DEBT MANAGEMENT AND DEBT SETTLEMENT IN MUNICIPAL FINANCE

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I. The Background, Aim, Subject and Relevance of the Research

Self-governance includes economic independence. Naturally, in this case we are not talking about unlimited and exclusively self-serving freedom, but rather presume the extent of liberty required for the implementation of tasks, i.e. the social function of municipalities and the comprehensive management of public affairs. Economic independence is an indispensable and the most essential condition of municipal autonomy, which can only be limited by law. At the same time, municipal budgets form an integral part of government balance, and their entire cash-flow is linked to it.

Based on the interpretation of the relevant legislation it is obvious that municipalities fundamentally possess the conditions required for economic independence. However, we cannot be nearly satisfied with the actual economic opportunities of municipalities, as neither the extent of state financing nor that of own revenues reach the level necessary for economic autonomy. The majority of municipalities survive on “state aid” or state subsidy and are exposed to uncertainties arising from the frequent changes in politics and economic policies - seen in every political cycle - as well as annual budgetary modifications.

However, own revenues, which serve autonomy much better, are limited by the vertical inequality in the right of taxation seen between government levels, the horizontal inequality resulting from local taxes imposed (local business tax revenues), the tax competition between municipalities, and the low capacity and tendency of taxpayers to pay local taxes.

Nowadays, the majority of local municipalities are significantly underfinanced, and their economic opportunities are chiefly devoured by the provision of compulsory public tasks at the required level. The proportion of tasks municipalities volunteer to undertake decreases continuously, and in addition to the quick depletion of assets there is now a new phenomena, which is indebtedness, and for two decades (since 1996) we can talk about municipalities that are “bankrupt”, i.e. in their cases debt settlement proceedings have already been initiated.

Beyond the general economic situation of the country, the phenomenon described above may be attributable to the fact that since 1990 the scope of tasks and responsibilities has been extended continuously without commensurable financing. In some cases – especially at bankrupted municipalities – it was coupled with the recklessness and unpreparedness of
leaders, the lack of professional planning and control within the boards of members, but the overstretched investment policy can also be blamed for the difficulties, and state, economic and financial supervision and consultation aimed at helping are inadequate as well.

Of course, both parties seek possible and effective alternatives. Municipalities try to overcome “stringency” mainly by increasing local revenues, outsourcing tasks, and preferring forms of association. The governments that replace one another are also forced to seek alternative solutions through which they will be capable of providing public services at the same levels regardless of the fact that they have much fewer resources available due to the financial and economic crisis seen in the past decade and the social changes (decrease in population, social aids, responsibilities arising out of the EU membership etc.).

The most effective utilisation of state funds is a state duty. However, recently, we have seen the problems of national asset management at central, regional and local level. Let us just consider the municipal debt settlement proceedings, the state investments of “doubtful” outcomes, the inoperability of county-operated institutions, or the problems arising from municipal bond issues.

In the light of the above, the purpose of my research was to investigate the financial and legal aspects of the debt management, debt consolidation and debt settlement of local municipalities in Hungary. In the course of the research I examined the financial and legal aspects of the anomalies of municipal asset management and its reasons from the perspective of municipal debt management, debt consolidation and debt settlement in a problem-oriented manner seeking the possibilities of solving the conflicts, and also the new methods applied in debt settlement and managing municipal indebtedness.

The subject is absolutely relevant today, since, as of the year 2010, the provisions of the Government aimed at debt consolidation and the substantial transformation of the municipal financing system have laid down the foundation of the implementation of a new concept.

Based on the above, the subject of my research was the debt management, consolidation and settlement of local municipalities in Hungary, as a specific Hungarian legislation. When choosing the subject of my research my aim was to use a unique and complex methodology in investigating the financial and legal aspects of municipal debt settlement which is full of
controversy and questions needed to be answered, and the system of rules and tools in economic policy coordination that is implemented within its framework.

The timeliness of the subject of the research is indisputable. The financial and economic crisis that started in 2008 and shook the entire world, also forced Hungary to take effective measures. In the course of this it was indispensable to review and reassess government roles and tasks. All of this made it necessary to investigate and analyse not only the deficiencies of the rule and tool system of today’s economic policy, but also the experiences of national legislation and coordination.

With respect to the above, the reaching of my research goal presumed the knowledge of traditional financial theories and the relevant financial and legal legislation, but did not necessarily required their detailed – descriptive – presentation and analysis. As a result of that, in my research and thesis, I mainly concentrated on cases that raised novel questions so far not researched. Selecting these was subjective and at times of case study character.

Based on the above, the subject of my research and the connections ascertained during my research have created a piece of work that is novel, systemizing and gap filling from several aspects in the Hungarian financial and legal literature.

II. Basic Questions of the Research

In the course of my research I investigated four major issues, which were the following:

1. The central regulations following the change of the political system opened up the way for municipalities regarding their undertakings and development investments. However, the state budget was not held responsible for the results of the loss-making financial management. But the financial and economic difficulties arising in 1995, which hit some municipalities severely, forced the parliament to regulate municipal debt settlement. Thus the questions to be answered were: What caused the liberal way of financial management of municipalities, and also, was there any control in municipal financial decision making?

2. Act XXV of 1996 on the Debt Settlement Procedures of Local Municipalities entered into force on 11 June 1996. However, the makers of the act used not the European regulations
(mainly the German example) as a basis, but rather Chapter 9 of the Bankruptcy Law of the United States of America, which has been in effect since 6 November 1978. This step and the subsequent law proved to be a mistake, which the regulations effected in the 2010s tried to correct. Thus the question was what justified the application of the overseas example instead of the European regulations and how successful has the application of the Debt Settlement Act been in the last twenty years?

3. The municipal debt consolidation of the Government implemented between 2011 and 2014 practically repealed the Debt Settlement Act, as those municipalities were consolidated that had been practicing “ill-considered” financial management and that had avoided the debt settlement process due to the consolidation. My question was why the central liquidation of insolvency took place in this particular period? Why did the Government save all the municipalities that accumulated debts? And what was the real purpose of the full consolidation of municipalities?

4. Of the indebtedness models of municipalities, following the change of the political system, the national practice followed the model governed by the market, which – mainly as a result of the provisions of the “reform acts” and the municipal debt consolidation of 2011-2014 – exceeded even the rule-based model, and reached its peak in the centrally limited model in the time of the present government period. Thus the question was how the municipalities will be able to perform their compulsory task in this new model?

III. Scientific Methods Applied

The analysis of the problem required an interdisciplinary approach, therefore, in addition to some fields of law (administrative law, financial law and constitutional law), I reviewed and processed the relevant materials published in national and international economic literature, which contributed to a deeper understanding of the theoretical relationships.

Little theoretic work has been done with regards to municipal debt settlement processes in the past two decades. Naturally, it would have been easier for me, had there been excellent scientific studies on the subject, but due to the briefness of the analysed period that is not the case. Still, there was enough data to be researched and analysed.
There is an expectation that is often brought up when it comes to scientific research, and it is summed up as “one method is not enough”, meaning that, whenever possible, researchers try to apply more than one method. A standard method used in social sciences is the so-called survey method, which primarily includes questionnaires and interviews. In the course of my research, I also assembled a questionnaire of 48 points, which, in 2012, I sent to all municipalities that were involved in a debt settlement process. In addition, I conducted interviews, which clarified my data previously gathered.

Beyond the review of the literature, my research was primarily based on empirical studies which belong to the problem identifying or exploratory research types referred to by László Cseh-Szombathy and Zsuzsa Ferge. The main feature of this research type is that it explores new knowledge, identifies new problems or formulates new hypotheses in an area which has previously not been studied sufficiently or at all. Beyond the above, my research may be classified as an “action study”, as its purpose was to solve a special, specific problem in a given environment.

Based on all this, I may state that my investigation was a research based on inductive logic and empirical methods, as I set out to seek explanations and relationships on the basis of observing, investigating and analysing a large number of unique facts, and then formulated my theoretic theses and hypotheses.

**IV. The Structure of the Dissertation**

I divided the dissertation into four major sections. The first section includes the theoretic part, in which the basic concepts that mark and define the entire dissertation were explained. In this section, in addition to the specific features of the financial management of Hungarian municipalities, I examined the regulation of sub-sovereign levels in relation to state structure models. Also, I presented the models of municipal indebtedness and the methods applied in Europe to finance the deficits of the sub-sovereign levels. As my research primarily aimed at the Hungarian municipal system, I felt it essential to briefly outline the evolution of the Hungarian municipal system and the characteristics of municipal financial management since the change of the political system.
The primary objective of the second part of the dissertation was to give an overview of the concept of municipal debt settlement and debt settlement process, and also of the circumstances of the creation of the act regulating the insolvency of Hungarian municipalities. To this end, I made a distinction between the concepts of bankruptcy, windup, liquidation and debt settlement; I outlined the reasons leading to the regulation and the circumstances of legislation. The second part also provided information on the debt settlement processes carried out so far and the changes in regulation. In this section, in addition to presenting the results of municipal debt settlement, I evaluated the results achieved so far, and investigated their peculiarities, more specifically the deficiencies and controversies. With respect to this, in the second part, I described the development of the system of rules and tools of municipal debt settlement in effect since 1996, its changes that occurred from time to time, its content and its basic defects.

In the third part of the dissertation I carried out the thematic elaboration of municipal debt consolidation between 2011 and 2014. Its analysis was justified for several reasons. On the one hand, similarly to the debt settlement process, top-down (centrally) regulated debt consolidation provides a peculiar and unique solution in European regulation. On the other hand, it was important, because debt consolidation forms the basis of creating the conditions of municipal financial management that is currently under re-regulation. To end the third part of the dissertation, I shed some light on the theoretic relations of municipal debt consolidation. In the course of this, I presented the necessity of “soft budgetary limit”, which the Government brought up as justification, and I also analysed “velvet centralisation”, as the real reason behind municipal consolidation.

In the course of the nearly two-decade-long history of municipal debt settlement processes 66 Hungarian municipalities were subjected to 70 processes. As I pointed out in the dissertation, the road or the reasons leading to debt settlement, and the steps or the outcome of the procedure cannot be typecast, as every process was different; and based on this fact, all of them would be worthy of presenting. Consequently, in the fourth part of the dissertation I presented the two most special and most extreme processes as case studies: the debt settlement of the Municipality of Heves County and that of the Municipality of Gelse Township.
V. Research results

Due to the general crisis of the system, a reform process was launched at the end of the 1980s, a manifestation of which was that more and more specialists started working on the issue of establishing municipalities. This process was significantly accelerated by the change of the political system as a result of which, among others, the Municipality Act became effective on 30 September 1990, on the basis of which a settlement-centred, relatively autonomous but highly responsible system was created. By drawing up the act, the Parliament wished to lay down the foundations and framework of a strong municipal system. The primary objective was to have the local municipalities carry out as many public tasks and provide as high a proportion of the compulsory services as possible. Thus instead of the provident state, the municipalities had to take over the provision of public and public utility services.

The majority of specialists dealing with the analysis of municipal financial management mention the municipal financial system of 1990-2012 as an educational example of putting financial federalism into practice. The regulation and financing of Hungarian municipalities followed the principles of financial decentralisation as of the change of the political system, which had an impact on the allocation of tasks and resources of the various levels of state powers.

In the course of my investigation I established that, as a result of the euphoria following the change of the political system, municipalities had a wide scope of tasks and responsibilities. A huge and unsatisfied demand for investments had accumulated in the municipal sector, which could not be financed from current revenues. After the Municipality Act had made it possible for municipalities to assume market roles and with that all forms of loan transactions, municipalities used these opportunities and tried to solve their investment needs primarily by borrowing (and after the mid 2000s by issuing bonds in addition to borrowing). They could do this quite easily as municipalities did not have an effective scheme for controlling financial management: mainly legal audits could be conducted in case of municipalities through the municipal clerk. Naturally, there was an external control by administration offices, too, but actual audits only took place in few cases. As a result of that a proportion of municipalities became financially unviable.
The above had started the course that led to the development of the municipal debt settlement process. The first concept was to take the rules applicable to business organisations and apply them to municipalities; however, in time, they realised that due to the special situation of municipalities the bankruptcy law cannot be applied and equivalent legislation cannot be made either, because municipalities are obligated to carry out the compulsory basic tasks even during the process, and they have to assure the full exercise of municipal rights. As a result of that, the Parliament introduced a separate law to regulate the problem.

In the course of my research I came to the conclusion that those who prepared the legislation had not used the European regulations as a basis, but rather Chapter 9 of the Bankruptcy Act of the United States of America in effect since 1978. However, this measure and the subsequent legislation proved to be a mistake. The proof of it not living up to expectations was that the Government introduced a new legislation in 2010, which had been used by European states successfully, i.e. the prevention of irresponsible borrowing and thereby indebtedness through strict central regulation.

According to István Hoffmann the German debt settlement rules could not be adapted to the national conditions and that is why the people who prepared the legislation tried to find some other example. Of the European regulations that of the UK’s may have been used, instead they adapted the regulation of the United States of America in 1996, which was not appropriate, as the municipal system of the USA is completely different from that of the Hungarian, and consequently the overseas regulation cannot be viable and applicable in Hungarian circumstances.

Consequently, it is obvious that the central regulation related to the limitation and rationalisation of debts had not fulfilled its function till 2010. Municipalities had undertaken responsibilities which exceeded their financial capacities, and therefore central debt settlement was unavoidable. Naturally, not because of this, as the mass bankruptcy of municipalities would have resulted in unforeseeable state budget problems, but because without consolidation, due to the launching of the new financing system, two third of the Hungarian municipalities would have requested the initiation of the debt settlement process.

But after two decades, the financing system was changed. As of 2010, the decentralised public service system underwent a radical transformation, as a result of which in two years the size
of the financial tasks undertaken at local level decreased by nearly 30%. Due to recentralisation, taking back tasks from local levels also meant the limitation of the openness of the allocation of resources. Suddenly, the influence of state ownership increased, and the possibility of service organisation based on alternative and private organisations in the fields of human and public areas decreased even further. It was not just recentralisation, the allocation of community task implementation was changed, too. Thus following the preparation and the underpinning of the legislation, as of 1 January 2013, wiping away community decision making at the lowest level and the most effective way of resource utilisation, the municipal system was transformed. The financing system put an end to the previous normative support scheme, and put task-based financing in the centre, for the sake of which compulsory municipal tasks and local public matters were separated.

In the course of my research I established that the debt consolidation of the Government undertaken between 2011 and 2014 basically repealed the Debt Settlement Act, as primarily those municipalities were consolidated that had been practicing ill-considered financial management “producing debt” and that had avoided the debt settlement process due to the consolidation.

According to government communication, by 2010, the financial situation of municipalities was bordering on the impossible. They were unable to get rid of their significantly bloated outstanding debt on their own or balance their budgets. Consequently, masses of debt settling processes would have neglected the provision of public services, and social conflict could have arisen, which would have basically meant state bankruptcy. Against this background, the Government justified the transformation of financing by stating that the municipal financial system was unsustainable, its collapse was apparent, there was an increasing threat of masses of debt settlement processes and also the possibility of state bankruptcy.

Before consolidation, the extent of annual municipal loan exposure reached app. 40% of the subsystem, which contributed to only half the level of debt in terms of public finances. Consequently, the local subsystem was not close to a state of bankruptcy at all. However, the extent of indebtedness of municipalities was not nearly as severe as it was stated, since it primarily affected typically urban municipalities of large capacities and those capable of issuing bonds. Of the HUF 1,200 billion debt that was recorded in 2011, only HUF 70 billion was produced by settlements of a population of less than 3,000 people; a huge proportion of
the debt accumulated at larger settlements. When compared to the increase of state debt, the debt of municipalities seemed “insignificant”.

On the other hand, it is obvious that the number of municipalities where debt settlement processes were initiated between 1996 and 2015 was infinitesimal, as they only meant 2.2% of the 3,177 municipalities and 1.5% of the population of Hungary. And this proves that we cannot talk about masses of debt settlement processes.

Based on the above, I established that indebtedness primarily affected larger settlements (typically towns) and local authorities (counties). Moreover, it is also obvious that the debt settlement process mainly appeared at the level of small settlements, where the extent of indebtedness was significantly lower than that of the larger settlements. All of this means that instead of debt settlement processes, the period between 1994 and 2014 was chiefly characterised by a state of “latent bankruptcy”, as carrying out the process was only necessary for a few significantly indebted municipalities, whereas the possibility of debt settlement was not even considered by the majority of municipalities.

Based on the above it is clear that the decentralisation was not impossible to finance, and the Government simply redistributed revenues within the framework of the a Kornai-type soft budget limit syndrome by giving it the label of debt consolidation. Thus it does not mean that the Government used the tool of soft budgetary limit to rehabilitate municipalities and thereby avoided state bankruptcy, but rather that the Government centralised the local subsystem by “giving a present” to the municipalities with one hand in the form of loan substitution, whereas, with the other hand, it took everything from them that they had fought for in the previous twenty-five years: the local administration of local matters.

So one of the objectives of the comprehensive transformation of the municipal system – through the Basic Law and the fundamental acts – and the quick implementation of debt consolidation was centralisation, which, evidently, brought with it a significant decrease in the functions of the local authority system, a dramatic narrowing of latitude and the loss of independence. In the light of the above, the debt consolidation of the municipal system, a formally defined government objective, created a new model, which is much more like the “local interpretation of the state itself” than a proper municipality.
All factors concerned, I came to the conclusion that the Hungarian municipal debt consolidation between 2011 and 2014 was not another manifestation of the soft budget limit, it was only a single bail-out, which – built on the Basic Law and the fundamental acts, and based on the hard budget limit – laid down the foundations of state centralisation in a period that was considered politically favourable.

However, to a certain extent – neglecting my statements above – I agree with Dr. Gábor Péteri and Dr. Zoltán Józsa, too, according to whom, in the middle of the previous government cycle, the municipal system moved into a direction, which presumes the constant presence and application of the soft budget limit (in this case the “bail-out” of municipalities) in the future. Consequently, there is no connection between centralisation and consolidation. Whether the consolidation was a single bail-out or the first major manifestation of a longer process is something we cannot tell yet, but the future will definitely provide an answer to that, too.

Naturally, many believe that the consolidation of local authorities has brought balance to the municipal system, and the Debt Settlement Act has become obsolete and lost its function. However, one must not forget that companies fully or partially owned by municipalities accumulated huge debts till the middle of 2015. According to some estimations the amount of this debt equals the amount of central funds spent on debt consolidation, thus nearly HUF 1,400 billion. The question is then when and how the Government is going to intervene in the operation of the instable municipal system again? In this relation I believe that the situation can primarily be improved by increasing the efficiency of municipalities and by privatising municipality-owned companies. Thus the next task is the elaboration of the conditions of selling ownership within these companies.
List of publications related to the dissertation

Article(s), studies (18)

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