



Taxes as intergovernmental revenues¹¹⁵

§ 1. Intergovernmental levels

Fiscal federalism provides for the distribution of functions and fiscal capacity among different levels of government. It concerns fiscal functions such as raising revenues and making expenditure decisions. Local governments usually need more funds than are usually generated from its own efforts. Central governments levy taxes and use this revenue to equalize fiscal capacity of local units. The fiscal responsibility is mixed among the levels of government. Democratic decision making and control are parts of fiscal federalism. The relationship between central and local governments is the starting point for the decentralization debate. This issue was focused very much at the beginning of the systemic transition period in 1990s. Simultaneously, this subject involves the dilemma of separating political values and economic efficiency. Currently, there is a need to devolve authority to lower units for delivery of services, as the lower units lack in most instances the fiscal capacities to assume these responsibilities. The context in which intergovernmental fiscal decisions are made depends on what the functions of sub-national units are. According to Sharpe, there are three functions of local governments such as defence against abuse of central power, provision for popular participation in government decisions, and being an effi-

¹¹⁵ Research presented in this chapter is also based on the investigation of MTA-DE Public Service Research Group (Research Group of the Hungarian Academy of Science and the University of Debrecen) on Regulation of Local Public Services (2012-2016).

cient provider of services¹¹⁶. The dilemma faced is that there is a conflict between how democratic the decision making process should be while still providing services at an economical and efficient level. The Hungarian case shows either clear preferences or radical neglecting of the former priorities.

Fiscal federalism means the distribution of functions among different levels of government. It includes the most important fiscal function: raising revenue. Local governments usually spend more than their directly obtained revenue. Central governments levy taxes on local revenue sources and partly use the realized income. Thus, the fiscal responsibility becomes mixed. Therefore, democratic decision-making and control is indispensable in a democratic system. It is realized by the ruled mechanism of fiscal federalism which involves organizational, economic, and fiscal mechanisms at the same time.

In general, fiscal federalism is a means to guarantee effective independence of sub-national units. The national (federal) level always has an influence on local and regional incomes and spending through the system of taxation, grants and regulations. Fiscal federalism provides the linkages between these different levels. It provides principles and practical means for effective central influence within the democratic system. Fiscal linkages also exist between the European level in the framework of the European Union and member states, including their regional and local levels.

There are different reasons which necessitate the need for national influence. One stems from the need for fiscal unity of every independent country. National taxes are applied in a uniform way so that all citizens are compelled to contribute to the national needs. The second equalization, which is important for the various areas of countries with different social conditions and levels of economic development. The third one is the impact of externalities, which is also substantial. The delivery of local functions has an effect on other government units. These effects can be positive in the construction of roads, bridges, hospitals, and schools, or perceived to be negative such as in the case of the building garbage disposal areas, prisons or nuclear power plants in a particular neighbourhood. For this reason, cooperation between different municipalities and the coordination of policies between regional and national levels is very important. Coordinated fiscal policies help to distribute advantages and disadvantages throughout the country on an equitable basis.

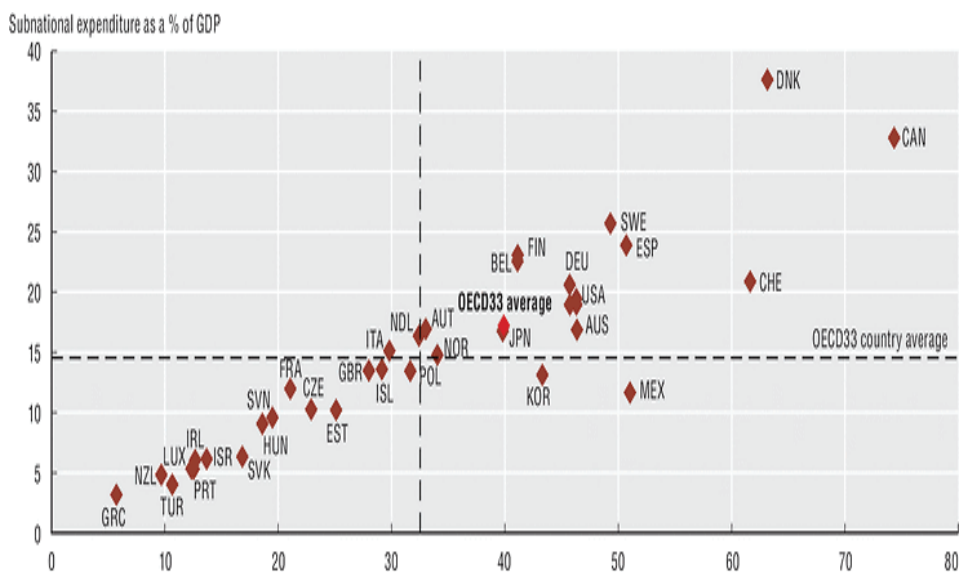
¹¹⁶ J. Sharpe, *Local Government: Size, Efficiency and Citizen Participation*, Strasbourg 1994, p. 20.

§ 2. The extent of sub-national finance

The scope of sub-national finance can be measured in different ways. The more expanded the local and regional financial capacity, the more important may be the tasks and responsibilities that are given to these governments.

The total sub-national expenditure is related in many respects to the general overall government expenditures. This data can be compared with respect to general government expenditure as a percentage of Gross Domestic Product. The relationship of GDP to government expenditure illustrates the real size of the state financial dimension. The relationship with general government expenditure helps categorize the structure of the state expenditure and its distribution of functions between central and local levels. See Figure 1 showing comparative data.

Figure 1.
Sub-national government expenditure as a % of total public expenditure and as a % of GDP, 2012



Source: OECD Regions at a Glance 2013¹¹⁷.

There are significant differences between the Scandinavian countries, which traditionally spend more through local governments. The politically more con-

¹¹⁷ See on: <http://dx.doi.org/10.1787/888932913969>, (access date: 29 October 2015).

servative nations generally limit the allocation of funds to local units. At beginning of the transition period in 90s sub-national responsibility was growing in Central European transition countries¹¹⁸. As far as data show this trend has already changed in some cases, especially the Hungarian one, because of significant decrease.

The main forms of financial transfers are as follows: taxes, grants and user charges. According to the narrower meaning of transfers, they are only grants (and subsidies) simply. User charges are unique in this list of revenue collection, because require a central or higher government approval.

Taxes are levied centrally or locally. Local taxes go directly to the local government. These revenue sources are typical of a decentralized system. However, the amount of local tax revenue may be limited because the national government regulates rates of these taxes. Practically all of the central taxes are collected at the taxpayer level. Therefore, in the case of central taxes, collection is a type of redistribution or equalization among different municipalities. Municipalities vary greatly in their ability to produce tax revenue. They depend on their inhabitants' wealth and local economic factors. The more centralized the taxation system, the smaller linkage exists between the locally collected sources and local spending. A portion of central taxes is often a revenue shared between the national and sub-national levels. The proportion of shared revenue is significant from the point of view of the extent of intergovernmental financial transfers. Tax revenue may be shared on the basis of the source, or on the basis of a formula that equalizes revenue among the sub-national units. In the first case, the proportion of the centralized share is large and it limits the linkage between the locally collected sources and public spending decisions. Shared taxes are also used for equalization among different units of governments. It is also important between the levels of government. It is necessary in the case where the level of self-government does not have its own sources or does not have enough sources of revenue.

Taxes as revenues cannot be understood without grants. Grants are also sources of government expenditure but there may not be any linkages between the source of the revenue and expenditure. Grants serve different functions in the local government finance of decentralization. First, the equalization function guarantees that less wealthy areas can finance an acceptable level of services despite limited tax resources. Second, the impact of different government functions on areas differs considerably from one to another. This is the case where a main road passes through the residential area which is used by non-residents

¹¹⁸ R.M. Bird, R.D. Ebel, C.E. Wallich, *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, Washington 1995, p. 443.

of the municipality. In this situation externalities can be equalized as benefits and costs of local government activities spill over the local boundaries and influence other places, causing unexpected benefits or damages. Grants can compensate for these impacts.

Grants are made on the basis of specific policies. Preferences are prioritized and added to other sources from different levels. The decisions on transfers are decided on in public forums. Rules are decided on in advance as an application is required and the specific decisions are made within the authority of the unit of government. In principle, this is a guarantee against bias and potential lobbying activity from special interests.

In sum, grants serve as a balancing mechanism between the levels of government or different areas of a country by providing preference to poorer areas with less revenue. In order not to allow local governments to levy or collect taxes at minimal levels and to maximize their grant income, grants can be used by central governments to encourage local expenditure for particular purposes. This pushes municipalities to use their own sources in addition to the grant from the central government. Therefore, the higher unit is responsible for the crucial determination of targets for grants.

User charges are also forms of financing. The long history of transition countries demonstrates that these sources may also be considered as transfers depending on the decision regarding which level of government may collect them. In communist countries, most urban services such as water and sewerage, central heating, solid waste collection, as well as education and health were free or the price was symbolic in the case of rental flats or public transport. Some services were subsidized centrally, particularly electricity and gas. In the process of transformation giving these revenues 'back' to local governments has become a decision of financial transfers. This process is composed of several steps. First, starting from the 90s, the prices were to be liberalized in the public sector. This was important even if the state enterprises were the only providers. Second, conditions for competition had to be established. An emerging market with privatization for these services parallel with the multiplying number of service suppliers provided an opportunity to decide about that application of user charges.

In principle, user charges are good for some different purposes of local government. These include:

- covering costs;
- maximizing revenues;
- an incentive for economical use.

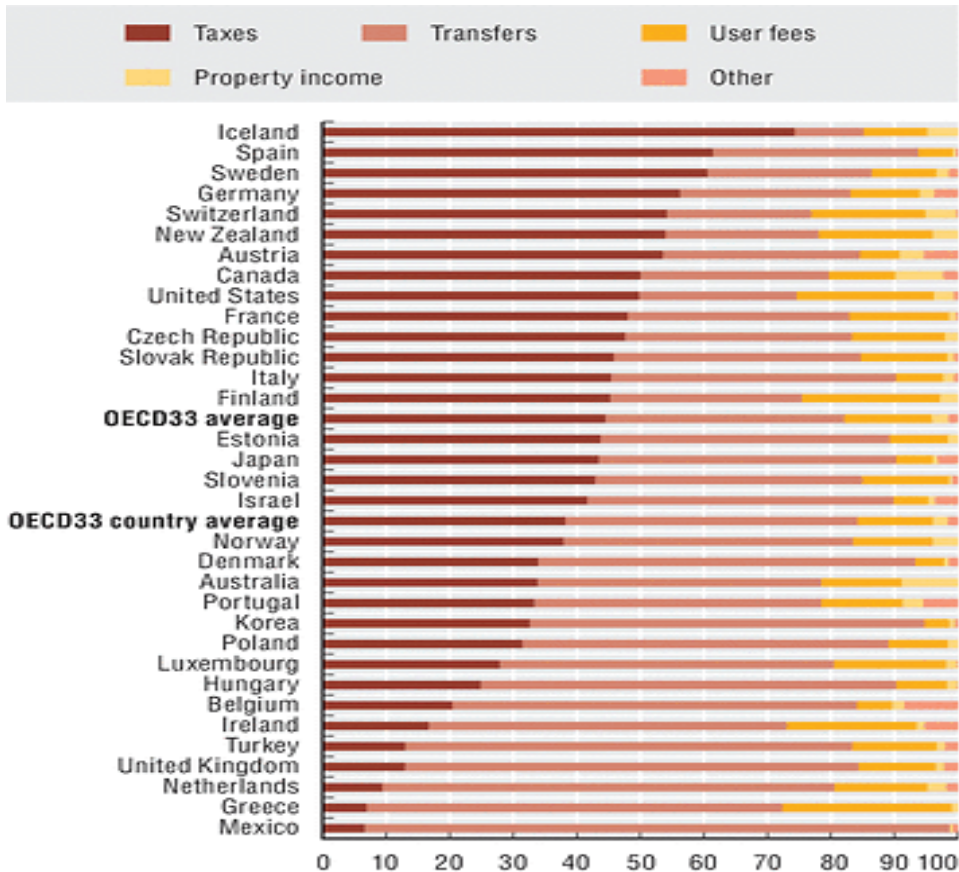
According to the theory, the importance of user charges lies in the fact that municipalities can behave as service providers¹¹⁹. It means that the correct (roughly marginal cost) price is achieved for public consumers. However, it is nearly impossible to introduce user charges in all services. Several conditions must be met. First, a measurable output is necessary. For instance, health and education costs are difficult to direct toward a specific user or beneficiary. Benefits from the services should be measured directly with reference to the user. This is impossible in some public services like police or fire protection where the benefits are not realized or not exclusively realized by the direct recipient of the service. Second, the excludability of individuals from receiving the service or benefit is important. In general, persons who do not contribute to the production of a service should be excluded from enjoying it. However, this is impossible to do with many services such as social care or education. Third, the character of consumption should be analyzed from the point of view of user charges. The user charge should be appropriate to the amount consumed. In the case of water it would not be appropriate to use a property tax as property does not necessarily relate to the amount of water consumed. Consumers would not adjust consumption of water under a property tax, and would actually be encouraged to be wasteful. Consequently, a charge based on usage would be more fair and would discourage wasteful consumption. The implementation of user charges is clearly a public policy decision. General taxes can be chosen as well, but the question in every case should be which type of transfers is the better to reach the preferred policy goal being consistent with basic principles of taxation.

Figure 2 shows the proportion of transfers in different countries. Revenue of general government comprises tax revenues (own-source and shared tax revenue), grants and subsidies, user fees and tariffs, property income, and other like social contribution.

In the Visegrad countries, i.e. in the Czech Republic and the Slovak Republic the proportion of tax sources is higher than the OECD average. Hungary and Poland are under this limit. In contrast, the ratio of grants and subsidies is higher. Generally, the smaller the proportion of tax sources, the more grants and subsidies are in the local revenue structure.

¹¹⁹ R.M. Bird, R.D. Ebel, C.E. Wallich, *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, Washington 1995, p. 443.

Figure 2.



Source: OECD Regions at a Glance 2013.

Statlink¹²⁰: <http://dx.doi.org/10.1787/888932914007>.

§ 3. Local Units of Government

According to Sharpe, most of the countries significantly reduced their number of municipal units in the second half of the twentieth century¹²¹. However, not all of them. It depended on the model of local self-government. The main

¹²⁰ Access date: 29 October 2015.

¹²¹ J. Sharpe, *Local Government...*, p. 20.

impetus for reduction was the belief that by consolidating these units greater economy and efficiency could be achieved in the delivery of services. The values of economy and efficiency dominated over the political units of a size that is conducive to citizen participation in local decision making. It is assumed that small units of government, population wise, provide for greater democratic participation and increased power to individuals. In some of the transition countries, large numbers of small size local units create service difficulties and force the intergovernmental fiscal system to provide additional resources than might otherwise be necessary. On this challenge different answers have been made. Otherwise, Page and Goldsmith classified two basic groups of Western European unitary states according to their systems of local government¹²². In the northern region of Western Europe municipal systems are termed integrated. This means that the political boundaries of local units do not follow the geographical boundaries of settlements. They have been adjusted to the rationality of service provision. This is why a smaller number of units with larger population have been created. The large cities are units of local authority as well as geographically unified areas. On the basis of this philosophy small local units have been merged and large self-governments have been established. In contrast to this model, in southern unitary states of Western Europe the reform of the Napoleonic state was realized without any organizational integration. Many municipalities exist and typically every settlement has its own self-government. However, the service providing system capacities are established at different levels of government (three or four tier systems) with a relatively wide range of associations among small municipalities. The autonomy of rural and urban units is very important from the political point of view. This is called the non-integrated system, underlining the administrative character of these systems, as opposed to the defined autonomy for small communities.

These systems are compared in Table 1, according to the indicator of average population of their basic units of local government.

What is the connection between the level of integration and fiscal capacity of the system? To answer this question compare Table 1 with Figure 1. Let us call the system in the countries under 10,000 average inhabitants at the basic level of local governments a non-integrated system. The total fiscal capacity is lower in this group in general. There is an exception of the United Kingdom, which is also in this cluster, notwithstanding its extremely integrated structure. The explanation might be the traditionally limited (but strong in this framework) position

¹²² E.C. Page, M.J. Goldsmith, *Central and Local Government Relations: A Comparative Analysis of West European Unitary States*, London 1987, p. 179.

of the state compared with the public as a total in this country. Federal states are a different issue because Lands, etc. are also subjects of decentralization, but these are not additionally represented to our local community based statistics.

Table 1. Basic units of local governments in the member states of the European Union, 2013

| Country | Number of local governments at the basic level | Average population of the basic level |
|----------------|--|---------------------------------------|
| Austria | 2 357 | ~ 3 500 |
| Belgium | 589 | ~ 18 000 |
| Bulgaria | 264 | ~ 26000 |
| Cyprus | 523 | ~ 1 900 |
| Croatia | 576 | ~ 8 000 |
| Czech Republic | 6 250 | ~ 1 600 |
| Denmark | 98 | ~ 57 000 |
| Estonia | 226 | ~ 5 600 |
| Finland | 336 | ~ 16 000 |
| France | 36 682 | ~ 1 800 |
| Germany | 13 299 | ~ 6 500 |
| Greece | 325 | ~ 33 000 |
| Hungary | 3 175 | ~ 3 200 |
| Ireland | 85 | ~ 56 000 |
| Italy | 8 094 | ~ 7 600 |
| Latvia | 119 | ~ 20 000 |
| Lithuania | 60 | ~ 59 000 |
| Luxemburg | 106 | ~ 4 900 |
| Malta | 68 | ~ 6 900 |
| Netherland | 418 | ~ 41 000 |
| Poland | 2 479 | ~ 15 000 |
| Portugal | 308 | ~ 2 500 |
| Romania | 3181 | ~ 6 900 |
| Slovakia | 2 792 | ~ 1 900 |
| Slovenia | 211 | ~ 9 400 |
| Spain | 8 117 | ~ 5 800 |
| Sweden | 290 | ~ 31 000 |
| United Kingdom | 466 | ~ 136 000 |

Source¹²³: <http://www.ccre.org/en/>.

¹²³ Access date: 29 October 2015.

§ 4. Local Taxation

1. Tax assignments are based on providing taxing power to local jurisdiction

There are different ways of assignments. One is to give tax basis to self-governments and allow them to decide for what they spend it. This right involves also collection and administration of the financial source (own source local taxes). The other way is when tax bases and rates are assessed by the territorially relevant local governments, but the collection and administration are done centrally. These sources are frequently shared between central and local levels (shared revenues). Shared revenues are important from the point of view of the decentralized autonomy according to the European comparative experience. The Hungarian development is an example of gradual negligence of this opportunity. Table 2 shows elimination of shared taxes in 2010s.

Table 2. Centrally allocated revenues of local expenditures in Hungary, 2011–2016

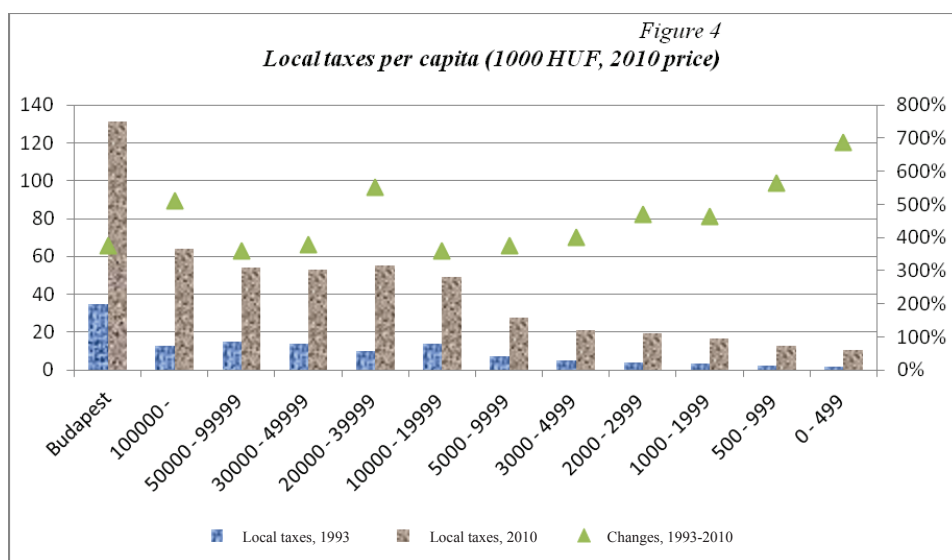
| <i>1000 MILLION HUF</i> | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Normative grants | 582,1 | 473,1 | 504,3 | 574,6 | 542,4 | 552,6 |
| Normatively addressed grants (for functions) | 183,8 | 173,2 | | | | |
| Centralized spending | 80,9 | 74,9 | 43,7 | 94,3 | | |
| Supplementary grants | 41,7 | 44,7 | 56,8 | 39,2 | 113,6 | 107,1 |
| Other grants | 17,7 | 14,0 | 5,3 | 7,7 | | 2,0 |
| Addressed grants | 63,0 | 81,9 | 64,8 | | | |
| <i>Shared revenues with regulated equalization</i> | 226,3 | 204,8 | - | - | - | - |
| Proportion of central sources (%) | 37,2 | 40,2 | 29,9 | 28,6 | 26,5 | 26,5 |
| Local expenditures as a % of GDP | 11,5 | 9,3 | 7,6 | 7,9 | 7,4 | 7,1 |

Source: Hungarian central budget accounts (2011-2013) and planning (2014-2016); Eurostat, cited Péteri, 2015.

2. Own revenues of local jurisdiction

Own revenues consist of locally levied taxes, user charges and revenues from municipal property. Since the transition, the importance of local taxes has been increasing. As far as the Hungarian case is concerned, this process is shown in Figure 4. It is visible that the importance of local taxes is increasing. This trend is continuous also in the 2010s under conditions of functional decrease (because central subsidies are diminished).

Figure 4.



Source: Horváth, Péteri and Vécsei¹²⁴.

Local taxes in Hungary are based on Act C of 1990. After the system transformation there was a fixed pool of objects by the law, and the selection among them was the right of local bodies. In this legal environment property taxes, communal taxes and business tax could be levied. Nowadays, property taxes may be levied on buildings and un-built sites. Residents may be burdened by communal taxes. There is also an option on tourism tax. Business tax is the best revenue for local governments: about 80 % of sources from local taxes is from here.

¹²⁴ T. M. Horváth, G. Péteri, P. Vécsei, *A helyi forrásszabályozási rendszer Magyarországon. Közgazdasági Szemle, Vol. LXI., No. 4/2015., pp. 121–147.*

Almost all of the municipalities draw revenue from local taxes. The most popular form is business tax for municipalities. However, the average amount of revenues is very different country-wide according to the inhabitants' income. In rich areas a relevant sum of money may be collected, in poor ones there is not enough paying capacity. As in general, it is also a regional problem in this country.

A new phenomenon in the Hungarian system is that local governments are entitled to levy taxes on other objects, not prescribing directly in the law. It is also prohibited to build up the paying obligation on original local taxes. These settlement taxes are levied, depending on the will of representative bodies, on different objects such as land, dogs, etc. However, among local revenues, the weight of business tax has remained on the top.

Apart from levying, also collection of local taxes is the right and obligation of municipalities. In these circumstances, mayors' offices work as tax authorities. The importance of cooperation is most apparent in the case of business tax in order to prevent undertakers from avoiding the fulfilment of their financial obligations.

3. Type of local taxes in Hungary

Recently, there have been two groups of locally levied taxes in Hungary. One is 'classical' local taxes as regular sources of decentralization which were established in 1990 at the beginning of the system transformation. The other group consists of so-called 'settlement taxes' which come to force from 2015. These latter ones are limited as far as spending is concerned.

Classical local taxes are prescribed by central law and they may be chosen by representative bodies. In Hungary, these are as follows:

- o property taxes
 - building tax
 - tax on un-built sites
- o communal taxes
 - communal tax on households
 - tourism tax
- o income taxes
 - business tax

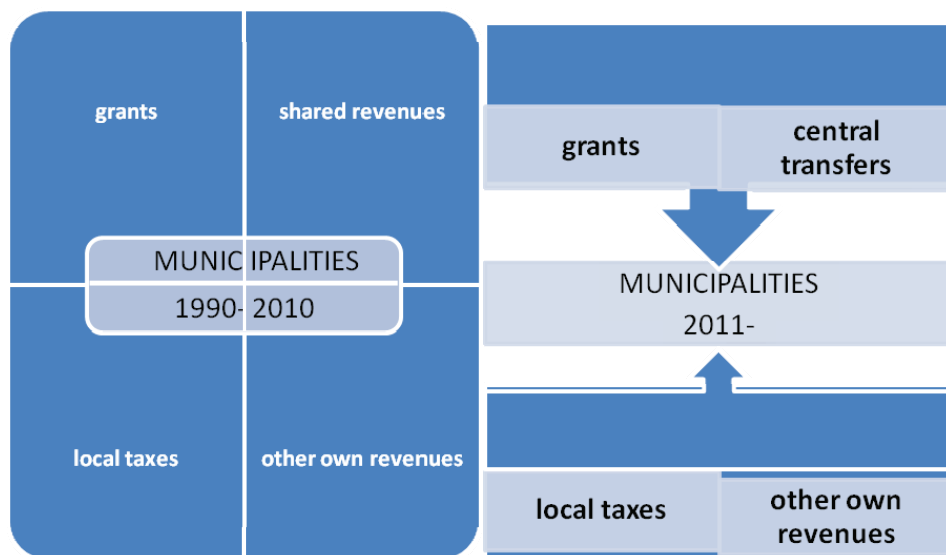
Out of 3178 municipalities 3135 levied at least one of the local taxes in 2015. Business tax is preferred by most of them (2767), then communal tax on

households (2250). Building tax (892), tourism tax (784) and tax on sites (503) follow in the list¹²⁵.

Settlement taxes are not restricted according to their subject. However, it is prohibited to burden the same objects or activities which have already been burdened by other laws. Experience shows that, these are most popularly levied on (agricultural) land and dogs. There are also examples of high buildings, agricultural vehicles and local roads¹²⁶. These sources are allowed to cover only purposes of development or social tasks.

How popular are locally levied taxes? Almost all of the municipalities introduced at least one of classical taxes in the period of the last quarter of century. In contrast, the settlement tax is quite unknown and some of the elements of the regulation are under discussion. Out of total 3178 local governments only 116 are involved. That is why municipalities seem to be still quite reluctant to levy this type of taxes because they must be afraid of legal conflicts.

Figure 5.
Comparing models of revenue systems in local regimes in Hungary



Source: Edited by the author (T.M.H.).

¹²⁵ P. Bordás, *Ki mint vet, úgy arat – de lesz mit? Gondolatok a települési adó bevezetéséről*, in: The Blog of the MTA–DE Public Service Research Group, www.kozjavak.hu, No. 03.08.2015.

¹²⁶ Ibidem.

Currently, local taxes simply supply revenues from the bottom, which, in turn, are supplemented by the sources from the top. The decentralization option for representative bodies is more and more restricted in this country, neglecting seriously the tradition of system transformation in the period of 1990–2006. Changes took place formally in 2011. The new system of fiscal regulation started on 1 January 2013. Old and new models are compared in Figure 5.

As it is seen in Figure 5, shared tax income revenues disappeared, only symbolic amount remained at a local level. The largest one is 40 percent of the centrally levied but locally collected vehicle tax. Notwithstanding this one and some other smaller items, centrally defined transfers are introduced instead. Grants have also been changed. They used to be normative but now they are not. Some of local (settlement) taxes are restricted only to allowed spending. With reference to the taxing process, local authorities preserved their collection power. Therefore, mayors' offices remained tax authorities.

However, as Figure 5 shows, financial sources have already become very centralized. Taxing power as basic criteria of local self-governance has been restricted. Independence of local decisions is limited especially from the financial point of view. Local authorities used to be local governments but now they are not, and we can say that in Hungary there are simply dependent agencies.

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TAX AUTHORITIES IN THE VISEGRAD GROUP COUNTRIES

Common experience after accession
to the European Union



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