THE EFFECTIVENESS OF DECENTRALIZATION IN HUNGARY AND SLOVAKIA

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This paper contrasts decentralization in Hungary, one of the most decentralized countries of Central and Eastern Europe, and in Slovakia, one of the least decentralized, during the decade of transition from socialism to market. It also draws lessons based on this experience. Has decentralization been effective? Has decentralization improved the delivery of essential services? Has it promoted efficiency, ensured accountability and encouraged participation? We make the point that the effectiveness of decentralization depends on three crucial factors—which we document in this paper. First, appropriate expenditure and tax assignments. Second, governance mechanisms to strengthen accountability and fiduciary responsibility. Third, incentive mechanisms to ensure that agents deliver services of an acceptable quality at least cost. For constitutionally guaranteed entitlements like education, the latter condition is not easy to achieve because many principal-agent problems arise in the context of shared governance. We discuss this issue, using as an example education, a type of public good for which governance is typically shared between central and local levels of government.

The Hungarian and Slovak experiences show that, even when expenditure assignments and accountability rules in intergovernmental affairs are specified by legislation, in practice, major expenditure management and public accountability issues still arise. We examine both fiscal and institutional aspects of decentralization—venturing into issues of accountability mechanisms and incentive schemes that are used to ensure balance between revenue and spending and minimum quality standards in the delivery of public goods.

The role of incentives in determining how local organizations like schools operate is crucial.[2] The fiscal literature suggests that it is not possible to ensure incentive compatibility simultaneously with optimal allocation of resources and a balanced budget in the provision of public goods. In the absence of incentive constraints, an optimal fiscal system would equalize the marginal utility of taxation with the marginal utility of consumption of local and national public goods. But in the presence of incentive constraints, public expenditure management is costly. The free rider problem has to be recognized as a second-best problem, imposing the requirement of incentive compatibility. The problem then becomes one of supply of public good and optimal taxation in the presence of information constraints. In addition, the literature on governance stresses the constraints imposed by the political system—i.e. by the governance system which regulates the exercise of power. Thus the provision of the public good has to be recognized as both a political process and a budget process (Laffont 1988).

There are two options to reduce information asymmetries and induce compliance in the relationship between central and local governments. First, it is possible to make cheating and information hiding costly through various reporting requirements, monitoring and controlling arrangements. However, this is costly for the principal (the central government) and it is only efficient in informing the principal to the extent that there are sufficient capacities to process and use the information—which is not always the case in Hungary and Slovakia where local skills are scarce. Second, principal-agent-type problems can be solved through incentive arrangements where the agent's utility maximizing behavior and the behavior expected by the principal can be approximated to each other (Papp 2000). We review both types of arrangements in this paper.

A priori, decentralization is expected to increase public expenditure, first because tax revenue is managed by smaller entities (diseconomies of scale) and, second, because of duplication of administrative structures. If greater democracy and participation are also objectives, cost savings are even less likely. Thus decentralization by itself is more likely to increase public expenditure. Early on, Vito Tanzi has cautioned against excessive enthusiasm for decentralization. In a recent paper, he showed skepticism about decentralization —grounded in empirical, not in ideological issues—for fiscal and macroeconomic, but also for institutional reasons (see Tanzi 1995 and 2000). A broader issue, raised by Oates (1999), is whether the Tanziesque "politically incorrect" view can be put in terms of trade-off between economic efficiency and political participation? We do not answer the question but we illustrate the dilemma.

This paper is organized as follows. Sections 1 and 2 describe the experience with decentralization of Hungary and Slovakia, respectively. We then address in section 3 one of the key fiscal issues, which is the imbalance between expenditure needs and fiscal capacity. In section 4, we turn to the governance framework: we discuss mechanisms for accountability and fiduciary responsibility and examine some available evidence on corruption. Section 5 then turns to the issue of shared governance in the education sector in Hungary. Section 6 examines "high powered" incentive schemes used by the central government to force local governments to comply with minimum standards in the delivery of services while staying within a given budget and asks whether they have been effective. Section 7 examines education policy in Slovakia. Section 8 concludes with some remarks on decentralization in Hungary and Slovakia in the context of EU accession.

Section 1. The Decentralization Process in Hungary

Hungary was one of the first transition country, with Poland, to reform its intergovernmental system. In 1990 it enacted a fundamental law establishing local governments patterned after the Council of Europe's European Charter. The 1,523 local councils that had functioned as the agents for carrying out central governmental fiscal orders through a system of 19 county councils were abolished. The Law on Local Self Government dramatically scaled back the responsibilities of the 19 regional bodies (*megye*, counties). To replace the local councils, citizens were granted the right to create autonomous self governments (*önkormany*). This process was driven in large part by an understandable political imperative to get rid of the old system but led to excessive fragmentation. As a result, there are now some 3,200 local governments of which about 1,670 have less than 1,000 inhabitants.

The Law on Local Self Government was the first of eight laws that now frame the Hungarian intergovernmental system and lay out the terms of autonomy for local governments (Ebel , Varfalvi and Varga 1998).This legal framework establishes that local governments are no longer agents of the center and its ministries and adopts the principle that local governments should be public service entities with assigned tasks and local taxing powers. It adopts the general principle of subsidiarity—that public services should be supplied by the smallest unit of government that is administratively and economically capable—embodied in the European Charter (On subsidiarity, see Inman and Rubinfeld, 1998).

Local governments are obliged to provide primary education, basic health and social welfare provisions, waste disposal, safe drinking water, public lighting, and to maintain local public roads and cemeteries. They are also obligated to enforce the observance of rights of national and ethnic minorities. Other tasks—not all mandatory—include providing local mass transport, settlement development, snow removal, fire protection, and public security and the explicitly voluntary provision of cultural and sports facilities, housing, and public safety.

Local government expenditures in Hungary have accounted for roughly 20 percent of public sector expenditures and 35 percent of public sector investment. Locally raised tax revenues over which localities have control have amounted to only 20 percent of total revenues, or roughly 3 percent of GDP. Local governments also receive a share of the personal income tax, based on the amount collected within their jurisdiction, and 50 percent of the motor vehicle tax; but these two revenue sources yield only 11 percent of total local revenues. As a result, local governments depend heavily on transfers from other parts of the public sector to finance their expenditures. Transfers include a series of normative and earmarked transfers to cover current expenditures, as well as a system of specific grants to finance investment.

Before 1996, transfers and own revenues, including borrowings, were insufficient to cover total expenditures. They resulted in residual deficits (Table 1) which were ultimately covered by the Central Government. During this period, some local governments also started to default on their debt and to call for additional resources from the Central Government. This situation stemmed, in part, from an imbalance between expenditure responsibilities and revenue assignments, but also from the lack of transparency in the use of public moneys, and from the fact that the central government is ultimately responsible for many local government obligations.

In 1995, faced with a major macroeconomic crisis, Hungary implemented a stabilization program.[3] The stabilization program included three elements that introduced greater discipline in the management of local government finances. First, "high powered incentive schemes" were used to force municipalities to reduce spending. Transfers did indeed decline by around 3 percent of GDP, and efforts were made to improve and simplify the system of normative transfers. However it is not clear whether this led to the desired results. This issue is discussed in section 3.

Table 1: Hungary. Local Government Accounts, 1993-1999

(percent of GDP)

	1993	1994	1995	1996	1997	1998	1999
Total Revenues	16.1	15.9	13.6	13.0	12.8	12.0	12.3
Own current revenues	3.0	2.8	2.6	3.0	3.3	2.9	3.5
Revenue sharing w/ Centr.Govt.	1.4	1.5	1.7	1.6	1.7	1.9	1.8
Transfers from Central Govt.	7.7	7.3	5.7	5.0	4.3	4.2	3.9
Of which education norms	33%	22%	23%	20%	19%	18%	19%
Transf. from other public sector	2.8	2.9	2.4	2.4	2.4	2.3	2.2
Capital revenues	0.7	0.9	0.8	0.6	0.6	0.5	0.5
Other revenues	0.5	0.5	0.4	0.4	0.5	0.4	0.3
Total Expenditures	17.2	17.4	13.9	13.0	13.1	12.7	12.5
Current expenditures	13.5	13.7	11.5	10.9	10.5	10.2	10.2
Of which education	44%	37%	38%	36%	35%	34%	32%
Capital expenditures	3.1	3.3	2.4	2.1	2.6	2.4	2.3
Of which education	6%	5%	4%	3%	3%	2%	2%
Other expenditures	0.6	0.4	0.0	0.0	0.0	0.0	0.0
Balance	-1.1	-1.5	-0.3	0.0	-0.3	-0.7	-0.2
Net Financing	0.5	1.0	0.2	0.3	0.3	0.4	0.1
Privatization revenues	0.2	0.3	0.5	0.7	1.0	0.5	0.2
Net borrowing	0.3	0.7	-0.2	-0.4	-0.7	-0.1	-0.00
Balance	-0.6	-0.5	-0.1	0.3	0.0	-0.3	
Memorandum:							
Borrowing or borrowing cap (percent)	117.0	167.0	81.0	27.0	19.0	30.0	??

Source: Ministry of Finance of Hungary. Draft Final Account for 1999

Second, annual borrowings by local governments were subject to a cap (equal to 70 percent of own revenues minus debt servicing costs). Third, the Parliament enacted a local bankruptcy law that prevents bailouts by the central government, forbids the use of core local government assets as collateral, forces local governments to negotiate with their creditors, and allows the central government to appoint a commissioner to control local finances during bankruptcy proceedings. As shown in Table 1, these measures have resulted in a substantial reduction in current and capital expenditures and in the reduction of local government deficits. New borrowing has remained well below the borrowing cap, and local governments have also made use of their privatization revenues to retire part of their debts.

Although local governments have been able to meet fiscal targets in recent years, there are indications of inefficiencies in the delivery of public services and of strains in local finances (World Bank 1999). First, there is still a systemic imbalance in the intergovernmental finance structure. Expenditure and revenue assignments are not well matched. The system of transfers creates inappropriate incentives, which lead many local governments to claim additional deficit grants to manage financial difficulties. Although the amount of deficit grants has remained about HUF 7 billion in 1996 and 1997 (around 0.1 percent of GDP), the number of local governments applying for such grants increased to almost 25 percent of all municipalities.

Second, fragmentation in the provision of services implies that economies of scale are not exploited, leading to high costs and poor quality services in many areas. There have been efforts to promote cost-effective service delivery through the creation of functional associations and regional development units. Such associations are, however, constrained by their limited legal status, and by their inability to either collect own revenues or to receive grants from the state as a single entity. Roles and responsibilities of the different levels of regional development are still unclear. This creates problems of coordination and undermines efficiency in service delivery.

Third, although it is true that local expenditures have declined as a share of GDP in response to the decline in transfers and the tighter borrowing constraints, it will not be possible to maintain expenditures at their current level. This is because the amortization of local assets has not been properly incorporated in local spending decisions, because the renewal of assets has been repeatedly postponed, and because there are substantial additional investment needs. As an example, in the health sector, in which a majority of hospitals are owned by local governments, the stock of buildings needing renovation or replacement was an estimated HUF 140 billion (or 1.7 percent of GDP) at the end of 1997 (World Bank 1999).

Section 2. Decentralization in Slovakia

While Hungary is one of the most decentralized countries in Central and Eastern Europe, Slovakia is one of the least decentralized. Following the democratic elections at the national level in Czechoslovakia in June 1990, autonomous local governments were created by law and the first municipal elections took place in November 1990. Local governments are self-governing but have much more limited powers than in Hungary. Similar to Hungary, there has been a process of fragmentation and there are now 2,881 local governments. Their spending represents only about 7% of general government expenditure, one of the lowest levels in Europe.

By law (Act No. 369 of 1990), local governments are obliged to provide basic services such as waste disposal, safe drinking water, public lighting, maintenance of public roads, etc. Currently, municipal governments have four major sources of revenues. Shared taxes represent the biggest amount (SK 10,6 billion or 37% of total revenue in 1997).[4] Non-tax revenues, such as revenues from business activities, administrative fees and capital revenues make up the second major source (SK10,3bn or 36%).5 Central government transfers amount to 5,4bn (or 19%) and borrowing to 2,4bn (or 8%).

The expenditure of the local governments is dwarfed by that of the central government which maintains 8 regional offices and 79 district offices.6 The regional offices are responsible for essential public services including primary and secondary education, social assistance, fire protection and culture. These public administration entities are arms of the central government and maintain close contacts with the Ministry of Interior. Each regional office is a separate budgetary chapter in the state budget and has the authority to prepare and submit their own budget. The total budget of the 8 regions in 1999 was SK 47 billion (or 14% of total general government expenditures). Regional offices are responsible for distributing budgetary funds to the 79 district public administration offices and/or directly to regional budgetary institutions. The allocation takes place on the basis of norms which are based, in theory, on the cost of public goods or services. In actuality, the norms are subject to budgetary bargaining so that the relationship with actual costs is rather weak. For example, no per pupil normatives exist for education expenditures. Unpaid public utility bills (as discussed in section 5) and postponement of maintenance expenditures also indicate that the link between costs and normatives is weak.

In April 2000, the coalition government headed by Prime Minister Dzurinda approved a framework for decentralization and regionalization.7 The essence of the reform, as stated by the MOF, is “how much power and resources are to be delegated to lower levels of government, to what levels and what finance system is to be chosen for the decentralized sphere” and to this day, some basic issues are still unresolved concerning these points—reflecting profound differences in political philosophy between the coalition partners. There were major differences of opinion within the cabinet since the Slovak Democratic Coalition of the Prime Minister; the Democratic Party of the Deputy Prime Minister in charge of economic affairs; the Socialist Party (SDL) of the Minister of Finance; the Hungarian Minority Party (SMK) and the other parties of the coalition represent different constituencies with different agendas and different views on decentralization.

The reform is scheduled for a vote in Parliament in late 2000. It would introduce major changes in intergovernmental finances and a new layer of government. It would create regions with autonomous administrative decision-making and management authority. Direct elections for this subnational level would take place in the fall of 2001. A political agreement between the coalition partners was reached in June 2000 that there would be 12 regions with self-governing bodies but the boundaries of the region where the ethnic Hungarian minority is concentrated are still being debated, threatening the stability of the coalition. The intergovernmental fiscal system would also be reformed, and central government responsibilities and resources would be transferred to local and regional government units. Resources would be transferred to the regions and the municipalities with the notional aim of sharing public expenditure in a ratio of the order of 55% for the central government and 45% for local and regional governments.

The main expenditure areas that would be transferred to both subnational levels are schools and social assistance. Other items are local road maintenance, maintenance of some health care facilities, fire protection and culture. Table 2 contains a list of these expenditure areas and an estimate of their importance in the 1999 and 2000 budgets. Changes in expenditure assignments would be incorporated in the 2002 budget. According to MOF estimates, local government expenditure would increase approximately from 7% to 20% of total spending and would amount to SK43 billion. This includes SK25 billion for education (including salaries) and SK12 billion for social welfare payments. It is not yet clear whether responsibility for teachers salaries (representing around 80% of current expenditure on schools) would be devolved. At present the government is still analyzing options for financing and delivering education and social assistance services. No estimates are as yet available for the value of state assets that would be transferred to the municipal and regional levels. The intended objective of the reform is to improve public services by reducing excessive centralism, increasing local participation and increasing the accountability of elected officials and administrators. There is, however, a risk that the reform could greatly increase public expenditures; introduce new inefficiencies in the system; threaten macroeconomic stability and increase the risks of mismanagement and corruption at local level because the reform has been insufficiently prepared. The MOF is concerned that the reform could increase spending in a context of already strong fiscal pressure (the fiscal deficit for

2001 is projected to reach 5 percent of GDP and possibly more given the cost of the on-going bank restructuring program) and proposes to delay any amendment to the existing tax legislation—which, in effect, would postpone the reform sine die. Local government representatives, on the other hand, are reluctant to accept temporary arrangements for financing their new responsibilities and structures. They fear erosion of state support, particularly if a permanent settlement is delayed beyond the next general election. They know from previous experience that their level of funding is vulnerable to discretionary changes in budget laws.

Table 2. Expenditures to be transferred to Regional and Local Governments in the Proposal adopted by the Cabinet (1999 and Budget 2000 data, in SK thousand)

Sector	1999	2000
Health Care	**34,904**	**32,160**
Social Assistance	**14,318,437**	**14,410,830**
Fire Protection	**600,492**	**627,002**
Civil Protection	**51,835**	**53,902**
Local Road Maintenance	**1,000,000**	**1,200,000**
Education - Total	**25,773,725**	**25,055,517**
Of which:		
Preschool education	3,145,331	2,959,661
Elementary schools	9,731,006	10,053,182
High schools	1,230,256	1,148,173
Vocational high schools	2,214,535	1,986,882
Apprentice high schools	3,745,627	3,482,104
Art high schools	151,171	139,232
Special schools	1,085,406	999,618
Church schools and facilities	629,127	663,943
Private schools and facilities	102,482	104,355
Other schools	3,623,746	3,406,543
School holdings	115,038	100,337
School forest establishments	12,868	11,487
Culture – Total:	**934,180**	**921,311**
Of which:		
Theatres	147,449	194,687
Libraries	186,763	193,801
Museums and galleries	232,013	245,267
Monuments	7,747	4,117
Archives	72,924	85,395
Other cultural activities	287,284	198,044
Total (SK thousands)	**42,713,573**	**42,300,722**

NOTE: Average exchange rate for the year 2000 is approx.1 US$ = 45 SK

Section 3. Expenditure Needs and Fiscal Capacity [8]

To transfer funds to local governments on the scale envisaged in the proposed Slovak reform will require a system of revenue-sharing. To do this entirely by tax sharing would favor rich local governments which have large tax bases and prejudice poor local governments which have small tax bases (Davey et al. 2000). Tax sharing as an (unconditional) grant mechanism entails important efficiency cost: fiscal gap estimates are based on historical data on supply of public services, not on an assessment of demand, and therefore tend to favor rich regions or regions where tax collection is mediocre. Welfare costs can also be high since targetting is poor. Tax sharing also has costs in terms of accountability: it lack transparency because transfers are effectively based on "horse trading" i.e. bilateral political negotiations. (Wetzel and Dunn 2000).

Ideally, municipalities should fund their own spending at the margin subject to matching grants which may be necessary to internalize spillover effects between jurisdictions (Oates 1999). To avoid major disparities between communities, equalization transfers are necessary. The aim of equalization transfers is not to achieve complete equalization but to ensure basic levels of social provision, particularly in local government areas with large low income populations. Such transfers are based on indicators such as numbers of population, numbers of children of school age, incidence of poverty, numbers of the elderly etc. Hungary extensively makes use of formula-based normative grants. About 25% of subnational funding comes from such grants while another 10% comes from categorical grants and targeted matching grants for investments (Wetzel and Dunn 2000).

The formula-based, unconditional and transparent character of the normative grant is its main advantage. Its main drawback is that such grants are a disincentive for local revenue mobilization because of their "fiscal gap" nature and thus contributes to perpetuating municipal fragmentation.

The policy choice is between the system under which grants are largely distributed according to capacity-use (e.g., number of care-days for elderly, beds in institutions) vs. one based on indicators of expenditure need such as the number of "workload needs" (e.g., the number of inhabitants in a jurisdiction) or tax capacity (potential to generate revenues given some average national tax rate).

The capacity-use norm is appropriate to the extent minimum service levels are mandated by the center. Some argue that it is not fundamentally different from the system in pre-reform days that provided incentives to institutions to self-generate local demand, and, as a result corrupts the record keeping process as local officials inflate expenditure measures. For example they over-report the number of pupils in a school to qualify for larger grants. A further aspect of the capacity-use approach is that the grant itself is perceived as an entitlement due local officials. Moreover, because the normative directs some minimum amount of grant to small jurisdictions otherwise unable to build up enough capacity units to satisfy the statutory minimum, the grant is criticized for providing support to localities which, on efficiency grounds, should not exist and should voluntarily consolidate with neighboring jurisdictions.

Robert Ebel et al. (1998) propose a compromise—to move from a formula based on use to a formula in which funds are allocated on some measure of *fiscal capacity*. Fiscal capacity can be defined as the potential ability of a local government to raise revenues from its own sources relative its expenditure needs. Thus, it has both expenditure and tax dimensions. But they concede that such an approach is complex, runs the danger of becoming highly non-transparent, and would probably not result in large efficiency gains. Accordingly, Ebel et al. propose to maintain the norm-based system, while considering two improvements: a reasonable reconsideration of duties and competencies in which the norms are less differentiated and their number is reduced, and looking at the fundamental issues of government size and structure, and addressing equalization by providing incentives for municipal associations in taxation and services delivery. This is—hesitantly and slowly—the road taken by Hungary (see Kopanyi et al. 2000).

The fiscal issues faced by Hungary are similar to those that Slovakia has to face to design a transfer system to cover the gap between devolved expenditures and revenues. To finance education, the Slovak government intends to revise currently used education normatives, and establish per child, per class room and per school normatives. The Davey et al. (2000) report favors a Hungarian or Polish-style system of per capita transfers based on the numbers of actual pupils within each municipality/region, with suitable variations for type of school and population density. Coupled with parental choice, if this was also the basis for municipal/regional government budget allocations to individual schools, it could promote rationalization of the system by "simulating the market". Similar formula-based normative grants are envisaged for social assistance.

Is there a need for horizontal equalization grant system if schools are financed through a grant system, social assistance is reimbursed from the central budget and the balance of the transfers are allocated according to weighted population and density? In Poland, for example, equalization brings the per capita revenues of individual gmina nearer (but not up) to the national average, but aims to bring all wojewodztwo and powiat revenues up to the per capita level of the highest (Davey et al. 2000). The question arises mostly at the regional level. Slovak regions are likely to have fairly similar needs in terms of per capita spending needs because their budgets are likely to be dominated by the costs of educational, social and health care institutions whose services are constitutionally guaranteed. If these spending needs are mostly expected to be covered from regional government taxing sources, horizontal equalization would be necessary and justifiable. The Davey report notes that it should be based on the yield of a standard rate of surcharge which is below the maximum permitted rate so that the incentives of the taxing power are not totally eliminated.

Section 4. Subnational Governance: Accountability and Fiduciary Responsibility

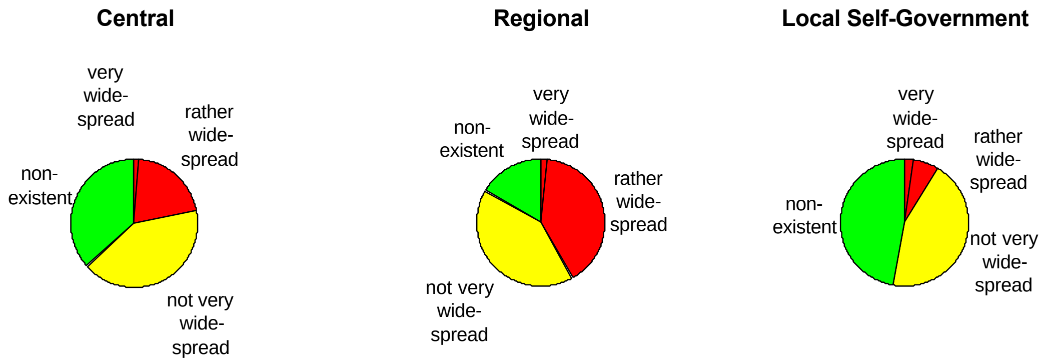
A good framework for decentralization involves designing good incentive mechanisms and rules of governance for economic management. Arrangements appropriate for self-governing local governments involves some basic principles. Since self-governing entities dispose of public funds (tax revenues from their residents and transfers of state funds), they should be publicly accountable for these funds. Full accountability means caring for public funds and managing them on behalf of the people transparently according to proper standards and known principles. Budgets and annual financial statements should be public documents. Local government entities should be subject to independent audit by relevant professionals. Self-governing bodies should have their own accountability arrangements. But, in addition, they should be controlled by the upper tier of government since they have a fiduciary responsibility toward the state. Since the central authorities provide transfers to self-governing units, the state is entitled to require full accountability on behalf of taxpayers. It also makes cheating and hiding information costly through various reporting, monitoring and controlling arrangements such as carrying out audits and inspections to see that the funds are used properly for their intended purpose (Dean 2000).

Financial control and accountability are not simply a question of legislation but of democratic practice. There are complex conditions for their success or failure, particularly in former socialist countries where historically, control had an entirely different connotation from what it is in democratic market economies. Moving from a system of central directives to one based on public accountability and a wider devolution of power, can only happen as fast as the participants are prepared to go. In this respect, Hungary seems to be more advanced than Slovakia.

In theory, decentralization increases transparency and efficiency, and reduces corruption. In practice, however, decentralization merely changes the location of corruption, the amounts involved and the identity of the perpetrators and the beneficiaries. To have an impact on the level of corruption, decentralization would also have to affect the causes of corruption such as weak controls, lack of transparency, incentives to cheat, lack of public interest in honest administration and low likelihood of being penalized. We would not expect decentralization by itself to reduce these causes of corruption unless it changes behavior through accountability and various democratic practices.

There is scant evidence from Slovakia that behavior has changed fundamentally. Data from corruption surveys in Slovakia[9] indicate that corruption is endemic in the public sector. Responses from public officials confirm the findings from household and enterprise surveys that the use of bribes is common. More than two out of five officials said they had been offered a „gift“, and one in ten had been offered money or an expensive present, in the two years before the survey. Of those who frequently interact with the public, roughly half had been offered small gifts, and 10-15 percent had been offered money or expensive presents. Public officials also clearly indicated that the offers of bribes by clients were sometimes accepted at their institutions (USAID/World Bank 2000). Interestingly, the perception of corruption is higher for the central and regional governments than for the local governments. However, local governments are perceived to be <u>less</u> corrupt than the central government and its regional offices. Nearly a quarter

Figure 1. Public Official's Assessments of the Levels of Corruption in their Institutions Source: USAID/World Bank 2000



of the central government officials reported that corruption was widespread at their institution, and nearly half of the officials at the regional and district bodies of state administration report the same. A smaller percentage of officials from local self-governments reported corruption to be widespread. These results are correlated with the type of public good provided by each level of government. Central and regional governments manage education and health care, for instance, while local governments are essentially in charge of municipal services.

While most public officials feel that their institutions offer quality services, most believe that incentives to generate quality service delivery do not exist in their institutions. From the perspective of the public official, high quality service in associated with low levels of corruption. Similarly, slowness of service delivery fosters corruption – from the perspective of an enterprise waiting for a permit, or a household waiting for their day in court, a bribe may be a small price to pay speed things along. The findings of the public official's survey suggests that corruption is greatly facilitated by slow service delivery, which in turn is frequently generated by bureaucratic rules that hinder an institution's ability to deliver services quickly.

Halasz (1998) provides some evidence on accountability of the owners of schools and of the schools themselves in Hungary. Accountability refers to both legality of use (i.e., absence of corruption) and reasonableness of use (fiduciary responsibility). In the case of municipalities, reasonableness of resource management is not subject to external auditing. Funds for development have come under greater control with the introduction of county-level planning, but there is no external control of current expenditures. As far as the legality of the use of funds is concerned, external audit is limited. Examinations by the State Audit Office of Hungary are very rare and do not cover all municipalities. Complaints regarding the legality of educational resource management are few and those that are filed go to the Ministry of Interior offices operating at the county level, which then can enforce the law through the courts. In the case of private school owners, legality is controlled by local governments. Though accountability is weak at the level of local governments that have political autonomy, it is very strong at the level of schools: local governments can exercise almost full control, and do it in most cases. They can control cash management in their own schools, both in terms of reasonableness and legality. However, the control of "reasonableness" is very restricted and—though it is a legal obligation of municipalities—rarely covers the evaluation of teaching efficiency. Elected school councils can also exercise some control over schools.

There are three main challenges to fight corruption and improve accountability (Dean 2000). First, managing finances responsibly implies the need for specific legislation defining the financial powers and responsibilities of local self-governing entities, in particular covering tax administration (raising revenue), budgeting, accounting, reporting and auditing, and controls that are consistent with the spirit of decentralization. Second, meaningful local participation implies the need for openness and transparency in their financial dealings (for instance local budgets and annual financial statements to be made public, as they are at present in Hungary and Slovakia); local self-governing units to be audited by independent auditors (as occurs at present in both countries) and involvement of the citizens either individually or collectively (e.g. parent associations) in local affairs. Third, local governments cannot be independent from the central government. They use public money; have a duty to be open about its use and must be subject to independent audits. The audit findings must be made public and such audits must be comprehensive (applicable to the entire local entity not just restricted to the funds transferred from central government). From the point of view of the State, decentralization implies a danger that resources transferred to local units will be misused (control and accountability being weaker at local levels). The natural reaction is a search for strict central controls. If successful, this will negate the fundamental objectives of decentralization. It is important to ensure that the central government plays a minimal role. As stated by Peter Dean (2000), the trick is therefore to create a system of “remote control”: one in which local self-governing units are both responsible and accountable and in which central government has a predominantly monitoring role.

The basic reason for decentralization is to achieve greater local participation in decisions about local use of funds. The decline in state influence on local matters is only a consequence of that. Therefore, wherever possible, policy should be directed at achieving proper public accountability without putting State bodies in a position of supervisory control. In practice, this means that local governments must be governed by sound financial management principles set centrally; must be publicly accountable (as discussed above); must have a choice as to where they maintain bank accounts; must keep their own accounting records and process their own transactions; and must be audited by independent auditors (professional auditors from either the private or the public sector).

In terms of accountability, the central government thus has the responsibility to establish the financial management and accounting framework in which local governments are to operate; to ensure, when state funds are provided to local bodies for specific uses, that the purposes intended were in fact achieved; to set limits to the borrowing powers of local bodies and establish a reporting framework to ensure compliance; to monitor compliance with public accountability requirements (public budgets and financial statements and independent audits) via receipt of the relevant documents; and, finally, to exercise reserve powers in the case of a local body seriously failing to meet its public accountability obligations (this would include taking the local body into temporary state receivership in the most serious cases) as the 1996 Hungarian law on municipal bankrupcy envisages.

Both Hungary and Slovakia have laws defining accounting norms that must be followed by local authorities, the latter must prepare their own budgets, can maintain bank accounts with commercial banks, prepare their own accounts, borrow money, carry forward unused resources beyond the end of the budget year and invest any surplus they may have. But there are differences between the two countries. The main difference is that Hungary has set a “hard constraint” on borrowing: there is a yearly cap for borrowings by local governments, equal to 70 percent of own revenues minus debt servicing costs. Moreover, a stringent local bankruptcy law was passed in 1996. Slovakia has no law restricting the borrowing powers of local governments and no law organizing municipal bankrupcy. This has led some local governments to become over-indebted, to fund non-viable construction projects and/or to be in financial crisis.

Table 3. SLOVAKIA - GENERAL GOVERNMENT DEBT
(billion of SKK at market prices)

	1994	1995	1996	1997	1998	1999
Consolidated Debt	116.4	124.5	166.2	203.8	228	255.8
of which						
Local Governments	2.0	4.4	5.5	6.9	9.2	11.2

Source: Ministry of Finance
Figures include domestic and foreign debt. Local governments did not report any foreign debt

The laws and institutions on financial control and accountability are in place in Slovakia but several problems have been reported with the accountability framework (Dean 2000; SIGMA 1999). First, the flow of funds from the central government to local governments is reported to be unpredictable, making financial management difficult. Second, internal audit is carried out by a controller who is voted into office by the elected council and then paid from the budget of the self-governing unit. The controller is appointed for life and has a status independent of the mayor. The controller's reports go directly to the elected council. He reports on the budget (which is made public in draft form 14 days before it is debated) and on the annual final account. Each local government is also theoretically subject to annual audit by an independent auditor. Controllers appointed for life are certainly independent but may present other disadvantages as part of a modern accountability system.

Section 5. The Problems of Shared Governance faced by Education in Hungary

Quantity and quality of public goods provided by governments are directly affected by the mode of governance of the organization which provides these goods.[10] Generally, the agency funding the public good and the agency responsible for actually delivering the service are different. This is often the case for constitutionally guaranteed services such as basic education and health care in countries like Hungary and Slovakia. Schools or hospitals are managed by an agency not responsible for its funding. Governance is shared between the center and subnational levels. What level has the authority to make a particular funding or management decision may not always be clearly defined.

For constitutionally guaranteed entitlements, a good case for shared governance—i.e. for complementarity between decision-making at the local and central levels—can be made. In education, for instance, some parts of the system (such as setting the curriculum, organizing examinations at secondary school level, monitoring the quality of instruction, etc) are best centrally provided; for many other activities it does not make sense for the center to get involved or to sign off on decisions; while for yet other issues, it is best to share governance. Teacher absenteeism is such a case. Local communities have more information and a greater stake in monitoring the teachers. At the same time, their own action can be effective only if the education management structure itself responds to parental complaints (Drèze 2000). Shared governance may thus be the optimal system to ensure minimum standards of service and accountability toward taxpayers when the central government transfers large sums to local governments. However, the issue that arises is what incentive schemes the central government can use to enforce these norms and whether these incentive schemes actually have their intended effects. In this section, we use education as a case study to examine some of the incentives that are at play and the role of stakeholders (central government, municipal authorities, teachers' unions and parents) in the governance of social institutions. We focus more particularly on the effects of the amendments to the Education Act during the 1995 "Bokros package" (stabilization program) in Hungary. Our account follows closely Halasz 1998.

Hungary has transformed its system of financing and managing public education over the past two decades, moving from a highly centralized system to one in which most decisions regarding the use of resources are made autonomously by local actors and the central government has only indirect tools to influence these decisions. Decentralization is characteristic of almost all functions, from establishing schools to employing teachers to defining the contents of the curriculum. The decentralization process began in the 1970s, well before the democratization process after 1989 and is, therefore, not only the product of the "transition" but of more gradual structural changes. The transition, however, accelerated the changes.[11]

The financial links between central and local governments are governed by norms regulating central-local transfers: municipalities automatically receive a predetermined amount from the central budget when normative criteria are met. On average, municipalities allot about 30 percent of their incomes to education, and education is the largest local expenditure. Local authorities spend more on education than they receive from the center (e.g. the ratio of normative grant to local education expenditures decreased from 66% to 56% from 1991 to 1996). Normative education grants (related to the number of students) are the largest transfer to municipalities, and are set in each year's budget law. Until 1996 there were few normative grant categories; their number has since grown to include, for example, students enrolled in ethnic or national minority programs, or transferring from other municipalities. The normative grant is available to every school with an operating license. Non-state schools can receive subsidies from central or local budgets. The Constitutional Court ruled in April 1997 that the state is obliged to provide similar subsidies to church and local government schools. In addition to normative grants, the state supports local public education activity through subsidies for specific goals, usually keyed to priority development tasks. These expenditures have increased since the new 1996 law: the 1997 budget includes for such tasks more than 8 percent of planned normative public education expenditures.

The financial links between municipalities and schools, which are entirely independent from the financial connection between central government and municipalities, are only marginally regulated by law and are governed by a bargaining logic. The law sets the educational activities that local governments have the obligation to finance—and required quality levels—only in very general terms. Two laws form the basis for education financing: the legislation on the remuneration and legal status of public servants and the rules contained in the Public Education Act amended in 1996, which play an important role in evaluating the budgetary demands of schools. These rules define the amount of time put in by qualified teachers as the basis for calculating wage costs and criteria for demand for equipment and material expenditures. As these regulations do not set precise determinants for wages and other costs, bargaining between schools and their owners takes place. The rules only make it possible for municipalities to calculate the minimum teaching load mandated by law, for which they have to secure financing for teacher remuneration. Schools where teachers have higher qualifications—or average ages—than prescribed by law have higher wage costs than those employing less qualified or younger teachers. Municipalities can also extend school hours, provide extra services, or agree to pay higher than obligatory wages.

Hungary has a large number of municipal schools. There are more than 1,000 settlements with schools having eight grades, which means that more than 55 percent of all municipalities run such schools. Almost one-quarter of eight-grade classes are in settlements that have less than 2,500 inhabitants. Since all municipal schools have the right to bargain on their budgets, the number of such bargains each year is very high and outcomes can be very different.

The school budget emerges each year from several rounds of bargaining. The budget bargaining process differs in villages with only one school and larger cities with complex school systems. In a typical budget bargaining scenario local authorities request the budget plan for the following year from the school principal and inform him/her about the scope for change compared to the year before (e.g., wages may be increased in a determined proportion, material expenditures frozen, etc.). The school principal and staff then produce a budget and submit it to local government staff. The latter then compare school budgets with each other and prepare the municipal budget for approval by the assembly of elected representatives.

Until 1995, most schools simply adjusted the budget of the previous year for inflation, and it was approved without changes by municipal authorities. In addition to normative grants, the state budget provided (until 1996) transfers to cover wage increases adopted in (tripartite) collective bargaining agreements. Apart from agreed wage increases, deviations from the previous year's budgets were relatively rare and happened only in some large urban municipalities.

Following the measures adopted as part of the March 1995 stabilization program, many local governments began to pay more attention to the budget of their schools. Often with the help of outside experts, they analyzed the wage "grids" used by the schools to put together the school budgets. This process was first done on the basis of local regulations or locally agreed practices (for example, regarding teaching loads) then, after 1996, under the provisions of the amended Education Act.

Section 6. High Powered Incentives: Are they Effective?

The Public Education Act stated that the education transfers by the central budget had to cover wages, but it was not clear whether this should to be understood at the national level—and cover only average local wage expenditures—or should be applied to every teacher who was already employed. Whether the central or the local government should bear the responsibility for paying teacher salaries—and whether this covered all employed teachers—has been a hotly debated issue in Hungary since 1990.

The issue was particularly sensitive due to the decline in student numbers starting at the beginning of the 1990s caused by demographic changes. In primary schools (6 to 13 year olds), the student/teacher ratio fell from 14 to 11 over 1988-94, a very low ratio by international standards; the number of students per classroom fell from 25 to 20 over this period. This has created a large surplus of teachers. Whether the existing financing system for public education could handle this problem was open to question and led to lively debates.

In the aftermath of the “Bokros package” (stabilization program) of March 1995, it was finally decided in 1996 not to move to direct central wage financing—despite proposals (supported by the Ministry of Finance) to directly finance teacher salaries and achieve a more efficient level of employment of teachers through direct measures. Trade unions also supported direct financing of teacher salaries, but for different reasons: they hoped that adoption of this system would lead to guaranteed security of employment and better pay levels. By contrast, the Ministry of Culture and Education wished to continue decentralized financing, because it felt that this was the most appropriate system to guarantee both efficient employment and security of wages in a decentralized context.

Finally it was agreed that efficiency issues would be addressed by direct government action—under decentralized patterns—by influencing the behavior of local decision makers; the 1996 amendment to the Public Education Act set standards under which local governments calculate wage expenditures and the appropriate number of teachers.

The center can only affect the education system and local budgetary decisions by indirect means. [12] The central government postulated in 1995 that if transfers declined, local governments would be faced essentially with two options only, given that their ability to borrow is limited. Either reduce their expenditures, or increase their own revenues in order to compensate for declining transfers. The central government assumed that cost-reduction on the spending side, sufficient to accommodate revenue decline, was possible only if institutional adjustments such as closing down of schools; reductions in the number of teachers, etc. took place which, in turn, would have led to a restructuring of primary education services. Alternatively, local governments could have increased revenues under their authority or could use revenues from selling their assets in order to maintain expenditure levels. The central government was in favor of the first form of adjustment, leaving savings from cost-reductions at the disposal of local communities. Our discussion follows Papp (2000).

Reducing central government transfers while rewarding cost-saving efforts can be interpreted, in theory, as an efficient incentive scheme. According to the theory of incentives (see e.g., Tirole and Laffont 1993), contracts in which the costs of operation are fully taken into account by the agent can be considered to be the most efficient incentive scheme with respect to cost reduction. Primary education in Hungary is financed through normative transfers which cover a certain share of input costs in education. The basic structure of the incentive contract is $t=a+(1-b)C$, where (t) represent transfers from the principal to the agent, and these transfers consists of two parts, a constant support (a) and a cost sharing part ((1-b)C). The share of costs financed by the principal are represented by the term (1-b). What is known as the "power" of the incentive schemes is b, which is the link between the transfer and the cost performance of the local government. If b=1, the total cost of the services is borne by the agent. This is the most powerful incentive scheme since the ratio of expenditures to be financed from own financial resources directly depends on the agent's cost-saving efforts. If b=0, costs are totally reimbursed and this is the weakest cost-saving incentive. The "Bokros package" let coverage (1-b) of educational costs decline, so that local financing had to increase unless cost-reduction took place. In other words, 'b' increased, while any cost-saving (decline in C) was left with the local governments.

There is another reason to argue that cutting transfers while rewarding cost-saving efforts can be interpreted as an efficient incentive scheme. Local governments—who have information on the operation of public schools—were entitled to decide whether they want to increase own revenues or reduce costs. If they chose the latter, they could choose the actual form of cost cutbacks (school mergers versus outsourcing). Allocating decision-making authority to the most informed level is a necessary requirement for organizational reforms. De Groot and van der Sluit

(1987) investigate this issue with respect to the hospital system in the Netherlands and argue that reform schemes in regions where actual reorganization decisions were allocated to the level of government who had full information on the operation of the sector, led to better outcomes.

Declining transfers to local government could thus be interpreted as a high powered incentive scheme, because service delivery costs, directly borne by localities, increased while cost-diminishing efforts were rewarded by leaving savings for local disposal.

What happened actually? Local governments in Hungary reacted on two ways to declining government transfers. On the one hand, they tried to compensate for declining transfers by increasing own revenues. Own revenues have grown continuously from 1995 onward. On the other hand, expenditure side adjustments have taken place as well. Local budgets as a whole declined by 4.7 percent as share of GDP during the 1990s. However, contrary to the expectations of the central government, the expenditure side response of local governments to declining transfers was not accompanied with a large scale reorganization of the services. The number of schools, teachers, pupil-to-student ratios remained unchanged (Bokros and Dethier 1998). In other words, instead of cost-reducing institutional arrangements, such as having fewer but bigger schools, local governments cut several expenditure items, such as cash and in-kind social benefits available to the poor, or maintenance and renewal. Other more “tricky” methods were also applied, for example cutting social security expenditures through forcing teachers to change their employment status (Davey, 1998).

Preliminary analysis of the twenty-two largest Hungarian local governments which have the largest number of service delivery institutions carried out by Anita Papp (2000) shows that localities adjusted in non-personnel (material) expenditures, rather than in wages as a response to declining general government transfers. Reduction in maintenance (measured by non-personnel expenditures) or postponement of maintenance often results in quality deterioration of services (Domberger et al, 1995). The data partially support the view that quality deterioration took place in public primary education in Hungary as falling non-personnel expenditures proved to be directly associated with declining general government transfers.

Therefore, despite the seemingly proper design, declining central government transfers to the local governments were inefficient as an incentive scheme, due to reasons which economic rationale alone cannot explain. The modest observed cost-reducing behavior of local governments stands in sharp contrast to the large expected adjustment predicted by incentive theory. Hungarian local governments were more eager to reduce scope and quality of their services than to make attempts to reduce the costs of services through reorganization.[13]

Section 7. Basic Education in Slovakia

Slovakia inherited an integrated but strongly centralized and hierarchical education system from its socialist past. The Ministry of Education (MOE) directly controlled all levels of education through its regional and district level units, called Regional and District Educational Committees. Employment and financing decisions, for both current and capital expenditures, were made by the Regional Committees in consultation with the MOE. Allocation of funds did often not reflect the need of the schools and there was no flexibility in the financing system.

At the start of the transition, a new education structure was established (Act 542/1990) which consisted of the MOE, three independent regional school councils responsible for higher and secondary education, and 39 district level school councils dealing with primary and pre-school education. In addition, a special school inspection body was established. This system lasted until 1996. Act 222/1996 reestablished regional and district offices of public administration, in which education issues is represented through departments of education within public administration units. Moreover, it increased the numbers of these units from 3 to 8 at the regional level and from 39 to 79 at the district level (in line with the new territorial structure introduced by the Act) and public administration employment skyrocketed, including in education.

Under the current system, the MOE is responsible for higher education institutions, educational methodology, state pedagogical institutes, methodological centers and leisure centers. The Regional offices are responsible for secondary education, and the district offices for primary education and pre-K childcare. All financial resources are allocated to the district level by the regional level. In principle, this allocation of funds to district takes place on the basis of guidelines prepared by the MOE. But the chairpersons of the regional public administration offices often disregards educational issues and rarely consult with heads of education department in their office. Given the close links between the regional offices and the Ministry of Interior, it is not an exaggeration to say that, in Slovakia, education policy is done by the Ministry of Interior!

A 1999 decree transferred the authority for the allocation of funds from the chairmen of the (regional and district) public administration offices to the heads of educational departments within the offices. In practice, however, only 3 out of the 8 regions and 39 out of 79 districts had complied with the new rule by the summer of 2000.

In terms of financing, currently, approximately SK 25bn are spent on secondary, primary and pre-primary education, of which SK 15 bn represent wages (net payroll taxes) and 10 bn are operational expenditures. Taking into account social security contributions, personnel expenditures for secondary and lower levels of education amount to SK 21bn. Investment expenditures are relatively small: SK 0.75bn in 1999 and 2000, or about 3 percent of total expenditures.

Table 4. SLOVAKIA - Arrears of the Regional Offices (in SK tousands)

Regional Offices		**1998**	**1999**	**2000 Estimate**
Bratislava	Total	119, 489	53, 342	116, 949
	Education	75, 064	16, 415	74, 607
Trnava	Total	56, 335	13, 575	72, 329
	Education	31, 943	7, 726	50, 016
Trencin	Total	114, 081	61, 610	130, 559
	Education	60, 693	51, 077	109, 562
Nitra	Total	97, 157	38, 371	102, 000
	Education	66, 712	24, 731	85, 000
Zilina	Total	111, 721	73, 744	191, 000
	Education	66, 303	42, 934	153, 000
Banska Bystrica	Total	150, 200	73, 592	167, 415
	Education	115, 773	58, 105	148, 989
Presov	Total	252, 867	169, 199	217, 300
	Education	165, 223	86, 913	176, 373
Kosice	Total	283, 366	131, 673	309, 685
	Education	196, 290	64, 865	239, 175
8 regional offices	**Total**	**1, 185, 216**	**615, 136**	**1, 307, 237**
	Education	**778, 001**	**352, 766**	**1, 036, 722**
Source: Ministry of Finance				

Education financing in Slovakia is based on institutional normatives (per school as opposed to per student). Normatives are supposed to cover the operational costs of education institutes whereby costs are differentiated according to geographical location: e.g. higher heating expenses due to colder climate in the mountains are accommodated by the system. Since there are few incentives for the institutions to save on fuel and other expenditures and since the formula used for the transfers probably underestimates some of the true cost of running the schools, the regional offices have been in arrears since their creation in 1996. Month after month, their spending exceeds their receipts and they accumulate arrears (generally, vis-à-vis the district heating company) which the Ministry of Finance ends up covering at year's end.

During the budgeting procedure, the MOE only has a consultative role on secondary and lower level education expenditures. The eight regional public administration offices prepare their budget proposals and submit them directly to the Ministry of Finance.

Education policy in Slovakia is undergoing profound changes. Three different processes of reform are ongoing. First, a reorganization of the administration of the education system is planned—and the MOE wishes to establish its own education offices independent of the currently existing Regional and District Public Administration offices. Second, arrangements are being made to introduce decentralized management of individual schools with elected local governments becoming responsible for financing operational costs. Third, the design of education financing through a major revision of the current system of normatives is also under discussion. Currently, the MOE seems to concentrate mainly on the first issue. This satisfies neither the supporters of more substantial decentralization, such as ZMOS (the Association of Municipalities), nor the MOF which considers that it could lead to increased expenditure.[14]

The reform of education that is being planned raise the issue of state control over education. Should the central government's role be limited to providing educational methodology and carrying out school inspection, or should the state also have other responsibilities? Who will be in charge of budgeting, employment policy and financing? Should these functions go to the new elected regional self-governing bodies? If education is managed at the regional level, what would be the role of local governments? One option, favored by the MOE, is that local governments be involved in the operation of district education offices. They would thus have a right to influence the education process as well. The MOE does not want mayors to manage schools because of the risk that they 'use schools to further their political agenda; misuse educational assets and/or misuse operational funds resulting in the breakdown of educational services in some localities. The MOE believes that wages should remain the responsibility of education offices (In instances where a local government would not be able to finance operational costs, the MOE would do so). If the latter idea were to be implemented, there would be no incentives to reduce operating costs at the local level. This would seriously soften the budget constraint for local governments right from the beginning.

In terms of financing, the MOE intends to revise currently used education normatives, and establish per child, per class room and per school normatives.[15] It is unclear whether the normatives that are planned are simply budgeting tools for calculating expenditure needs, or represent earmarked expenditures, so that there would be no flexibility in their use at the local level. If the latter holds true, the new system cannot be truly considered a decentralized one. Local governments would simply be “pass-through” paying agencies.

Regarding the employment of teachers there are two competing views. The MOE, in line with the Teachers’ Unions believes that employment should be the responsibility of district education offices. The alternative is that all educational staff becomes employee of municipalities. The MOE believes that this arrangement would reduce the school’s role to that of an ‘economic unit’ within the budget of local governments. In their view, their proposal would ensure that professional aspects would guide hiring and firing, as in case of school with legal entity school directors would be entitled to decide on employment issues, while in case of schools with no legal entity, district education offices would do so.

Section 8. Conclusions.

For small countries like Hungary and Slovakia which are in the process of joining the European Union and wish to catch up as fast as possible with their European partners in terms of growth and living standards, one important issue is to find the optimal organization for the provision of local public goods such as education, health care or social assistance services.

Decentralized government creates several problems. First, countries like Hungary but, particularly, Slovakia face a major constraint: the lack of qualified personnel in the public sector. Human capital is likely to remain in the foreseeable future a major constraint in the conduct of public affairs. Many communities cannot meet minimum standards of services simply because they do not have enough qualified personnel to do so. The authorities of communities with population of less than 1,000 have (nearly) the same set of duties as large jurisdictions like Bratislava or Kosice.

Second, organizational and institutional issues are more complex in a decentralized context because they require more coordination. Many problems of expenditure management require not only good local human resources and capacity but also appropriate organizational models and appropriate incentive structures. The example of education in Hungary that we have given indicate the complexity of the coordination problems involved. Three things are required: a clear definition of roles and responsibilities (and avoiding duplication) across tiers of government; good tax legislation providing incentives to improve services and finally, incentive structures that improve accountability and participation.

In terms of organization, reform is possible along three avenues (Ebel, Varfalvi and Varga 1998). One option is to follow the path many EU countries have taken since 1960, and abolish and/or consolidate small units. In Sweden the number of localities has been decreased from 2,500 to 278. Denmark merged 1,388 habitations into 275 localities. Similar stories happened in Germany (24,512 to 8,500 by 1980) and Belgium (2,663 to 589 between 1961 and 1980). Britain went even further, and has no local authorities in its villages, with the basic unit being the district with an average population of 120,000. The consolidation option has economic merits but, in Central Europe, ten years after the restoration of local autonomy, it does not seem to be a politically feasible—nor probably a decent or appropriate—option.

Another option is to generally redefine the competencies among subnational governments, with an eye to assigning functions such as water supply, basic health and social services, and primary education to general purpose regional governments. This is clearly the vision behind the Slovak reform proposal. It could make sense in terms of principles of economies of scale, appropriate size benefit areas, and administrative feasibility for the local public sector. Its attractiveness for Central European EU accession countries, however, seems to be elsewhere: it conforms to the European Union's use of regional governments to carry out various EU directives and spend structural funds. Achieving EU membership would give Hungary and Slovakia access to structural funds that could amount to about 2 percent of GDP every year. Although access to these funds would substantially increase the scope for rebuilding local infrastructure, local governments do not have yet the capacity to meet the cofinancing requirements. These requirements, at about 20 percent, imply that local governments will need to contribute an additional 0.5 percent of GDP to infrastructure projects in order to utilize the EU's structural funds. If local governments are able to develop their own revenue sources, the cofinancing requirements could be partially met from these sources. Any remaining cofinancing needs would have to be met from additional transfers from the central government or from borrowings. Note that convincing empirical evidence indicates that there is no link whatsoever between amount of structural funds spent in EU countries over the past 20 years and regional development (Boldrin and Canova 2000).

One last option is for the central government to provide incentives for intergovernmental cooperation and privatization in local service delivery. This is already happening on a large scale in Hungary through the design of matching grants to encourage cooperation, local government establishment of nonprofit organizations for purposes of delivering services, the granting of central transfers and non-muncipal organizations and the municipalities' own decision to cooperate for common functions.

Whatever option is chosen, there will be a need to develop the capacity of local governments to generate and to manage a larger volume of resources (World Bank 1999). Shared governance between the center, intermediate tiers (regions, counties and associations) and local governments will require clarification. Expenditure assignments will need to be specified more precisely and the legislation on health, education and other sectors will need to clarify who has decisionmaking power. It would be desirable that oversight over financial management remain centralized through „remote control“ of lower levels. Regional development organizations could also perform the function of managing funds but their programming and implementation capacity will need major improvements.

Local governments will also need to develop their attractiveness for business and their capacity to generate revenues from local sources. Introducing a value-based property tax and implementing a gradual upward revision of the vehicle tax rates could boost local revenues. Personal income tax sharing currently allocated by origin might be replaced by a PIT surcharge system. There is also scope for raising more revenues from the business tax by having the tax implemented by a wider range of sub-nationals. The property tax, the PIT surcharge, and the business tax are expected to gradually become the major sources of local revenues (Ebel et al. 1998; World Bank 1999). This would increase the ratio of revenues subject to local discretion, and hence also increase local accountability. Transfers will continue to be the principal source of funds for current expenditures. The annual level of those transfers could be tied to macroeconomic benchmarks such as inflation and GDP growth (as in France) or determined as a fixed percentage of taxes (as in Japan). Moreover, the system for allocating current grants needs to be simplified and made administratively less burdensome. Equalization grants which are now allocated through numerous parallel channels should be consolidated into a single equalization fund designed to compensate imbalances across municipalities and regions.

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ENDNOTES

1 The opinions presented in this paper are the personal views of the author and do not represent the views of the World Bank or its Member Governments.

2 We use the concept of incentive (i.e., any norm leading individuals to behave in a way that facilitates cooperation) to include both economic incentives, such as pay or benefits, and political incentives which can be guaranteed by democratic systems that include safeguards for voice, participation and checks and balances.

3 This program and its components is described in details in Bokros and Dethier (1998). Kiss and Szapáry (2000) also contains a good summary.

4 There are three kinds of shared taxes: personal income tax, business tax and road tax. Out of the total 8.2 bn PIT revenues planned for 2000, approximately 6.4 bn (or 78%) is meant to be shared with local governments. These taxes are redistributed to local governments on a per capita basis. The business tax (tax on income of legal entities) is much smaller. Sixty percent of it is redistributed to localities on a per capita basis and 40% on the basis of origin. The road tax is expected to yield SK1bn in 2000. Thirty percent of it will be transferred to municipalities on a per capita basis and 70% will go to the Road Fund.

5 Local governments cannot vary the rate of the real estate tax. Real estate registers are not always complete. More significantly valuations are more or less meaningless. An additional problem arises where the state has leased land to farmers. The State Land Fund collects the money and pays it to the Ministry of Agriculture, thus diminishing the possible revenues of local governments.

6 In 1996, under the Meciar government, the Parliament adopted Act 221/1996 creating 8 regions and 79 districts. These are not decentralized organs but deconcentrated organs of the central government. The number of territorial units increased—with respect to the socialist period—from 3 to 8 at the regional level and from 39 to 79 at the district level. As a consequence, public administration employment skyrocketed. In addition, the 2,881 local governments remained.

7 Resolution 230 of April 11, 2000 on the "Concept for Decentralization and Modernization of Public Administration", Government Office of the Slovak Republic.

8 This paper does not discuss the experience of Hungarian and Slovak local governments in mobilizing own-source revenues which has been a failure. This failure is linked to the fact that the autonomy of the municipalities is limited to minor sources of revenues but also to the fact that the municipalities lack the incentive to seek own revenue since all major expenditure is financed through tax sharing or transfers. Local taxation in Hungary is extensively discussed by Ebel, Varfalvi and Varga (1998) and Kopanyi et al. (1999). Local taxation in Slovakia is discussed in Bercik (1998) and Davey et al. (2000). The Davey report suggests for own revenues at the municipal level, two possible additional revenue sources: real estate taxation and business payroll tax. The latter could have an adverse effect on employment in the present context of very high unemployment (national average of 18%). There is some scope in the long run to increase municipal real estate tax yields in urban municipalities but this is predicated on the development of an active real estate market (which itself presupposes improvements in the cadaster, etc). Deregulation will progressively increase the responsibility of municipalities for sensitive utility pricing and this will also enhance their accountability. For the own revenues of the new regions, the Davey report recommends against the current proposal of a regional surcharge on the income tax on enterprises and is in favor of a "piggyback" surcharge on individual income tax as in several EU countries. This could be introduced in such a way as to have a neutral impact on both the State Budget and individual tax burdens initially; and it would have a considerable impact on the accountability of regional governments to their voters.

9 At the request of the government, the World Bank and USAID have financed three surveys on corruption in Slovakia in 2000 (USAID/World Bank 2000). Questionnaires on perceptions and experiences with corruption were

administered to three distinct groups: 1,100 households, 400 enterprise managers and 350 public officials. The 3 samples were national in scope, with respondents drawn from all 8 regions of Slovakia. The surveys reveal that corruption is common and affects all key sectors of the economy. Individual citizens were most affected in the social sectors, with 60 percent indicating payment of pozornost (bribes, gratitude money) to obtain hospital services and between a quarter and a third for other medical services and higher education. Enterprises are most affected by licensing and regulatory bodies, courts and customs, with incidences of bribes reported by one-third for a number of these offices. Many firms reported that they unofficially sponsor political parties. All three groups of respondents identified the judicial system as a major area of corruption, with enterprises reporting frequent bribes in court cases and citing slow courts and low execution of justice as the most important obstacles to doing business. Moreover, households report paying frequent bribes to court personnel, especially to speed up the process, and those who found experiences with courts to be inefficient and slow were much more likely to report that the process was corrupt. The public officials survey demonstrates that corruption is closely related to the quality of the institutions of public administration. The bodies with the lowest levels of corruption were those in which the lines of internal communications were clear, administrative rules were well-implemented, personnel decisions were based on merit rather than connections or corruption, and the organization's mission was widely understood by staff. The level of meritocracy is particularly strong for explaining levels of corruption.

10 Modes of governance are characterized by their degree of centralization or decentralization; by the degree of participation of the stakeholders; by the transparency of the procedures adopted; and by the accountability of the agents involved. These issues, of course, are inter-related. Accountability is not possible without transparency, and fiscal discipline is related to accountability. Decentralization to the appropriate level, participation and accountability can lead to improvements in constraint (financial discipline); and competition (or, at least, the avoidance of persistent rents). Certain modes of governance provide stronger inducements to equity than others. Whether good governance is welfare-enhancing, and how benefits are distributed, however, remains a controversial issue. In part this is because the conditions under which decentralized organizations lead to Pareto efficient allocations are restrictive. In part, it results from political economy considerations: even though in theory efficiency-increasing reforms allow winners to compensate losers, in practice institutional changes and the lowering of transaction costs may be to the disadvantage of some groups and affect the distribution of welfare in society, prompting some groups to react — in proportion to their political power — and demand changes in their rights. (Dethier 1999).

11 In 1989 local budgets were separated from the central budget. Central subsidies were transformed into normative grants, and local councils became independent units interested in raising their own revenues. In 1990, the councils became autonomous local governments. Almost all state schools became the property of the new local authorities. Providing primary and secondary education became a legal obligation of local governments. In 1990 the Public Education Act was amended to allow private and church schools. A year later expropriated assets were returned to the church and church schools nationalized after 1945 went back to their former proprietors.Under the 1992 Act on Public Servants teacher remuneration is defined by the same central salary scale as other civil servants, and termination of employment has become more difficult. The 1993 Act on Public Education gave independence to local and institutional bodies in curricular questions and established a new central curricular document called the National Core Curriculum. The law gives broad responsibility to local governments in the area of public education. In 1996, the law of 1993 was amended to regulate parameters, such as the number of obligatory teaching hours and size of classes that are the basis for estimating expenditure demands (salaries and school equipment).

12 In addition to regulating the performance of educational tasks and defining subsidy entitlements and scale and "output requirements," the state also has the responsibility to establish a system of evaluation and quality assurance. In Hungary, output requirements have been defined through three basic documents: the National Core Curriculum, the requirements for the Maturity Examination and the National List of Qualifications. The National Core Curriculum, which sets out the knowledge that has to be acquired by the end of the fourth, sixth, eighth and tenth grades, was adopted by the government in 1995. The Requirements for the Maturity Examination, which includes the knowledge required to pass the final examination for secondary school were issued in 1997. The National List of Qualifications, which includes the requirements for vocational public education, was last amended in 1996. The new public education evaluation system rests on three basic pillars: the examination system, the system of nationally accredited experts, and the definition of the evaluation tasks assigned to the various actors in public education. The

government, through the above-mentioned documents for output regulation, jointly with the "social partners" during collective bargaining, defines detailed requirements for the examinations taken at the end of the compulsory school attendance period and at the end of secondary school studies. It is also the state's duty to accredit public education experts to oversee schools. Finally, the Public Education Act defines in broad terms the evaluation roles of the actors in the public education system—central government agencies, municipalities, school principals, and social partners. (Halasz 1998)

13 There is a lot of specialized literature in Hungary measuring the quality of education in terms of performance (as measured by standardized tests) and satisfaction with education. The two are not necessarily correlated, since the public could become more satisfied as test results get worse. Sample survey results indicate that school achievements have declined during the 1990s, and that results are worse the smaller the size of municipality. Public opinion polls show a declining trend in the public's satisfaction with education. While the level of satisfaction increased over 1990-95, it fell over 1995-97. However, education is in the group of public services that the public is most satisfied with. Interestingly, increasing dissatisfaction is mostly characteristic of more educated people living in urban areas, i.e., who are connected with those schools where the measured decline in school achievements is lowest. Many factors play a role in the deterioration of school performance and the weakening of satisfaction. The financing system is one, but not the most important. We cannot exclude that performance and satisfaction could have been worse with a different financing system. In the case of small villages, however, the fact that performance is getting worse is probably connected either with the decentralized financing system or the loss of adequate compensation mechanisms. The decentralized system of financing and administration could also have a positive influence on the quality of education. One of the key features of the Hungarian educational system is competition among school owners, schools, and users of the services. This competition—even though it is known to have negative effects—has led in many places to an improvement in quality. For example, efforts to meet consumer demands played a significant role in spreading computer literacy and early education in foreign languages. Because they were obliged to prepare their own pedagogical programs, schools have had to analyze their conditions and draw up development plans. Local self-diagnosis, which often means identifying quality issues and searching for ways to solve them, is an important part of such plans. They often have resulted in quality improvements built upon local initiatives, which otherwise would not have taken place (Halasz et al. 1998).

14 The current fragmentation of educational services, where 47 percent of schools have only two classes (one for pupils aged 6-10, and another for 11-14) would be addressed through subordinating small schools to big schools (with a pupil number of 250 -300) in the neighborhood. Small schools would not be closed down, but they would have their director jointly with bigger schools, and they would have a joint account for the funds they receive.

15 As mentioned above, the Davey report favors a Hungarian or Polish-style system of per capita transfers based on the numbers of actual pupils within each municipality/region, with suitable variations for type of school and population density. Coupled with parental choice, if this was also the basis for municipal/regional government budget allocations to individual schools it could promote rationalization of the system by “simulating the market”.