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Viewpoint

On the regulation of municipal indebtedness

Erzsébet Pocsai *

Budapest Business University. Budapest, Hungary

* Correspondence: pocsai.erzsebet@uni-bge.hu

Abstract: The indebtedness of the Hungarian domestic municipal lending market was an area of intense research prior to the consolidation of municipal debt. Research analysed the possible causes and explanations of the rise in indebtedness and attempted to identify a model of indebtedness in the domestic municipal system, drawing on the experience of international models and examples. In parallel with the debt consolidation process, which was carried out in several steps between 2011 and 2014, a number of active and passive control elements were introduced in Hungary, which can be grouped in several ways. The introduced control elements have lived up to expectations. At the same time, the increase in the stock of other liabilities in the sector points to a shift in the sector's indebtedness from being indebted to bank financiers to being indebted to other counterparties.

Keywords: indebtedness; active and passive control; golden rule; borrowing

1. The evolution of municipal indebtedness

The primary instruments of external indebtedness of the local government sector are loans and bonds. The pre-2012 surge in external indebtedness of the sector, as well as its causes, management and regulatory shortcomings have been extensively discussed in the public finance literature.

The reasons for the indebtedness of local governments go back to the very origins of local governments as institutions. The local government system established in the 1990s was highly decentralised, but this no longer entailed the decentralisation of resources. This led to the emergence of an operating deficit in the sector, as well as the decentralisation of the public deficit and public debt due to the insufficient resourcing of functions. The local government subsystem has become a 'conflict container' for public finances (Vigvári, 2010).

The accession of Hungary to the European Union opened up new opportunities for local governments to raise external funds. Although a complex system of subsidies was established for local authorities, these authorities did not receive sufficient resources to cover their share of EU subsidies. During this period, the legislation gave municipalities considerable freedom to raise external funds in the form of loans. Thus, a wave of borrowing and bond issuance by municipalities was launched to ensure adequate provision of co-financing. However, due to the high foreign currency denomination of the instruments issued, the financial balance of the local government sector – like that of other economic operators – was experiencing a crisis during the 2008 financial crisis. The majority of local governments' outstanding long-term debt was linked to non-cash-flow generating investments, so that the source of debt servicing also had to be financed from municipal operations. The indebtedness of municipalities started to increase rapidly between 2007 and 2011.

The auditing work of the State Audit Office (SAO) in Hungary focused on the local government subsystem after 2010. In addition to the public finance research carried out at that time, the SAO also found that the sector was severely under-resourced in both of its budgetary legs (operating and capital). The findings of the research carried out in the local government sector, which highlighted the sector's liquidity risk, resource constraints, increasing external and internal indebtedness, emerging exchange rate risk, overhang of assets and the emergence of contingent liabilities, were also reflected in the SAO's reports (Homolya & Szigel, 2008; Vigvári 2009a, 2009b; Gál, 2010a, 2010b; Aczél & Homolya, 2011; Gál, 2011; Vigvári, 2011; Lentner, 2014).

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The risks identified in the sector were further increased by the accumulation of debt on the balance sheets of companies in the quasi-municipal sector majority-owned by the municipality, and by the contingent liabilities associated with these (Hegedűs & Széles, 2015). Research also addressed the risks of the quasi-municipal sector including after debt consolidation (Hegedűs et al., 2019). The risks building up in the quasi-municipal sector were further increased by the fact that the SAO's authority did not extend to the control of these economic agents until 2011. Moreover, in presenting the risks of the sector, the municipalities themselves did not seek to present the combined risks of the entire sector.

In addition to the external indebtedness of the sector, researchers were also concerned with the issue of internal indebtedness, which deals with the cost of wearing out fixed assets and the lack of resources to replace them (Gál, 2010b). The research conducted concludes that the legislation in place before 2011 greatly contributed to the rise in external indebtedness of the sector and to the development of moral hazard. Between 2001 and 2011 (Figure 1), both short-term and long-term debt increased dramatically, and in parallel, debt securities almost doubled the sector's external debt position. The drastic indebtedness of the sector has reached a level that is both quantifiable and tangible in terms of the budget deficit.

For these reasons, the sector's debt was first partially and then fully consolidated between 2011 and 2014. During the 4-stage consolidation process, HUF 1,369.1 billion of debt was repaid to creditors. The debt repayments involved 2,058 municipalities and 24 associations of municipalities. Municipalities without credit received subsidies, which affected 1,139 municipalities (Lentner, 2014; Berczik et al., 2019).

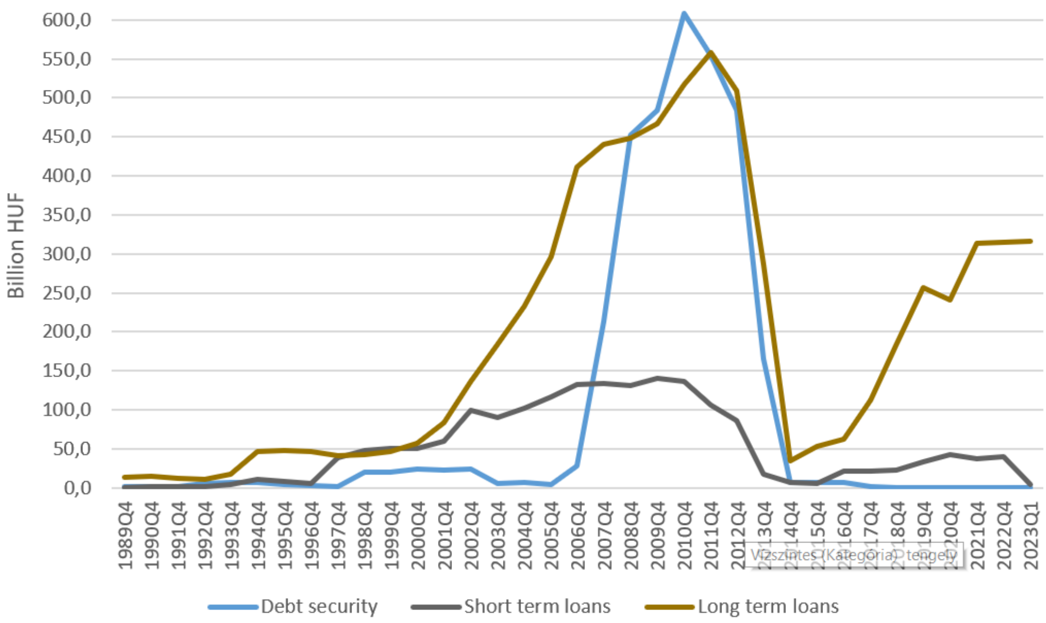

Figure 1. Credit and bond position of the local government sector.
Source: Author's own editing based on Hungarian National Bank (HNB) data

After the consolidation, the researchers were also concerned with the process, motivation and results of municipal indebtedness and debt consolidation, as well as the Economic Stability of Hungary Act (2011) [Gst] and its borrowing rules, which came into force in 2011. Research disagreed on whether the new rules were intended to soften or harden the fiscal constraint (Vasvári, 2019; Lentner, 2014). However, it is clear that the domestic local government system was characterised by a golden rule indebtedness following consolidation. Bond-like instruments were effectively phased out of the system. As of 2013, the stock of local government loans did not exceed HUF 400 bn, while the total deposit stock of the sector as a whole was close to HUF 2,000 bn.

2. Controls on the regulation of indebtedness

In the local government system established by the Local Governments Act (2011) [Mötv], the Fundamental Law (2011) and the Gst, thrifty management and sustainable operation are important principles. This sustainability is reinforced and supported by both active and passive control elements of the centrally constrained model (Ter-Minassian & Craig, 1997; Ter-Minassian, 1996). There are several ways to interpret such active and passive control elements. According to one approach, active control implies that borrowing is subject to prior central government approval, i.e. borrowing is subject to specific authorization. In the case of passive control, the regulation may specify a maximum amount of credit or the mandatory application of the golden rule (Gurley & Shaw, 1955; Győrffi et al., 2009).

However, active and passive control can also be grouped according to the objective and subjective elements introduced in the regulation. In this approach, active control can take the form of an objective upper criterion for debt servicing, an objective approval decision by the government when a certain amount of credit is reached (approve or reject), or the setting of specific objective time limits for forfeiture in legislation. Passive control elements in this approach include limiting short-term borrowing along the lines of the golden rule principles, the formulation of an operating surplus requirement, etc.

Based on the above principles, we can classify the rules introduced in Hungary from 2011 into active and passive control groups (Table 1). The active and passive control elements introduced in OECD countries since 2011 are described in detail in study of OECD (2022).

Table 1. Possible groupings of active and passive controls. *Source: Authors' own*

Place of regulation	Active control	Passive control
Mötv		No operating deficit for external financing can be planned
Fundamental Law	Borrowing under the Mötv is subject to prior Government approval	
Gst	Regulation of Government Authorisation	
Gst		Authorisation of indebtedness under the golden rule
Gst	Obligation to provide prior information to the Hungarian State Treasury	
Gst		Borrowing subject to the imposition of a local tax
Gst	50% rule	

As an active control, Article 34 (5) of the Fundamental Law stipulates that borrowing or other commitments to the extent specified in the Mötv are subject to conditions and to the consent of the Government. The conditions of the above clause are laid down by law along the relevant provisions of the Gst. Municipalities are required to plan their borrowing in advance in the interests of sustainable and responsible management. At the beginning of the year (by 16 March), municipalities must submit to the MCC information on the transactions they intend to conclude in the current year. This can also be interpreted as an objective active control element linked to a time limit. Among the objective elements, the 50% limit imposed as a ceiling for the annual debt service should be mentioned.

Among the elements of passive control, the management rules of the Municipal Act stipulate that no operating deficit for external financing purposes may be planned in the municipal budget regulation, i.e., no operating deficit may be covered by financial instruments. The provisions of the Gst stipulate not only that borrowing is subject to Government authorisation but also that indebtedness consists essentially only of the creation of debt for development purposes (application of the golden rule). Also among the elements of passive control is the provision in the Gst that the borrowing is subject to the imposition of a local tax on the municipality intending to borrow.

3. Evolution of the sector's net financial assets in light of controls introduced

If we look at the financial accounts of local governments as a whole (Figure 2), we can see that the net financial wealth of the sector is increasing.

Local authorities	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023Q1
Financial instruments	**1 318,8**	**1 399,5**	**1 522,4**	**1 590,7**	**1 685,4**	**1 992,4**	**2 636,4**	**3 037,2**	**3 083,5**	**3 016,6**	**3 087,8**	**3 016,3**	**3 235,0**
Cash and deposits	**420,0**	**436,5**	**515,2**	**579,4**	**603,4**	**786,4**	**1 210,2**	**1 490,5**	**1 478,2**	**1 480,1**	**1 638,0**	**1 672,1**	**1 927,3**
Cash	1,0	1,2	1,8	1,6	1,8	3,1	3,5	2,3	1,9	2,0	2,1	2,4	3,5
Current account deposits	215,4	245,2	313,8	354,9	412,1	678,0	1 178,4	1 455,5	1 446,1	1 451,4	1 531,2	1 517,2	1 492,1
Other deposits	203,6	190,1	199,6	222,9	189,5	105,3	28,3	32,6	30,2	26,7	104,7	152,5	431,7
Debt securities	**16,3**	**14,0**	**17,4**	**14,9**	**26,9**	**147,6**	**265,4**	**286,5**	**292,9**	**203,4**	**144,7**	**80,8**	**83,7**
Short-term securities	10,7	7,6	4,9	5,4	20,3	136,7	129,1	38,4	1,1	5,5	4,6	9,2	17,4
Long-term securities	5,7	6,4	12,5	9,5	6,6	10,9	136,3	248,0	291,8	197,8	140,1	71,5	66,3
Credits	**35,5**	**49,0**	**49,2**	**37,5**	**33,9**	**31,9**	**32,5**	**29,7**	**31,4**	**33,9**	**31,7**	**30,3**	**30,0**
Short-term loans	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Long-term loans	35,5	49,0	49,2	37,5	33,9	31,9	32,5	29,7	31,4	33,9	31,7	30,3	30,0
Shares and participations	**795,5**	**862,6**	**869,4**	**891,0**	**966,4**	**973,9**	**1 045,8**	**1 113,7**	**1 130,9**	**1 165,1**	**1 123,3**	**1 076,3**	**1 066,8**
Technical provisions	**0,9**	**1,0**	**0,8**	**0,8**	**0,8**	**0,7**	**0,7**	**0,8**	**1,5**	**1,6**	**1,6**	**1,9**	**2,0**
Financial derivatives	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**
Other receivables	**50,5**	**36,3**	**70,4**	**67,0**	**53,9**	**51,8**	**81,8**	**116,1**	**148,6**	**132,5**	**148,6**	**154,8**	**125,3**
Trade credits and advances	34,3	35,4	62,1	67,0	53,9	51,8	81,8	116,1	148,6	106,4	122,5	128,7	125,3
Other	16,2	1,0	8,3	0,0	0,0	0,0	0,0	0,0	0,0	26,1	26,1	26,1	0,0
Commitments	**1 483,4**	**1 290,8**	**658,6**	**264,9**	**227,0**	**404,5**	**966,3**	**1 234,8**	**1 289,7**	**1 137,0**	**1 152,0**	**1 266,2**	**1 353,7**
Debt securities	**554,3**	**484,0**	**165,1**	**7,0**	**7,0**	**6,6**	**1,2**	**1,0**	**0,9**	**0,7**	**0,5**	**0,3**	**0,3**
Credits	**663,7**	**595,6**	**304,2**	**42,3**	**59,5**	**83,0**	**134,7**	**206,6**	**290,3**	**283,0**	**351,1**	**355,1**	**320,4**
Short-term loans	106,2	85,8	17,5	7,6	6,1	21,0	21,6	22,5	33,9	42,0	37,6	40,2	4,4
Long-term loans	557,5	509,8	286,7	34,7	53,4	62,0	113,1	184,1	256,4	240,9	313,5	315,0	316,0
Financial derivatives	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,5**	**0,1**	**0,1**	**0,0**	**0,0**
Other debts	**265,5**	**211,2**	**189,3**	**215,6**	**160,5**	**315,0**	**830,3**	**1 027,2**	**998,0**	**853,2**	**800,4**	**910,7**	**1 032,9**
Trade credits and advances	141,5	114,4	132,1	169,5	108,1	101,8	138,0	131,7	149,9	130,1	130,8	135,0	126,7
Other	124,0	96,9	57,2	46,1	52,5	213,1	692,4	895,5	848,1	723,1	669,5	775,7	906,3
Net financial assets	**-164,6**	**108,7**	**863,7**	**1 325,8**	**1 458,4**	**1 587,8**	**1 670,1**	**1 802,4**	**1 793,8**	**1 879,5**	**1 935,8**	**1 750,1**	**1 881,4**

Figure 2. Financial accounts of local government. Source: Author's own editing based on Hungarian National Bank (HNB) data

Although the golden rule applies to loans (long-term loans account for 99% of total loans and debt securities have disappeared from the system), we are still witnessing a build-up of other debts in the sector, which are internal liabilities, presumably linked to debts to suppliers. These other liabilities three times exceed the stock of loans. The analysis of the actual risks behind these supplier debts can be supported by an analysis of the ageing supplier analysis of each municipality. It is important to note, however, that supplier debts overdue by more than 60-90 days already represent a serious risk of debt settlement at both the individual and aggregate municipal levels. At the same time, such debts also reflect the sector's lack of liquidity.

4. Summary

With the full consolidation of the local government sector debt and the creation of a legal framework for indebtedness, the indebtedness of Hungarian local governments has been replaced by a centrally regulated model, which applies both active and passive control elements instead of the previous market-based model. These elements can be grouped according to the introduction of legislative control and other requirements, as well as the objectively and subjectively measurable validity of the control element applied. The applied controls have come up to expectations and the external indebtedness of the sector presents low risk. However, there has been a notable increase in internal liabilities since the years following consolidation, which is presumably linked to supplier invoices. The risk of this stock of liabilities could be significant for external financiers and the central budget, and this situation highlights the fragile liquidity situation of the sector.

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