could monopolize this function. In practice, the assembly's budget committee or finance committee could be in the dark entirely.

11 In an ideal situation, a complex reorganization of the municipality could take place in the context of the emergency budget.

12 The survey took place at the end of 2007 on behalf of the Ministry of Economics. Its purpose was to investigate the cause of late payments in the private sector, and the private sector's relationship with municipalities was a sub-topic.

13 For details see Hegedűs–Tönkő (2007).

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Treasury nor the Public Administration Office reported these violations. The sanctions that do exist in the law (Article 5 § (4)) are not effective, because there is no one to enforce the law, nor does the State have any capacity to monitor and detect these violations. The State also does not have a real time database on municipal budget execution. The law currently only sanctions the mayor with potential fines for non-cooperation with the court. It would make sense to extend financial responsibility to the members of the assembly and to the non-voting members of committees. For this reason, we propose that the debt adjustment law contain sanctions if a municipality does not pay an acknowledged invoice within 60 days, and hence violates Articles 4 and 5 of the law. Also needed would be public financial reports that contain explicit information on payment histories, that is, the municipality is not in violation of this law. This could be similar to the auditor's statement, except that in the final annual accounts of a municipality the mayor and notary would have to certify that the municipality did not violate the debt limit clause of the Law on Local Government (Article 88) and is in compliance with Articles 4 and 5 of the Debt Adjustment Act.

A portion of the creditors and suppliers are not fully aware of the rights that they have in the debt adjustment law. But the exact opposite may also be true, in that they know what will happen during one of these procedures, where they stand a good chance of losing a good portion of the their claims of principal and perhaps all of their interest claims. They opt to choose a long cycle of lawsuits under civil law, that will bring a certain judgment and collection action in their favor. So they choose to "wait" for the municipality to pay. One could imagine a requirement that beyond a certain threshold the creditor be required to initiate a debt adjustment proceeding against a municipality. This raises constitutional issues, since it violates equality before the law, in that in commercial bankruptcy the creditor is never required to initiate a proceeding.

To solve the problem of asymmetric information, there is a need for an accessible, up to date, and credible database on municipal debt and other obligations. This could solve the problem, assuming that the entire public finance system, including the central budget and municipalities, were thoroughly modernized from the perspective of accounting, reporting and budgeting.[14]

NOTES

[1] For more information, see Csapodi (2007).

[2] We agree with Vigvári's assertion in 2007, that this is the key issue in Hungary under current conditions.

[3] Act on Municipal Debt Adjustment (Act XXV of 1996). Available in English at www.igeconsulting.com

[4] The United States' first Federal municipal bankruptcy law is Chapter 9 of the Federal Bankruptcy Code, passed only in 1978. South Africa uses a central government administrative procedure until the forced sale of assets, when the court steps in.

[5] For a detailed critique of Hungary's municipal system and the local government law, see Pálné (2008).

[6] See Jókay et al (2004).

[7] One of the authors served as the bankruptcy trustee in this case.

[8] See Vigvári (2005)

[9] Vigvári (2005) pointed out the problem of asymmetric information in the public finance system and the role it plays.

[10] Based on local regulations, the mayor or clerk

their unprofessional conduct. But their authority only extends to determining the formal legality of municipal decisions and local legislation. They cannot use their wealth of experience to warn municipalities if they detect irresponsible financial management. The State Audit Office does not have the capacity to audit the most endangered type of municipality on a constant basis. Prevention of financial difficulties is an important aspect, thus it is worthwhile to redesign the entire system of internal and external controls at the municipal level. Our case study demonstrates that even the presence of an annual compliance audit in its current form could not detect Nemesgulacs's financial difficulties.

The town clerk (chief administrator, notary) plays a key role in either preventing or helping to cause insolvency. Their current legal status is full of contradictions and they are subject to the whims of the elected officials. Municipalities acting on short-term political motivations did indeed engage in capital projects that had no connection whatsoever with mandatory municipal functions. The investment boom stimulated by "free" EU funds has multiplied this potential source of danger.

Changing tax rules and instable interpretations of tax regulations led to two municipal debt adjustment procedures caused by value added tax refunds that were later deemed illegal by the tax office. Most of the debt adjustment procedures happened owing to illegal and fraudulent activity. A common feature of all debt adjusted municipalities is that their standard operating procedures were faulty, had very weak or non-existent internal controls, and lacked proper professional staff in the financial area. These cases all pointed to the general weakness of the public finance information system. Cash-based bookkeeping, as well as violation of basic bookkeeping rules made it possible to avoid paying bills 60, 120 days, or even years late, without these invoices showing up in the books. Contingent liabilities and off the books accounts payable simply does not show up in the budgeting and accounting system.[12] The current financial risks of large municipalities simply do not appear in the State's public finance information system.

In several cases, the State Audit Office had previously audited municipalities and issued warnings about their problems that with time will lead to insolvency and other difficulties. We may conclude overall that the debt adjustment law provides an adequate framework to conduct bankruptcy procedures. But disobeying the law does not lead to any appropriate sanctions. The procedure is best suited for settling the claims of creditors and is to be recommended. After the court initiates the procedure by publishing its announcement in the public record, all debts come due simultaneously. This means that all suppliers and employees get in line with the rest of the creditors. In about half of the cases so far, it was unpaid vendor and supplier invoices, and not loan payments nor foreclosure against mortgages that led to legal liens and forced payments being applied against the municipalities. These legal actions finally convinced the municipalities to obey the law and to petition for debt adjustment by first asking the court to declare them insolvent. For this reason we propose that the law be made stricter with sanctions for non-reporting. This stricter approach may have a positive effect on financial discipline at the local government level.

We find it to be most important that widespread violation of the law be punished with sanctions of some sort. Creditors and suppliers are not required by the law to initiate these procedures. On the other hand, mayors are required to announce their insolvency to the court if invoices are not paid within 60 days (in some cases 90). In all cases, the municipality repeatedly violated this provision of the law. Internal controls, independent audits, the State Audit Office, the regional office of the State

We would like to take a detour to discuss the bank as a special type of creditor. The financial institution providing constant project and short term liquidity lending is the least interested in initiating a debt adjustment procedure. As long as the municipality behaves "normally" and offers solid mortgages to guarantee its borrowing, the bank has much formal and informal leverage over its behavior. But initiation of a debt adjustment procedure significantly hinders the bank's influence, not to mention the interest and handling charges it may have to sacrifice in the meantime. *Table 2* below represents the cash available to Nemesgulács during various phases of the procedure.

Table 2

CASH
(In HUF)

June 21, 2007	1 839 653
Oct. 31, 2007	13 930 494
Dec. 18, 2007	19 293 451
Dec. 31, 2007	27 103 726
Feb. 15, 2008	14 425 878

After the emergency budget was prepared, it was determined that the municipality qualifies for deficit financing grants from the Ministry of Local Government and Regional Development. So the municipality received grants totaling 12 million forints in November and December 2007. These funds by definition are to be used only for financing mandatory tasks, so they could play no role in the work out agreement. The numbers speak for themselves even without the deficit grants. This municipality used its full overdraft facility of 20 million forints during the debt adjustment process, and was able to pay all of its invoices on a current basis. In addition, it could also set aside funds in a reserve account.

When formulating the emergency budget, we only looked at the financial aspects of providing mandatory services.[11] For example, we did not review the number of teachers employed at the local school from a technical perspective nor did we suggest an optimal faculty size. We did not question the optimal way of delivering primary health care or its human resources needs. Of course, these service delivery options contain hidden reserves of savings.

The assembly learned the most during the adjustment process. Perhaps their perspective has changed in that serving the public is important, but all must bear a portion of the cost. One must not be deluded into proposing dream-like capital investment projects that exceed the financial capacities of the locality, especially taking into account inefficiencies that are not sustainable. One must not only take into account the current budget, and perhaps next year's budget, but should instead also calculate the impact of long term financial commitments.

GENERAL LESSONS LEARNT AND POLICY PROPOSALS

The cases we have examined suggest several general lessons learnt that would help us create stricter financial discipline at the local government level. An important lesson is that suppliers and creditors alike do not consider it in their interest under current conditions to petition the court for debt adjustment proceedings against a municipality. A study written in late 2007 confirms[12] that businesses do not blame municipalities for their unpaid accounts receivable. At the same time, it may be worthwhile to revisit this question in the light of numerous EU-funded projects. The example from Nemesgulács is also exemplary from this perspective.

Public administrative offices (located at first at the county level, then regional level) were in many cases quite familiar with the hazardous financial situation of municipalities and with

attend. We asked the creditors to send a statement ahead of time if they agreed with the proposed work out document. This was done in order to assure a quorum in terms of number of attendees as well as representation of a sufficient percentage of total claims.

Eighteen creditors took part in the debt adjustment procedure. Six attended the work out negotiations, and an additional six sent written notices of their agreement with the proposed compromise. This meant that over 99% of the total claims were represented. Even within the creditor categories, the overwhelming majority of claims were represented.

Article 24 of the debt adjustment law lists the mandatory, formal contents of a work out agreement, but it details neither deadlines nor enforcement methods. This is left up to the parties concerned. It is obvious that if the parties reach this stage in the debt adjustment process, that it is in their mutual interest to sign an agreement that cannot be disputed later and that such an agreement guarantees the restoration of a balanced budget along with the satisfaction of creditor claims. The law practically draws attention to the need for the creditors to retain someone to monitor implementation of the agreement. Such monitoring is in the interest of both the debtor and the creditors.

The creditors who took part in the work out negotiation asked the bank to monitor implementation of the agreement. The bank, of course, can track the flow of funds through the municipality's accounts, and can place proceeds from land sales into a separate debt service account which it controls. With such oversight, the bank has significant influence over the way in which the agreement is executed by the municipality. The court did not examine the contents of the work out agreement, it only checked for formal compliance, as well as determined that the creditors who signed it were authorized to sign in the first place. The court does not consider whether the agreement is in the interest of the parties concerned, nor does it analyze the effect the agreement has on the municipality's creditworthiness. The court decision ending the debt adjustment process in Nemesgulács was published in January 2008.

The debt adjustment procedure executed in Nemesgulács is unique among all the rest of these procedures so far in Hungary in that it was the first case in which a creditor petitioned the court to declare the municipality insolvent and subject to an adjustment procedure.

Participant motivations and interests

We would like to summarize the duties, rights, tasks, interests and responsibilities of the participants by referring to some of the key events that took place.

The municipality is the main stakeholder involved. Even though the law states very specifically under what conditions the mayor, even without assembly authorization, is obligated to petition the court to initiate the debt adjustment procedure, this only happens if basic mandatory tasks become endangered due to financial problems. If we took the time to thoroughly examine Hungary's more than 3,000 municipalities, then we can say with absolute certainty that 80% of them have unpaid invoices that are more than 60 days overdue. Despite this, they do not act in accordance with the law. Why should they? They would cause great difficulties for themselves, since up until insolvency they could use current revenues to pay the most important invoices and simply "stockpile" the rest of their unpaid bills somewhere in short term debt in the best case. In the worst case, these invoices do not ever appear in the books of the municipality and lay dormant until a vendor wins a lawsuit. They only took the step of petitioning the court, if they could no longer stay current in financing mandatory tasks.

Article 20 of the debt adjustment law allows the designation of *three groups of creditors.* We must mention an important precedent. The elementary school had been refurbished with an EU grant starting in 2006, with the acceptance of the finished project taking place in May 2007. Unfortunately, the financial closing had not taken place by that time due to the start of the debt adjustment process. The municipality received ex post facto financing of 95% of the project's cost in grant form. It became obvious, if the municipality did not pay its 5% cost share, that the entire grant amount would be lost, and the municipality would have to pay for the entire project by itself. Instead of an 8 million forint cost sharing payment, the entire project cost of 81 million forints would have to be paid. So those contractors who finished the school project had to be in a priority category by themselves. If they were fully satisfied, then the 120 million forints of claims could be reduced to 45 million very quickly. The municipality's bank guaranteed its overdraft loan to the municipality with a mortgage on municipal real estate. We had to take this claim into account as well, since if there were no agreement and the court liquidated assets, the law gives a priority to those holding mortgages over all other claimants with the exception of salaries and related benefits. The account managing bank submitted a claim of 20 million forints of principal and variable interest supported by a mortgage. We had to put the bank into its own priority category for this reason. Only the "small creditors" remained. Ironically, the creditor, that is the construction contractor who initiated the debt adjustment procedure in the first place found itself in the also ran, "everyone else" category of creditors. This group included mostly those firms who supported the mandatory functions of the municipality with goods and services. Their claims amounted to 18 million forints.

The creditors ultimately fell into one of these three categories:

Group 1: The creditor whose claim was supported by a mortgage (the account management bank).

Group 2: Creditors related to the EU-funded school reconstruction project that was finished as the procedure was initiated by the court.

Group 3: All others including the original petitioner, the construction company.

The municipality made the following commitments in the work out agreement:

The municipality transferred 2 million forints immediately to the bank, and asked the bank (in group 1) to allow it to pay the contractors on the EU project first by late-February, 2008. This meant that a creditor in the first group essentially yielded its rights to the contractors in the second group.

The bank in group 1 was offered a mortgage on those negotiable plots that were to be sold in future. This way the bank was assured that it would eventually be paid in full.

With the bank's agreement, the creditors in group 2 were immediately paid 8 million forints, that is the 5% cost sharing amount. This made it possible to financially close the ROP supported school renovation project. The State Treasury could then pay the balance, i.e. 95%, to the contractors directly. Creditors in group 2 received 100% of their claims.

Creditors in group 3 would be paid as the construction plots were sold.

All the details of the work out plan, oversight procedures and deadlines were recorded in the transcript of the work out negotiations. With the new mortgages on the unsold construction land, the bank in group 1 essentially was assured of being paid before "all others" in group 3.

▫ *Work out negotiations*

Work out negotiations took place on December 18, 2007. The invitations sent to the creditors included a statement that they could sign if they could not attend or did not want to

must take core property into account separately, as it is protected under law if used to perform mandatory functions. Assets available to satisfy claims must be identified and listed separately. There could be situations in which assets that are classified as being non-negotiable or partially negotiable have to be reclassified by the assembly in order to reach a compromise with the creditors.

After examining the real estate assets in Nemesgulacs's balance sheet, it became apparent that despite owning real estate within incorporated and unincorporated areas, those assets that are negotiable and have market value are rather limited in scope. Of course, even if a plot is negotiable, it may not have market value due to weak demand. Sales of these assets are made more difficult by the very short statutory deadlines made available during the procedure. While negotiating the work out agreement, it became obvious that we did not have enough time to conduct sales of real estate. So we had to adjust the work out agreement to allow the usefulness and the future retail value of these assets to be increased.

A proposed compromise

The next important step after passage of the emergency budget and review of negotiable assets is to produce a draft work out agreement. The municipality must also outline its reorganization plan that will enable it to operate rationally over the long run. A successful long term strategy enables the municipality to offer a credible and well-founded compromise to the creditors.

The assembly had been planning a new residential zone that would consist of 27 construction plots. Past budgets had been balanced by gradual sales of these construction plots. We are talking about empty land that has not yet been incorporated, and changing their status from farmland to construction land had been permitted already. But the actual reclassification had not taken place due to excessive legal costs that the municipality was not able to afford. This land was to be provided with water and other infrastructure, and the municipality submitted an application for funding to the Central-Transdanubian Regional Development Council. The council approved a 10 million forint grant for this purpose in May 2007.

At that point in time, of course, the Regional Development Council did not know about the debt adjustment filing that had taken place in April. This initial joy had turned to hopelessness rather quickly. It was obvious that adding communal infrastructure would increase the market value of this land, as well as increase the chances of finding buyers. During contract negotiations, it became apparent that a municipality that is undergoing debt adjustment is not eligible to receive such grant support. It was not possible to conclude the debt adjustment procedure during the 90 days that were available to negotiate the contract with the Development Council. Besides problems with this deadline, the municipality also faced the challenge of coming up with an amount of money for cost sharing. During debt adjustment, and until acceptance of the work out agreement, the municipality is allowed only to spend funds for mandatory tasks, and could not therefore set aside funds for the cost sharing required by the grant described above.

Our preliminary calculations and estimations indicated that sales of 8 to 9 plots would have generated the cost sharing amount, while the remaining 18-19 plots would have been enough to satisfy almost all of the creditors' demands. While it would have taken much longer, it would have been beneficial for the creditors if the construction land could have been prepared and sold, and a large portion of claims could also have been satisfied. The assembly accepted the reorganization plan and the proposed work out agreement in November 2007.

◗ The costs of the shared notary (clerk) district were reevaluated.

Nemesgulács operates a shared notary (clerk's) office with the neighboring village of Káptalantóti. The state finances 28% of the shared office, with the balance of costs split between the two villages. But costs were not shared on proportional basis. Nemesgulács with 68% of the population of the notary district paid for more than 80% of the costs not covered by state funds, the other village with nearly a third of the population paid for only 20% of the costs. How did this happen? The answer was quite surprising. When the district was created, Káptalantóti was engaged in a capital investment project and did not have any additional funds. So the two villages agreed to this disproportional cost-sharing.

This problem could not be dealt with during the debt adjustment process, and given the short deadlines that apply to creation of the emergency budget, and that the whole procedure happens within one budget year, the assembly could not make decisions or pass resolutions within the constraints of the legislative cycle. Recognition of the problem offered another set of ideas for the assembly's planning of future budgets.

■ *Creditors' Claims*

Article 15 of the law regulates how creditors may file their claims upon initiation of the debt adjustment process. The trustee records all claims submitted with 60 days of publication of the court's initiation of the debt adjustment process. The trustee examines the claims and confirms them within 15 days. The trustee accepts and confirms these claims, but does not necessarily rank order them. This is an important aspect, since the trustee compares the claims to the municipalities' own records, budget statements and other documents within 15 days, but the trustee cannot rank order the claims of creditors relative to each other. It is important to note that while there still is a flicker of hope for a work out agreement without forced liquidation, the committee and the trustee are in a flexible position to offer compromises to satisfy creditor claims.

Article 20 of the debt adjustment law allows the trustee to propose groupings of creditors by date, amount or any other reasonable indicator, all in the interest of reaching a work out agreement. The usual rank ordering using in corporate liquidations only comes into play if there is no agreement and the court has to order liquidation.

In a corporate bankruptcy situation, claims submitted beyond the 60 day deadline are rejected and the creditor loses his legal rights to compensation. In the case of municipal debt adjustment, claims submitted beyond the 60 day deadline are simply acknowledged, but may only be acted upon 2 years after the original debt adjustment had been declared closed by the court and published in the Enterprise Gazette.

Since the municipality "will not go out of business," the creditors still have an opportunity to act upon their claims in a later period. But based upon the experience of debt adjustments to date, municipalities finish these debt adjustment procedures with little cash and no saleable assets whatsoever.

In our opinion, given the multi-step and comprehensive communication requirements of the law (daily newspaper, local media outlet, written notice), it may be justified to reject claims that are submitted beyond the 60 day deadline. In the case of Nemesgulács, creditors had an opportunity to submit claims to the trustee until mid-August 2007. The court recognized and creditors submitted a total of 118 million forints of principal and accumulated interest in claims.

■ *How to get out of this situation?*

In order to identify resources available, one must evaluate all of the municipality's assets. When examining the municipality's assets, one

tions to their problems, and to solve their financial and liquidity difficulties. The trustee was expected to at least provide suggestions.

Based on past experiences and practices, the emergency budget is really the portion of the annual budget that applies to the period in question. Their 2007 budget amounted to 295 million forints. The first draft emergency budget for the June 21, 2007 to December 31 amounted to 95 million forints. They had to take into account and correct for a school renovation project that began in 2006 using ROP (Regional Operational Program) funds from the EU. The municipality succeeded in getting a 95% grant to cover the 160 million forint project's costs. The project extended into the 2007 calendar year, and as a consequence, the 2007 budget showed a 125 million forint construction project in the capital expense category. The emergency budget, of course, could not take this investment expense into account, so the corrected 2007 annual budget was reduced to 170 million forints, so the emergency budget of 95 million forints would have been a calendar-adjusted 55.9% of the original annual budget.

The village had to break its old habits and seriously rethink how it delivered mandatory services and how it accounted for its costs. The Debt Adjustment Act (Act XXV of 1996) lists the mandatory tasks of municipalities in an appendix. The municipality may only fund activities that appear on that list. The emergency budget calls for self-discipline in the delivery of services and in the exercise of public authority functions. The debtor has to acknowledge that even during a debt adjustment procedure, the insolvent municipality must deliver the mandatory functions listed in the law, even though it has limited capability to increase revenues.

Why can't a municipality increase its revenues? The largest portion of the municipality's revenues consists of indicator-based normative transfers that are fortunately not affected by the initiation of the debt adjustment process. These funds arrive month after month, providing constant liquidity. In theory, the municipality could increase its tax-like revenues, but in practice, it cannot increase local taxes during a budget year. So during the 210 days that the law allows for this phase, it is practically not possible to increase revenues based on local taxes.

The municipality had to be shocked into the realization that community burden sharing does not mean that the municipality finances, organizes and delivers certain services entirely at its own expense. Instead, the purpose of local taxes is to co-finance such activities. For example, in Nemesgulács the municipality paid the cost of household solid waste removal. Though the law treats the sanitation of public areas, solid waste collection and annual "spring cleaning" of large household waste items as required tasks, it does not specify how costs should be borne. The members of the debt adjustment committee thought that all public sanitation costs were covered by the communal tax (essentially a poll tax), and thus the population had "paid for" all forms of waste management. During the debt adjustment process, the local assembly decided to impose a waste hauling fee to be paid by each household, which meant the local budget could save about 3 million forints per year.

After a thorough review, the following expenditure reductions were identified.

- Fine arts instruction in the elementary school were reduced to be in line with the maximum amount paid by the state normative.
- Assembly members' honoraria were eliminated.
- All capital investment projects were removed from the budget.
- Material and supply expenses were reduced in the budgets of municipal institutions.
- The public library was temporarily closed during the debt adjustment procedure.

payment of the invoice and the petition to initiate the debt adjustment process. The debt adjustment law regulates the debt adjustment process only once it has been published by the court in the Enterprise Gazette (this took place in June 2007).

Between April 2006 and June 2007, the case was before the court in the so-called "court phase" in which the authority of the municipality to act was not yet hindered in any way. The court notified the debtor (municipality) of the petition in May 2006. The local assembly questioned the legitimacy of the contractor's claim, and referring to problems with guarantees, decided to reject payment of the invoice and even passed a local resolution to this effect. (With this resolution, the municipality thought it solved the problem.)

The municipality did not question the legitimacy of the contractor's claim in writing in the appropriate manner, thus it should have paid. Of course, the issue of repairs under guarantee and gaining compensation from the contractor would have been different question. From the perspective of the debt adjustment procedure, we can state that this "liability" was not dealt with in the proper legal manner, and this mistake is the direct cause of Nemesgulacs's bankruptcy procedure.

What could the municipality have done during this period? The lack of communication was the most significant problem. Nobody conducted any negotiations either with the creditor (the contractor) or with the municipality's bank about how this relatively small invoice amounting to only 2.5% of the village's annual budget would be paid. The municipality did not speak with the contractor, as they were "convinced that with our council resolution, we declared that we did not consider the invoice acceptable due to problems with the contractor's services." They made their biggest mistake when they simply did not even include this invoice in their accounts payable. What is even more striking is that the auditor's certification of the municipality's annual statement did not even hint at this accounts payable in 2004, or in 2005 or even 2006. *Not even the 2006 statement included* a reference to the bankruptcy petition that was filed in April of that year.

As the court announced the official starting date of the procedure on June 21, 2007, several important deadlines and tasks are defined according to the law relative to this starting date. One of the legal consequences of this starting date is that the municipality's bank account may only be burdened with the countersignature of the trustee. This can be regarded as the ultimate instrument in supervising the financial activities of the municipality. They regarded this as a violation of their freedom to make decisions, since any cash or bank transaction could take place only under the supervision of the trustee.

The municipality's bank refused any further lines of credit, so the only sources of revenue that remained were normative transfers from the State, local taxes and some minimal business income. The law assigns mandatory tasks for each participant in the process. The mayor and clerk are required to cooperate in briefing the trustee in full within a short time about municipal services, financial condition, liabilities and institutions.

■ *The Emergency Budget*

Preparation of the emergency budgets presents the first opportunity to examine the financial operations of the municipality, including how it operates its institutions and how it performs its mandatory functions. In Nemesgulács, the mayor, clerk, assembly and the newly formed debt-adjustment committee carried out their legal obligations. The trustee's role was to supervise the legality of the municipality's activities as an operational of the court. It is completely natural that the municipality and the assembly hoped for and expected the trustee to offer solu-

municipal assemblies hoped that the bankruptcy trustee would provide them with ideas for financial and organizational reforms, and also make difficult decisions on their behalf. Based on official transcripts, the trustees acted with utmost diligence and care when evaluating emergency budgets and proposed workout agreements. They could not represent the interests of the assemblies nor the creditors. Instead, the trustees acted on behalf of the court, and in an indirect way, the State. The main problem with the assemblies was that they were not willing to reduce staff levels, to raise local taxes and to concentrate the budget on only mandatory functions. Furthermore, they tried to head off further difficult decisions by applying for deficit grants and other state funds.

Asset liquidation was mostly caused by creditors' insistence on unrealistic satisfaction of interest claims. If they had exercised their rights in time, for example, not waiting 5 years in the Atkár case, the bank may have recovered most of its principal. But during a bankruptcy proceeding all of the interests and principals come due at once, and in the meantime time some municipal assets may "disappear." Asset liquidation means that creditors can recover none of their interest claims, and receive only 1–10% of their principal claims in cash.

It is interesting that in the periods immediately before a bankruptcy filing, in most cases, municipalities had significant financial problems regarding their operational budgets that had nothing to do with debt. Thus, in the months before insolvency, the amount of unpaid bills for operational expenses could double or even treble. In these situations the municipalities could not stay current on their invoices for operational expenses, and suddenly, the court order to pay arrives after 4 to 5 years of anticipation.

The cases described above lead us to the conclusion that the municipal Debt Adjustment Act was only implemented when basic municipal functions were endangered from a financial perspective. It is quite striking that with the exception of Nemesgulács, *creditors and suppliers* did not ever initiate debt adjustment procedures against a municipality. This is most likely justified by the fact that in the beginning creditors "believed" that the central budget would step in to pay on behalf of debtor municipalities. (This is a reflex that stems from the old "council" days of socialism). Given their knowledge of the law, the creditors had no incentive to initiate bankruptcy proceedings, because they knew that only a small portion of their claims could be paid. They chose to wait for better times. From the perspective of municipalities, it is "understandable" that they would delay declaring bankruptcy for as long as possible, because if the court accepts their petition, they no longer qualify for a host of state grants. So this "escape route" is truly a last resort for a municipality.

We present a specific debt adjustment case in the next section. This example, as we have indicated, is unique since it was initiated by a creditor. But we feel that in the context of the other cases, this unique event offers the insightful perspective of a practicing bankruptcy trustee.

The Village of Nemesgulács's Debt Adjustment Procedure

In April 2006, a construction contractor petitioned the court to initiate a debt adjustment procedure against the Village of Nemesgulács. The company justified its claim by stating that a contract signed in 2002 for building the second phase of a waste water project that had been modified many times authorized the enterprise to issue an invoice that eventually was not paid on time.

The municipality failed to pay this invoice in 2004. Almost two years passed between non-

described in detail so that each participant knows what comes next, and what their responsibility is. There were no disputes concerning procedures in any of the 19+ cases. The trustee and the court have authority and are respected.

The law has proven beyond a shadow of a doubt that the state will under no condition guarantee the debts of a municipality, or will it assume responsibility for their borrowing. The cases to date, of course, involved the smallest of municipalities, so one may ask what will happen if a county government reaches insolvency, and will the State step in as a "last resort?"

Vital public services were maintained in each case. The trustee, however, was not always in a position to suggest reforms, budget cuts and reorganization, because these skills do not belong to his profession. So the most successful reorganization plans came about with the full involvement of the assembly and the management of municipal institutions. In these cases the trustee simply reviewed the suggestions made by the reorganization committee.

The debt adjustment procedures conducted to date gave participating municipalities a clean slate, i.e. tabula rasa, enabling them, in theory, to continue to borrow for development purposes. But a typical municipality that has undergone debt adjustment is usually in a dire economic condition, and will have eternal revenue shortfalls, and will remain non-creditworthy for reasons other than an earlier debt adjustment.

In a significant portion of the cases we examined insolvency came about *due to accounting and internal regulatory shortfalls.* In these situations, there were no counter-signatures, no internal controls, receipts were missing, and assembly decisions were astray. As a consequence, unpaid bills accumulated if they were recorded at all, until an outside actor, such as a court order, upset the system. By violating the rules of internal controlling, accounting and procedural requirements, combined with some fraud and counterfeit documents, a bad lending decision that is well managed may lead to insolvency. The practice of payments to subcontractors without counter-signatures and valid contracts also violates written and informal money management rules that apply to public officials. If accounting and procedural rules had been obeyed, then perhaps 3–4 insolvency cases would have come to light sooner, or perhaps would have been prevented among the 19 known cases.

Creditors and suppliers behave in a variety of ways. On the one hand they trust municipalities and have faith in their willingness to pay. On the other hand, failed work out agreements can mostly be blamed on the largest creditor, usually a bank, claiming back interest or other penalties to preserve the real value of their claim. Even in the case of work out agreements that never came about, the municipalities were able to offer 50–70% of the principal claimed by creditors on a cash or deferred payment basis. The large creditors, who for years did not exercise their contractual and mortgage rights or engaged in long law suits, suddenly hardened their position during the workout negotiations. Because of their interest claims, they were willing to risk a failure to reach agreement, even assuming the risk of court-ordered liquidation of municipal assets. Asset liquidation always affects the creditors negatively. Despite this, in our opinion several large creditors rejected compromises on an arbitrary basis. In many cases not all the creditors filed their claims who were in the records of the municipality. For example, there were 72 million forints of unpaid bills on record in Dunafalva, of which 5 million forints were never claimed by the creditors.

The local assemblies, seemingly naive in cases, cooperated with the court and the trustee in each bankruptcy procedure. No assembly had to be threatened with new elections and dissolution. One source of difficulty was that

Table 1

MUNICIPAL DEBT ADJUSTMENT (BANKRUPTCY) CASES IN HUNGARY (1996-2008)

Municipalties	Population Debt (million HUF)	Amount of on Date of Initiation	Publication Date (publication)	Conclusion	Result
Atkár	*1685*	*98*	*25. 10. 2001*	*1. 8. 2002*	*agreement*
Bakonszeg (I.)	*1278*	*152*	*22. 8. 1996*	*23. 7. 1998*	*liquidation*
Bakonszeg (II.)	1278	60	3. 8. 2000	26. 9. 2001	liquidation
Bátorliget	*783*	*79*	*22. 8. 1996*	*26. 3. 1997*	*agreement*
Csány	*2298*	*46*	*15. 8. 1996*	*3. 4. 1997*	*agreement*
Csepreg	3333	89	15. 4. 1999	27. 4. 2000	liquidation
Domaháza	1082	22	20. 11. 1997	6. 1998	agreement
Dunafalva	1185	69	13. 3. 2003	29. 12. 2005	liquidation
Egerszólát	1107	24	25. 8. 1996	3. 4. 1997	agreement
Felsőmocsolád	559		11. 8. 2005	??	No data
Forró	2547	163	7. 4. 2005	15. 12. 2005	agreement
Gilvánfa	341	26	21. 9. 2000		liquidation
Kács	*654*	*32*	*12. 12. 1996*	*24. 7. 1997*	*Agreement*
Nágocs (I.)	856	123	5. 9. 1996	23. 7. 1998	Agreement
Nágocs (II.)	856	46	21. 9. 2000	9. 5. 2002	Liquidation
Nemesgulács*	***1100***	***118***	***21. 6. 2007***	***28.1. 2008***	***Agreement***
Páty	*4998*	*400*	*15. 8. 1996*	*4. 3. 1999*	*Liquidation*
Sáta	*1391*	*55*	*25. 2. 1999*	*1. 8. 2002*	*Liquidation*
Somogyfajsz	553	86	29. 7. 1999	13. 9. 2001	Liquidation
Somogyudvarhely	*1208*	*31*	*5. 3. 1998.*	*19. 11. 1998*	*Agreement*
Sorokpolány	825	11	1. 4. 1999	30. 12. 1999	Agreement
Sóstófalva	3509	6	21. 1. 1999	31. 12. 1999	Agreement
Nick			29. 6. 2007		
Boba			16. 1. 2008		

Debt adjustment cases underway (incomplete list): Pilisjászfalu (February 7, 2008), Tiszaderzs (January 7, 2008), Neszmély (August 2008).

advantage of their rights under the law (to petition the court to declare the municipality insolvent after 60 days). We therefore state that the law does work in a preventive manner, since the explicitly irresponsible lending practices have all but disappeared under the threat of asset liquidation by the early 2000s. But in this light, it is obvious that in the absence of any legal sanctions and credible enforcement (of the 60 day rule), and as a result of the patient attitude of most creditors, the law is simply not obeyed by the municipalities. Lastly, the relatively low number of formal debt adjustment cases signals, that beyond acting as accomplices, the creditors and debtor succeed in agreeing at the last minute, essentially extending the deadlines. The debt adjustment procedures reveal many unpleasant secrets, and in the majority of closed cases the creditor receives only a small percentage of its principal, and virtually none of its interest claims. Thus irresponsible lending has all but ceased, and the causal factors behind a growing number of insolvency cases involve criminal activity and fraud, as well as improper refunds of value-added tax and other central government funds.

One of the merits of the law is that *the procedure is transparent and explicit.* Each step is

municipal sector and its business partners to engage in more prudent behavior to prevent excessive debt.

This "Hungaricum" (i.e. Hungarian specialty) has served to protect both creditors and municipalities since 1996. The law is justified by the notion that Hungarian municipalities are free to engage in business activities, but the State does not guarantee their debts, and makes State funds available only for the provision of mandatory public services. The 1991 Act on Local Self-Government (Act LXV) stated that a municipality may be declared to be insolvent by a county court upon the request of creditors or suppliers. And in order to restore solvency, the municipality must suspend the financing of all activities and services that are not serving basic functions or exercising public authority on behalf of the State.

The Debt Adjustment Act's additional positive feature is that it lists in detail all mandatory municipal tasks that must be performed even during the debt adjustment process, and must be financed in the emergency budget. This list of mandatory tasks is difficult to identify in other Hungarian statutes such as the Local Government Act, and the Debt Adjustment Act makes this list slightly more precise than here to fore.[5] The following *table 1* below represents 22 known cases of municipal "bankruptcy," with the case of Nemesgulács being the newest well-documented occurrence.[6, 7] We consider the analysis of these cases to be important, because some involved criminal activity and fraud, while others demonstrate the weaknesses of the "financial architecture"[8] of local government in Hungary, and highlight the need for increased financial discipline. The list is not complete, because press accounts do not report all cases, and only a thorough examination of public court disclosure documents, such as the Enterprise Gazette, would reveal all occurrences.

The debt adjustment procedure is always preceded by municipal insolvency, defined as an inability to pay its employees, creditors and suppliers on time. The debt adjustment law uses a threshold of 60 days to separate liquidity problems from legal insolvency. These procedures have participants with varying degrees of information and divergent interests.[9] The municipality represents one side, the bank managing the municipality's account the other, with the third side represented by the collectivity of other suppliers and creditors. The municipality has a significant advantage in terms of information.[10] The account managing bank has a distinct advantage over the other players, in that as a provider of liquidity (before insolvency) it can influence the ability of the municipality in paying the bank's claims ahead of time. On the other hand, irresponsible lending by banks can also contribute to insolvency. In the table above, italics marks those cases where a bank was a significant creditor.

GENERAL FEATURES OF OUR EMPIRICAL INVESTIGATION

Our analysis examined these cases along the following lines: to what extent did the Debt Adjustment Act prevent situation of insolvency, how transparent was the procedure, how could asset liquidation be prevented, and to what extent were mandatory municipal services maintained during the debt adjustment procedure?

Regarding *prevention*, it is obvious that municipalities do not comply with the law. In December 2002, it turned out that a municipality (Dunafalva) was two years late in paying 14 invoices, and six months late in paying 18 others. Upon initiation of the debt adjustment procedure in Sata, large numbers of invoices that were 60–90 days late were discovered. We assume that this phenomenon is repeated in many places in Hungary, but in a cynical manner the local assembly ignores its obligations under the law, while the creditors do not take

Károly Jókay – Katalin Veres-Bocskay

Only in Hungary: experiences with municipal debt adjustment and suggested regulatory changes

Reforming Hungary's government sector seems to be an unavoidable task. A competitive economy does not exist without modern public finances. (Kovács, 2006). The State Audit Office outlined a possible path to reform in 2007.[1] Local government (or municipal) reforms play important roles in these theses. Increased financial discipline is part of these reforms.[2] Municipal reform proposals to date did not pay much heed to the legal institution of municipal debt adjustment. We will attempt to generalize our observations of municipal debt adjustment in Hungary, and attempt to show how slight modifications to the law may result in stricter financial discipline in the local government sector.[3]

Hungary is the only European state – perhaps with the exception of cantonal legislation in Switzerland – that has a municipal debt adjustment process in its statutes that is supervised by a court-appointed independent bankruptcy trustee.[4] In Slovakia, Latvia, Romania, the Russian Federation or Estonia, the Treasury or Finance Ministry, or a state institution, intervenes directly into the affairs of an insolvent municipality.

The 1991 Act on Local Self-Government (Act LXV) stated:

- A municipality may be declared to be insolvent by a county court upon the request of creditors or suppliers;
- In order to restore solvency, the municipality must suspend the financing of all activities and services that are not serving basic functions or exercising public authority on behalf of the State.

These clauses of the local government law were practically impossible to implement over time. Starting in 1995, more and more municipalities signaled that their budgets were not in balance, and have protracted solvency problems. Policymakers decided to regulate the legal indebtedness of municipalities in several steps. On one hand, the local government law began to regulate the maximum debt of municipalities in 1996. Of course, these regulations did not apply to debt already on the books, but they did prevent future financial instability.

In a second step, the Parliament passed the 1996 Act on Municipal Debt Adjustment (Act XXV). Experience has shown that local governments experiencing financial difficulties need assistance in making adjustments, and vital public services are in the public interest and may not be degraded. The lawmakers had three goals: to restore financial solvency at the municipal level, to ensure the provision of mandatory municipal functions, and of course, to satisfy fully, or at least proportionally, the claims of creditors and suppliers. An additional policy goal was to encourage both the