József Hegedüs

Financing Local Public Services

Introduction

Sector policies, decentralization, and public services

The paper deals with the financial and organizational structure of local public services with a special attention to the transitional countries. Public services can be defined as the services which are produced for the benefit of the whole society, i.e. the goods whose consumption yields collective benefits. Public services do not necessarily mean the services provided by the public sector, but rather the services normally thought to be the responsibility of the government. Primary education, typically a government responsibility, can be provided through non-government institutions, e.g. private schools. There are more and more areas where the public institutions are replaced by private organizations while the regulatory task remain at the level of central or local governments (other examples are child-care centers, social-care institutions, e.g. old people's homes, etc.). This is especially important in transitional countries with the legacy of the state-dominated society where there was no room for the private institutions in public services.

The overall economic and sector policies of the government (such as educational policy, housing policy, health care system, etc.) define the public role in a given area. The countries which went through the transition after 1990 had to transform their centrally planned economies into the market economy. The public sector reform proposal had to redefine which public services the government wanted to have provided for the society, and which regulative and financial means could provide them. The basic question the transitional countries had to face was the scope of the government responsibilities that is, how the government can decrease its direct role in economy, especially in the provision of public services. This task required the sector policies with major restructuring programs which could include the elements of privatization, new financial structures, and redesigned responsibilities. Most countries found this public sector reform politically difficult to carry out (Kornai, 2000).

The decentralization required that sub-national governments - in line with the national macro policy - provide a wide range of public services with local relevance (housing, public transportation, social services, education, etc.). The range of public services, transferred to the subnational governments, varies from country to country. The decentralisation process reformulates the intergovernmental finance. Expenditure and revenue assignments were restructured, which typically increased both the responsibility and autonomy of local governments. A real decentralization is critical to eliminate the soft budget constraint that encourages local government representatives to try to maximize the central grants (rent-seeking strategy), while downplaying the performance of local services.

Alternative service delivery systems

After the 1990s, the changes in the organizational structures in Hungary were influenced not only by the well-known legal requirements, but also by the new responsibilities of local governments introduced by sectoral laws (e.g. fire protection). In several cases the incentives built in the tax and grant policies urged the local governments to restructure their service delivery system. The institutional changes were supported by local interest (lobby) groups as well. Municipalities provide services through various forms of organization: (a) Mayor's Office; (b) budgetary institutions (e.g. schools); (c) business organizations in full municipal ownership or foundations created purely by municipalities; (d) joint ventures (with a minimum 25% stake in it); (e) predominantly private firms or companies that are not municipally owned.

Source: Hegedüs, 2004

Local public services can be analysed from two aspects:

a) administrative and management characteristics (taxation, bookkeeping, proprietary rights, control, legal standing in terms of labour affairs) and
b) financing models (costs, revenue alternatives, and a mechanism to create a “balance” between the two).

The financial and organizational structure of local public services differs from sector to sector. The public sector reforms in transitional countries created a new legal and financial framework for the local service provision. This includes the scope of the autonomy of local governments to influence the organizational structure, the user charges, the competition, etc. The social services (education, social care, health) and communal services (transportation, housing, water etc.) have very different “natures”.

The observers of these processes supposed that there was a single-direction progress through which municipalities - in order to find more and more efficient solutions - move from a government-dominated structure towards a structure where the direct public service provision is replaced by the more efficient non-government solutions. (that approach proved to be one-sided for several reasons: it fails to take into consideration the fact that without a proper regulatory environment the efficiency of the new institutional forms will be questionable). In Hungary, the development of the “regulatory background” did not precede contracting out, privatisation of services, transferring public service delivery to foundations and “one-person” limited liability companies. There were examples when the only reason for the new - off-budget - organizational solution was to escape from the constraints of the budgetary control. The advantage of non-profit organizations over the public institutions is their independence and flexibility in financial management (financing wages, taxation). In the area of typical communal services, the municipal companies were replaced by the private companies (owned partly or totally by the local governments) in order to provide more manoeuvring space for service improvement (access to capital market). The involvement of non-governmental agencies in public services raises the question of financial sustainability. NGOs in social services are almost entirely dependent on the government, thus their financial stability is questionable.

However, the regulatory background does not only mean laws, such as price regulation, procurement law, etc., but the emergence of behavioural norms and the enforcement of the law as well. The importance of the organizational structure is that it affects the efficient use of financial resources through the incentive structure and behavioural norms. The institutional framework and the design of these financial means define the incentives and the room for maneuvering both for the local/central government and the service providers in the provision of public services. The relation between the government and the service provider can be described as a principal-agent problem (Le Grand, 2002). The key organizational question is the relation between the government (principal) and the service provider. The relation could be defined within the government sector, which happens when the budgetary institutions provide the services. For example, the relation between the school management and the local government in Hungary is determined through the educational programme and the budget. In the case of off-budget institutions[1], the relations are defined by the contract which may stipulate some kind of risk-sharing procedures besides the price and the quality of the services.

Financing public services requires reimbursing the service provider, whether it is provided through a budgetary institution, a municipal company or a private entity. Public services can be funded through user charges and/or grants. The service provider may have a relation to the central government and/or the local government. The next figure focusing on the household sector shows the main funding sources.

The service provider gets revenue from the user charges[2], from the grants provided by local governments and from the central government grants (the source of the grants are the taxes paid by the users). The households (users) pay taxes and get income support from local and central governments. Local governments finance their grants (and income support) from local taxes and central grants. The key question is what kind of incentives for the service provider are created through the financing and organizational arrangements.

The chapter will focus on the basic funding structure of the services related to the institutional environment of service provision[3].

In the first part we deal with the problems of user charges. After clarifying the economic background and the different types of user charges, we examine the different methods whose aim is to increase the paying capacity of the households. This is very important in transitional countries, where the household capacity to pay for the services is limited. At the end of the first part we discuss the different incentives related to user charges including the "informal pricing".

The second part of the chapter focuses on grants. After summarizing the main economic justification in using grants for financing public services we will deal with the grants which go directly to the service provider and the grants which go first to the local government and are afterwards forwarded to the service provider. The main message of this part is that the local institutional structure has an effect on the efficiency of the grants structure.

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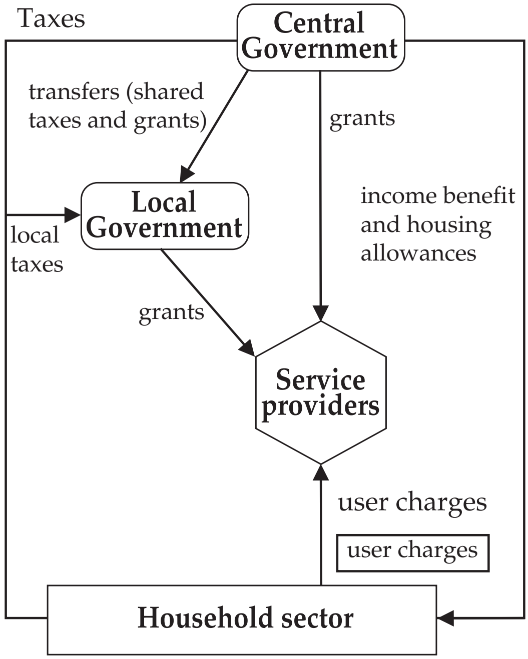
[1] The financial data (turnover, revenues, and expenditures) of service providers outside local governments are off-budget institutions. It means that their budget, although they are owned by local governments, is not part of the local government budgets.

[2] User charges are the charges for the goods or the services that the user is required to pay. There is a link between the payment and the service provided, but it may vary considerably in terms of the degree of "cost-recovery" (Bailey, 1998, p. 126). The tax, as an alternative financing method, is an "unrequited transfer" and there is no relation between the paid amount and the service provided.

[3] Our interest is limited to the operational part, especially the user charges and the grants, and its relation to the organizational structure of service delivery; thus in this chapter we do not deal with the issues of capital investment.

Figure 1: Funding sources of local public services



User charges

1. Economics and politics of user charges

User charges have played an increasing role in the financing of local governments in recent decades in the OECD countries, but this is a relatively new financial technique[4].

According to the economic theory, the appropriate policy is clearly to charge the correct price based on roughly the long-run marginal cost criteria (Bailey, 1995). Only thus will the correct amounts and types of service be provided to the right people - that is those willing to pay for them. Efficiency thus demands user charges to be levied wherever feasible. It is often suggested, however, that equity considerations argue against user charges. "Although in principle the incidence of user charges is no more relevant than the ultimate incidence of the price of cheese, studies in different countries have shown that the distributive

[4] However, there is greater disparity in the administration and collection of user charges and fees. Full information on revenues is not available only through the analysis of sub-national government accounts, because the significant part of user charges are collected through off-budget institutions In particular, for user charges and according to the organization of service provision, the revenues may be recorded in the accounts of private companies contracted by the public sector, in the accounts of companies wholly or partly owned by the local government(s) or by departments within the local government administration. Thus it is very difficult to get precise comparative data about the use of user charges in the local government sector.

Types of user charges

At least three types of user charges can be differentiated: (1) service fees, (2) public prices, and (3) specific benefit charges. Service fees include such items as license fees (marriage, business, dogs, vehicles) and various small charges levied by local governments for performing specific services - registering this or providing a copy of that - for identifiable individuals (or businesses). In effect, such fees constitute cost reimbursement from the private to the public sector. In contrast, public prices refer to the revenues received by local governments from the sale of private goods and services (other than the cost-reimbursement just described). All sales of locally provided services to identifiable private agents - from public utility charges to admission charges to recreation facilities - fall under this general heading. In principle, such prices should be set at the competitive private level, with no tax or subsidy element included unless doing so is the most efficient way of achieving public policy goals, and even then it is best if the tax-subsidy element is accounted for separately. A third category of charge revenue may be called specific benefit taxes. Such revenues are distinct from service fees and public prices because they do not arise from the provision or sale of a specific good or service to an identifiable private agent. Unlike the prices which are voluntarily paid - although like the fees paid for services that may be required by law - taxes represent compulsory contributions to local revenues. Nonetheless, specific benefit taxes are (at least in theory) related in some way to the benefits received by the taxpayer in contrast to such general benefit taxes as fuel taxes levied on road users as a class or local general business or property taxes viewed as a price paid for local collective goods (see below). Examples abound in local finance: special assessments, land value-increment taxes, improvement taxes, front-footage levies, supplementary property taxes related to the provision of sewers or street lighting, development exactions and charges, delineation levies, and so on. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property - its area, its frontage, its location.

Source: Bird, 2001

consequences of charging for local public services may even be progressive. In any case, attempting to rectify fundamental distributional problems through inefficiently pricing scarce local resources is almost always a bad idea, resulting in little if any equity being purchased at a high price in efficiency terms." (Bird, 2001, p 6.).

There is some confusion about the precise distinction between the user charges and the local taxes. Of course there are revenue sources which clearly fall into the tax category (e.g. sales, income and property taxes). Other revenues, such as park entrance fees, sewer charges, and highway tolls - payments for government services used - clearly fall into the user charge category. But there are also numerous examples of revenue sources that are not so easily categorized, because the actual financial design of the fee better fits the tax category. For example, the fee for garbage collection levied compulsory on every property ("garbage tax") is closer to the taxes than the user charges. On the other hand, some taxes levied on the areas of development are closer to the benefit prices than a typical tax (this is called impact fee, and is levied, for example, in an area of development to share the cost of the infrastructure investment).

Different types of services have different potential for "charging". The "economic nature" of the services sets the limits to the use of user charges. One way of justifying the differences in public pricing is the categorization of the services into the "need", "protective", "amenity" or 'facility' services (Bailey, 1999, p 133). The services related to the "needs", such as social services (income benefit programmes, housing allowances, etc.) are fully funded from the central or the local resources, while on the other extreme, the facility services (like photocopying) are fully funded from the user charges. The "protective" programmes are the services close to the need approach, e.g. shelters for the homeless, school meals, etc. and the "amenity" programmes (e.g. special classes) are financed as a combination of the grants and the user charges.

The other rationalization of the application of user charges is the external benefit of the programmes. If the whole benefit is reaped by the user of the services, the full cost recovery is justified; if the majority of the benefit is derived at the community level, the subsidy is justified.

However, the "charging" policy is loosely connected to the economic principles. The sector strategies establish the framework for the possible direction in public pricing policy. For example, the possible role of student fees in financing education is a question for the central government not for the local government or its institutions. But among the limits set by the sector policies and the legal framework, local institutions could have an important role.

The applicability of user charges depends very much on other factors, such as enforcement, collection method, measurability, etc. (see possible options in the area of waste collection, in the next box).

Revenue raising possibilities in waste management

User charges are commonly utilized to recover a portion of the costs of solid waste management from those generating the waste. User charges can generate substantial revenues and provide incentives to minimize waste, especially if structured so that those who pollute more, pay more ("polluter pays principle"). Although user charges can be imposed at different stages of solid waste management (including collection and disposal), in many cities they do not cover the full costs of solid waste management activities. While citizens and enterprises are generally willing to pay for solid waste to be collected, they are often unwilling to pay the full cost of disposing of the waste in a sanitary manner. Experience in many countries has shown that charging the full costs of disposal may create incentives for littering and open dumping, especially if the enforcement of regulatory standards (i.e. no dumping) is weak and entities can avoid paying the user charge by disposing of the waste themselves.

Analysis of the financial records of many developing country cities shows that current practices for cost recovery for solid waste are very weak (recovery rates of less than 10 percent are not uncommon) and have substantial scope for improvement. Options to recover the costs associated with solid waste management range from instituting or enhancing garbage taxes, collecting tipping fees, or relying on other general revenues (including the property tax and business licenses). Choosing among these options depends upon the relative importance of various criteria: whether revenues are adequate and easily collected, whether the polluter pays for the damage inflicted, whether the option is politically acceptable, and whether payment of the revenue can be enforced.

User charge option:
"Garbage Tax": The garbage tax is typically a flat tax collected with other taxes, such as the community tax. It can be supplemented with

a tax on establishments and products that generate garbage, for example, tax on plastic packages, restaurants and similar services should be levied. This is tax because the payments are not proportional with the quantity of the services. It can generate adequate revenues if rates are set based on costs, and are updated as needed. It is often collected with property tax because direct collection is expensive (about 10-13% of total costs). The "polluter pays" principle is valid only to the extent that the rate depends on surrogate for waste generation, like lot size and property value. It requires political will to set and update rates. It is difficult to withhold services for non-payment.

Volume or Weight Based Fees: *Volume-Based Fees mean that the fee depends on the quantity measured as volume or weight of the waste* to dispose. It generates adequate revenues as long as fees are set based on costs and updated as needed. It is difficult to collect, however, because it requires sophisticated refuse collection system. It fits to the "polluter pays" principle, but politically raises difficulties. Leads to dumping behaviour without local inspection and enforcement capacity.

Tipping Fees (for unloading waste at a landfill, transfer station or recycling facility): Substantial revenue if based on full costs of investment and operation. If weight-bridges are utilized, it is easy to collect. The "polluter pays" principle is followed, if hauler to waste generator passes on fees. Municipalities are often reluctant to pay fair share. Enforceable, but must verify that trucks go to disposal site.

Other revenue options can also be taken into consideration such as property taxes, business licenses, utility surcharges, or General Fund Subsidies (including transfers).

Source: World Bank[5]

The utility surcharge represents an interesting case when "general taxes" are paid through the fee for public services. One of the reasons for this is that the willingness to pay is higher for the fees for public services than for the taxes.

[5] http://wbln0018.worldbank.org/External/Urban/UrbanDev.nsf/Urban+Waste+Management/B5478BCC312272128525688D0051A0E8?OpenDocument

2. Increasing household capacity to pay for services

An important way of financing public services is to subsidize users through different programmes. These programmes demand side subsidies, while the grants transferred to the service providers can be considered as the "supply side" programmes.

In the former socialist countries of Eastern Europe, housing allowances were the critical element in public sector finances. Housing allowances are demand-side subsidies, usually in the form of a discount on the bill the resident receives for public sector services (water, district heating, housing, etc.). They are typically provided on a means-tested basis to low-income families to help them pay these costs; generally they are structured so that poorer households receive larger benefits. Housing allowances were widely adopted in the region (see Lux, 2003, Katsura and Romanik, 2002, Lykova et al. 2004). The demand side programmes can be financed 1. from the central budget, 2. from the local governments' budgets or 3. from the budget of the service provider. Typically the uniform housing allowance programmes are financed from the central budget, but there are examples for some matching schemes as well. In Hungary (until 2004) the housing allowances were financed from the local governments' general revenues. The service providers can contribute to the funds designed to help low-income households (see next box).

The demand side subsidies are the most important techniques to manage the problem of the low-income households in the transitional countries. Apart from this solution (which can be termed the target group solution) there are methods which try to control the demand through a modification of the user charges (tariff solution). Through the "user charge specification" (giving allowances to a certain group of users) the demand for public services can be increased or maintained (at the time of economic recession). These are indirect subsidies typically paid by the "good payers". The experience of the transitional countries has showed that the problem of low-income households cannot be solved without increasing the end use efficiency (Hegedüs, 2003). The critical point is the efficiency of public service companies, that is the "end-use". If the companies are not under any pressure to improve their efficiency, the efficient pricing supplemented with a housing allowance system will not guarantee the best use of public resources.

According to the public finance literature the programmes which involve income redistribution (e.g. housing allowances) should be financed from the central budget. In most cases, local governments manage the income subsidy programmes through the matching grant systems. It means that a certain share of cost (5-20 %) is paid from local budgets, which gives an incentive to a more careful selection of the recipients of the programme.

Budapest Utility Allowances Scheme

The Municipality of Budapest has set up a foundation (popularly called the Compensation Fund). Its board of directors consists of the delegates of the servicing companies, the representatives from the city's Assembly and the members of certain civic organizations. Under its statutes, the service companies (i.e. water supply, sewage, solid waste disposal, and district heating companies) transfer 1-2 percent of their sales returns to the Foundation (this contribution amounts to nearly 10 percent of the arrears). The companies are granted special tax exemptions based on these public utility transfers. It is the public utility companies' basic business interest to keep the arrears at a level that does not jeopardize their daily operations or the provision of their long-term services. These companies regard their contribution to the Foundation as a business technique aimed at reducing their losses and also as a guarantee for the smooth continuation of their services (as will be seen, these contributions are directly linked to the companies' attempts to preserve their consumers' willingness to pay). The programme envisages granting the district heating allowances to the households in the lowest tenth of the income scale (maximum 25.000 households) and water, sewage, and waste disposal allowances to 50 percent of the households in the lowest tenth of the income scale (40.000 households). Consequently, the allowances tend to cover around 15-20 percent of the utility bills per household.

Source: Gyori, 2003

3. User charges and incentives

The ultimate funding sources of local public services are the user charges and the grants/transfers. This means that each service provider has to recover its cost through the user charges paid by the beneficiaries of the services and some kind of the transfers either from the public sector (local or central government) or private donations. The lack of real decentralization (expenditure and revenue autonomy) led to the "no-cost recovery" situation, which inevitably caused a huge service level decline (Hegedüs, 2003).

Informal pricing

Donations and voluntary contributions for public purposes are another type of revenue. In principle, no return for this contribution is given. The social and the educational sectors often benefit from donations. Service providers under fiscal pressure want to increase their revenues, but try to keep them as off-budget revenues. Typically donors can write off their donations from their tax base, which gives an incentive to the institutions to raise money through foundations, even if they replace regular user charges. In Hungary many schools finance special services through "foundations". Parents pay the fees for the courses to the schools' foundations. Extra-curricular language courses, tennis classes, for instance, are financed in this way. Another example is The "Clever Love" Foundation of the children's day care center in Berettyóújfalu registered in 1995. The objectives of the foundation were 1. to promote the integration of the kindergarten education into the school education; 2. to develop the children's skills by means of special activities that do not constitute part of the regular education (crafts workshops, drama groups, physical education etc.); 3. to purchase additional equipment (e.g. sport equipment, a small weaving loom, books, musical instruments); 4. to pay for the teachers of extra-curricular activities. The board of the foundation decides on the use of the financial support and the proceeds, considering the objectives specified in the foundation deed. The payment is voluntary, but almost every parent pays a smaller or bigger amount every month.

Source: Hegedüs, 2004

The institutional setting of the service sector (education, health care, social, utilities etc.) has an effect on the mechanism of setting user charges. The first question is which level of government is responsible for "setting" the prices. To set the prices typically means procedures, or an approval process through which the service provider will be given the "price" of services. In some cases these are very simple procedures, when a law or a government decree defines the prices. For example, the fees for social services (public meals, social homes, etc.) are typically defined through government decrees. In other cases, the government has only a “regulatory” role, which sometimes means that they have a strong say in the pricing process, but the government does not always have the capacity to exercise any real control over the pricing, and different levels of government can share the responsibility for pricing.

The formal role of service providers in pricing is limited. However, in practice, service providers make the proposal for the change of the prices, and through this process they can have an influence.

In social services where the equity is an issue, the service providers have a very limited influence in the decision of the user charges. However, there are informal ways to increase the effective contribution of the user to finance services (e.g. donations and voluntary contributions).

Setting tariff in Budapest Public Transportation

Public transportation in Hungary is a local responsibility. In Budapest, the Municipality of Budapest has the right to set the tariffs. However, the central government subsidizes the public transportation by paying the tariff allowances for the pensioners and the students. The size of the transfers depends on the tariff: the higher the tariff, the higher the subsidy. The procedure is that first the assembly decides on the proposal made by the city-owned Public Transportation Company, but because of the government subsidy, the tariff changes have to be approved by the central government, as well. Right after the transition, the new assembly opposed the tariff increase for political reasons, sacrificing the state subsidy (the tariff at that time covered 40% of the cost of the public transportation). In 2003, when the city decided on a substantial tariff increase, it was the central government that rejected the approval of the increased tariff.

Source: BKV (Budapest Transport Company)

In the public utility sector most of the countries in the region have delegated the pricing functions to local governments, but the real influence depends on several other things. For example, the pricing procedure is very important in itself as well. In some countries in the region, the local government units have the right to set the tariff, but they have to be approved by the central government or by the relevant central government agency. There are some cases when the central government gives a subsidy proportional to the tariff to the service provider (see previous box).

In this case, the right of central governments to give or withhold its approval, that is, to share the responsibility for pricing, is understandable. Service companies need security, especially if they make long-term investments, because they can incur losses if their services are underpriced. The law defines the procedures or accounting rules which again - depending on how enforceable the laws are - could limit the manoeuvring room for an organisation with the price-setting rights.

Governments struggle with the rising service spending and the user charges represent a possible incentive mechanism to control the costs. A recent study (Borge and Rattso, 2004) indicated that 30-40% of any cost increase is passed on to consumers in the form of higher user charges. Moreover, user charge financing has a significant negative effect on the unit cost. An increase in the user charge financing by 10 %-points is expected to reduce the unit cost by 6-9%.

Grants

1. Economic effects of grants

In countries around the world, the costs of public services are often shared between those who use them (i.e. households, commercial and industrial establishments) and governments. The government cost-sharing arrangements include matching the grants[6] of the higher government levels and the general fund subsidies from local governments. In Hungary, matching grants are used, for example, in local government benefit programmes, where 80% of the programme cost is paid by the central government and 20 % by the local government. An example of the general fund subsidy (in financing education) is a grant based on the standard cost of a student and typically finances 70-80 % of the cost.

Matching grants are used to induce local governments to provide a socially and environmentally desirable level of public services. Without these grants, the level of the output of the services would be lower than the social optimum. General fund subsidies reecognize the public good and equity aspects, i.e. with the help of the grants each municipality is

[6] Matching grants are the grants with the specification that the amount transferred must be matched by the local funds.

able to secure a minimum level of its public services. An adequate cost recovery (supported by the grants) is the key to both the sustainability and the private sector participation in service provision.

The basic question of the public policy related to the grant structure is the possible effect of the grant design on the response of the sub-national government and the service providers to the grants. If we can answer this question, the criteria of an efficient grant system can be defined. The “theory of grants” examines how different kinds of grants should affect the budgetary behaviour of the lower levels of government. Gramlich (1977) identified three types of grants which have - on the basis of the grant theory - different consequences, and studied the empirical evidence supporting the theory. The Case A grant (the open-ended matching grant) is suited to capture the spill-over benefits because it subsidizes the supply of public services where the benefit goes over the boundary of the sub-national government. The Case B grant (the close-ended lump-sum grant) compensates for the difference in income levels and consequently public services. The Case C grant (the close-ended categorical grant) is supposed to provide the minimum service or spending levels for different government- provided goods and services.

Empirical research has partly corroborated the “grant theory”. However, research has highlighted the criteria for bad grants (Bahl, 2000). The reasons for “bad grants” fall into four categories. The first is to discourage local government autonomy. That is, the central government is unwilling to give up control over governance that would come with ceding the revenue-raising powers to local governments. As an alternative, intergovernmental transfers are given as a local government revenue source. The second reason might be an attempt to maintain or enforce uniformity. The goal of the central government might be to resist diversity on the part of local governments, in terms of expenditure mix or revenue structure. The third reason could be a belief that local governments are more corrupt than the central government, and therefore a shift of responsibility to subnational governments would lead to a waste of revenues. There is some grain of truth in the claim that local government officials are more susceptible to fall under the influence of local citizens because they are closer to the local electorate. Fourth, a transfer system may be put in place as part of the strategy to offload the budget deficit on to the local governments. For example, a grant system may be put in place but become underfunded at a later point when the central budget is pressed.

2.Grants at service provider level

Grants to service providers can be based on a standard (normative) procedure or can be negotiated.

The example for the first solution are the grants based on the standard cost. It means that the transfer only covers a certain standard cost. If local expenditure exceeds this amount, a reduced grant - or no grant at all - is given. The standard cost solution frequently has no close relation to the actual cost, which is typically higher than the standard. In this case, the grant based on the standard cost is a matching grant, where the matching rate depends on the actual cost.

The grants based on the actual cost are typically negotiated, and no limit as to the standard costs or the like exists. It means that the actual cost minus the user charges are funded through the grant (see next box).

Water sector subsidy in Hungary

The Hungarian government has phased out a large part of water sector subsidies from the state budget since beginning to move towards a market economy in 1989. The subsidy reduction in the water sector is significant. The major steps taken by the Hungarian government to reduce the high state budgetary subsidy for water include decentralizing the responsibility of the central government for providing public water services and raising water tariffs. The central government has legally transferred water supply facilities to local authorities, along with ownership of existing water assets. Water tariffs have been raised to the level based on a formula that includes the cost of inputs, depreciation, maintenance, and a return of assets. As a consequence of the decentralization, the 33 water companies were disintegrated into 250 companies, and the price differences increased greatly. To compensate for the high production cost in certain areas of the country, the central budget allocated a fund (3 billion in 2003) to reimburse the service producer with high production costs. According to the grant formula, the difference between the production cost and the maximum price set by the government is given to the companies.

Source: Papp, 1999

The importance of these two methods lies in their effects on the organizational incentives. In the first case, economic rationality pushes organizations to economize with the cost and to restructure their services towards the better-paying activities. The second solution could lead to a sub-optimum situation as well. In the negotiation process (because of the asymmetric information issue[9]) the service provider could withold the facts, which makes it impossible to control the actual expenditure. The general rule is that the standard cost solution is more efficient if the risk of opportunism is limited or if it is too expensive to get a "tight budget control" (contract procedures could improve this situation).

Cross-subsidies can play an important role in financing certain services. One of the typical examples is the housing service when the rents do not cover maintenance costs, and the Public Management Companies use non-housing revenues (rent for commercial property) to cover the loss on the residential units. The important factor here is that cross-subsidizing is not the decision of the service provider but of the local government (principal). However, larger institutions, which have more than one task, frequently use the techniques of cross-subsidies.

3.Grants at local government level

In the decentralised system, service providers get the transfers from local governments. However, this does not necessarily mean that local governments have real decision-making powers on the use of the grants. The pass-through grant means that money is transferred by local governments directly to service providers. In this case, grants are a part of local budgets, but local governments do not have the discretionary right on the use of the funds. In Hungary, the typical pass-through grants are the fund from the National Health Fund or the grant to the Fire-Fighter Services.

The grant typology

There are several ways to classify *transfers*. Transfers mean financial flows from the central level to the subnational level. They have two basic forms: revenue sharing and grants. *Revenue sharing* is a nationwide based taxes and rates, but within a fixed proportion of the tax revenue (on a tax-by-tax basis or on the basis of a "pool" of different tax sources) being allocated to the subnational government, based on (1) the revenue accruing within each jurisdiction (also called the derivation principle) or (2) other criteria, typically

[9]The regulator never possesses as much information as the service provider.

population, expenditure needs, and/or tax capacity (Shah, 1994). *Grants* are financial resources flowing from one government (grantor) to another government (recipient). There is very little practical difference between the revenue sharing, if the allocation is not based on the origin and grants. The other approach of the taxonomy of grants is tied to the degree of the autonomy of the subnational governments to use the transfer. In the case of *unconditional transfers*, no strings are attached to the use of the money. The *conditional* (or *categorical*) grant defines exactly how the money is used, and provides financial help for particular services. Between these extremes are the *block grants*, which can be used freely on a defined functional area. The block grant can be spent in a broad area of local government service, such as urban development, with recipient governments having substantial autonomy to decide on the specific use to which the funds are actually put. *Matching grants* require the recipient local government to provide, according to the matching rate, their own share to the services supported. Matching categorical grants match expenditure on a specific grant-aided service. Matching grants can be *open ended or close ended*, which means that the pool of the grant is determined or left open. *Effort related grants* are typically unconditional transfers and are related to the revenue effort of the local government. The revenue effort is usually measured in terms of tax effort: the greater the revenue is raised from local taxes, the more grant the local government receives. The grants can be allocated as an *entitlement* or can be *competitive.* Local governments can be granted an entitlement to a specific amount of funds provided that they submit a proposal, which satisfies the funding criteria for approval by the central government. In the case of competitive grants the local governments compete against one other by submitting requests which best meet the central government funding criteria.

Sources: LGI/WBI, 2003

With pass-through grants the incentive structure is embodied in the contract between the central government and the grant's beneficiary. Thus it could be based on the standard cost regulation or the negotiated budget (in Hungary, for example, hospitals are financed through the standard cost method, while the Fire Service relies more on the negotiated budget).

Local governments have general purpose grants which can be used for any legitimate purpose, in the same way as the their own tax revenues. However, formula grants allocated on the basis of objective criteria (e.g. some measures of taxable capacity and/or expenditure needs) are frequently general-purpose grants, if their use is not earmarked (see previous box).

General purpose grants can be allocated on the formula basis or ad hoc basis. The formula usually includes the variables that reflect the variation in the need and the cost across jurisdiction; sometimes the formulas compensate for the low fiscal capacity or reward a high fiscal effort. The formula that uses with high weight the number of the beneficiaries of certain services means that the grant is conditional. The reason is that the grants typically do not cover the total cost of the services and de facto require from local governments to co-finance the service. The grant formula in this case includes the "per beneficiary" factor. Consequently, if the grant per beneficiary is lower than the actual cost of the services per user, the grant is earmarked independently of the fact that cost-sharing is not legally required.

Normatives in Hungary

For the performance of their mandatory responsibilities, local governments are automatically entitled to normative contributions from the central budget. This, however, is not a form of task-financing, as the spending of such subsidies is not subject to restrictions. A local government decides at its own discretion how much it spends on what tasks. Initially (in 1990), global contributions dominated (relating at first to the total number of residents, later to the number of individuals in the various age groups). Later on, however, the share of contributions based on the indicators of more concrete tasks (number of children in créches, kindergartens, primary and secondary schools, those using the services of student hostels, social institutions, etc.) made up an increasing part of the total funding. The aim of this, however, was to improve the allocation of such funding from the central budget among local governments. There is only one item that is directly related to the revenues collected by the local governments. Each forint of the actually-collected holiday accommodation charge is matched by two forints of subsidy - this makes up less than one per cent of the total budgetary subsidies.

Source: OECD, 2001

The third option to give grants through local governments for public services is the specific (conditional) grant. In this case it is the local government who has the "legal contract" to the central government. They have to guarantee the quality and quantity of services their office or the service provider (typically budgetary institutions) offer (the earmarked grants are very similar to the pass-through grants).

Grant structure and distortions

In the current Hungarian intergovernmental transfer system, grants are negotiated annually. The grant structure, depending on the type of grants, in one way or another affects the economic behaviour of local governments. As local governments try to maximize the amount of grants they receive from the central government, the grant allocation process may distort their financial decisions resulting in a situation where local user preferences have no or little effect on the provision of services. The response of local governments to the grant allocation system can be described as optimal when they discontinue or minimize the provision of services with low grant-to-cost ratios and of low local priority. The grant-to-cost ratios can be low not because of insufficient grant financing but due to the high costs incurred by over-capacity or bad management. An example of such behaviour was the closing of nursery schools in the early 1990s due to the lack of grant financing and partly because of a smaller number of eligible kids. Only when municipalities discontinue the provision of the services which were badly needed by a community but received insufficient grant financing, can their economic behaviour be considered distorted. An extension of this type of distorted behaviour is when municipalities reduce the scale or quality of important local services, typically by neglecting adequate maintenance or renovation work, or by scaling down the level of services. Another form of municipal response to the low grant-to-cost ratios for certain local services has been to transfer the responsibility for their delivery to the county level.

Sources: Hegedüs, 2003

The categorical and the general purpose grants, as we have seen, affect the behaviour of the local governments differently. However, the distinction between these types of grants is artificial because of the "fungibility" of money. The availability of grants frees up other local revenues that would otherwise be spent on supported public services. So in this way there are two options: 1. local governments allow tax reduction and make it possible for the households to increase their individual consumption, or 2. local governments increase the expenditure on another, non-supported area. In other words, the funds may end up being used for any purpose even though they were intended for a specific one.

Local governments regulating the service providers could formulate two strategies. The first is the *traditional model of budgeting and financial management based on historical cost*: In this case, the budget for an institution is a projection based on the previous year's figures (plan) and the budgetary items for institutions are a product of individual bargaining, which can be modified during the fiscal year according to the changes of external and internal conditions[8]. The other strategy tries to give clear financial rules for service providers and base their transfers on formula grants[9]. In various cost elements different methods are used to estimate the order of the magnitude of funding, depending on the functions of the given service provider.

Conclusion: service contracts and enforcement

There are other factors as well. Contracts themselves have an effect on the incentives, and this could modify the grant design. The "mission" of institutions (e.g. social institutions) can also be an important factor in explaining the behaviour of organisations, which contributes to the outcomes (Besley and Ghatak, 2003).

The financing of local public services can be reduced to instruments: user charges and grants. The institutional framework and the design of these financial means define the incentives and the room for manoeuvring both for the local/central government and the service providers in the provision of public services. The relation between the

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[8]This makes everyday practices rather ad hoc and substantially reduces the financial discipline of institutions. Institutions tend to over-spend as the budget is underestimated anyway, and are not worried if they cannot collect the planned revenues since they are overestimated anyway. A further consequence of this practice is that they do not pay their bills, for instance utilities, and are indebted to local government-owned companies. Clearly, this is a case of organized irresponsibility and shows the power status of the professional /financial management of an institution how much it can overspend. A further negative consequence of this solution or inevitable practice is that the information for the local body of representatives is necessarily incomplete, as the apparatus and the institutions cannot reveal the internal details of the financial management, which often violate the spirit and sometimes the requirements of legal provisions.

[9]In this theory, transfers for local governments should cover the difference between the expenditure needs and the revenues capacity. This method is *close* to this idea.

government and the service provider can be described as a principal-agent problem (Le Grand, 2002).

The key problem in the principal-agent relation is that the agent (service provider) can behave "opportunistically" (the principal is the political, decision-making unit of government; the service provider can be part of the government, such as various departments, or budgetary institutions, independent or quasi-independent units). It means that - according to the theory - and because of the asymmetric information, the service provider (seeking its interest) will deviate from the behaviour prescribed by the regulators (principal) whenever this is advantageous to him. The regulation of the user charges and the grant structure influence the chance of the danger of "opportunistic behaviour".

Beyond the institutional framework (basic laws, etc.) and the financial elements, the "service contract" and its enforcement are a determining factor influencing the efficiency of services. The contracting should be interpreted in a broader sense, as it includes some modern budget methods (programme budgeting), monitoring and performance measurement.

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