since 1993, 1998 saw an increase in retail trade in Hungary. More than a quarter of Hungary's 1998 retail trade (27%) was conducted by the network of retail shops in Budapest, with a 46% higher per capita turnover in the capital than across the country.

## Investment activities

In 1998, the volume of investments in the capital was almost 50% higher than in 1991. In the 1990s such volume was largely in line with the nation-wide trend, except for 1993 and 1994, when growth in the capital was faster than across the country.

In 1998, the total value of all investments in Budapest by business entities equalled HUF 545 billion and 31.5% of the investments were implemented in the capital. Per capita investments in Budapest were 67% higher than the national average.

In 1999 firms with Budapest headquarters and with 5 employees at least invested HUF 866 billion according to preliminary data – 5.3% more than in 1998 at comparative prices. Investments increased in the following sectors: real estate, business services, public administration, defence, social security, construction and education.

The transport and telecommunications sector precedes all other sectors concerning their share of implemented investment projects in Budapest. As a consequence, the number of telephones in Budapest has dramatically increased.

Companies with foreign capital play an important role in the investment activities in the capital. In 1992, foreign capital had a 25% share of investments by business entities, while this number approximated 50% by 1998.

## APPENDIX 2: THE HUNGARIAN LOCAL GOVERNMENT SYSTEM

The 1990. Hungarian Act on Local Governments was created on the basis of the major values and principles of the Council of Europe's European Charter of Local Self-Governments. The locally elected governments have their own assets and their own revenues that are supplemented by revenues from the central government. They are basically public service entities to which obligatory tasks are assigned, while they can also undertake voluntary tasks. They have the right to associate. They have considerable decision-making power. Decisions of local governments can be overridden only by the decision of a court in the case of violation of law or by the Constitutional Court.

**Table 6: Expenditure of the Public Sector in Hungary**

| YEAR | PUBLIC EXPENDITURE (as % of GDP) | LOCAL EXPENDITURES (as % of GDP) | LOCAL EXPENDITURES (as % of Public expenditure) |
|---|---|---|---|
| 1994 | 54.0 | 16.8 | 26.7 |
| 1995 | 44.7 | 14.1 | 26.6 |
| 1996 | 40.5 | 13.3 | 27.2 |
| 1997 | 39.0 | 12.0 | 25.5 |

Source: Hermann, Horváth, Péteri, Ungvári, Önkormányzatok feladattelepítésének szempontjai és feltételei, 1998

In Hungary the local governments are organized by settlements. They have the general responsibility for the basic local public services. Beside this, as a weak middle tier, county governments are also elected for subsidiary functions. I.e. for services that the settlements are not capable to perform or are of regional character. Local governments have mandatory services and can overtake by choice any optional services as long as they do not endanger the supply of mandatory services. The parliament defines the mandatory services and it has to allocate the necessary financial resources for their fulfillment. As local government sizes and capabilities strongly differ, there is a sub-group of mandatory services that must be supplied by all local governments, and there are some other services that are assigned to governments with greater capacities.

**Table 7: Rights and Responsibilities of Local Governments in Hungary**

| RESPONSIBILITIES | RIGHTS |
|---|---|
| Development planning, Master Planning and urban regulation | Political independence |
| Protection of the natural and built environment | Property transferred |
| Transport and Public works | Annual revenue transfer |
| Cemeteries, fire brigades and public security | Shared revenues |
| Management of housing | Normative grants |
| Education and Culture | Targeted- and aimed revenues |
| Social and Health Care | Own-source revenues: |
| Others | Local tax and user charges |
| | Other incomes |
| | Loans and bond issuing |

Local governments can freely select the forms of their service delivery. They can provide services by their own budgetary institutions, they can contract the private sector or utilize any alternative form of service delivery. (i.e. privatization, out sourcing, concessions, etc)

The rights and responsibilities of local governments are exercised by the elected body of representatives. The local government has an office as well who is responsible for preparatory and administrative tasks. The government can autonomously decide about the organizational structures and rules of procedures.

Operation of local governments is financed by own revenues, shared revenues (PIT and vehicle tax) and normative grants. Own revenues are the local tax revenues, user charges and fees collected by the local governments. Municipal governments can levy taxes on property, tourism and turnover of businesses. They can set tax and other revenue rates within the limits given by the central government.

Other own revenues of local governments are from profits, dividend yield, leasing fees and sale of assets. For capital investments aimed and targeted subsidies can also be tendered from the central government.

The Act on Local Governments includes the right of borrowing and bond issuing, but at the same time sets the limit of annual commitment of debt service. The borrowing limit is pegged to a specific portion of own-source revenues.

**Table 8: Distribution of Local Government revenues in Hungary (%)**

| REVENUES | 1997 | 1998 |
|---|---|---|
| Own source revenues | 23.4 | 22.6 |
| Shared revenues | 12.1 | 14.6 |
| Grants | 29.2 | 31.7 |
| Capital Investment Financing | 15.5 | 10.3 |
| Transfers from Social Security Fund | 16.9 | 17.5 |
| Others | 2.9 | 3.3 |

| | | |
|---|---|---|
| TOTAL | 100 | 100 |

Source:Edit Nyitrai Kusztosné, ed.: A helyi önkormányzatok és pénzügyeik, 1998

## APPENDIX 3: RELATIONSHIP BETWEEN THE CENTRAL AND THE MUNICIPAL BUDGET OF BUDAPEST

The municipal budget and the state budget are separated. Their relation is regulatedin the following manner:

- General rule specified in the Act on Local Governments: when passing a law defining mandatory duties and powers for the local government, Parliament shall also provide for the allocation of funds necessary to execution and decides on the extent and manner of budgetary grants.
- The annual Budget Act provides annually recurrent regulation on the relationship between local governments and the central budget (i.e. re-regulates it), the components being the following:
    - state grants and subsidies;
    - assigned, shared revenues;
    - supplementary rules of money supply;
    - obligatory payments made to the State.

Due to the two-tier system of local governments in the capital (according to which both the City and the Districts are local governments with independent duties and powers as specified by law), the Act on Local Governments sets out as a special rule that revenues of the municipalities are to be shared between the City and the Districts in proportion to the duties and powers actually exercised by the City and the Districts. It specifies item by item

- the revenues which are to be received directly and independently by the City and the Districts, respectively;
- the revenues which are to be shared by the City and the Districts, respectively;
- the exclusive revenues of the Districts and of the City, respectively.

Authority on the allocation of revenues to be shared between the City and the Districts is granted to the General Assembly of the Municipality of Budapest after it has obtained the opinion of the district councils.

# APPENDIX 4: REVENUES AND EXPENDITURES OF THE MUNICIPALITY OF BUDAPEST

## Revenues

The revenues of the City between 1997 and 2000 are shown in *Table 1.*

The revenue side of the budget of the City – inclusive of the borrowings to finance the deficit – rose from HUF 195.7 billion in 1997 to HUF 249.9 billion (by 28%) in 1999 and revenues in 2000 are projected to HUF 275.5 billion. The share of centrally regulated resources within revenues in the reporting year dropped approximately by 9% in four years, declining from 36% to 27%. Two out of the three main components of the centrally regulated resources – budgetary grants to the City (operating state grants, specific purpose disbursements and targeted disbursements) and personal income tax – resulted in a drop of approximately 7% in share among budgetary revenues due to the principle of solidarity and regional equalisation applied across the country. Resources received from the Health Insurance Fund for the operation of health care – as the third component of centrally regulated resources – are channelled directly to the institutions by the National Health Insurance Fund as performance finance which manages the Health Insurance Scheme.

The ratio of own-source revenues in the reporting year equalled 54% in 1997, 38% in 1998 and 42% in 1999. This included revenues from asset utilisation, primarily from the sale of shares in the course of the privatisation of public utility companies.

In parallel with the above, pursuant to a financing strategy designed to achieve a balanced municipal budget between 1995–1998, financial reserves were accumulated in order to attenuate „the shock waves" of ad hoc revenues. Thus, the percentage share of funds derived from the redemption of Government securities purchased in previous years was 6.1% in 1997, 17.65% in 1998 and 20.22% in 1999, while 22.85% has been projected in the plan for 2000. The above strategy resulted in financial stability: fulfilment of debt service obligations on the one hand, and spreading the utilisation of ad hoc revenue items over time on the other. Should the Municipality of Budapest adopt any other practice, infrastructure development projects planned by the General Assembly could only be implemented if subordinated to the extent of privatisation revenues actually collected.

In 1998, a bond issue in an amount of DEM 150 million (HUF 18.436 million) took place within projected borrowing to an amount of HUF 20 billion as part of the funds required for the implementation of medium-term development plans at an even pace.

The actual borrowing of the Municipality amounted to HUF 2.3 billion from the World Bank, serving the development of public transportation.

The budget for 2000 envisages loans in the value of HUF 18.8 billion that aggregates World Bank loans (HUF 2 billion for the development of public transportation and HUF 3.7 billion for modernising sewage farms) and a HUF 13.1 billion EIB loan for co-financing infrastructure developments of crucial importance. These borrowings are planned with the respective guarantees of the Hungarian Government, so the budget is not supposed to include the calculations for the borrowing limits.

**Table 9: Revenues of the Municipality of Budapest**
(thousand HUF)

| Description | 1997 | | 1998 | | 1999 | | 2000 | |
|---|---|---|---|---|---|---|---|---|
| | Actual | % | Actual | % | Actual | % | Planned | % |
| a) State grant for operations | 18 832 162 | 9.62 | 23 814 013 | 10.50 | 26 930 033 | 10.78 | 20 212 146 | 7.34 |
| b) Targeted and specific purpose disbursements | 2 170 057 | 1.11 | 4 005 438 | 1.77 | 4 773 602 | 1.91 | 6 053 644 | 2.20 |
| Total budgetary grant | 21 002 219 | 10.73 | 27 819 451 | 12.27 | 31 703 635 | 12.69 | 26 265 790 | 9.54 |
| Personal income tax | 18 914 371 | 9.66 | 16 819 340 | 7.42 | 13 417 355 | 5.37 | 11 812 169 | 4.29 |
| Health care transfers from the Social Security Fund | 30 671 877 | 15.67 | 33 360 342 | 14.71 | 37 520 852 | 15.01 | 37 202 500 | 13.51 |
| Total centrally regulated funds | 70 588 467 | 36.07 | 77 999 133 | 34.40 | 82 641 842 | 33.07 | 75 280 459 | 27.34 |
| Own revenues in the reporting year | 106 601 797 | 54.47 | 85 132 624 | 37.54 | 105 615 686 | 42.28 | 112 827 523 | 40.95 |
| Current revenues | 57 441 571 | 29.35 | 70 196 549 | 30.95 | 91 150 642 | 36.48 | 88 360 714 | 32.06 |
| a) operating revenues of institutions (including VAT) | 23 931 465 | 12.23 | 30 273 137 | 13.35 | 32 174 140 | 12.88 | 29 340 467 | 10.65 |
| b) local taxes | 24 709 817 | 12.63 | 29 357 121 | 12.94 | 46 955 005 | 18.79 | 46 524 086 | 16.88 |
| - business tax | 24 240 246 | 12.39 | 28 758 921 | 12.68 | 46 364 516 | 18.55 | 45 864 086 | 16.64 |
| - tourism tax | 469 571 | 0.24 | 598 200 | 0.26 | 590 489 | 0.24 | 660 000 | 0.24 |
| c) stamp duties | 5 723 662 | 2.92 | 6 729 971 | 2.97 | 7 765 517 | 3.11 | 9 375 271 | 3.40 |
| d) environmental fine | 46 902 | 0.02 | 30 603 | 0.01 | 294 | 0.00 | 0 | 0.00 |
| e) other specific revenues | 562 940 | 0.29 | 716 175 | 0.32 | 921 985 | 0.37 | 724 942 | 0.26 |
| f) funds received for operating purposes | 2 466 785 | 1.26 | 3 089 542 | 1.36 | 3 333 701 | 1.33 | 2 395 948 | 0.87 |
| Accumulation and capital-type revenues | 49 160 226 | 25.12 | 14 936 075 | 6.59 | 14 465 044 | 5.80 | 24 466 809 | 8.89 |
| a) sale of tangible assets | 2 369 914 | 1.21 | 1 512 151 | 0.67 | 2 231 204 | 0.89 | 2 776 078 | 1.01 |
| b) sale of flats owned by the municipality | 909 761 | 0.46 | 492 413 | 0.22 | 743 998 | 0.30 | 472 000 | 0.17 |
| c) revenues from privatisation | 51 764 | 0.03 | 2 331 440 | 1.03 | 27 062 | 0.01 | 21 000 | 0.01 |
| d) revenues from the sale of companies | 5 490 547 | 2.81 | 3 456 604 | 1.52 | 1 824 130 | 0.73 | 8 610 764 | 3.13 |
| e) sale of other pecuniary rights | 22 785 | 0.01 | 20 839 | 0.01 | 15 385 | 0.01 | 0 | 0.00 |
| f) rent revenue on other assets | 0 | 0 00 | 0 | 0,00 | 200 160 | 0.08 | 1 645 050 | 0.60 |
| g) return on financial investments | 35 533 641 | 18.16 | 1 530 022 | 0.67 | 4 785 364 | 1.92 | 5 417 448 | 1.96 |
| - sale of shares and stakes | 35 285 125 | 18.03 | 515 917 | 0.23 | 2 898 138 | 1.16 | 3 671 000 | 1.33 |
| - dividends and yields received | 248 516 | 0.13 | 1.014 105 | 0.45 | 1 887 226 | 0.76 | 1 746 448 | 0.63 |
| h) funds received for accumulation | 4 781 814 | 2.44 | 5 592 606 | 2.47 | 4 637 741 | 1.86 | 5 524 469 | 2.01 |
| Total revenues in the reporting year | 177 190 264 | 90.54 | 163 137 757 | 71.94 | 188 257 528 | 75.35 | 188 107 982 | 68.29 |
| Residual funds | 5 005 058 | 2.56 | 3 617 665 | 1.60 | 8 719 580 | 3.49 | 131 417 | 0.05 |
| Redemption of Government securities purchased in preceding years | 11 857 474 | 6.06 | 40.015 080 | 17.65 | 50 552 619 | 20.22 | 68 446 304 | 24.85 |
| a) maturity within one year | 11 292 174 | 5.77 | 34 727 694 | 15.32 | 35 374 235 | 14.15 | 43 379 755 | 15.75 |
| of which: municipality | 11 292 174 | 5.77 | 34 727 694 | 15.32 | 35 348 718 | 14.14 | 43 379 755 | 15.75 |
| Institutions | | | | | 25 517 | 0.01 | 0 | 0.00 |
| b) maturing over one year (municipality) | 565 300 | 0.29 | 5.287 386 | 2.33 | 15 178 384 | 6.07 | 25 066 549 | 9.10 |
| Total revenues | 194 052 796 | 99.16 | 206 764 502 | 91.19 | 247 529 727 | 99.06 | 256 685 703 | 93.19 |
| Loans | 1 658 802 | 0.84 | 19 979 389 | 8.81 | 2 345 882 | 0.94 | 18 768 900 | 6.81 |
| Grand total of revenues and loans | 195 711 598 | 100.0 0 | 226 743 891 | 100.0 0 | 249 875 609 | 100.0 | 275 454 603 | 100.0 |

**Local taxes**

Concerning the economic independence of the local government, local taxation providing possibilities to increase own revenues plays a significant role. The possibility of introducing local taxes by local governments was introduced by Act C of 1990. Local taxation is currently regulated by the same statute, (as amended) together with Act XCI of 1990 on Tax Administration.

Pursuant to the provisions of the Act on Local Taxation, only the following types of local taxes may be imposed: tax on buildings, tax on land, the communal tax of private individuals and that of businesses, tourism tax and local business tax.

By the force of its decree, the local government may introduce new types of taxes from the beginning of any calendar year, it may repeal types of taxes already introduced, and it may modify the terms of the application of existing types of taxes, with the condition that mid-term amendments may not exacerbate the burden of the taxable entities' during the calendar year.

The right of local governments to impose taxes is limited in that respect that only one type of local tax may be imposed on one taxable item (taxable items include real property, business activities, etc.).

In the capital, the General Assembly decides on the introduction of local taxes and specifies the types that the Districts are entitled to impose on their own after having obtained the opinion of District Councils. The Districts may not impose the same type of tax imposed by the City until such have been repealed.

Pursuant to an agreement entered into with the Districts, it is the City to impose the tourism tax and the local business tax in the territory of Budapest. A majority of the Districts introduced taxes on buildings and land only in recent years, and the scales of the relevant taxes have usually been below the limits determined by the Act.

By the year 2000, the rate of the business tax (the predominant type of local taxes) gradually reached its upper limit (2% of net sales) defined by law. Also from 2000 on, material expenditure can be deduced from the tax base.

The rate of the tourism tax is 3% of the accommodation fee for every guest night.

Pursuant to the Act on Local Taxes and the Act on Tax Administration, the Municipality of Budapest is entitled to develop a unified tax system for the capital, incorporating tax on buildings and tax on land (property tax) into the system.

With regard to property tax, the City wishes to introduce a value-based tax system, but has to wait for the amendments of the respective Acts to make it possible.

For the period till fulfilling this expectation the General Assembly passed its Decree No. 14/2000. (III. 30.) on the uniform regulation of the taxes on buildings and on land.

The general tariff of tax on buildings is HUF 900/m2. Taxation on dwellings is differentiated, taking into consideration the value differences among dwelling areas. Buildings used by the owners themselves for dwelling are exempt from taxation.

The general tariff of tax on land is HUF 200/m2.

Revenues from taxes on buildings and on land are expected to reach HUF 15-18 billion in 2001.

**Table 10: Revenues from local taxes, 1996–1999**
(thousand HUF)

| Year | DISTRICTS | | | CITY | |
|---|---|---|---|---|---|
| | Tax on buildings | Tax on land | Communal tax of private individuals | Tourism tax | Business tax |
| 1996 | 3,833,398 | 949,401 | 165,280 | 451,005 | 31,827,440 |
| 1997 | 5,713,879 | 1,082,999 | 262,887 | 466,175 | 41,020,936 |
| 1998 | 7,435,070 | 1,223,211 | 251,567 | 560,731 | 49,811,667 |
| 1999 | 9,113,017 | 1,419,832 | 249,286 | 590,489 | 64,966,488 |

## Expenditure

The expenditure side of the budget rose from HUF 191.6 billion in 1997 by almost 25% to 239.2 billion in 1999, while the 2000 plan includes a projection of HUF 275.6 billion.

Despite their diminishing rate within the budget, operating expenses earmarked to finance budgetary institutions and certain tasks of the local governments – public utilities, public transport – represent a significant volume: in 1997, they accounted for 53.4% of the expenditure, while this ratio is projected at 47% in 2000 (taking into consideration also specific and general reserves). The largest item among operating expenses are the so-called „material type expenses".

**Table 11: The expenditure of the Municipality of Budapest**
(thousand HUF)

| Description | 1997 | | 1998 | | 1999 | | 2000 | |
|---|---|---|---|---|---|---|---|---|
| | Actual | % | Actual | % | Actual | % | Planned | % |
| Operating expenses | 102 388 830 | 53,44 | 115 284 692 | 53,02 | 130 023 193 | 54,35 | 125 433 003 | 45,54 |
| a) personal allowances | 29 592 318 | 15,45 | 34 149 656 | 15,71 | 38 007 915 | 15,89 | 39 388 954 | 14,30 |
| b) contributions borne by employers | 13 053 719 | 6,81 | 14 996 249 | 6,90 | 15 125 331 | 6,32 | 15 957 695 | 5,79 |
| c) cash allowances to beneficiaries | 328 649 | 0,17 | 407 987 | 0,19 | 518 405 | 0,22 | 472 821 | 0,17 |
| d) material expenditure | 51 073 264 | 26,66 | 59 359 658 | 27,29 | 69 419 115 | 29,01 | 61 140 766 | 22,20 |
| e) transfers of money instruments | 8 340 880 | 4,35 | 6 371 142 | 2,93 | 6 952 427 | 2,91 | 8 472 767 | 3,08 |
| Investments, transfer of funds | 25 850 093 | 13,49 | 36 119 718 | 16,61 | 37 214 716 | 15,56 | 61 830 126 | 22,45 |
| Cost of refurbishment | 4 345 279 | 2,27 | 3 493 703 | 1,61 | 6 358 691 | 2,66 | 8 969 598 | 3,26 |
| Debt service | 6 322 081 | 3,30 | 12 623 800 | 5,81 | 1 236 670 | 0,52 | 2 412 612 | 0,87 |
| amortisation of loan principal | 4 754 960 | 2,48 | 11 404 883 | 5,25 | 14 312 | 0,01 | 498 812 | 0,18 |
| interest on loans | 1 050 462 | 0,55 | 1 182 767 | 0,54 | 1 222 358 | 0,51 | 1 691 900 | 0,61 |
| interest on loans accounted for as investments | 516 659 | 0,27 | 36 150 | 0,02 | 0 | 0,00 | 221 900 | 0,08 |
| Government securities bought | 52 660 251 | 27,50 | 49 904 576 | 22,95 | 64 372 963 | 26,91 | 36 012 504 | 13,07 |
| a) maturity within one year | 34 757 680 | 18,15 | 35 392 616 | 16,28 | 43 379 755 | 18,13 | 18 512 504 | 6,72 |
| of which: municipality | 34 727 696 | 18,13 | 35 392 616 | 16,28 | 43 379 755 | 18,13 | 18 512 504 | 6,72 |
| institutions | 29 984 | 0,02 | | 0,00 | | 0,00 | 0 | 0,00 |
| b) maturing over one year | 17 902 571 | 9,35 | 14 511 960 | 6,67 | 20 993 208 | 8,78 | 17 500 000 | 6,35 |
| of which: municipality | 17 902 571 | 9,35 | 14 511 960 | 6,67 | 20 993 208 | 8,78 | 17 500 000 | 6,35 |
| institutions | 0 | 0,00 | 0 | 0,00 | | 0,00 | 0 | 0,00 |
| Specified reserves | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 39 060 760 | 14,18 |
| a) for operations | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 2 353 624 | 0,85 |
| b) for accumulations | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 36 187 036 | 13,14 |
| c) for refurbishment | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 520 000 | 0,19 |
| d) for local minority governments | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 100 | 0,00 |
| General reserve | 0 | 0,00 | 0 | 0,00 | 0 | 0,00 | 1 736 000 | 0,63 |
| Total expenses during the reporting year | 191 566 534 | 100,00 | 217 426 489 | 100,00 | 239 206 233 | 100,00 | 275 454 603 | 100,00 |

Between 1997 and 1999, they accounted for 27–29% of the budget. They include all expenditure not tied to human resources and relate to the operation, maintenance and professional activities of institutions as well as expenditure items related to the specific duties of the City. Over the same period, personal allowances relating to the provision of human resources and contributions borne by employers accounted nearly for 22% of expenditures. Cash allowances to beneficiaries do not represent a significant item. They include cash grants to beneficiaries in educational, child and youth care institutions. Transfers of funds for operating expenses also represent a small ratio in the expenditure and such funds primarily relate to grants for foundations, churches and civil organisations.

Items representing another major aggregate on the expenditure side of the budget are connected to investments and transfers of development funds. Their proportion within

the total expenditure was around 13–16% between 1997–1999 and together with the planned expenditure from the specific purpose reserve, is projected to be at 35.6% in 2000. These funds are intended to finance development projects specified by the urban policy. The Municipality of Budapest has taken major steps to reduce the backlog in the supply of infrastructure in the fields of transport, water management, health care and culture.

Investments by the Municipality of Budapest broken down to sectors are shown in Table 4, refurbishment expenses are shown in Table 5.

**Table 12: Investments by Sectors**
(million HUF)

| Sectors | 1997 | | 1998 | | 1999 | | 2000 | |
|---|---|---|---|---|---|---|---|---|
| | actual | % | actual | % | actual | % | plan | % |
| Housing | 380.0 | 1.5 | 658.3 | 1.8 | 752.1 | 2.0 | 8 717.6 | 8.9 |
| Transportation | 8 948.0 | 34.6 | 11 261.8 | 31.2 | 10 633.0 | 28.6 | 40 701.4 | 41.5 |
| Water management | 3 452.2 | 13.4 | 6 141.8 | 17.0 | 5 000.3 | 13.4 | 12 557.9 | 12.8 |
| Management of public utilities | 1 077.0 | 4.2 | 794.6 | 2.2 | 3 751.0 | 10.1 | 5 991.8 | 6.1 |
| Environment protection | 172.0 | 0.7 | 406.8 | 1.1 | 204.2 | 0.5 | 1 486.0 | 1.5 |
| Health care | 4 270.7 | 16.5 | 5 668.6 | 15.7 | 5 469.5 | 14.7 | 9 025.8 | 9.2 |
| Social plociy | 772.6 | 3.0 | 1 336.9 | 3.7 | 1 491.3 | 4.0 | 2 629.1 | 2.7 |
| Education | 2 227.2 | 8.6 | 3 168.2 | 8.8 | 3 952.6 | 10.6 | 2 883.0 | 2.9 |
| Child and youth care | 329.9 | 1.3 | 633.3 | 1.8 | 410.7 | 1.1 | 2 149.7 | 2.2 |
| Culture | 2 995.8 | 11.6 | 3 992.2 | 11.1 | 3 521.5 | 9.5 | 6 453.3 | 6.6 |
| City development | 54.3 | 0.2 | 52.0 | 0.1 | 2.2 | 0.0 | 80.0 | 0.1 |
| Information technology | 72.7 | 0.3 | 87.5 | 0.2 | 273.8 | 0.7 | 518.2 | 0.5 |
| Developments for the Mayor's Office | 137.2 | 0.5 | 194.3 | 0.5 | 149.4 | 0.4 | 894.7 | 0.9 |
| City administration | 125.1 | 0.5 | 234.3 | 0.6 | 316.1 | 0.8 | 304.6 | 0.3 |
| Public supply, tourism | 497.4 | 1.9 | 149.3 | 0.4 | 191.3 | 0.5 | 589.2 | 0.6 |
| Central and other tasks | 338.0 | 1.3 | 957.3 | 2.7 | 1 095.7 | 2.9 | 877.7 | 0.9 |
| Specific reserves for institiution rartionalisation | | | | | | | 2 157.2 | 2.2 |
| Financial investments | | | 382.5 | 1.1 | | 0.0 | | 0.0 |
| **Total of investments, the transfer of funds** | **25 850.1** | **100.0** | **36 119.7** | **100.0** | **37 214.7** | **100.0** | **98 017.2** | **100.0** |

**Table 13: Refurbishments by Sectors**
(million HUF)

| Sectors | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|
| | actual | actual | actual | Plan |
| Housing | 54.7 | 39.0 | 147.5 | 108.6 |
| Transportation | 31.2 | 35.6 | - | 87.6 |
| Public utilities | 2.2 | 1.0 | 2.7 | 1.5 |
| Health care | 647.0 | 488.8 | 887.7 | 734.5 |
| Social policy | 149.2 | 159.8 | 352.1 | 661.4 |
| Education | 451.2 | 313.9 | 1 188.1 | 915.4 |
| Child and youth care | 77.2 | 88.5 | 93.8 | 107.5 |
| Culture | 217.3 | 152.2 | 163.1 | 146.1 |
| Renovation at the Mayor's Office | 69.5 | 40.6 | 12.2 | 106.6 |
| City administration | 30.4 | 50.9 | 53.9 | 132.0 |
| Public supply, tourism | 34.1 | 51.4 | 76.0 | 113.9 |
| Central and other tasks | 0.7 | 0.7 | 1.0 | 57.6 |
| Reconstruction of roads and bridges | 2 580.6 | 2 071.3 | 3 380.6 | 6 316.9 |
| **Total** | **4 345.3** | **3 493.7** | **6 358.7** | **9 489.6** |

In addition to realised accumulation – in line with the financing strategy to be described in detail later – the amount spent on the purchase of Government backed securities (state bonds, discount treasury bills) and NBH bonds was significant. Surpluses from ad hoc and one-off revenues can provide the necessary financial reserves for an active borrowing policy and a balanced City budget in the period after 2000.

**Table 14: Portfolio of Government papers bought from municipal accounts**
(as of December 31, million HUF)

| Accounts | 1997 | 1998 | 1999 |
|---|---|---|---|
| Budgetary settlement account | 44 544,7 | 49 809,9 | 57 932,3 |
| of which: within one year<br>Government bonds | 25 820,5<br>18 724,2 | 27 892,6<br>21 917,3 | 32 912,9<br>25 019,4 |
| DBR Metro segregated special settlement account | 9 251,9 | 13 259,7 | 18 221,4 |
| of which: within one year<br>Government bonds | 6 351,2<br>2 900,7 | 4 327,6<br>8 932,1 | 11 644,8 6<br>576,6 |
| Housing rehabilitation accounts (within one year) | 2 556,0 | 3 128,5 | 3 890,3 |
| Total for the Municipality of Budapest | 56 352,6 | 66 198,1 | 80 044,0 |
| of which: within one year<br>Government bonds | 34 727,7<br>21 624,9 | 35 348,7<br>30 849,4 | 43 379,8<br>36 664,2 |

Debt service appears as a diminishing obligation on the expenditure side of the budget, its percentage share dropped from 3.3% in 1997 to 0.52% in 1999, predominantly as a result of loan prepayments.

Obligations concerning the repayment of loan principal at the end of 1995–1999 are shown in *Table 7*. The repayment of the loan principal as of December 31, 1995 (HUF 12,978.7 million), as a result of significant prepayments, is focused on the years 1996-1998.

**Table 15: Changes in the amortisation of principal by the Municipality**
(million HUF, end of year)

| | Description | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|
| 1. | Loans acquired before 1992 | | | | | |
| | a) North-Pest traffic control centre | 53.6 | 47.3 | 41.0 | 34.7 | 28.4 |
| | b) Budapest Congress Centre | 40.0 | 32.0 | 24.0 | 16.0 | 8.0 |
| 2. | Loans acquired in 1992 | 440.0 | — | — | — | — |
| 3. | Loans acquired in 19931 | 3,945.1 | 2,000.0 | 1,000.0 | — | — |
| 4. | Loans acquired in 1994 | 6,000.0 | 2,800.0 | — | — | — |
| 5. | Loans acquired in 1995 | 2,500.0 | — | — | — | — |
| 6. | DEM 150 million Bond of 1998/2003 | — | — | — | 19,314.0 | 19,588.5 |
| | Total for 1–6: | 12,978.7 | 4,879.3 | 1,065.0 | 19,364.7 | 19,624,9 |
| 7. | EBRD loan2 | 5,325.4 | 8,633.0 | 9,431.1 | — | — |
| 8. | World Bank loan2, 3 | — | 944.6 | 3,145.0 | 4,093.5 | 7,214.9 |
| | Total for 1–8 | 18,304.1 | 14,456.9 | 13,641.1 | 23,458.2 | 26 839,8 |