Chapter 13
Municipal Bonds in Hungary: Constraints and Challenges

Gábor Kovács

Abstract After the collapse of communist rule, Hungarian local governments had to meet new challenges and expectations. Due to the decentralisation process, local governments' revenues decreased significantly in the last two decades, while the level and scope of services provided decreased less rapidly, if at all. Consequently, local governments, short of resources, had to develop their ability to raise funds needed to meet local spending needs. This study examines the general theoretical framework of municipal borrowing, comparing the economic and social advantages of bank loans versus municipal bonds. It also evaluates the role of the national government's central administration in regulating local authority indebtedness. It then presents and analyses the characteristics of Hungarian local government bond financing, assessing the appropriateness of bonds as a local government fundraising tool. The indebtedness of Hungarian local authorities has increased drastically since 2006, mainly through bond financing. A substantial proportion of these bonds were issued in foreign currencies because interest rates were lower. The subsequent economic downturn and devaluation of the Hungarian forint has left many local governments worse off because their indebtedness has increased in forint terms. Bond financing is often considered simply an alternative form of borrowing, and Hungarian local governments do not fully benefit from the flexible features offered by bonds. In today's Hungary, bond financing offers opportunities to broaden local government financial freedom and reduce the financial risk related to borrowing, but they also pose risks, particularly in the absence of local expertise. Regulation of local government borrowing is still mainly based on the coercive effect of a credit limit. This is a one-sided approach to the problem, and current Hungarian regulations fail to meet the expectations of the most important players in the European capital market, namely, institutional investors. New regulations are needed which can enhance the beneficial characteristics of bonds, while preserving the security they provide to local governments and prospective investors.

Keywords Local government finance • Municipal borrowing • Municipal debt management

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Introduction

Following the 1990s, after the termination of the economic transition process, the Hungarian local government system had to meet new challenges and expectations. Due to the decentralisation process, local governments' revenues decreased significantly in the last two decades in real value, while the level and scope of services provided did not decrease at the same time. Therefore, local governments, which are short of resources, have had to perform what is probably one of their most important tasks: to develop their resource absorption and fundraising capacity, which would ensure the necessary financial tools to implement development.

One of the methods of using outside resources is borrowing, among which fund acquisition via local government bond issuance should be listed. The enhancement of the resource-deployment capacity of the local authority sector is a fundamental condition to ensure the necessary development resources at the local level. The extension of the capital absorption capacity at subnational level is also of high importance in relation to opportunities to obtain funding from the EU.

This chapter presents and analyses the main characteristics of Hungarian local government bond financing and assesses the usefulness in Hungary of bonds as a local government fundraising tool. The sample studied includes all the Hungarian bond issues between 2006 and 2008. This is deliberate: the aim is to examine local government behaviour before the onset of the current credit crisis in 2008–2009. As can be seen from the analysis below, since then the credit crisis began, the fiscal position of many Hungarian local governments has worsened, particularly because of a large number issued bonds in Swiss francs or euros rather than Hungarian forint. This is because the interest rate on francs and euros was significantly lower than that on forint, thus lowering borrowing costs over the term of the bond. However, devaluation since 2008 has actually increased indebtedness in forint terms. Hungarian local governments were not unique in this regard: within Hungary, in 2009, 60 % of all housing loans were in foreign currencies (European Covered Bond Council 2010). Moreover, in the United States, which has a long history of local government bond issues (municipal bonds), a growing number of local governments have overborrowed and been forced to default on their bonds (Walsh 2012).

This chapter attempts to summarise the lessons learned from local authority bond financing in Hungary and to develop some future perspectives regarding the viability and role of municipal bonds in the finance of Hungarian local governments. The timeliness of this research is primarily proved by the fact that compared to the mid-2000s, considerable changes have happened to the size of indebtedness of Hungarian local governments. Local authorities' external indebtedness has increased drastically since 2006, mainly in the form of bond financing.

The Role of Municipal Bonds in Local Government Finance

In the first, theoretical part of my paper, I introduce the most important types of municipal bonds, discuss the economic advantages and disadvantages of their use and summarise recent regulations of the Hungarian central government on the issue.

Why Issuing Bonds by Local Authorities Makes Sense

Borrowing – and issuing bonds – represents one possible and important way to finance local capital projects. The most important arguments for borrowing by local governments and against other forms of financing (e.g. against raising the level of local taxes or levying new local taxes) are as follows:

Long-term debt allows subnational governments to acquire or build capital improvements more quickly than they could on a pay-as-you-go basis. Borrowing over time is an effective way to overcome the problem of an inequitable burden of costs among tax payers. It allows more equitable payment schemes, since users can be made to pay for the capital cost of facilities as they are used over time. Most users will pay for the benefits either through local taxes or directly through user charges, and thereby an optimal allocation of resources can be achieved.

Benefits from accelerated local development can overshadow the cost of borrowing. When carrying out the investment quickly, operational costs (related to the given service) can be reduced (Swianiewicz 2004). Borrowing can also stabilise the required budget resources. The volume of capital spending in local government units fluctuates from one year to another. If capital projects are financed from current revenues, the demand for funding resources changes over time as well. In countries where a large proportion of local revenues is raised through local taxes, an irrational fluctuation of local taxes rates may result.

There are also *costs and risks* in the case of borrowing. Long-term debt limits a subnational government's future budget flexibility. Unwisely used, it can burden citizens with high taxes or service charges. Many countries permit long-term debt only for capital spending and not for meeting operating deficits (sometimes called the "Golden Rule").

Borrowing to meet short-term financing needs can provide opportunities for banks and subnational governments to develop working relationships and allow bankers to become familiar with the governments' financial affairs. Provided that the financing is repaid within the budget year and that carrying debt beyond the budget year is prohibited, there is no a priori reason to limit such financing to capital spending (Freire-Petersen 2004).

Borrow from a Bank or Issue Debt?

Even if borrowing appears to make more sense, the type of borrowing that is most appropriate to finance capital projects needs to be considered. The simplest way might be to borrow through a local or national bank. An alternative method is to issue debt in either the domestic or international capital markets.

Possible Advantages of Bond Financing

In the case of bond financing, sub-sovereigns can get all the funds they need upfront through the bond offering. Funds are not subject to partial payments based on a bank's monitoring of the project construction progress. In other words, the whole credit sum is available immediately, allowing local governments to quickly commit the capital.

Domestic bond markets can also provide an added source of financing which can tap into the wealth of a wide range of players, from individual investors to pension and mutual funds. The marketability of bonds induces the fact that theoretically more funds from potential investors are available for local governments, and several potential investors' savings can be mobilised by investing in bonds. Another consequence of marketability is that bonds generally have a longer repayment period than bank loans, and they may indeed provide a cheaper source of capital, especially when the offering is backed up by a robust dedicated revenue source. Bonds are lower in price than bank financing, due to lower interest, because of their marketability. In addition, a bond issue allows a higher volume of fundraising compared to bank loans which also creates more favourable conditions for investment.

The more flexible cash flow of the bond is also a crucial argument for bonds as opposed to bank loans. In general, in the case of bond financing, the whole sum of the capital payment is due only at the end of term. Therefore, if a fiscal problem should arise, repayment of a bond issue can be financed by a new bond issue, and so the obligation of repayment can be "rolled on".

The distant nature of the relationship between bondholders and issuers can enhance both the efficiency and transparency of government operations. At the same time, there is an opportunity – taking advantage of strength of potential local linkages – to raise and use funds for expansion at a more favourable rate through the public issue of bonds.

The Drawbacks of Bond Financing

Advocates of bond issuance, however, do not reckon with the fact that sub-sovereigns need to be familiar with *risk management* (e.g. interest rate and foreign exchange rate risk). The conditions related to staffing, experience and material resources required for well-founded local fiscal management are still missing in many places.

Auditing and other transaction costs (procedural fees for supervision, trading costs, the fee for taking it to the stock exchange, etc.) increase costs and make this instrument a great deal more complicated. In addition, issuing bonds increases the administrative costs of borrowing. Local governments must provide more detailed information for the investors than they would in the case of bank loans. For example, it is necessary to prepare a prospectus, publish a report every year to the Supervisory Commission and publish any extraordinary information where important changes have occurred in the project or in the local government.

Generic Categories of Municipal Bonds

In their broadest definition, municipal bond markets refer to borrowings by sub-sovereign public entities, directly or through public corporations, to fund governments (El Daher 1997). Municipal bonds can be classified and analysed primarily based on the securities pledged to repay the debt (Petersen-Valadez 2004). Concerning the pledges for the repayment of the bonds, three generic categories of long-term bonds can be distinguished: general obligation bonds, project revenue bonds and dedicated revenue bonds (Freire 1999).

In the case of *general obligation bond*, repayment is guaranteed by the "full faith and credit" of the issuing government. Issuers generally back general obligation bonds with all their revenue-raising powers. This means that the full taxing authority of the issuer is pledged to pay back the bonds. In addition, in the case of general obligation bonds, the local government itself acts as the issuer, and the local government's negotiable assets are counted against liabilities.

Project revenue bonds are secured only by the expected stream of revenue from the project being financed. These are secured by user fees or dedicated taxes rather than the general taxing power of local governments. The issuer may be a sub-sovereign or a public authority, such as a water authority, which is independent of the government. The expected future income coming from the project is the primary asset for repayment. On the part of the issuer, expected repayments from the bond are based on the surplus income arising from the completion of the project. Security can be provided by liens on real property owned by the public corporation, and repayment can also be made by mortgaging that property.

In the case of dedicated revenue bonds, repayments are guaranteed by a particular revenue stream which is unrelated to the project being financed. For example, a bond may be backed by the pledge of funds from intergovernmental transfers, which the sub-sovereign is due to receive, or by specific tax revenues such as liquor, sales or gas taxes.

In practice, the picture is more cloudy. Some bonds do not fit precisely into any one of the above categories. This is because in some cases, for example, dedicated project revenue bonds (and dedicated revenue bonds) are also guaranteed by the local government which owns the public corporation.

Municipal Bonds in Hungary: A Historical Overview

The transition to a market economy created growing difficulties in financing the central government budget. This led to the transfer of a greater share of public service provision to the local level. The *Act on Local Authorities* assigns responsibility to local governments for providing an extraordinarily wide range of public services, even when compared internationally. Since transfers from the central budget are less and less able to cover the investment needs of local governments, there is an even stronger demand for external funds that can be obtained through borrowing.

After an early and short-lived “bond-boom” in the middle 1990s from 2002, indebtedness started to increase. One of the reasons was the favourable macroeconomic environment (low inflation rate, moderate interest rates). The increase was also due to a decrease in revenues derived from the privatisation and sale of locally owned assets and a growing need for investment which could not be met by central government. Since accession to the EU accession in 2004, indebtedness has increased further, although it has not yet exceeded 2.5 % of GDP. The characteristics and features of a new “bond-boom” which started in 2006 are discussed later in the empirical part of this study in more detail. The extent of bond issues and local government debt is shown in Fig. 13.1.

Regarding the borrowing of local governments, the proportion of long-term loans has been increasing since the 1990s relatively to short-term funds. This is shown in Fig. 13.2. The volume of municipal bonds issued during the last 10 years

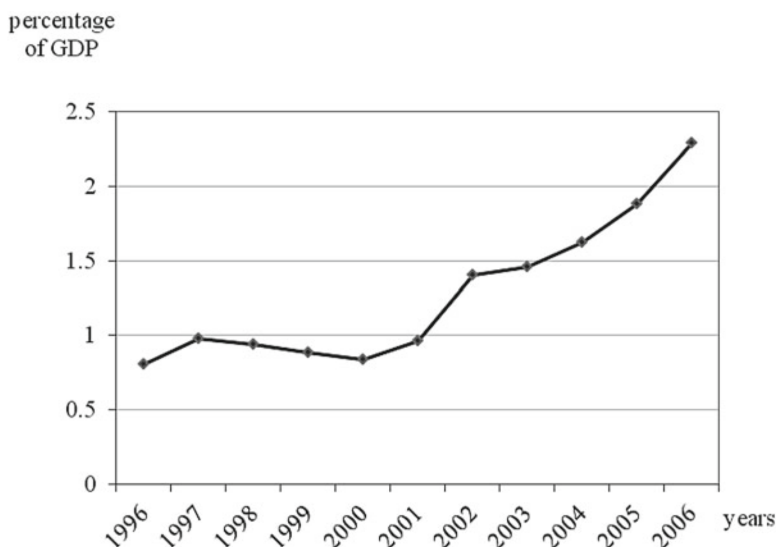

Fig. 13.1 Borrowing of local governments in Hungary in the percentage of GDP (1995–2006) (Source: Hungarian National Bank)

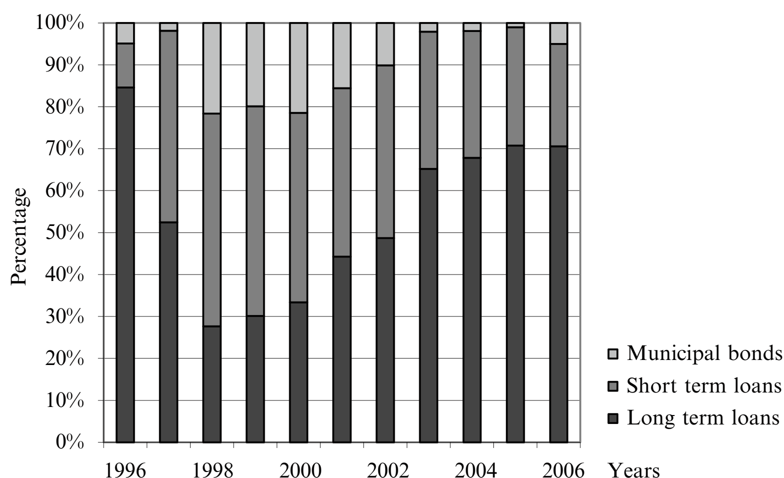

Fig. 13.2 The structure of borrowing (1996–2006) (Source: Hungarian National Bank)

is characterised by high volatility. After a slight drop at the beginning of the 2000–2010 decade, a considerable increase could be observed.

Examining the features of municipal bonds issued by local governments in Hungary, it can be stated that almost all bonds were placed privately, and the buyers were commercial banks. Municipal bonds could therefore be considered "bank loans in disguise". One possible explanation is that in Hungary, capital market financing is a less accepted and widespread solution than borrowing from a bank. However, despite administrative overheads, the total cost of issuing bonds – mainly due to a reduced interest rate – is less than that of obtaining a bank loan. At the same time, the banks have provided a guaranteed market for municipal bonds.

Legal Regulations Regarding the Issue of Municipal Bonds

The *Act on Local Self-Government* (1990/LXV) allowed the free borrowing – hereby also the issuance of bonds – of municipalities without the permission of central government. Legal restrictions regarding the size of borrowing and the nature of the securities which must be pledged to repay the debt were formulated in 1996:

- Municipalities are not permitted to meet their debt service obligations from personal income tax revenues, the normative state contribution, central subsidies or by selling core assets.
- Total debt (including bank loans, municipal bonds, lease, third-party obligations, commitments) cannot exceed the Corrected Current Own Revenues, which is 70 % of the positive difference between current own revenue and short-term liabilities.

In 1996, a *Bankruptcy Law* for municipalities (Municipal Debt Adjustment Act, Law XXV) was prepared and came into force. The law defines a debt adjustment process whose objective is to allow local governments to regain their financial health while at the same time protecting the rights of creditors. The Municipal Debt Adjustment Law defines and restricts the risk of investing in municipal bonds by imposing a definite financial and moral cost on local governments which default on debt or other payments (Makay 2004).

On the 1st of January 2002, the law on the "capital market" took effect and a new decree on "bonds" came into force. Both measures reflect considerable changes within the regulation of local government bond issues. A very important argument for bonds in Hungary is that this way of financing does not require the local authority to announce public procurement, which decreases the administrative burden on the one hand and the issuer's responsibility on the other.

Current Loan Financing of Hungarian Local Governments

After pioneering attempts at the beginning of the twenty-first century, the number and the total value of municipal bond issues have increased significantly, particularly since 2006 in Hungary. Accordingly, the period from 2006 can be considered a new period in the history of the Hungarian municipal bond issues, which is why I have decided to describe the characteristics of municipal bond financing for the period between 2006 and 2008.

Since the bonds issued during the studied period were almost always private issues and their buyers were commercial banks, a global analysis of local government loan financing is crucial. As the bond issues of the period increased the indebtedness of the local government sector to an unprecedented extent, I analysed the liquidity position of the sector and the characteristics of the application of external resources.

I have also described and evaluated the most important characteristics of Hungarian bond issues. As the bond issues of the period incurred significant fiscal risks in the municipal sector, it is crucial to evaluate the central regulation of loan financing and to reveal the connected deficiencies.

The Liquidity Position of Local Governments

I have described and characterised the increasing rate of local government debt by quantitative index numbers. As well as accounting for the constitution of local government debt, I have attempted to explore the primary reasons for local government indebtedness. It is important to examine the form of the financial instruments used to borrow and the extent of bond financing in local government

borrowing. In addition I describe how indebtedness may influence individual institutions and actors in the local government sector differently and what kind of fiscal risks it involves.

Breakdown of the Net Financial Property of Local Governments

Figure 13.3 clearly indicates how the borrowing has accelerated since the end of 2006. Compared to the total amount recorded at the beginning of 2002, the liability portfolio of local governments multiplied approximately sixfold by the end of 2008. At the same time, it is noticeable that the net financial wealth did not decrease in proportion to the increase in borrowing. This is because increases in the value of financial assets paralleled increases in the value of borrowing – that is, the bulk of the money raised from borrowing were deposited with banks, while the remainder financed project costs (Homolya and Szigel 2009). Thus, as well as borrowing from banks through bond issues, local governments were present on the credit market as resource providers. This role made them "VIP" customers with banks (Gál 2009).

The volume of the extra deposits realised in connection with loan financing may amount to as much as HUF 200 billion (Vigvári 2009). By investigating the financial asset line of local governments' asset and liability statements, we can establish that the dynamism of the increase in money instruments was mainly due to an increase in the long-term liability portfolio. The bulk of the money from the loans was deposited with banks or placed in central government securities. Long-term bonds also allowed local governments to buy out some of their short-term debt (Gál 2009).

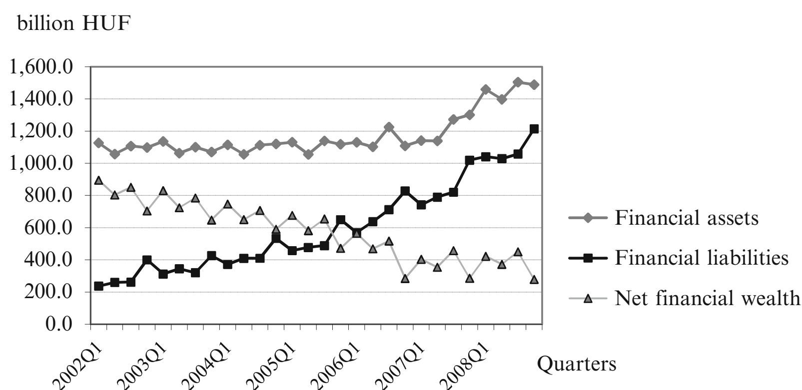

Fig. 13.3 Conformation of net financial wealth of local governments (Source: Own construction based on Hungarian National Bank's data)

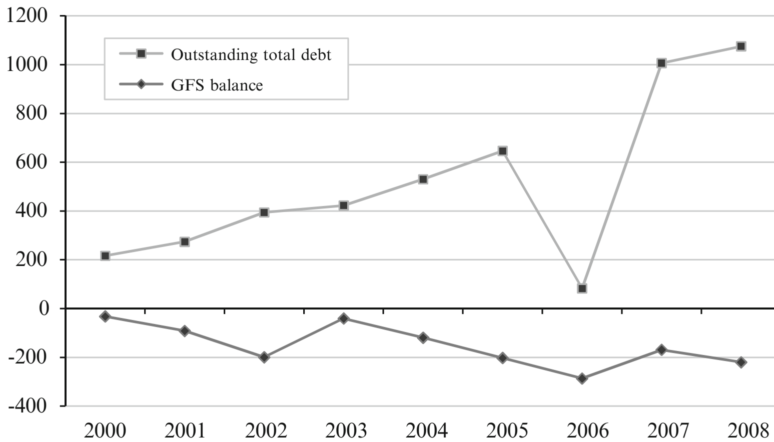

Fig. 13.4 The budgetary balance (GFS) of municipalities and the formation of outstanding total debt between 2002 and 2008 (in billion HUF) (Source: Own construction based on Gál (2009). Note: 2008 balance excludes privatisation revenues. Graph includes only data through the third quarter of 2008)

Reasons for Debt

The wave of debt, which started at the end of 2006 can be traced back to a variety of factors. The government's bill restraining local government borrowing and a fear of additional restrictions were primary causes (Bill No. T/4320 for the modification of Act No. LXV of 1990, 9 November 2007).

The upward long-term trend in borrowing can be explained mainly by the permanent discrepancy between mandatory tasks of local governments and the size of grants from the central government. Nonetheless, as is shown in Fig. 13.4, between 2000 and 2008, there was no strong correlation between the size of local governments' balance of payments and outstanding total debt (Vigvári 2009). As the research of Vigvári (2007) confirmed, the increase in debt was also not due to the increasing volume of investment grants received from the European Union.

Instruments of Indebtedness

When examining the individual components of local government financial liabilities, we can establish that the long-term (investment) loan portfolio did not change significantly between 2006 and 2008. As is shown in Fig. 13.5, short-term loans were extremely volatile and, over time, increased by only a small extent. Most of the debt increase was through the issue of long-term bonds.

However, although the increase in the volume of the short-term debt portfolio was marginal in absolute terms, it was significant in relative terms. This may be

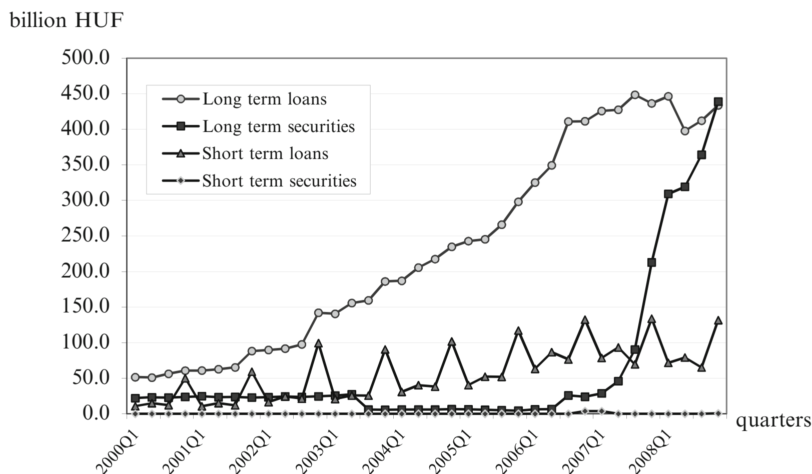

Fig. 13.5 The formation of local government loan financing between 2002 and 2008 (Source: Own construction based on Hungarian National Bank's data)

because municipalities were trying to exceed the credit limit. Concurrently, the long-term securities' portfolio increased drastically due to the wave of municipal bond issues from the end of 2006.

Between 2006 and 2008, another typical characteristic of local governmental borrowing was the rocketing increase of loans denominated in foreign currencies. The rate of financing in foreign currency increased by over 60 % between 2005 and 2008. Among foreign currency liabilities of local governments towards commercial banks, foreign currency credit portfolio increased by 50% and it exceeded HUF 90 billion at the end of 2008. The bond portfolio denominated in foreign currencies had shown a significant increase which was even higher. While the volume of the foreign currency bonds was negligible prior to 2005, it increased up to 15-fold to HUF 350 billion at the end of 2008 compared to the portfolio volume at the end of 2006.

Municipalities Involved in Debt

Not all local governments are indebted to the same extent. Homolya and Szigel (2009) found that indebtedness was primarily noticeable within a relatively small group of just 74. However, the number of local governments whose liabilities exceeded their own revenues doubled from 2006 to 2007. Over and above this fact, the volume of the liabilities of these 74 bodies accounted for half of the debt of the entire sector.

The extent of indebtedness differs between kinds of local government institution and incurs different risks, as Vigvári (2009) highlights. Accordingly, some local governments have excellent financial abilities. On the other hand, large city councils

with considerable resources often run into debt very quickly. As well as being responsible for a large share of bond issuances, majority of hidden debts and conditional liabilities can be traced to them, too.

County governments are also among the most important national bond issuers. The worsened financial position of these actors and their relatively high budget deficits characterise the recent period. The fiscal risks of this segment are increased by that fact that they often became over-indebted due to their poor fiscal abilities and do not have sufficient revenue to meet their future liabilities.

The extent of the debts of Budapest's city-wide government is truly alarming. What is interesting is that, in comparison with that of the city-wide government of Budapest, the financial situation of the majority of the districts can be considered stable, the rate of their debt having not increased drastically in recent years.

Local Government Bond Issue Today

As we have seen, the drastic increase in the volume of local government debt started in 2006, primarily due to the issue of local government bonds. While up to HUF eight billion worth of bonds were issued in 2006, bond issue value in 2007 nearly reached the HUF 200 billion mark, and in 2008 it exceeded this amount (if calculated at 176 HUF/CHF and 266 HUF/EUR).[1] Consequently, the portfolio of bonds issued in HUF reached the HUF 50 billion mark, while the value of those denominated in foreign currencies increased above HUF 350 billion (Fig. 13.6).

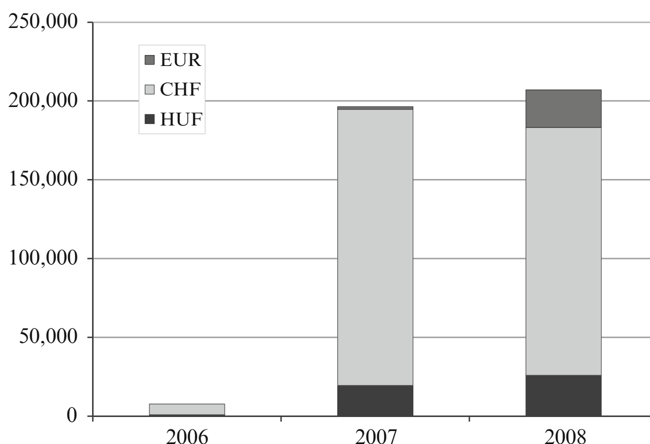

Fig. 13.6 Bonds issued by local government sector between 2006 and 2008 (in million HUF). (Source: Own construction based on Financial Supervisory Authorities data. Note: calculated at 176 HUF/CHF and 266 HUF/EUR)

[1] In June 2012, the Swiss franc was worth 240 Hungarian forint; the euro was worth 288.

Table 13.1 The total nominal value of the issued local government bonds per denomination (2006–2008)

Denomination	2006	2007	2008
HUF (in thousands)	900,000	19,497,966	25,969,000
CHF	38,519,371	996,123,591	893,403,144
EUR	0	6,000,000	89,297,722

Source: Own construction based on Financial Supervisory Authorities data

According to the report made by the Public Expenditure Survey Committee, 20 % of municipalities issued bonds in 2007 (among local governments which were audited by the Committee), while only one municipality issued bonds between 2004 and 2006 (Állami Számvevőszék 2008). The amount of bonds issued by individual governments ranged from HUF 200 million to HUF 5,000 million. Local governments planned to allocate 63 % of the income from bond issue to building up reserves, 15 % for operations and 22 % for debt services. Issued bonds had variable rates of interest and grace periods from 1 to 6 years. However, as is shown in Table 13.1, the issuance of bonds denominated in euros and Swiss francs increased dramatically in a relatively short period of time. This was because interest rates on euro- and Swiss franc-denominated instruments were significantly lower than those for bonds issued in forints.

In almost every case, the repayment of the principal of municipal bonds starts after passing of the *grace period*. According to Gál (2009), the selection from among competing banks organising the issue and listing of bonds is often decided by the length of the grace period. When examining bonds issued between 2006 and 2008 in foreign currencies, it is evident that the share of bonds issues in Swiss franc (CHF) and euros (EUR) soared and squeezed HUF-based bonds out (shown in Fig. 13.7). Comparing the two foreign currencies, the Swiss franc was more popular at the beginning of the period, while the euro overtook it at the end of the period. But bonds in Swiss franc were clearly dominant overall.

When we examine the currency of bonds on the basis of the number of issues, only 2 euro-based bonds (0.7 %), 37 HUF-based bonds (13.5 %) and 235 CHF-based bonds (85.8 %) were issued between 2006 and 2008.

An investigation of the length of the term of the issued bonds (Fig. 13.8) also shows an interesting result. The shortest term was 4 years, while the longest was 25 years for those bonds issued between 2006 and 2008. It is clear that the terms of bonds increased compared to earlier issues, and this increase was continuous between 2006 and 2008. While the average term of bonds was 16.73 years in 2006, it was 17.2 years in 2007 and 19.3 in 2008. During the researched period, there appear to have been no bond issues with terms shorter than 10 years. Most had 20-year terms. Nearly half the issues had 20-year terms in 2006 while the rate increased to roughly 60 % in 2007 and 2008. The appearance of extremely long-term

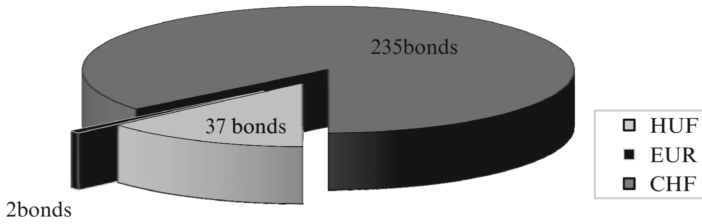

Fig. 13.7 Currencies of local government bonds between 2006 and 2008 (*Source*: Own construction based on KELER (KELER provides quasi-wholesale services and infrastructure to the players and intermediators of the Hungarian capital market))

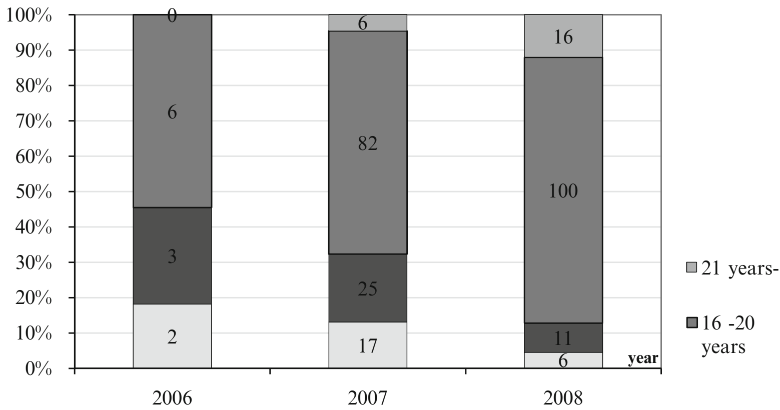

Fig. 13.8 Distribution of the duration of the local government bonds (numbers = number of issues) (Source: Own construction based on KELER)

issues is an important characteristic. Six bonds with a term longer than 20 years were issued in 2007, while 16 were issued in 2008.

Current Problems of Regulation

Problems and deficiencies of regulation are linked both to the drastic debts of local governments and to the significant increase in the fiscal risks within the sector. The fiscal risks to the subnational system appear in several forms: liquidity risk, lack of funds and in extreme cases insolvency (Vigvári 2009). The regulation system used by the central government could not function properly within the changed macroeconomic and money market environment. Problems in the budgeting process particularly related to obtaining revenue to meet local expenditure requirements and to forward the objectives of economic policy revealed gaps in bond financing regulation and also affected loan financing.

The Abnormal Function of Credit During the Credit Squeeze

As was mentioned above, limits on local government borrowing were approved in the middle 1990s, at roughly the same time as the Act on debt service of local governments. Since then, there have been no significant modifications to the regulations. The regulation of local government borrowing still relies mainly on the *coercive effect of the credit limit*. This is an unjustified, one-sided approach of the problem. On the basis of experience, it would be better to apply more sophisticated ways and means of controlling borrowing, either by counting local government borrowing as part of overall public sector borrowing (i.e. having a national limit on total public sector borrowing by all levels of government) or by defining specific limits for different settlement categories.

Vigvári (2009) underlines the fact that the public finance information system of Hungary only shows the redeemed guarantees. This situation results in that the traditional index numbers indicating the indebtedness of local governments can reflect a better but false image of the real solvency situation. Moreover, the regulation – though unintentionally – left a loophole: the debt limit doesn't apply to liquid loans. In practice this situation lets local governments roll debts forward and allows them to finance current budget deficits through borrowing.

Fast-spreading *financial innovations* have also played an important role in altering the credit balance of local authorities (Vigvári 2009). For example, guarantees provided within public-private partnerships (PPP), financing by bills of exchange and factoring all fall within the range of financial innovations. In the case of PPP, application banks provide a loan to the private operator providing the local service. The source of repayment is the service fee or rental paid by the local government to the private operator. According to the effective public acts, such borrowing should be treated as corporate borrowing, even though the ultimate guarantor of the loan is the local government (Gál 2009). These kinds of financial instruments and the resulting debt are not listed among those elements of debt which should be taken into consideration when determining if a local government has reached its credit limit.

At the same time, Vigvári (2009) points out that local government borrowing has generally not been restricted by this rule but by the willingness of banks to purchase bonds. According to the relevant reports of the Public Expenditure Survey Committee for recent years, debt limits did not serve as an effective barrier for towns with county rights and for the twenty districts of the capital city, Budapest. According to the Public Expenditure Survey Committee's report for 2007, 96 % of local governments taking on debt remained within the provisions of the credit limit specified by law (Public Expenditure Survey Committee's report in Állami Számvevőszék 2007).

Enforcement of the law is another issue. For example, in 2004, four municipalities successfully issued bonds despite having exceeded their credit limit (Balás-Hegedüs 2004).

Local Government Insolvency Law

Another important instrument for regulating local government borrowing is the Act on Debt Settlement Procedures for Local Governments, in other words the local government bankruptcy act. Overall, the act was well received as practical experiences demonstrated that the act was able to function effectively, highlighting its protective role. The act helped to increase financial discipline. Between its introduction and 2004, there were 60 cases that were settled out of court, and courts applied debt settlement procedures in 11 cases (Jókay-Szepesi-Szmetana 2004; Kopányi et al. 2004). On the basis of yearly reports made by the Public Expenditure Survey Committee between 2005 and 2008, there were one to three solvency restitution and debt settlement procedures in 3 of those years (Vigvári 2009). Consequently the local government bankruptcy act provides an excellent basis for assessing credit risks from bonds, but it cannot solve problems caused by the opaque financial reporting system, nor compensate for the lack of other, alternate institutional solutions to risk management.

Local Government Bonds as Secure Investments

The issuance of bonds eases the administrative burden on municipalities and at the same time forces issuers to provide financial information needed to satisfy prospective investors. However, the process of issuing bonds remains focussed primarily on meeting formal requirements. As noted, local government bonds are superior to simple borrowing due to their security aspect. The marketability of bonds allows them to tap into the savings of numerous market participants. This can reduce the general costs of borrowing, and more flexible, tailor-made terms of repayment are possible. Consequently it is important to have regulations which can enhance the beneficial characteristics of bonds while preserving their security aspect.

Present Hungarian regulations do not meet the requirements of *regionalisation*. Nor do they meet the expectations of the most important players in the European money market, namely, institutional investors. Furthermore, they do not support the fundraising efforts of local organisations. The capital market act does not allow regions or multipurpose micro-regional associations to raise money by issuing bonds, and it significantly restricts such possibilities for municipal service corporations.

Another characteristic of national regulation is that the Public Procurement Act does not require obligatory public procurement procedures during a bond issue, unlike regulations regarding normal borrowing. Consequently national regulators prefer the issuing of bonds over borrowing from banks because the administrative costs and their responsibilities are reduced. Although this reduces the cost of local government borrowing, it complicates the assessment of local government indebtedness by outside players. Conditions cannot be renegotiated or modified, and the only way to *eliminate* liability is for the issuer to repurchase the bonds (Gál 2009).

Conclusions

The drastic increase in the volume of local government debt started in 2006, primarily due to the issuance of local government bonds. Among Hungarian local governments, bond financing has followed a similar pattern in terms of bond issuance, bond purchases, investment by local government and the borrowing periods. Hungarian local governments are not yet able to fully benefit from the flexible features offered by bonds. Bond financing is often considered simply an alternative form of borrowing. Local governments remain unaware of the potential advantages of bonds as security. In today's Hungary, bond financing offers unrecognised opportunities to broaden local government financial freedom and reduce the financial risk related to borrowing.

The regulation of local government borrowing is still mainly based on the coercive effect of a credit limit. This is an unjustified, one-sided approach to the problem. Current Hungarian regulations do not meet the requirements of regionalisation – that is, of devolved regional policy making and policy implementation – and fail to meet the expectations of the most important players in the European capital market, namely, institutional investors. They fail to support the fundraising efforts of local organisations. New regulations are needed which can enhance the beneficial characteristics of bonds while preserving the security they provide to local governments and prospective investors.

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