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RISKS OF EXTERNAL RESOURCES OF LOCAL AUTHORITIES IN HUNGARY

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ABSTRACT

The transition to a market economy in Hungary began 22 years ago. The process targeted first and foremost the financial infrastructure and its institutions (e.g. bank reform, tax reform) and the rapid transformation of ownership relations (privatization). In light of the three dimensions of the Europe 2020 Strategy new definition of state tasks, re-thinking of the range of public services and that of municipal finances is necessary. The author aims to analyze the debt service and opportunities of local governments from rural and settlement development point of view and the new pattern of state-municipal relationship.

Local authorities at district ("járás") and town level are also often able and willing to provide assistance, particularly for new projects or those likely to revitalize failing enterprises. Although cash grants are rarely available at this level, valuable help can often be given in other ways. Possible examples are the provision of cheap land – in some cases even free of charge – assistance and help with finding and training employees and introductions to other reliable local businesses as future suppliers or customers.

Many local authorities have established formal programs for the encouragement of local investment. Smart towns have established industrial parks as home for new businesses. Investors can essentially expect to receive appropriate premises with full infrastructure back-up services, thus enabling their management to concentrate – especially during the start-up stage – on matters specific to business. While the nature and extent of local government support varies by place and timing, appropriate contact with the local authorities is recommended in all cases of potential significance to the local community. The state, municipalities, investors, pension funds are all interested in smart, sustainable financing. From local and regional economic point of view their financial and non-financial contribution to the new projects is essential. The author believes that in future regional and business models aiming for competiveness no longer the capital but aptitude, intelligence and skill will be decisive. The main conclusion of the study is that sustainable growth and high-employment economy delivering economic, social and territorial cohesion in today's Hungarian municipal, regional sector is reachable with smart financing and using "Distribute to Originate" technique.

Keywords: local government, sovereign debt, bond, debt settlement procedures

JEL classification codes: H63, H74, H83, R53

Introduction

In European comparison, Hungarian statehood looks back on a long history that has been continuously characterized by new challenges, expectations to be fulfilled. The period of 1950–1990, similarly to most of the previous eras in the development of the state, was dominated by strong centralization, and therefore, before the regime change in 1990, Hungary did not have firm traditions in municipal decentralization. The "victims" of centralization endeavours were mostly the local governments of villages and small towns, as well as their societies (Pálné, 2008). According to István Bibó, within the Hungarian system of public administration it was solely the "administration of cities" where the "communal control function of municipalities" appeared (Bibó, 1990).

In Hungarian history, cities were usually understood as privileged settlements, while quite frequently their actually fulfilled functions and the legal status they had been granted did not really correlate with each other (Kiss, 2006). István Kiss regarded the state to be the unit that was capable of synthetizing partial interests, and therefore he suggested "The more developed a society having been organized into a state is, the more complex the life of the state and its public administration activities are. And it would call for decentralization or rather deconcentration." (Kiss, 2006, p. 232).

To some extent, the associated literature has a normative approach to decentralization, meaning that it regards democratic legitimacy to be desirable in terms of both the efficiency and effectiveness of performance of public functions (Saito, 2011). Regional politics consider decentralization and deconcentration as fundamental requirements, and we know that in

Europe and the developed regions there is plenty of evidence that regionalized governance enhances the competitiveness of the regions (Horváth, 2006).

Decentralization should not exclusively be viewed as the spatial distribution of public functions, but as the opportunities of the lower level governments (hereinafter referred to as the local governments) to consider and decide on the ranking of public services, as well as the financing, organization of collective goods independently (Vigvári, 2011). This municipal independence appears in the legal system of modern states alongside the requirements for local governments to fulfill certain tasks and the associated municipal expenditure assignment. In financial context, decentralization indicates in relation to which functions and expenditure items the central government grants the right of decision-making to the local level, and how the necessary resources are provided (Vigvári, 2011). In view of the division of work among the various levels of government, conceptual distinction should be made between local public functions purely fulfilled by local governments and tasks delegated to local governments. Delegated tasks tend to include instances where the local government has no influence on the form of implementation, its efficiency and the costs incurred. In fact, it is a special form of deconcentration. There are tasks delegated to local governments where both the sectoral laws and financing options offer the opportunity to local governments to decide partially on their own in relation to the characteristics of the services and the associated sources of funding. The fulfillment of a public function is not different from market production in view of the fact that in both cases a measure of the quality of economic operations is the expedient and professional use of limited resources. During the performance of public services, the “3E” criteria need to be fulfilled, i.e. public functions are to be fulfilled efficiently, effectively and economically. Effectiveness means that public services accomplish their objectives, i.e. the public funds spent have triggered the effect for which their utilization has been ordered. Efficiency means that the resources have been used to an appropriate extent. Economy indicates that the factors required for public services in any necessary quality have been acquired at the best possible prices.

The decision-making independence of local governments also gives way to competition between local authorities. This decision-making independence may encompass the determination of the framework of the performance of delegated tasks, the ranking of the various public functions, as well as the assumption of a range of voluntary tasks. There is special competition among local governments but it cannot be compared to the classic market competition. The elements of this competition include the race for the funds of the European Union, for commercial banks, rivalry for investors and the “consumers” of local public services. This non-market competition may result in the expedient use of resources but in many cases it may as well contribute to the prodigal utilization of resources or the resulting loss of funds (Vigvári, 2011).

As a result of the financial–economic crisis unfolding in 2008 and the accompanying social, economic tensions, competition tends to be sharpening. As long as recession was mostly a consequence of the tensions and serious problems generated in the financial system, "it in turn affected all sectors" (Bailey–Chapain, 2011, p.6), including the municipal sector. In this competition, only those local governments have been able to survive that use the available resources in a transparent manner. From this starting point, my study has had its main focus on the institutional system of financing within the very complex activities of regional development (Faragó, 1987) and thus intends to present the associated options of financing and the acquisition of funds in international and domestic terrain.

1. Financial architecture of local governments

The financial architecture of state finances denotes the complexity of the set of rules prescribed in relation to the sources and tasks of certain subsystems, including the municipal subsystem. In the case of the municipal subsystem, this financial architecture is viewed to include central grants and subsidies, revenues shared with the central government, as well as the rules and privileges associated with own revenues (Vigvári, 2005).

To produce the collective goods that are necessary for the operation of settlements, regions and the fulfillment of local public functions, it is necessary to concentrate the appropriate resources. In the specific forms of decentralization, it is effectuated by various financial means. One of the key issues of the municipal financial system is the way how resources are generated (Vigvári, 2011). There is a strong correlation between the devices used for the generation of resources and the nature of the tasks performed by the local government.

In European practices, Article 9 of the European Charter of Local Self-Government[1] drafted by the European Council and approved in Strasbourg on 15 October 1985 states:

"Article 9: Financial resources of local authorities:

(1) Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

[1] In Hungary, the Convention on the European Charter of Local Self-Government accepted on 15 October 1985 in Strasbourg was enacted by Act XV of 1997.

(2) Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

(3) Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate."

Transfers originating from the central government should be foreseeable and bound to certain goals, whole in view of shared revenues their extents, amounts are particularly important from the perspective of local self-governments. Concerning their own revenues, it is to be examined to what extent the level of the central government delegated the right of taxation to the level of local governments, and how much financial and capital markets are accessible to them.

All the elements of the financial architecture call for proper regulations in relation to reporting, the transparent accountability for finances, the establishment of appropriate management information systems, as well as the operation of control mechanisms both within and beyond the organization. Municipal systems continuously develop, and therefore it is expedient to interpret the financial architecture of local self-governments dynamically, via changes. With respect to the regulation and financing of the economic role of the level of the central government, the development of global economy has given rise to two different state models. The main characteristics of the Anglo-Saxon and continental model are summarized in Table 1 (Kusztosné et al., 1999):

Key characteristics of the Anglo-Saxon and Continental municipal models

Table 1

Anglo-Saxon model	Continental model
- local governments pursue well-defined public service activities.	- municipal tasks are defined in looser framework regulations.
- the state has a managing, financing role in the provision of public services.	- local governments perform both public services and administrative tasks.
- during the performance of service, they strongly rely on market organizations.	- an extensive network of budgetary institutions and communal network under the leadership of the local government are operated.
- redistribution is not a municipal responsibility.	- redistribution is a municipal responsibility.

Source: Kusztosné et al., 1999.

The basic difference between the two models is apparent. On the one hand, they differ from each other in terms of the scope and nature of the tasks delegated to the local self-governments, as well as the institutional background. Apart from their diverging economic and historic development, the reason for the roots of the difference of the two models should be found in the economies of scale, the varied income-generation abilities of the individual countries, the degree of the mitigation of the overspill and – among other things – the different territorial demands for public goods.

The figures in Table 2 reflect that for the EU–27 the expenses of the local self-governments made up 25.5% of those of the government sector in 2000, whereas in 2010 this rate came to be 27%. In the case of the EU–27, the overall debt of local self-governments in 2010 totaled up to 6.7% of the GDP, and therefore it became necessary to stick to budgetary discipline.

Key data describing the economic operations of local governments in the average of the EU–27

Table 2

EU-27 countries	Amount EUR bn	As a % of total public sector		As a % of GDP	
	2010.	2000.	2010.	2000.	2010.
Expenditure (local level alone)	1.671,-	25,5	27,0	11,5	13,6
- of which direct investment	201,-	65,0	62,1	1,5	1,6
Revenue (local level alone)	1.591,-	25,3	29,5	11,5	13,0
Debt (local level alone)	826,-	9,6	8,4	5,6	6,7

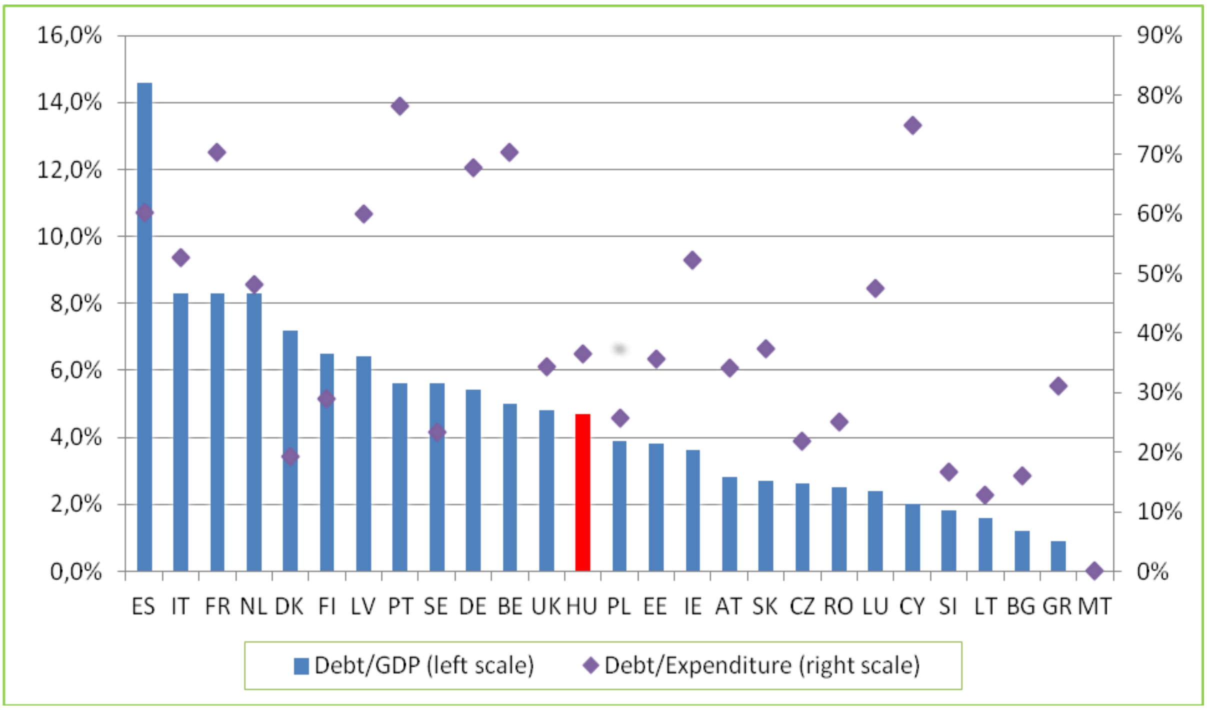
Source: Dexia (2011)

The outstanding significance of budgetary discipline and the borrowing activities of central governments are indicated by the fact that a major part of the investments of the public sector – 62.1% in 2010 – is implemented by the local governments.

Therefore, it is necessary to demonstrate the indebtedness of the municipal sector, which is shown in Chart 1.

Indebtedness of the municipal sector in 2010, in the EU–27

Chart 1



Source: CEMR-Dexia: EU subnational governments 2010 key figures, own edition

The above graph shows changes in the volume of municipal debts in relation to the GDP and expenditures, and in this context, in European Union, the volume of the GDP-proportionate debt of the Hungarian municipal sector was 4.7%, approximating the 4.8% value of the United Kingdom in 2010.

2. Characteristics of the Hungarian municipal system

In Hungary the system of local governments became formulated and consolidated in the process of the change of the political regime. Local governments were integrated in the market economy environment, given assets and allowed to manage their revenues freely. The initially fragmented nature of the Hungarian system further aggravated throughout the years, which was increasingly working against efficiency in the field of financing. By 2010, the number of the local governments increased to 3196, which was over the figure at the time of the change of the political regime by 103 local governments.

Distribution of local governments in view of their ranks in public administration

Table 3

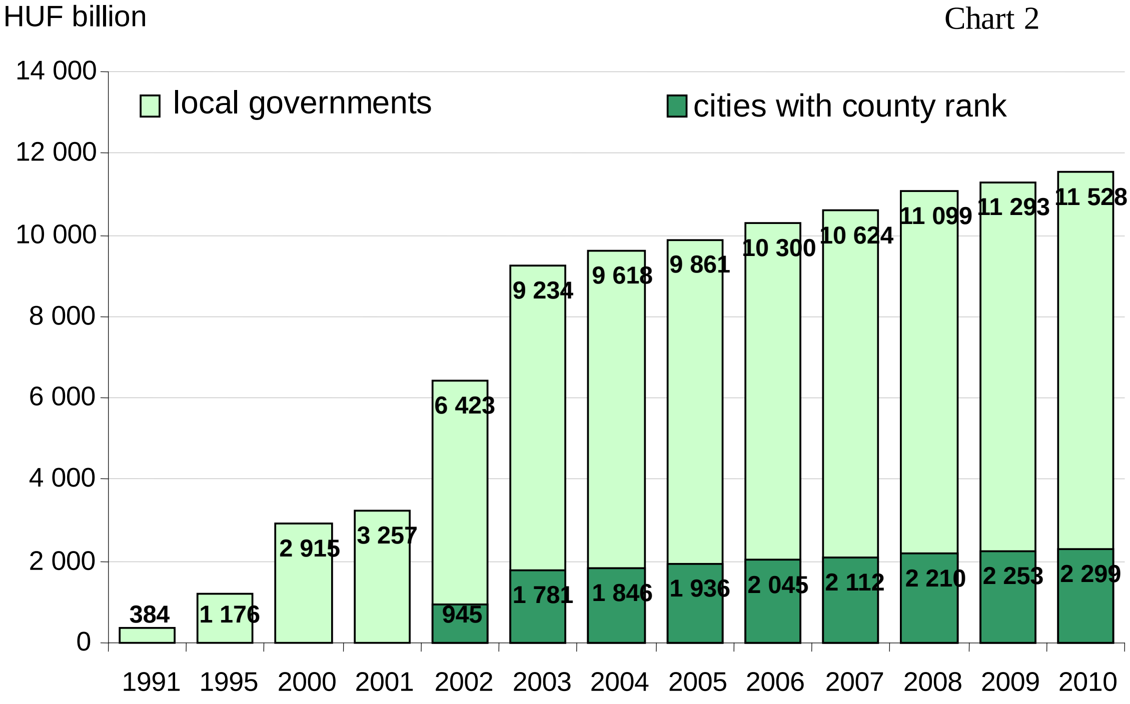
Capital and county	Districts in Budapest	Cities with county rank	Towns	Villages, Large villages	Total
20	23	23	304	2826	3196

Source: Hungarian Central Statistical Office (KSH), 2010

This fragmentation of the structure posed additional operating and financing problems, with one underlying reason being the large-scale differentiation in their property and asset standings. In 1990, the amount of the assets held by local governments started from HUF 384 billion and reached HUF 11,528 billion in 2010. A fundamental condition of the independence and operation of local governments was that they needed to have assets to perform and execute their statutory tasks, responsibilities, and thus on the basis of the Act on local governments (Ötv.) of 1990 the assets of local governments should consist of the tangible properties and assets owned by the local governments as well as intangible rights that were to serve the accomplishment of the objectives of local governments. The growth of the assets of local governments since 1991 is shown in Chart 2.

Assets of local governments according to their balance sheets, 1991–2010

Chart 2



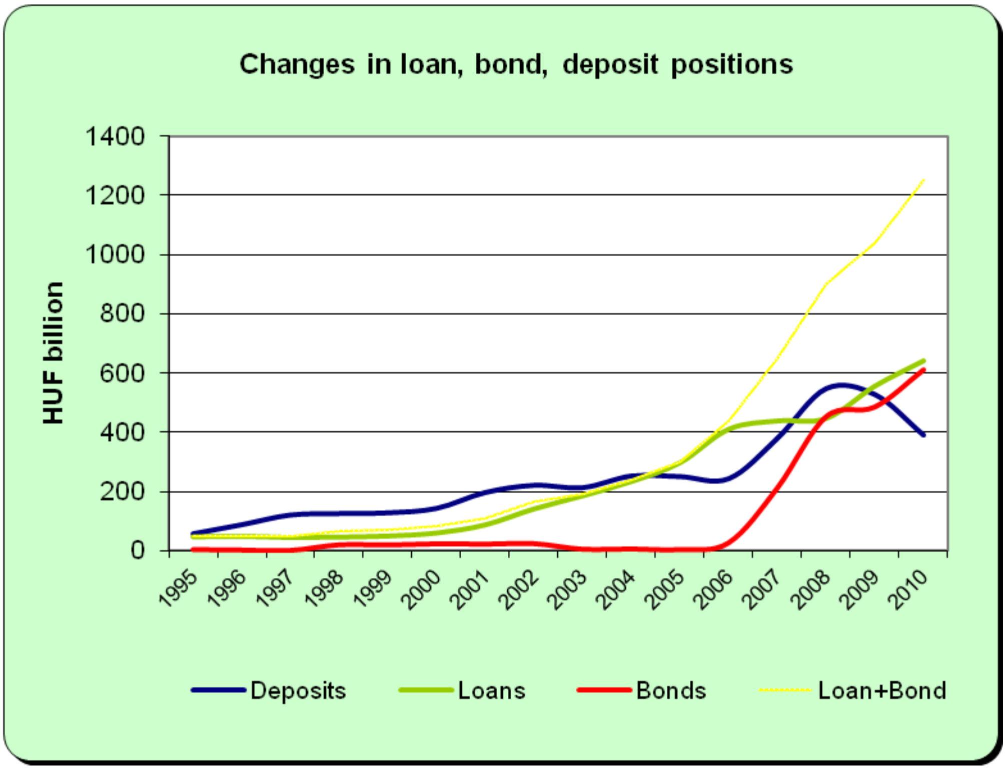
Source: Ministry of Finance (PM), Hungarian State Treasury (MÁK)

Nevertheless, 90% of all the assets of the settlements are concentrated in just 15% of the local governments, while 2700 small settlements share only 10% of all the assets.

The system-related problem of the Hungarian local governmental sector has been caused by the fact that in the past few years several billions of Hungarian Forints have been withdrawn from the sector. The settlements were granted significant rights and powers (e.g. right of taxation), the number of their mandatory tasks increased, while the amounts of the subsidies received from the central budget failed to increase in due proportion. The underfinancing of the system could be perceived as early as in 2002 and have remained a prevailing factor until today. In this situation for local governments a reasonable solution for preserving their operability and financially covering the necessary developments was to rely on the lending and bond issuance services of credit institutions. In 2010, the local governmental sector had an aggregate volume of debts of HUF 1,252 billion[2] (approximately EUR 4,3 billion).

Changes in the position of financial institutions against the local governmental sector, 1995–2010

Chart 3



Source: own compilation on the basis of MNB data

[2] Source: data of the National Bank of Hungary (MNB)

Changes in the volume of debts belonging to the local governments have also been strongly influenced by exchange rate fluctuations because more than 50% of these debts have been outstanding in foreign currencies and has been mainly denominated in Swiss Francs. The repayment obligations of FX-based loans/bonds became due in 2011–2012 and larger local governments started to witness payment difficulties due to the considerable weakening of HUF. **It was proved that the contradictions having accumulated for years could be tackled only with the comprehensive reform of the system.** Accordingly the legislative act on local governments enacted at the end of 2011 laid the foundations of a basically new system of local governments. Under this concept the current normative financing should be improved and shifted towards task-based financing.

Since 2012, the operation of the municipal subsystem in Hungary has been based on a newly conceived legal system. The scope of the competences and economic operations of the local self-governments has become considerably narrowed by having the state taken over by certain functions in the field of healthcare and education. With respect to the fact that the relevant detailed regulations are still under formation, one can shape an opinion only on the level of generalities, expected effects.

In Hungary, as a result of the transformation processes, the regulations pertaining to municipal borrowing have also been modified in 2012 alongside the changes in the legal regulatory and public economic environment. Passed by the Parliament, Act CXCIV of 2011 on the economic stability of Hungary (hereinafter referred to as the Stability Act) states that with certain, defined exceptions any transaction resulting in debts on the part of the local government may be validly consummated only with the prior consent of the Government.[3]

3. Legal background

The new regulatory system basically relies on the following legislation:

- Fundamental Law of Hungary, basis of the Hungarian legal system (*new Constitution, repealing the former one)* [4]

[3] Local governments are required to inform the Government in advance, in relation to their intents to enter into any debt specified in the accepted budget, while the actual consummation of the borrowing is dependent on its authorization. The rules for the authorization of transactions resulting in any debt are stipulated in Article 10 of the Stability Act, as well as its enforcement Government Act 353/2011 (Dec 30) on the detailed rules of the provision of consent to transactions resulting in any debt.

[4] Hungary's Fundamental Law was accepted by the 18 April 2011 meeting of the Parliament.

- 2012 Act on the central budget[5]
- New act on the local self-governments of Hungary[6] (new Ötv., MaHÖ)
- Act on the stability of Hungary[7] (Stability Act)
- New act on state finances (new Áht.) [8]
- Act on the national assets[9]

The above legislation is completed by the so-called cardinal laws that are passed by the Parliament in an ongoing manner. The part of the Fundamental Law relating to public finances is to be mentioned separately in view of stability.

Section (4) of Article 36 of the Fundamental Law pertaining to public finances stipulates that "the Parliament may not accepted such legislation on the central budget that would make the amount of the public debt exceed half of the total national product". An important condition set forth in Section (5) is that "as long as the amount of the public debt exceeds half of the total national product, the Parliament may accept only such legislation on the central budget that defines a rate of decrease for the public debt in relation to the total national product". Any deviation from these requirements may be made only in the event of any special legal regime to the extent needed for the mitigation of the consequences triggering such particular circumstances, or at times of the permanent and considerable fallback of the national economy to the extent necessary for the restoration of the balance of the national economy.

4. Relationship of the Fundamental Law and local self-governments

The Fundamental Law deals with local self-governments in Article 31–35. Under Section (2) of Article 35 of the Fundamental Law, the four-year cycle of municipal elections changes to five years, which – together with the increased term of re-eligibility – is expected to result in the improvement of the stability of local economic operations, the strengthened calculability.

Responses to the financing issues of the municipal sector can be found in the new Act on state finances, as well as the associated government decrees and cardinal laws.

Section (4) of Article 34 of the Fundamental Law states that "the Government shall provide for judicial review over local self-governments by way of the metropolitan and county-based

[5] Act CLXXXVIII of 2011 on the central budget for 2012
[6] Act CLXXXIX of 2011 on Hungary's local self-governments
[7] Act CXCIV of 2011 on Hungary's stability
[8] Act CXCV of 2011 on state finances
[9] Act CXCVI of 2011 on national assets

government offices", while Section (5) rules that "towards the preservation of the balance of the budget, legislation may require the fulfillment of certain conditions, other commitments or the Government's consent for borrowing by a local self-government in the amount specified herein", which are also subject to other detailed regulations.

5. New funding principles

Within the meaning of the Act on state finances, task financing to replace normative financing will be introduced in the relationship of state finances and the municipal subsystem from 2013. The associated details are still not known. The rules for funding and borrowing have been outlined on the basis of the interpretation of the proclaimed government decrees, whose key point is that the utilization of long-term credits and external resources – *with several exceptions* – are bound to the authorization of the Government.

6. Potentials for local governments to acquire funding

When the funding of municipal investments are concerned, it is primarily the "cheapest" governmental, regional development subsidies that are taken into account. The next potential source of funding is made up of the "actual" own resources that are available to the local government, the set of municipal revenues (such as privatization revenues), followed by various preferential loans (credits furnished by governmental, international organizations) and then loans, bonds of market interest rates. The participation of the private sphere in financing is increasingly wide-spread both in the field of service provisions, as well as in lending and as purchasers of bonds.

The narrowed group of governmental grants, subsidies has been replaced by European Union grants, though the associated details are not discussed in this study. The most frequent example of direct governmental guarantees is the guarantee for the repayment of loans, which also involves the assumption of exchange risks. In the domestic scene, this role of the state has emerged in the form of joint and several suretyship with the currently associated institution being Garantiqa Hitelgarancia Zrt., which has undertaken joint and several suretyship as a state-owned company for municipal commitments, up to 80% of the principal.

Further means of supporting the involvement of local governments in the borrowing market include the foundation of financing institutions representing local governments, which appear on the credit market by combining the demands of several local governments for credits. These institutions can be various funds that may be established with the purpose of supporting municipal infrastructure projects, as well as credit rating institutions that assist investors in ranking the different local governments and municipal projects, consequently they prepare local governments for improving their performances and making progress in the ranks of creditworthiness.

6.1.1. Special banks

The tradition of “special banks” is more extensive in Europe, where small investors deposit their savings in saving banks, postal banks that in turn furnish loans to local governments, thereby turning savings on the support of municipal investments. Even such “municipal” banks have come to existence that collect the savings of private persons and rely on these funds to provide credits – in certain cases – to the projects, investments of local self-governments.

6.1.2. State-subsidized bond banks

Those bond banks that take loans in their own names under preferential conditions with reliance on the conditions of the economies of scale the can be considered to be state-subsidized institutions. This involvement of funds can be implemented by way of issuing bonds. The collected amounts are further lent by the bond bank to local governments by purchasing the bonds they issue (Stecné, 2003)

The most significant advantage of this scheme is that the high administrative costs incurred with the issuance of bonds are allocated to several local self-governments, and therefore even local self-governments with weaker financial backgrounds are enabled to enter capital markets. The bank may complete these services with additional professional consulting or the pre-rating of the local governments or the projected municipal investments. The bond bank also takes a role in the mediation of certain grants, subsidies of the central government (e.g. governmental government), while in the case of local self-governments entering debt settlement proceedings, with the contribution of the bond bank the state has the option to assess the actual economic situation, financial standing of the local self-government to decide on any future subsidization, probably in the form of restructuring loans.

6.1.3. State revolving fund

A specialized form of bond banks is the constituted by state revolving banks that are operated as revolving state funds. The revolving fund may utilize its separated capital in the manner defined in the relevant legislation.

The point of the operation of these revolving funds is that the state (or any appointed institution) separate liquid assets under various legal titles, and then furnish this capital to fund specific investments, priority projects in the form of quasi loans. The liquid assets received from the loan repayments by local governments are disbursed again, thereby re-investing the funds. (Peterson, 1996).

6.1.4. Acquisition of funds by bonds

Bonds are highly popular in the international scene, and successfully applied by local self-governments as means of acquiring funds. In Hungary, however, financing via bonds took a special form, mostly after 2006. The main underlying characteristics are described in details below.

6.1.4.1. Revolving fund revenue bonds

This type of funds issues tax-free revenue bonds. The tax-free revenue bonds are primarily covered by the local revenues of self-governments or the revenues from the issuance of general revenue bonds, as well as the reserves of revolving funds.

An advantage of the revolving fund revenue bonds as a specific tool for acquiring funds is that in general the revolving fund has considerable capital, and thus is capable of achieving excellent credit rating. Consequently, in comparison with the market average, better conditions are applicable to the connected loans that can be forwarded to the local government as loans under conditions that are somewhat more favourable terms and conditions (Stecné, 2003.)

6.1.4.2. Bond issued at the account of general revenues

The associated literature also calls bonds issued at the account of general revenues as “go bonds”. The issuer of this type of bonds is the local self-government. These bonds are the most frequently covered by the revenues of the property tax and the revenues of local self-governments. In view of the subscription of go bonds, it is crucial for the potential investors that the local government can count on these local revenues on the long run, in a calculable manner and in definable amounts. The application of these funding means is conditioned on the long-term sustenance of legal security (Stecné, 2003).

6.1.4.3. Revenue bonds

Revenue bonds are issued by local governments. The coverage for the repayment of revenue bonds is in general the yield of the given project (or the special tax associated with the investment) that is funded from the issuance. These bonds are also suitable for financing investments in water supply and sewerage public utilities (Stecné, 2003).

Its advantage is that is appropriate for align the flows of financing costs and the project revenues in time. On the other hand, a disadvantage of this tool of funding is that if the collateral for the repayment of the revenue bond is restricted solely to the proceeds of the project that has been funded from the bonds, the redistribution of the produced goods is prevented, because the available revenues generated by the project are retained in the place of their generation.

6.1.4.4. Double-barreled bonds

These bonds are covered with double security that amalgamates the elements of revenue bonds and go bonds. The associated literature mentions such Canadian examples where in the case of the payment of the bond in conflict with the contract the creditor (the subscriber of the bond as the damaged party) has the right to obligate the local government to increase local taxes (Stecné, 2003).

6.1.5. Municipal development funds

These funds are virtually operated similarly to a bank of municipal financing. In many cases, subsidized loans and other governmental grants are streamed to the local self-governments via these development funds.

Municipal development funds may as well be operated in a manner where it is not the lower-level local governments that furnish the loans directly, but the financial institutions in partnership with the local self-governments, and therefore the development of the municipal credit market can be encouraged on the side of the banks, while with the application of the so-called “pull” technique they can persuade banks to work out more favourable credit schemes for the local governments.

For long, the domestic financing market knew only the various forms of credits, and then in 2007 a tide of bond issuance commenced, as discussed in the following chapter.

6.1.6. JESSICA financing

From the perspective of the local governments, JESSICA financing offers a new option to drive sustainable urban investments and utilize EU funds for supporting growth. JESSICA is in fact an acronym for "*Joint European Support for Sustainable Investment in City Areas"*, and refers to the joint European initiative for sustainable urban development investments.

This initiative has been brought to life by the European Commission and the European Investment Bank (EIB) together, but as a cooperating partner the Council of Europe Development Bank (CEB) is also involved. Under the newly adopted rules, the member states of the European Union have been given the opportunity to turn some of the EU grants utilized by them (those that can be drawn down from the so-called Structural Funds) on returning investments that are implemented as parts of the integrated settlement plan for the promotion of sustainable urban development. The projects wished to be implemented by the local self-governments are financed from the investments of the fund, in the form of capital supply, credits or guarantees, with the mediation of the so-called urban development funds and trust funds as required.

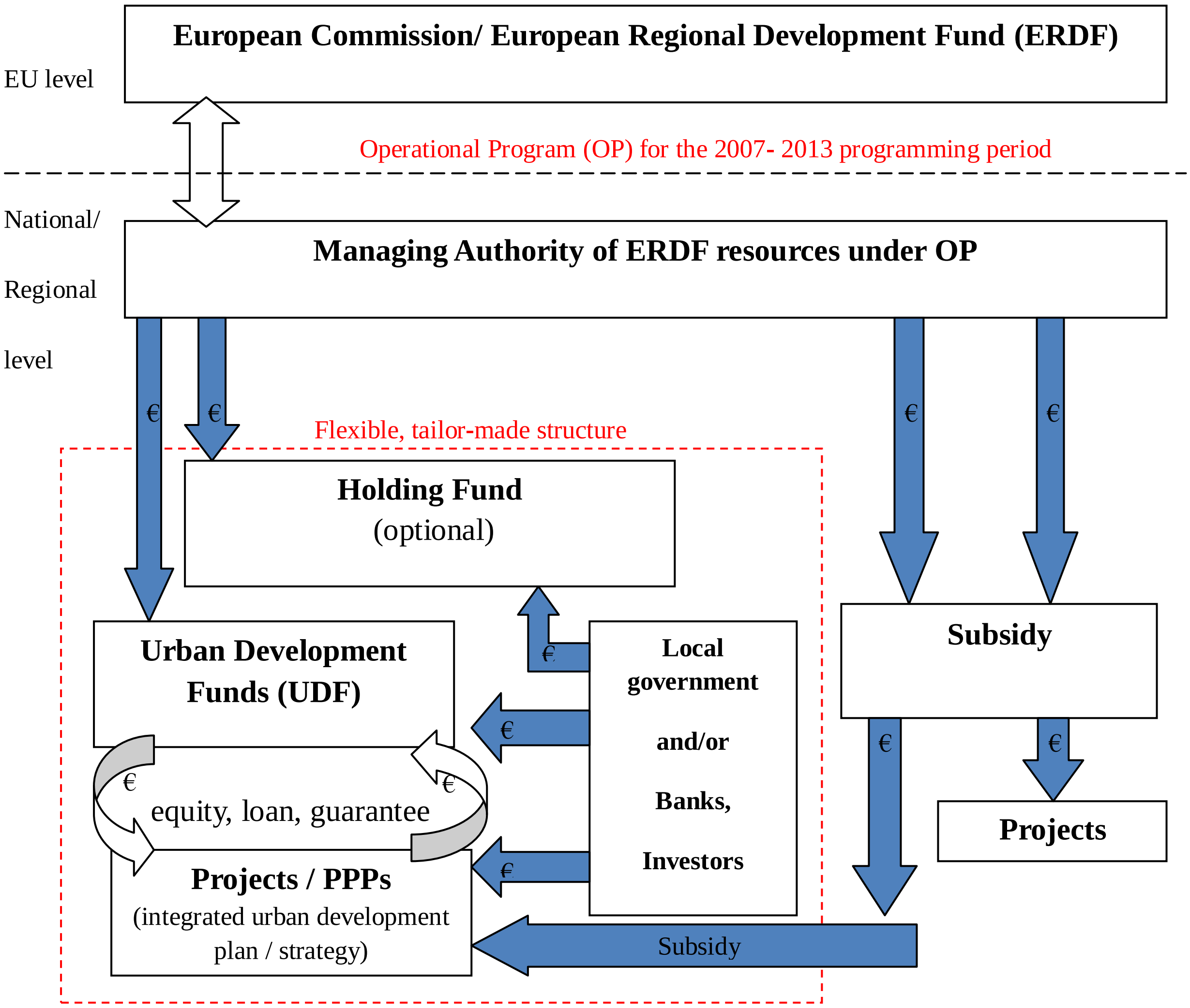
In past periods, the individual member states participate in the creation of the urban development funds within the framework of JESSICA with increasing activeness because it is a way to regroup the EU funds still not utilized from the Structural Funds, and thus ensure their availability even after the programming period of 2007–2013.

Accordingly, the member states that expect to have decreasing amounts of EU grants during the next programming period are offered a new opportunity by JESSICA to prolong the effects of the currently available funds in time.

The operating frameworks and feasibility model of JESSICA are demonstrated in Table 4.

General model of feasibility for JESSICA

Table 4



Source: EIB

6.1.7. DtO – Distribute to Originate technique

With the diminishing market resources and the decreasing demand for bank loans, DtO financing, i.e. the application of the "Distribute to Originate technique", is becoming an indispensible tool for municipal "smart" financing. This model should not be confused with the "Originate to Distribute" technique that contributed to the global-scale spread of mortgage loans of bad quality during the subprime crisis.

The rationale of the application of the "Distribute to Originate technique" can be traced back in the impending Basel III rules, which poses strict and rigorous capital and liquidity criteria on commercial banks. Due to the profit-making pressure on banks, the drop of the lending volume can be foreseen, particularly the limitation of project financing because this type of financing ties up a large amount of capital from the banks on the long run. Therefore, the Basel III regulations exercise negative impacts specifically on those banks that have considerable market shares in project financing and the funding of municipal projects.

During the application of DtO, similarly to the state-subsidized bond banks, such institutions or separate organizations within commercial banks are to be set up that can apply this method with proper reliance on the economies of scale.

The point of the model is that state-subsidized bond bank / commercial bank subscribes 10–20% of the financing demand (e.g. bonds) at the maximum, while the remaining tranche is offered to other market actors, private investment funds, private investors that are looking for investment alternatives beyond government bonds (with similar yield and risk expectations).

<u>Structure of the model:</u>

- the state-subsidized bond bank/commercial bank collects the investment, funding demands,
- it performs the necessary customer and credit ratings (**CAMPARI & ICE** standing for Character, Ability, Means, Purpose, Amount, Repayment, Insurance & Interest, Commission, Extras/Expenses),
- the municipal investment and settlement policy are examined from the perspective of indebtedness, liquidity, performance of tasks, financial capacity,
- 80–90% of the funding of the selected, sustainable and returning investments of excellent ratings is offered to the selected market actors **(Distribute),**
- if the market actors accept funding, the bond can be issued **(to Originate),**

This DtO technique is also applicable to the “selling” of the existing municipal portfolio, but in this case the market requires the use of 20–30% haircut.

I think long-term, sustainable, cash-flow generating municipal investments can be funded with reliance on municipal bonds having appropriate risk ratings, completed with governmental guarantees as required and subscribed by means of the DtO technique.

General conclusion

In the framework of the selected topic, the particular external and internal environment of the debt management of the local governmental sector – as it has been shaped in the past 20 years – has been described. The accumulated debts of the Hungarian local governments have made extremely difficult for the Hungarian economy to keep the target deficit of public finances. It can be claimed that due to the exchange rate risks that are inherent in the financing system of local governments there are serious uncertainties, which poses weighty burdens on the economy on macroeconomic and microeconomic level alike. The state, municipalities, investors, pension funds are all interested in smart, sustainable financing. From local and regional economic point the financial and non-financial contribution of the municipalities to the new projects is essential. In future regional and business models aiming for competiveness no longer the capital but aptitude, intelligence and skill will be decisive. Territorial cohesion in today's Hungarian municipal, regional sector is reachable with smart financing and using "Distribute to Originate" technique.

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