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## Comparative analysis of the process for compliance with the European Charter of Local Self-Government in The Czech Republic, Hungary and Slovakia - with special emphasis on economic conditions and Hungarian atypical features

**Abstract.** The aim of this paper is to analyse legal and financial dynamics of the self-governance in three countries of the Visegrad Group: The Czech Republic, Hungary and Slovakia. The paper explores compliance with the European Charter of Local Self-Government, financial independence and operational features of self-governance. The paper provides an overview of the regulatory environment that was set up for the local government in the Visegrad countries, examines the powers by local government, and the degree of its financial independence. The financial aspects of self-government are compared, and compliance with major fiscal rules is examined.

**Keywords:** European Charter of Local Self-Government; Fiscal Decentralisation; Local Self-Government; Public Finance; Local Debt; Public Service; Visegrad Countries; Slovakia; The Czech Republic; Hungary

**JEL Classification:** H70; H71; H72; H73; H74

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### Порівняльний аналіз процесу дотримання Європейської хартії місцевого самоврядування на прикладах Чеської Республіки, Угорщини та Словаччини з особливою увагою до економічних умов та угорських нетипових особливостей

**Аноція.** У статті розглянуто еволюцію системи місцевого самоуправління в трьох країнах Вишеградської групи, що є подібними за рівнем економічного розвитку, розміром й історичною спадщиною: Словаччині, Чехії та Угорщині. Проаналізовано зміни в законодавчому забезпеченні самоуправління та фінансовому регулюванню його діяльності. У статті досліджено відповідність організації самоуправління в згаданих країнах відповідно до Європейської хартії місцевого самоврядування, особливо в частині фінансової незалежності й принципів адміністрування. Також проведено кількісний аналіз встановлених фіскальних правил. Досліджено регулятивне середовище, в якому місцеве самоуправління здійснює свою діяльність, характер повноважень і фінансової незалежності органів місцевого самоврядування. У статті порівняно принципи фінансування діяльності місцевого самоуправління та фіскального регулювання досліджуваних країн.

**Ключові слова:** Європейська хартія місцевого самоврядування; фіскальна децентралізація; місцеве самоврядування; державні фінанси; місцеві фінанси; місцевий борг; державна служба; Вишеградські країни; Словаччина; Чехія; Угорщина.

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**Сравнительный анализ процесса соблюдения Европейской хартии местного самоуправления на примерах Чешской Республики, Венгрии и Словакии с особым вниманием к экономическим условиям и венгерским нетипичным особенностям**

**Анотация.** В статье рассмотрена эволюция системы местного самоуправления в трех странах Вышеградской группы, схожих по уровню экономического развития, площади и историческому наследию: Словакии, Чехии и Венгрии. Проанализированы законодательные изменения в обеспечении местного самоуправления и финансового регулирования его деятельности. В статье исследовано соответствие принципов организации самоуправления в упомянутых странах в соответствии с Европейской хартией местного самоуправления, особенно в части финансовой независимости и принципов администрирования. Также осуществлен количественный анализ установленных фискальных правил. Рассмотрена регулятивная среда, в которой местное самоуправление осуществляет свою деятельность, характер полномочий и финансовой независимости органов местного самоуправления. В статье проведено сравнительное исследование принципов финансирования деятельности местного самоуправления и фискального регулирования исследуемых государств.

**Ключевые слова:** Европейская хартия местного самоуправления; фискальная децентрализация; местное самоуправление; государственные финансы; местные финансы; местный долг; государственная служба; Вышеградские страны; Словакия; Чехия; Венгрия.

## 1. Introduction

The aim of this paper is to present the system of financing and performing duties of the self-governance in three countries of the Visegrad Cooperation (V4), which have similar level of development, area size, and close historical past, in order to define whether their practices are compliant with the European Charter of Local Self-Government of the Council of Europe<sup>1</sup> (hereinafter referred to as the «Charter»). The paper gives a detailed analysis of local self-government administrative measures, taken along the regime change after 1990, and in the course of integration to the European Union<sup>2</sup>. Our aim is to analyse the dynamics of national legislation while implementing legal arrangements of the Charter, and to reveal the dominant themes in the administrative reform of the Central European countries. Amid the broader picture of the EU impact on transformation of regulatory systems in three countries under review, the evolution of self-government remains an important part. It deals with effectiveness of public duties performance by the local governments, their ability to manage public finances, and to address build interaction with citizens as an immediate consumers of local public services. The European Charter of Local Self-Government plays an important role in development and maintenance of self-government systems in European countries, which ensures universal nature of the same fundamental values across the continent, with only slight peculiarities in different nations. These peculiarities are explained by certain geographical features and different tradition of public governance; as their systems of local authorities took different paths in past, they still carry some degree of heterogeneity. The paper also gives an account of the financial aspects of the self-governance in three Visegrad countries.

In the negations about the administrative reform launched in the late 20<sup>th</sup> century, the European Charter of Local Self-Government must be considered with due emphasis, as its adoption in Slovakia on 23<sup>rd</sup> February, 1999, and in The Czech Republic on 1<sup>st</sup> September, 1999 has great significance for the implementation of self-governance compatible with European norms. The Charter still plays a prominent role in the assessment of Czech and Slovak acts on self-government and other pieces of legislation related to the

self-governance. Twenty provisions of the European Charter of Local Self-Government took effect on 1<sup>st</sup> June, 2000, upon the amendments to the Constitution of the Slovak Republic and to Act No. 369 of 1990 on Municipal Establishment<sup>3</sup>. Later, Slovakia committed itself to adhering to such provisions of the Charter which had been treated with reservations earlier, and signed its commitment to all provisions of the Charter on 14<sup>th</sup> April, 2007<sup>4</sup>.

The reform in public administration in the spirit of the Charter began when the Act on Municipalities<sup>5</sup> (Act 128 of 2000), entered into force on 1<sup>st</sup> January, 2001. Although The Czech Republic approved several provisions of the Charter, it also took few reservations, with special regard to the financing principles set out in paragraph three («Part at least of the financial resources of local authorities shall derive from local taxes and charges...»), five (the protection of financially weaker local authorities) and six («Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them») of Article 9.

In Hungary, during the regime change, the principles of the Charter and the prevailing public administrative trends were considered when the regulation on self-government was designed<sup>6</sup>, and a modern system of its kind was introduced. The principles of the Charter were legally recognised by introduction of Act XV in 1997.

## 2. Brief Literature Review

The review of relevant literature provides a theoretical background to the study. The golden rule for budgets was introduced into the scholarly works on public finances by Musgrave (1959), therefore this rule is dubbed as the Musgrave rule. The rule does not allow to finance investments through current operational resources as it conflicts with financing logic.

In several European countries, the application of the golden rule means a certain degree - strict or more relaxed -

<sup>3</sup> According to Article 12 of the European Charter of Local Self-Government, each party shall undertake to consider itself bound by at least twenty paragraphs of Part I of the Charter, at least ten of which shall be selected among the paragraphs of the article. Upon the ratification in 1999, Slovakia considered twelve of the fourteen paragraphs binding on Slovakian local governments. See Statement No. 336/2000 of the Ministry of Foreign Affairs of the Slovak Republic on signing the European Charter of Local Self-Government.

<sup>4</sup> Statement No. 587/2007 of the Ministry of Foreign Affairs of the Slovak Republic on the Adoption of Additional Provisions of the European Charter of Local Self-Government.

<sup>5</sup> The new act on municipalities has repealed Act No 369/1990 Coll. on Municipalities adopted by the Federal Republic.

<sup>6</sup> Based on the principles of New Public Management. See Rosta (2013).

<sup>1</sup> The Treaty on the European Charter of Local Self-Government signed in Strasbourg on 15<sup>th</sup> October, 1985 - European Charter of Local Self-Government.

<sup>2</sup> For further details on the issues of integration, see Torma (2011).

of control over excessive indebtedness of local governments at the state level, referred to as the golden rule of financing by Dafflon (2010). In accordance with the golden rule of financing, current expenditures of local governments must be paid from current resources of revenues and tax revenues; investments, however, may be financed through longer-term loans as well. In fact, differences in debt control between countries lie in the upper limit of indebtedness. In practice, the golden rule of public finance controls the accrual of fixed assets, thereby the provision of public service by local governments is ensured for several generations, and, therefore, emphasis in financing should be placed on the division between generations (Heijdra & Meijdam, 2002.). In an operating approach, there are three known ways of controlling the indebtedness and borrowing of local governments. The first one is market financing, the second is characterised by the fact that borrowing requires authorisation, while the third one prescribes limited borrowing (Ter-Minassian & Craigh, 1997). In the European Union, the regulatory foundations of maintaining deficit at required level were introduced within the framework of the Stability and Growth Pact, and were studied against cases of OECD countries by Van Rumpuy (2016). Although not for three Visegrad countries, the mechanism of budgetary rules was examined in Italian and Swiss cases (Monacelli et al, 2016; Burrett & Feld, 2018).

These rules are important because they guarantee the solvency of the local governments and the implementation of the going concern principle (Duve & Dreschsler, 2011). Foremny (2014) studied the implementation of fiscal rules during the pre-crisis period, and the study concluded that it was impossible to keep a financial equilibrium in all cases, disregarding the existing rules. This was also confirmed by Levaggi & Zanola (2003), as they studied the case of Italian regions. In order to support sustainable public finances, governments should try to shorten the volume of debt by tightening fiscal policies and making public finances more resistant to crises (Uryszek, 2015).

### 3. Results

#### 3.1. Development of the system of performing functions and financing by Slovak local governments

In Slovakia, Act 416 of 2001<sup>7</sup> transferred a complex system of governance functions to the municipalities and eight higher territorial units<sup>8</sup>, and state assets indispensable for undertaking almost four-hundred new duties were also transferred to municipalities' handling. The law distinguishes between two kinds of obligations to perform duties, which merged into the acts on the municipalities<sup>9</sup> and higher territorial units<sup>10</sup> as functions and competences. The first group of public duties are attributed exclusively to the municipalities and higher territorial units, which perform them in behalf of themselves and under their own responsibilities, and finance them mainly from the municipality's or the higher territorial unit's own revenues. Obligations to perform duties, transferred by the state, constitute another group of public duties, which are undertaken by municipalities and higher territorial units in the name and under the responsibility of the central government. The funds required covering expenses by municipalities and higher territorial units in delivering public duties were granted by the central budget until the introduction of a fiscal decentralisation. As a result of the decentralisation taking place at the turn of the millennium, municipalities and higher territorial units took over some duties of the central government. The execution of delegated public administrative activities are managed and controlled by the Slovakian

government. The Act 416 of 2001 on the Transfer of some Responsibilities from State Administration to Municipalities and Higher Territorial Units has created a division of labour between various government levels, as well as social, economic and development-driven cooperation between local and national level governments. For long-term sustainability, however, the legal frameworks of resource allocation required for effective cost management and financing of public goods<sup>11</sup>. Decentralisation and the delegation of competences proved to be slow and troublesome in practice. To date, the execution of modern institutional governance supporting the effective organisation of new functions delegated by the state is still lacking in many senses. Habánik, Kordoš & Košťák (2016) also draw attention to the limitations of performing duties by municipalities and higher territorial units, which they explained with the different growth pace of public expenditures and subnational government spending. Public expenditures increased from 2006 till 2015 by 62.4% compared to only 40.8% growth in expenditures of higher territorial units and municipalities.

The adoption of Article 9 of the Charter and its incorporation into the Slovak legal system had a prominent part in the process of fiscal decentralisation launched at the end of the 20<sup>th</sup> century. As Section 2 of Article 9 stated, «Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law». The principle of commensuration between financial resources and responsibilities is also guaranteed by the Slovak constitution: «The costs of the performance of delegated state administration tasks shall be covered by the State» (Section 2 of Article 71), and the act on municipalities further clarifies: «financial resources and other financial assets required for the performance of state administration tasks delegated to municipalities shall be provided by the State» (Section 1 of Paragraph 5). In this Act, the principle of commensuration is applied not only to delegated responsibilities but also ex post needs for resources necessary to perform their duties. The principle of financial independence and the principle of diversified and buoyant financial resources, formulated in Sections 3 and 4 of Article 9 of the Charter, were recognised as binding by the Slovak state with the amendment to the Act on municipalities in 1999. According to the Act, municipalities shall cover their own needs from their own resources, state aid and other resources. By other resources, the Act on municipalities means reimbursable sources of financing, such as loans, and extra-budgetary resources deriving from funds established by the municipality.

The adoption of Section 8 of Article 9 of the Charter is particularly noteworthy, as it stated that «For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law». The Charter guarantees the right of borrowing for capital investment at the national capital market. In 2004, however, a rather strict provision was made on the inclusion of reimbursable resources of financing, which curbed the over-crediting processes of municipalities and higher territorial units in Slovakia, and created their long-term financial independence and stability. Act 583 of 2004 on the Budget Rules of the Regional Self-Administration lays down that municipalities and higher regional units may use reimbursable resources only for financing of investments. Credit resources may be used exclusively for the purposes of reducing interim deficit under conditions that «they will be repaid to the end of the budget year from the incomes of the current budget» (Section 2 of Paragraph 17). With the amendment to Act 583 of 2004 in 2011, and with the introduction of Act 493 of 2011 on Fiscal Responsibility, further restrictions were imposed. According to new legislation, municipalities and higher territorial units may use reimbursable sources of financing for the investment tasks if their total debt remains below 60% of the actual revenues of the previous fiscal year, and the amount of instalments, with the

<sup>7</sup> Act 416 of 2001 of the National Council of the Slovak Republic on the Transfer of some Responsibilities from State Administration to Municipalities and Higher Territorial Units.

<sup>8</sup> The Self-Governing Region of Bratislava, The Self-Governing Region of Trnava, The Self-Governing Region of Trenčín, The Self-Governing Region of Nitra, The Self-Governing Region of Žilina, The Self-Governing Region of Banská Bystrica, The Self-Governing Region of Košice, and The Self-Governing Region of Prešov.

<sup>9</sup> Act 369 of 1990 of the Czech and Slovak Federative Republic on Municipalities.

<sup>10</sup> Act 302 of 2001 of the National Council of the Slovak Republic on the Administration of Superior Territorial Units.

<sup>11</sup> Act 493 of 2011 of the National Council of the Slovak Republic on Budget Responsibility.



interest rate expenditure included, does not exceed 25% of the revenues of the previous fiscal year.

Slovakia has fully adopted the Charter's article on financial resources<sup>12</sup>, including the sections treated with reservations in The Czech Republic. The Act on Municipalities provides for the protection of financially weaker local authorities, keeping the principle of commensuration between responsibilities and resources, as «state aid may be granted to municipalities which have insufficient revenues for performing their duties» (Section 4 of Paragraph 7).

The revenue independence of municipalities was created only on the threshold of the 21<sup>st</sup> century, with the second wave of state administration reforms<sup>13</sup>, although real estate tax, providing a small source of revenues, and local fees, also amounting to small part of revenues, formed an independent source of revenues for the municipalities' budgets already in the 1990s.

Although fiscal decentralisation had formed an integral part of the state administration reform, it was implemented in Slovak Republic only in 2005, after the division of competences and responsibilities between different levels of self-government was completed. From the time of transfer of competences until the EU accession, Slovak municipalities and higher territorial units mostly depended on the subventions from the central budget. Before the implementation of fiscal decentralisation, the financial resources required for covering expenditures incurred by municipalities and higher territorial units while performing public duties falling within their competence and delegated by the state, were provided by the central government by sharing personal income tax, corporate tax and tax on motor vehicles, as well as from combined state aid. The extent of sharing taxes, and the amount of state aid for operational and development purposes were modified on an annual basis based on the Act on Public Finance. Aid - provided from the resources of the central budget - financing the obligation to perform duties delegated by the state were divided into three different groups. Aid financing the performance of municipal competences assisted municipalities with a population of less than three thousand people in execution of responsibilities delegated by the state. Five cities, Bratislava, Košice, Banská Bystrica, Žilina and Prešov, received aid to promote local public transport of municipalities. Public education aid was mainly granted to municipalities financing and operating educational institutions.

Three acts played a key role in launching the reform processes of financing: Act 583 of 2004 on the Budget Rules of the Regional Self-Administration, Act 582 of 2004 on Local Taxes and the Fees for Municipal Waste, and Minor Construction Waste and Act 564 of 2004 on the Budget Determination of Income Tax Yields to Regional Self-Administration.

The Act on of Budgetary Rules of the Regional Self-Administration regulates the procedure of planning budgets, and the budgetary management of municipalities and higher regional units. It also enumerates, with the reference to Act 564 of 2004, transfers between the state budget and the budgets of municipalities and higher regional units, shares on income taxes and tied and untied state financial aid for financing the performance of delegated state administration tasks.

After fiscal decentralisation processes ended, financial resources, required for financing general commitments to conduct responsibilities, are provided by the central budget through distribution of the entire amount of personal income tax to municipalities and higher territorial units and state financial aids. According to the Act 564 of 2004, currently in force, 70% of personal income tax is transferred to municipalities, and 30% is transferred to higher territorial units. The distribution of personal income tax to specific local and regional budgets is regulated by a government regulation of

2004, amended 9 times since<sup>14</sup>. According to the government regulation, income tax is distributed to municipalities based on four criteria: altitude of the municipality above sea level<sup>15</sup>, residential population of the municipality<sup>16</sup>, number of pupils and students of educational institutions operated by the municipality, and the number of the municipality's residents above the age of 62.

After fiscal decentralisation, financial aid for the performance of municipal competences and public transport subsidies of municipalities have been discontinued. Together with the tax reform in 2004, the Slovak state created the municipalities' independence in revenues, and own revenues have become key elements of enabling local resources. The new financing characteristics of municipalities were summarised in three points by Nižňanský, Cibáková & Hamalová (2014, p. 148):

- a) municipalities are entitled to levying local taxes and fees,
- b) receive a share of personal income tax,
- c) are granted financial aids from the central budget to perform tasks delegated by the state.

Act 583 of 2004 on the Budget Rules of the Regional Self-Administration identifies the following sources of municipal revenues:

- revenues from local taxes and fees<sup>17</sup>, in particular, real estate tax, dog tax, tourist tax, tax on the use of public areas, tax on vending machines, tax on operating gaming machines, tax on the entry and staying of motor vehicles in historical parts of towns, nuclear facility tax and local fees;
- revenues from asset management, and from possession and transferring of assets, and from activities of municipalities, and their budgetary organizations;
- revenues from interests on municipal investments;
- fines imposed by municipalities;
- donations;
- share of personal income tax;
- state financial aids and contributions to financing costs incurred when performing public administration tasks delegated by the state;
- further tied and untied state financial aid;
- tied financial aid transferred from the budget of a higher territorial unit;
- financial resources from the European Union and other foreign countries;
- other revenues according to particular regulations;
- shares of profit paid by enterprises established by the municipality;
- reimbursable credit resources.

Today, Slovak municipalities and higher territorial units finance their governance functions mainly from their own resources. Tax revenues constitute half (51%) of the sources of revenues of municipalities. Personal income tax amounts to<sup>18</sup> more than three-fourths of tax revenues<sup>19</sup>, and local taxes and fees amount to slightly less than a quarter of them. The share of financial resources (aid and contributions), transferred from the central budget, for the performance of competences delegated by the state, stay at 27.5% of the total revenues of municipalities. Revenues from entrepreneurial and other activities account for 10-11% of resources.

<sup>14</sup> Government Regulation No. 668/ 2004 of the Slovak Republic on the Distribution of Tax Revenues.

<sup>15</sup> The share of personal income tax increases with altitude above sea level.

<sup>16</sup> The share of personal income tax increases with the population number. The government regulation divides municipalities into five groups, based on their population number: Between 1 and 1,000 people the coefficient is 0.89; between 1,001 and 5,000 the coefficient is 0.90; between 5,001 and 10,000 people the coefficient is 0.91; between 10,001 and 50,000 the coefficient is 0.94; and between 50,000 and 100,000 the coefficient is 1.13; separate coefficients are determined for the city of Košice (1.50) and the capital city of Bratislava (2.23).

<sup>17</sup> Act 582 of 2004 of the National Council of the Slovak Republic on the Local Taxes, and Local Fee for Municipal Waste and Minor Construction Waste.

<sup>18</sup> Based on the 2017 data of the Ministry of Finance of the Slovak Republic, more than 76.7% of the tax revenues of municipalities.

<sup>19</sup> Based on the 2017 data of the Ministry of Finance of the Slovak Republic, less than 23.3% of the tax revenues of municipalities. While real estate tax amounts to 14-85% of the tax revenues of local budgets, other local taxes and fees account for only 8.4% of tax revenues.

<sup>12</sup> Statement No.602/2002 of the Ministry of Foreign Affairs of the Slovak Republic on Adopting the European Charter of Local Self-Government.

<sup>13</sup> The first wave means political decentralisation processes taking place directly after the regime change.

Due to the Implementing Act on Budgetary Rules<sup>20</sup> and Budget Responsibility<sup>21</sup>, municipalities have decreased the use of reimbursable sources of financing. Net borrowing does not exceed 6% of municipal revenues<sup>22</sup>. On average, overdue liabilities account for 0.7 percent of total liabilities<sup>23</sup>.

### 3.2. Characteristics of financing of Czech municipalities

Several common features can be traced in Czech and Slovak fiscal decentralisation processes. As district offices were abolished, state administration responsibilities and powers were transferred to the municipalities (in The Czech Republic the transfer was conducted in accordance to the Act 314 of 2002)<sup>24</sup>.

The reform of the Czech public administration mechanism started when several points of the Charter were adopted, although even today The Czech Republic still makes reservations to some of the provisions of the Article 9 of the Charter regarding the financing of municipalities (which is responsible for the difference in structure of financing of Czech and Slovak municipalities).

According to the Czech Constitution, municipalities and higher self-governing regions with own budgets shall manage municipal property in view and for the creation of public good. Budget management of municipalities and districts is an independent competency, which in practice means that municipalities decide themselves on the budget matters.

Czech municipal and regional revenues - similar to its Eastern neighbour - are divided into four main groups: tax revenues, non-tax revenues (for example, resources from entrepreneurial activities of the municipality or region, the lease or sale of property), non-operational and capital revenues, and other aid and contributions. Taxes are predominant sources of revenues for the municipal budget, as they account for almost 70% of revenues. The share of state aid is only 18% of total resources, and the share of non-tax revenues is around 11%. Marginalised capital revenues do not even reach 3%<sup>25</sup>. Czech central government provides financial resources required for financing municipal commitments to fulfil responsibilities from the central budget, by sharing value added tax, corporate tax, personal income tax and winnings tax, as well as by the state aid and contributions.

Although the institute of local taxes is not due in The Czech Republic, in practice real estate tax and local fees could be de facto defined as local, as they constitute municipalities' own resources, in compliance with - the Charter adopted in 1999. Thus real estate tax is contributed to the local budget in full. Tax revenues of regional self-governing units also comprise a share of value added tax, corporate tax, and personal income tax. The largest source of revenues of the local budget comes from its share of value added tax. According to the Act 243 of 2000<sup>26</sup>, municipalities and higher self-governing regions receive 35.2% of central taxes. Since 2018, 33.56% of value added tax, corporate tax and personal income tax have been transferred to the budget of municipalities<sup>27</sup>. It is clear that Slovak municipalities rely on their own resources to a greater extent than their Czech counterparts, and they have much wider range of local taxes available.

### 3.3. Description of the Hungarian system of self-government from the aspects of operation and financing

The Hungarian system of self-government has evolved from the Soviet-type system of councils prior to 1990, and has been gradually transformed into real self-government. State distribution, a common feature of planned economies, has

been replaced by decentralisation of responsibilities, where the state handled to local governments a growing number of responsibilities, but provided only limited finances. As the system of self-government evolved, the principle of «one settlement, one local government» arose, and the administrative responsibilities at the settlement level were similar for every local government since they were delegated (Csűrös, 2014).

Hungary introduced the principles of the Charter into its legal system by adopting Act XV of 1997, however, these principles were already respected when the Constitution<sup>28</sup> was amended and Act LVI of 1990 (hereinafter referred to as the «Self-Government Act») was adopted. The Constitution contained few references to the operation of self-government, but an important dimension of it was that it acknowledged the property of local governments<sup>29</sup>, and acknowledged local government rules as sources of law.

The Act on Self-Government of 1990 was completely compatible with the requirements of the Charter, as it conferred on freely elected representative bodies and general assemblies of local governments the right to act within their local competences, including the right to act as economic entities. It also identified the responsibilities and competences for local governments. The act introduced different levels of self-government in the country, financial basis, which has been expanded by the Act on Local Taxes<sup>30</sup>, ensuring the tax independence of local governments.

An important consequence of Hungarian approach to the regulation was that from the early 1990s the budgetary discipline of local governments became lax and their debts started to increase, due to underfunding, weak controlling methodology, and vast investment-development needs (especially after the EU accession). As a result of the state stronger decentralisation of duties («distribution of duties») and the interruptions in public financing, operating deficits became permanent, meaning that decentralised deficit (generated in local governments) became a system-specific factor of public finance as a whole. Another specific feature of the system was that in many cases (especially in the 1990s) settlements transferred their non-operational resources to meet operational expenditures. Problems were aggravated by the fact that debts were incurred in foreign currency after the turn of the millennium (Figure 1). The figure shows how drastically bonds have increased since 2006, but long-term loans, which, again, were denominated in foreign currency, also started to increase from 2002, thus the crisis of 2007-2008 affected the system of local self-government in Hungary much deeper than in most other OECD countries (Fábián, 2017).

While examining internal structural elements, it is natural to see that the GDP ratio of local tax revenues was higher in Hungary than in any other country examined. At the same time, a high increase in local governments' debt took place while levels of local tax revenues were stagnating, or even decreasing. Thus, the phenomenon is atypical, as one of the major resources to repay debts, i.e. local tax revenues decreased in this period compared to the GDP, which exposed the sensitivity of the Hungarian local tax system to economic downturns.

Debt accumulation can be explained by the fact that in the budgetary period of 2007-2013 the Hungarian national development policy aimed to provide local governments with a significant share, 15%, of the EU cohesion support granted for this period. The previous government provided the opportunity of taking out resources in the loan market, instead of national budgetary aid, to use these development resources, and arranged legally that such investment were accounted for as own contribution, although in reality onerous liabilities were assumed by the local governments. Another notable element of Hungarian decentralisation was the approach to the evaluation of assets, which took place from 2001 to 2003. The assets previously registered without purchase or

<sup>20</sup> Act 583 of 2004 of the Slovak Republic on the Budgetary Rules of Municipalities and Higher Territorial Units.

<sup>21</sup> Implementing Act 493 of 2011 of the National Council of the Slovak Republic on Budget Responsibility.

<sup>22</sup> Based on the 2017 data of the Ministry of Finance of the Slovak Republic, 5.44%.

<sup>23</sup> Based on the data of Slovak Credit Bureau (CRIF) and the Institute for Economic and Social Reforms.

<sup>24</sup> Act 314 of 2002 of the Parliament of the Czech Republic on the Municipal and Delegated Competences of Municipal Offices.

<sup>25</sup> On the basis of the 2017 data of the Ministry of Finance of the Czech Republic.

<sup>26</sup> Act 243 of 2000 of the Parliament of the Czech Republic on the Budgetary Allocation of Tax Revenues as subsequently amended.

<sup>27</sup> Between 2013 and 2016, 20.83% while in 2017, 21.4% of value added tax was transferred to the budgets of municipalities.

<sup>28</sup> Act XX of 1949.

<sup>29</sup> For provisions of the Constitution on the property and revenues of local governments, see Kecsó (2009).

<sup>30</sup> Act C of 1990.

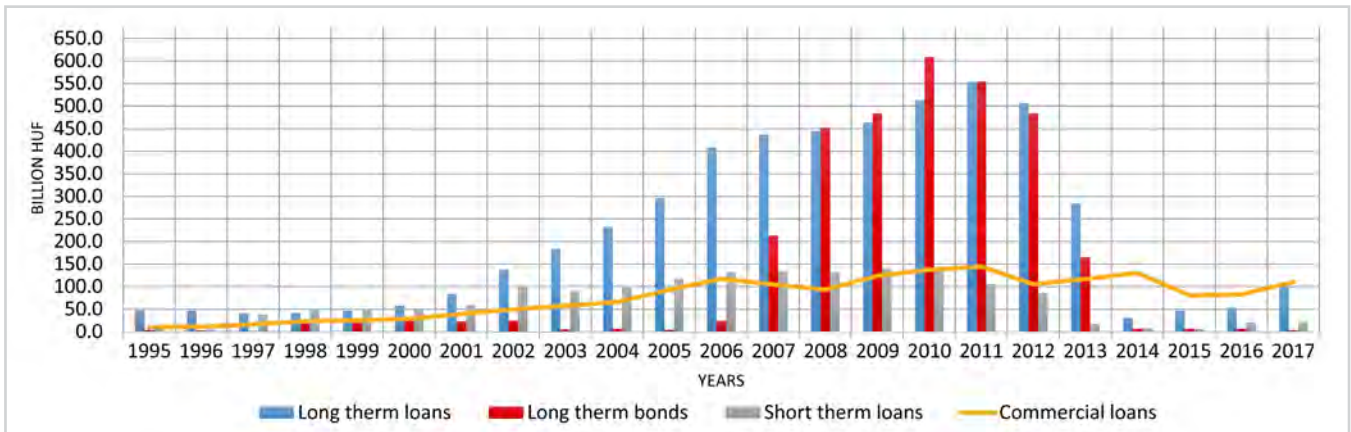


Fig. 1: Debt trends and structures of Hungarian local governments (1995–2017)

Source: Elaborated by the authors based on a specific data provision by the Central Bank of Hungary, 2018

accounting value, had to be evaluated and entered into books by Hungarian local authorities on their own. As a result, the wealth of local governments tripled, and accounted for 35% of the GDP by 2007, which improved the latent creditworthiness of local governments. This situation was exacerbated by the fact that the creditworthiness assessment carried out by banks was optimistic, even though this optimism was not completely justified. Amid this surge in formal wealth of local governments the debt accumulation continued, with increasing operational deficit, as the operational-structural problems of previous system remained unresolved. Debt accumulation, however, did not start in 2007 but well before, the pace of growth was high especially from 2004, due to the opportunity to use development resources after the EU accession. The central budget assigned an increasing role to local authorities in performing duties, which resulted in decentralised deficit and debt, while local and central governments lacked own resources required for the drawdown of EU grants. Another feature of that period was that in the years of local elections debts were always higher than in previous years, which also intensified the local authorities' demand for credit transactions.

From 2002, as it is shown in Figure 1, the debts of Hungarian local governments started to decrease significantly, as the Hungarian economic governance recognised that the debts of local governments posed a hazard not only to public finances as a whole, but also to fiscal compliance with the Maastricht protocol on convergence criteria and to the provisions on public services in settlements. Primarily, debt was accumulated in towns with county rank and county governments, which was a serious problem because the role of these local governments was prominent in providing public services. Thus entire regions would have got into harsh situation, especially because of soaring foreign exchange rates. Therefore, during four steps consolidation process in the period between 2011 and 2014 the total debts of local governments were assumed by the central budget, in cooperation with local governments, after long negotiations. This measure, which was unique of its kind, however, limited further indebtedness, as at the same time budgetary rules were tightened. This process fit in the process of re-defining of the legal frameworks of the Hungarian system of self-government, which started in 2011 (Lentner, 2014).

With the start of fiscal consolidation, the Parliament re-drawn the operation, the system of responsibilities and competences of local governments in 2011, acknowledging the local voters' rights to self-government, but equally observing the principles enshrined in the European Charter of Local Self-Government. When identifying the responsibilities of local governments, the performance of settlements was considered, and the new regulation customised the previously wide-ranging obligation to provide public services.

Articles 31-35 of the Fundamental Law, entering into force in 2011, declared the constitutional rights of local governments, with regard to the Charter. These rights include the adoption of regulation instruments and bodies exercising

the rights of local governments. In relation to public finances, Articles 36 and 38 provide a framework for managing the assets of local governments<sup>31</sup>. One of the novelties of the Fundamental Law, comparing to the previous Constitution, was the incorporation of the major guiding principles of public financial regulation.

The act on the operation of local governments declared<sup>32</sup> that voters of settlements and counties are entitled to the right of self-government. Municipal governments operate in villages, towns, township seats, towns of county rank and districts of the capital, while regional governments operate in counties. The act differentiates between the responsibilities of the capital, the districts, the towns, the villages and the towns of county rank. It prescribes for them to perform the duties and exercise the powers mandated by legislation and those assumed voluntarily, and determines that they may have different duties and powers.

After 2011 the regulatory environment has taken a rules-based course, which manifested in the Fundamental Law, the Stability Act<sup>33</sup>, and the Act on National Assets. These acts guarantee responsible budget management. The Stability Act has imposed an authorisation requirement on borrowing by local governments and local governmental companies. The National Assets Act included the assets of local governments into national assets.

The economic independence of the Hungarian system of self-government is in place under legal conditions, the main sources of law include the articles on public finances of the Fundamental Law, and the paragraphs of the Local Government Act, which ensure the independence of managing finances, completely in the spirit of the Charter. Thus, the Act on Local Taxes embodies taxation sovereignty of local governments, which is, however, limited. Local governments may choose from property-type taxes, communal taxes and business taxes as set forth by law, but the given base of assessment may be subject to one tax burden only, which is a limitation. Beyond the ban on tax multiplication, taxes levied by local governments shall not exceed the maximum tax rate imposed by the Parliament: for example, they may levy a business tax of maximum 2%. The local governments' right to levy taxes has been strengthened since 2015, as, with the introduction of the system of municipal taxes, local governments may levy tax on any basis of taxation which is not a basis of taxation for a central or another local tax. Local business tax revenues have significant weight in the system of financial management, since it accounts for 80-85% of the total taxes in the country. The share of local business tax differs by local governments and categories of self-government. A disadvantage of this tax is that it is sensitive to economic downturns,

<sup>31</sup> Risks related to the operation of local governments can also be mitigated by applying modern controlling principles. See Zéman (2017) and Zéman & Tóth (2015).

<sup>32</sup> Act XIX of 2011, hereinafter referred to as the Local Government Act.

<sup>33</sup> Act CXCV of 2011.



and deepens regional differences as only economically developed settlements can raise considerable revenues from it. Besides, it is disadvantageous for companies<sup>34</sup>, in particular service companies, due to the calculation of the tax base.

Summing it up, the Hungarian system of self-government meets the following requirement of the Charter: local governments shall enable their revenues predominantly by tax and fee policies developed within their own competence. This, however, differs to a great extent by settlement categories and geographical areas.

The local governments system of central budgetary support works within the framework of financing duties, the extent and amount of support is determined by the current budgetary act. In financing duties, dutie-based support is provided by the Parliament through the system of financing duties to cover operational expenditures of the performance of mandatory responsibilities by local governments, and the support provided for the performance of duties is in line with the public service level established by current legislation.

The system of financing duties is based on an imputation regime, which requires the local government:

- to manage its finances rationally;
- to have expectable own revenues based on legislation (the rate of which is stipulated by the budgetary act of the current year);
- to have actual own revenues due to the local government controlled basis.

The areas and rates of revenues to be considered are regulated by the budgetary act of the current year<sup>35</sup>. The act offers an opportunity for the state to provide local governments with state support to finance voluntary duties treated as priorities by the state (Kecskó, 2016).

#### 4. Assessment of operability

Important justification for our comparison is the fact that all three countries operate at accrual-based system of accounting. In The Czech Republic and Slovakia the accounting reform of public finance took place earlier (Otrusínová, 2016). Hungary took the same step in 2014, subsequently local authorities have been keeping books in an accrual-based, profit-oriented system of accounting, pursuant to Government Decree No.4/2013, which incorporated Directive No. 2011/85/EU into Hungarian legislation.

The fiscal rules of the local governments in three countries were compared by Bryson & Cornia (2000). Study by Davey & Péteri (1998) focused on the decentralisation process, which had been fully implemented by the countries examined before their accession to the EU. They established that Hungary was the first to implement changes, as well as improved fiscal and regulatory environment, based on the theoretical lessons of fiscal federalism. Nonetheless, the Hungarian system of self-government atypically turned indebted and was put at risk.

Regarding the self-governmental subsystem's ability to generate revenues we established that the revenues of the local governments are the highest in The Czech Republic, accounting for 7% of the GDP in 2016, while they stay at 3% of the GDP in Hungary, and 2% of the GDP in Slovakia (Figure 2).

The rate of local tax revenues in all three Visegrad countries are lower than average in OECD countries. Among the countries examined, it was the highest in Hungary, 2-2.5% of the GDP in the last decade. In Slovakia local tax revenues accounted for less than 1% of the GDP, while in The Czech Republic it stood at 0.5% (Figure 3).

Thus, the Hungarian regulation of self-government provides for the highest rate of own revenues, and comply with the requirement by the Charter that a part of revenues shall derive «sui generis» (from their own competence).

The share of own revenues as part of total revenues is also high in Slovakia, while in Czechia it is rather minor, meaning that the stipulations of the Charter has limited impact. The reason for the situation in The Czech Republic is that fees are the major sources of local governments' revenues (Bryson, 2016).

While examining compliance with fiscal rules, we established that starting from 2000 until 2012 (with the exception of year 2007) deficit as a percentage of the GDP did not reach even 1% in The Czech Republic. Since 2013, the Czech subnational governments showed financial management without deficit (same situation already took place in late 1990s). From 1997 (with the exception of years 1999 and 2001), Hungarian local governments were accumulating deficits, but the balance of the total expenditures and revenues of subnational governments is positive against GDP since 2011. In the case of Slovakia, the picture is mixed. In the late 1990s, Slovak municipalities accumulated massive deficits, which exceeded 1% until 1998, reaching the highest level among the countries examined. From the year 2000, a positive balance was achieved, but after the EU accession the balance of financial management turned negative again. Since 2012, except for a small deficit in 2014, the balance has been shifting to the positive range again (Figure 4).

In Slovakia, a debt rule was adopted in 2011, setting the debt limit at 60% of revenues. On the basis of the data by the Ministry of Finance, debts of municipalities and higher territorial units accounted for almost 3% of government debt in 2015, which shrank in the last two years, dropping to 2.5% of government debt. The debts of Slovak municipalities and higher territorial units were fluctuating between 3 and 5% of government debt during last fifteen years. Bryson (2000) claims that only larger cities, with a population over 100,000 people - the capital, Bratislava, and the city of Košice in particular - are threatened by excessive indebtedness, which is also underpinned by the data of the Bratislava-based Institute for Economic and Social Reforms. The indebtedness of the capital reached almost 53% in 2016, and that of Košice was nudging 30%. From 2000 to 2007, the Ministry of Finance of The Czech Republic was applying a debt service ratio to control municipal debts, the value of which could not exceed 30% of the sources of municipal revenues. Pursuant to currently effective Czech legislation (Act 23 of 2017 on the Rules of Budgetary Responsibility), the debts of municipalities and higher self-governing regions must not exceed 60% of the last four years' average municipal revenue.

After its introduction, the effects of new regulations were not felt between 2003 and 2006, but since 2007 this budgetary rule has been met every year. In Hungary, debts service was compared to own revenues, but not to the rate of indebtedness. With the accumulation of debts, the rate of debts compared to own revenues was growing gradually, reaching its peak in the most indebted year, and showed a downward trend with consolidation. From the rate of revenues, we can conclude that since 2011, it has met the budgetary rule, which sets a limit of debt service at 50% of own revenues. The analysis suggests that Czech municipalities complied with the requirements of the regulation, unlike in the case with Slovak local authorities, while compliance with the Hungarian regulation can only be presumed.

In terms of debts, municipal indebtedness was high in Slovakia in the 1990s, normalised by 2001, and remained within 2-3% range ever since. In the case of The Czech Republic, it is not possible to talk about a real accumulation of debts, as the debts of local authorities were fluctuating in the range of 3-4% of the GDP. In Hungary, debts were accumulated, from 2010 debts increased annually by 10.8% on average, reaching a peak in 2010. With the consolidation of debts, which began in 2013, debts decreased, accounting for 1.10% of the GDP in 2016. Compared to the data in OECD countries, debts remain below the median figures, except for Slovakia, where government debt was transferred to municipalities. After the world financial crisis, an increase of the average debt figures was witnessed in OECD countries (Figure 5).

#### 5. Conclusion

In the examined Visegrad countries, regulations are established in line with European norms and based on the principle of subsidiarity. Conducted legal dynamics analysis justifies continuity. Contemporary self-government have incorporated all the requirements of the Charter, with special emphasis on the financial independence. From the economic point

<sup>34</sup> On responsible corporate governance, see Kecskés (2016).

<sup>35</sup> In the budget year of 2018, the imputation and supplementation regime is 0.55% of the business tax base of year 2016.

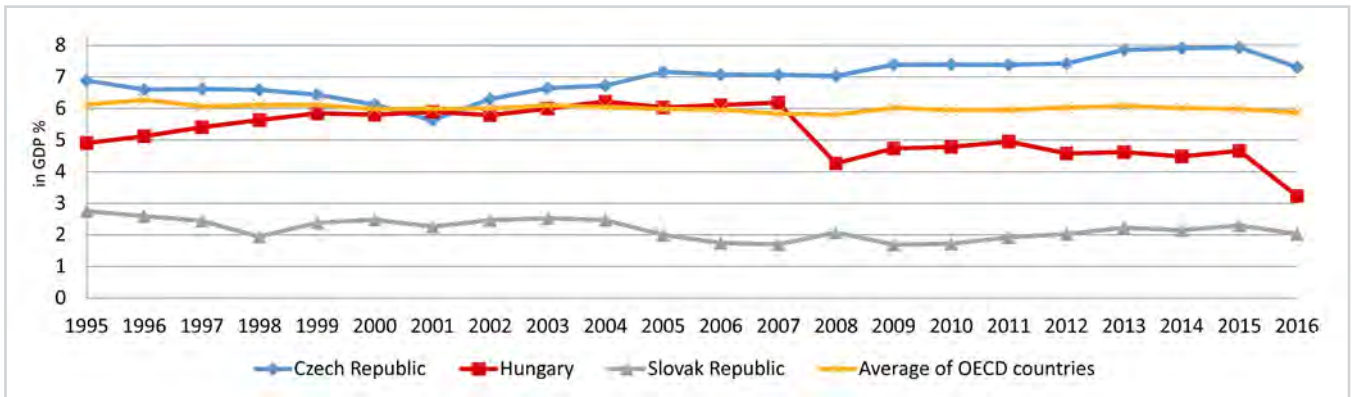


Fig. 2: Revenues of local governments as percentage of the GDP, 1995-2016  
Source: Elaborated by the authors based on the data of the OECD fiscal decentralisation database

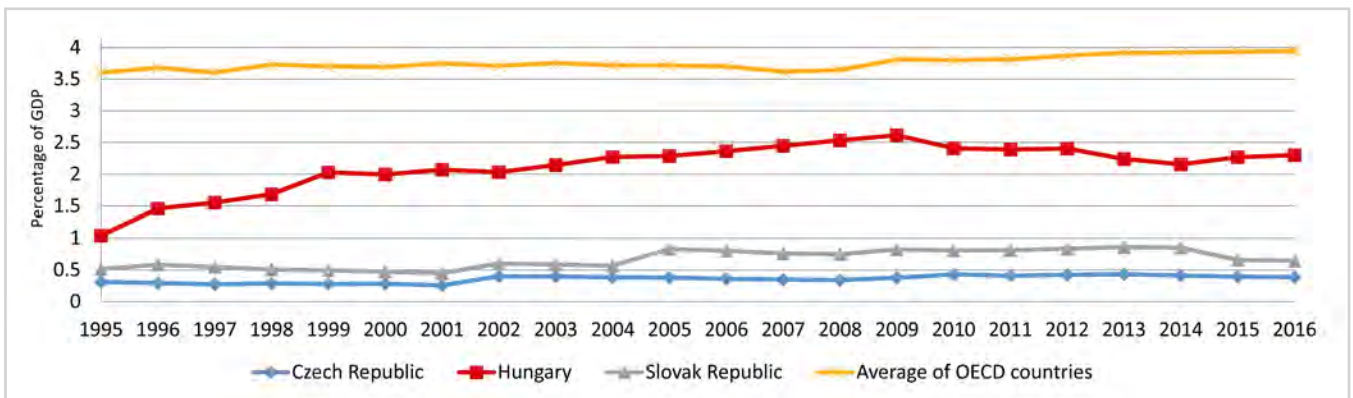


Fig. 3: Local tax revenues as percentage of the GDP, 1995-2016  
Source: Elaborated by the authors based on the data of the OECD fiscal decentralisation database

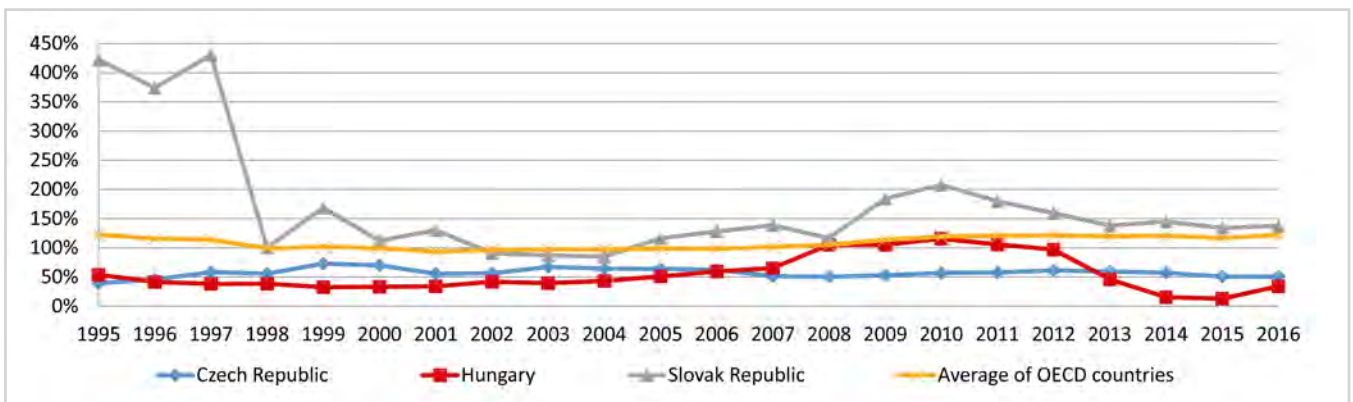


Fig. 4: Compliance with debt rules, 1995-2016  
Source: Elaborated by the authors based on the data of the OECD fiscal decentralisation database

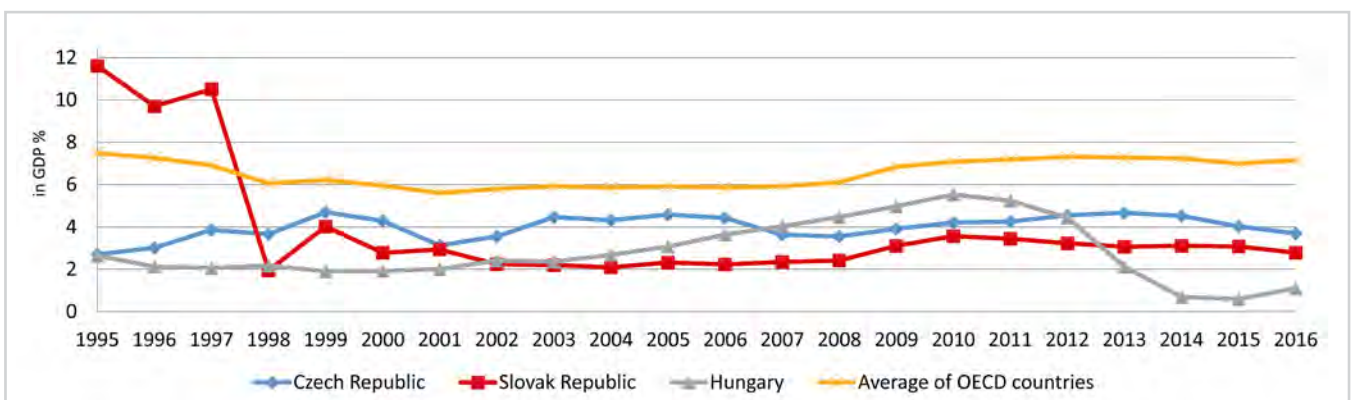


Fig. 5: Debt developments, 1995-2016  
Source: Elaborated by the authors based on the data of the OECD fiscal decentralisation database



of view, however, the stability of financial management and the methods of financing are very different in all three countries. In The Czech Republic, for example, the room for manoeuvre provided by local tax revenues is smaller compared to other nations. Thus, it is not local authorities' room for manoeuvre that is limited, but, in relation to revenues, the expenditure side and the debts that can be run up.

As for the debt rules adopted, in The Czech Republic regulations present a limiting factor to the indebtedness of the local governments since early 2000s, while in Hungary the appropriate regulation was installed since 2011.

The way local governments are managing their revenues is not the only important issue for the local governance. It is also important what limits to their independence are in place against their sustainability, aimed to prevent local governments from running deficits and accumulating debts, ensuring the prevalence of the most important basic principle of accounting, i.e. the going concern principle, and thereby budgetary sustainability.

The final conclusion of our study is that in the development of their system of self-government, three Visegrad countries under review have endorsed the recommendations of the Charter, which is regarded as a compass for the development of local governance in Europe, and a modern, rules-based practice of budget management has been continuously introduced with regard to the financial sustainability. It is a key finding of our research that in the relatively homogeneous Visegrad countries, in Hungary the regulatory environment, which existed before 2011, and weak control of public finances led to increase

in debts, and since their state consolidation, when regulatory limits preventing re-indebtedness entered into force, Hungarian system of local authorities moved to sustainable operation and continuous provision of public services.

Thus, all the three countries now demonstrate the major achievements of the theory of fiscal federalism, and established a decentralised system of responsibilities and competences, but at the same time they opted to avoid unfettered decentralisation, and to ensure an adequate operation of local authorities with the means of budgetary rules and active participation in the economic policy. It can be interpreted as an atypical phenomenon that the Hungarian sector of self-government, following and implementing the regulatory principles of the Charter like the Czech and Slovak practice did, became severely indebted, the provision of public services in settlements was compromised, and negative messages were sent on public finance as a whole. In order to counterbalance this challenge, debt consolidation has been implemented in the Hungary. At the same time, decentralisation of duties also took place, and duties related to healthcare, facility management, and education - with the exception of providing kindergarten care - have been assumed by the state. Furthermore, stringent budgetary regulations has been introduced to prevent another indebtedness cycle, and the prerogatives of the State Audit Office's control were expanded.

To sum it up, a similar regulatory environment does not necessarily mean an operation regulated in the same way, but economic governance must take an active part in it, and review the effectiveness of the regulation.

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