CASE STUDIES

Intergovernmental Fiscal Relations and Local Financial Management Course

September 13-19, 1998
Council of Europe Conference Center
Budapest, Hungary

Organized by the Council of Europe, Economic Development Institute of the World Bank, and Fiscal Affairs Division of the Organisation for Economic Cooperation and Development
There are two dramatic changes taking place in Central and Eastern Europe. The first and most discussed, is the dismantling of the command economy inherited from forty years of the dominance of the Soviet Union. It is economic decentralization that combines the movement toward free markets and integration into the global market place with the creation of a civil society whereby, as free agents, citizens are free to associate politically and economically.

The second is the equally important fiscal decentralization of the public sector—the sorting out of the roles and responsibilities among of governments. This transition is from one of a functionally single tier whereby local governments functioned as agents for carrying out the fiscal plans of the central government and its ministries, to the sorting out of roles and responsibilities among autonomous governments. The success of the economic revolution is inextricably tied to the success of the fiscal.

In all countries the structure of intergovernmental finances affect the degree to which the public sector can mobilize resources and, in turn, promote allocative efficiency for the nation as a whole. In addition, for countries undergoing the transition from socialism, the structure of intergovernmental reform influences the conditions for macroeconomic stability, provision of the social safety net, and the extent and pace of privatization.²

If the fiscal decentralization process is done well, there are significant benefits to be gained in terms of a reduced overall public sector size, economic growth, lower cost of public services, and establishment of a system that the citizens can understand and control. However, if implemented badly, the efficiency and accountability outcomes can be perverse.³

Hungary is doing it well. Indeed, in many ways it serves as a model for not only the region, but also other parts of the world that are embarked on some form of sorting out fiscal power among central and subnational governments. Although the process is still very experimental, as fiscal decentralization always is and will be, what has happened in the past five years is revolutionary.

Legal Framework

Hungary was the first among the countries in the region to reform its fiscal and intergovernmental system. In the late 1980s it pioneered in replacing corporate and
commodity taxes with a value added tax and personal income taxes similar to those of Western Europe. Then, between 1990 and 1996 the Parliament enacted a series of reforms, addressing a catalog of issues any decentralizing nation must face. Among these issues are: how many and what type of subnational governments should be established? Once established, how many of the tasks once performed by the Center should be transferred? What revenue authority should be devolved, and should this authority be shared fully transferred? What type and amounts of assets should be transferred? Should the new local government be burdened by debt? And, still at the center of much of today’s debate, should the system of new subnational governments have a hierarchy?

Again, Hungary was a pioneer, this time taking the lead (in 1990, with Poland) in enacting a fundamental law establishing local self government. Patterned after the Council of Europe’s European Charter, the 1990 Law on Local Self Government (LSG) established the framework for a modern, public sector. One of the first steps was to abolish the 1,523 local councils that had functioned as the agent for carrying out central governmental fiscal orders through a system of 19 country councils. Budapest enjoyed a special status as county and municipality, and thus, was directly represented in the central government planning process. Although the councils had some tax and fee authority, the level of spending framed by a so-called expenses-oriented financial regulation whereby local resources were adjusted to a centrally determined expense number with central and subsidies then defined as the difference between receipts and expenses. One important result was that the fiscal condition of a locality often depended on its ability to negotiate transfers from the center, resulting in a system of “soft budget constraints.” Moreover, local governments could be combined with other localities without their consent.

The Law on Local Self Government abolished the local councils and dramatically scaled back the responsibilities of regional bodies (the nineteen counties). To replace the local councils, citizens were granted the right to create autonomous self governments. Driven in large part by a political imperative to “un-do” the old system, the local councils broke up into discrete units such that there are now 3,169 local governments (initially 3,115). For agglomerations of 50,000 or more, twenty two “cities of county rank” have been established. Budapest was established as an autonomous municipality, though at the same time twenty-two (and, as of 1995, 23) general purpose district governments (the boundaries patterned the local councils) were established within the Budapest boundaries (Table 1.)

The Law on Local Self Government was the first of eight laws that now frame the Hungarian intergovernmental system and lay out the terms whereby all local governments (including the capital city’s 23 districts) are autonomous. The others (enactment year, as amended) include the laws on Local Taxes (1990), Elections of Self Governments (1990); Property Transfer Act (1991), the Tasks and Authorities Competencies Act (1991), the Capital City and Its Districts (1991), Municipal Bankruptcy(1996), and Debt Management Act (1996).
The laws

- Establish that local governments are no longer agents of the center and its ministries.

- Adopt the principle that local governments should be public service entities with assigned tasks and local taxing powers as opposed (to the much debated alternative of) a business type municipality whereby local taxes would be supplemented by revenues coming from government owned enterprises. 7

- Accept the general principle of subsidiary embodied in the European Charter that public services should be supplied by the smallest unit of government that is administratively and economically capable of doing so.

- Establishes sets of mandatory vs. voluntary tasks to be carried out by municipalities

- Accept the principle that the law can oblige municipalities to perform certain tasks, but that the relationship should not be one-sided and should be accompanied by some form of fiscal or other assistance.

- Make judgments on performance standards of voluntary tasks a local citizen responsibility

- Allow for local own-tax authority

- Establish that local governments have ownership rights

- Allow (indeed, encourages) local governments to enter into associations with one another

- Detail a step-by-step process for municipal bankruptcy proceedings (including the authority for “work-outs” for avoiding potential bankruptcy)

The remainder of this chapter examines the features of the Hungarian reform in terms of both the general parameters just listed and the major policy issues that are now the subject of policy debate. The paper first examines the functions of subnational (e.g., municipal) government, and then proceeds to a discussion of municipal budget trends and the municipal credit market. These discussions set the stage for the next section, which focuses on the issues that frame the Hungarian intergovernmental debate: strengthening own source revenues, the implementation of the central government’s major tool for achieving horizontal and vertical equalization (the normative grant), and the issue of
there are too many local governments. The chapter concludes with comments on the agenda for reform as Hungary enters an era in which it discards the "transition" label.

Functions of Local Government

Expenditures

The Law on Local Self-Government Act (Chapter II, Article 8) assigns a set of mandatory and voluntary tasks (competencies) to municipal governments. The municipal government is obliged to provide safe drinking water, primary school education, disposal of wastes, basic health and social welfare provisions, public lighting and the maintenance of (local) public roads and centuries. It is also obligated to enforce the observance of rights of national and ethnic minorities.

Among other tasks (not all of which may be mandatory) are the provision of 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.

This allocation of spending responsibilities is, in concept, consistent with that of most well-functioning intergovernmental systems throughout the world. It also is generally consistent with the roles the local councils played as the center's agents under communism. But there are two fundamentally important differences between the old and the new as made clear from the 1990 legislative debates. The first is the explicit recognition of the European Charter's subsidiary principle as the vehicle for promoting both economic efficiency in the allocation of resources. The second is the coupling of these assignments with laws on free elections as a mechanism for assigning accountability to the citizens and the officials they elect.

Moreover, there is a good deal of flexibility in the nature of the service delivery. Thus, local governments are not limited to the mandatory and voluntary services lists since they may take on any functions not specifically granted to another government. Moreover, a municipality may oblige a county to take over institutions with territorial duties.

Moreover, even for those services that are mandatory, there is no attempt by the central authority define the meaning of mandatory, either in terms of a minimum service delivery requirement or in terms of how local services should be supplied. Thus, for example, in Dunavarsany the mandatory requirement to provide basic health services is met by the community contracting with family physicians to offer services as entrepreneurs in the community. The municipality provides an office and pays a basic fee to the physicians, but, beyond that, the payment relationship is between doctor and patient.
Recurrent Revenues

The 1990 reforms also recognize the need to establish a system of local taxation as indispensable to provide for the independent management of local governments. Provision is made for six types of recurrent revenues: central-local grants, sharing of the centrally levied and collected taxes, social security fund transfers earmarked for health services, own-revenues including certain taxes and fees, profits from entrepreneurial activities. In addition there are non-recurrent receipts from the privatization of housing transferred from the center local governments. The details of the scope and nature of these revenues have been adequately addressed elsewhere. To summarize:

The Grant System

There are three major types of central-local grants that taken together account for nearly two-fifths of municipal revenues. The most important of these is the unrestricted, formula-based normative grant, which has ranged 60% to 80% of total grants (Table 3). Due to its flexibility as well as quantitative significance the normative receives most of the attention in fiscal policy debates.

The amount of the grant as well as all aspects of the formula (number, type and amount) is negotiated annually. The amount is set each year in the Budget Act, and takes into account factors such as the central government’s estimates of other central to local transfers and estimates of low own-source revenue generation. The elements in the distribution formula—the “norms”—are based on number of units served by function (e.g., per capitation measures based on students, persons, inhabitants). Such a per/unit approach has the dual advantages of simplicity and transparency thereby minimizing the need for bargaining for grant funds between the center and the locality. The number of norms has changed over the years, from 12 in 1990, 27 in 1994, and 21 in 1997 (Table 2). The values assigned to each norm are related to estimates service delivery costs, with an average norm: cost ratio of about 60 percent. Although many local officials tend to think of the norms as a form of earmarking—e.g., if an amount is allocated on the basis of 60,000 forints per kindergarten child, the funds should spent on that activity—the key feature of the normative is that is that the grant is fully unconditional.

The remaining grants are directed in a manner deemed in the national interest. The most important of these other grants are the class of targeted and addressed subsidies. Both types of grants are made for investment purposes. Closed ended, the targeted grants are matching grants (normally 60 percent central, 40 percent local), allocated by the Ministry of Interior following a needs review. Although there is an excess demand for targeted grants, once awarded initially about 6 percent of the funds remain undistributed as municipalities either fail to make the match or prefer to use their money for some other functions. To the extent there exists some undistributed funds in the initial allocation, these funds may be re--allocated to other municipalities such as those determined to be in...
fiscal stress. For the 1991-95 grants have been directed largely to investments in water and sewer systems (63%), education (18%), and health and social facilities (19 percent).

Addressed grants fall under the jurisdiction of the Parliament various ministries and are usually accompanied by full central financing. Although there is generally no matching requirement, the funds must be used as directed by law (i.e., for a specific project such as hospital or school construction, etc.) as the ministry directs. Here the mix has been largely for health and social facilities (73%), education (13%), and water and sewer (10%).

Shared Taxation

There are two shared taxes, each fully controlled and administered by the central government. The first is the personal income tax (PIT) collected from the residents. Initially (1990), 100 percent was distributed to localities almost entirely on the basis of origin (place of collection). The local share then fell to 50 percent in 1991 and 30 percent in 1994, 38 percent in 1997; and 40% in 1998. At the same time that the share has been decreasing, an increasing amount has been earmarked on an equalizing basis (where a component is said to be horizontally equalizing if it is based on criteria that falls outside the control of local government—e.g., general grants for villages and for municipalities in distressed areas). Initially fully origin based, by 1996 the equalization share had grown to nearly a third of the local share. Plans are already in effect to continue this shift toward equalization using the PIT vehicle.

The administrative arrangements for distributing the local share of the PIT merit brief comment. The Tax and Financial Audit Office (APEH) calculates the taxes based on returns filed by individuals and information filed by employers (not all individuals must directly file). Once collected, the taxes are then distributed to localities through a set of administrative bodies (TAKISZ). The TAKISZ distribute the shares for each municipality based on the income tax data provided by APEH, a process that leads to a two-year lag between tax collection and distribution. This has the great disadvantage of eroding the real value of the transfer (dramatically in the case of Hungary—Table 3), but, a salutary effect for some municipalities of moderating the impact of a significant downturn in economic activity.

The inflation erosion effect can be addressed by making compensating adjustments in intergovernmental grant policy, a practice that serves to emphasize the view that the shared PIT and the grant system work generally as a fiscal package.

The second shared revenue, the motor vehicle (engine) tax, is an acquisition fee on vehicles brought into a locality. Initially fully local, the revenues are now split evenly between the local authorities and the central treasury. Not to be confused with the with the local fee on a transfer of motor vehicles (Table 4), this is not an important revenue producer.
Own Source Revenues

Through the LSG the Parliament has granted authority for taxes on (i) a business receipts (ii) property; (iii) transient accommodations (e.g., tourist taxes); and (iv) lump sum communal levies on local residents (e.g., tenancy rights or rental contract) and businesses (average number of employees). In addition it authorizes fees on motor vehicle transfer (noted above), on the acquisition of property, and for administrative duties. The tax authority is municipal. The acquisition and administrative fees are administered and collected by the county and as a rule, split evenly between the counties and the 22 cities of county rights (50%) and the central government (50%).

What is noteworthy about the group of municipal taxes is that, taken as a whole, they are simply not very important the local budget. Local taxes account for less than six percent of total local revenues, below that of most European neighbors (Poland, 26 percent; Romania, 17 percent; Austria, Denmark, Finland, 50 percent; and, France 44 percent).

Moreover, although there are other taxes that might be considered as potential candidates for the local own-taxation in Hungary, they tend to be either administratively unrealistic and, in some cases, an especially bad idea (e.g., a local VAT); inconsistent with the Directives of the European Union, of which Hungary is an associate member (e.g., broad based local sales taxes); or having limited revenue potential (utility surcharges).

The reasons for their limited contribution to local revenues can be attributed to a number of (not mutually exclusive) factors: preemption of the local tax base by the central government (e.g., the PIT and mandated property tax exemptions); central limits on the tax rate (1.2 percent on the business turnover tax), the lack of tax administration capability in all but the largest municipalities, and the operation of the grant system.

Each of these reasons will be addressed in the appropriate next sections of this paper. For now it is important to comment on the fiscal economy of constraints on local taxes. Because local governments operate in open economies, that is, they cannot effectively control the movement of goods and services or factors (e.g., labor, capital) that flow across their borders, the choice of tax instrument is constrained. Thus, just as it has to be legally careful to avoid imposing a tariff, it is economically constrained in exploiting a tax base (e.g., including those it now levies on business receipts) for fear of getting too out-of line with neighboring jurisdictions with which competes for jobs and residents.

At a practical matter, this leads the conclusion that local governments are often restricted in practice to those taxes for which there is a linkage between the payment of a tax and service benefits received (user charges and taxes on property, personal income, business receipts, transient accommodations, and automobile use generally; most this...
test) and for which the tax base is largely immovable (this is the case for strengthening the property tax). Finally, for the efficiency and accountability benefits promised for fiscal decentralization to be achieved, elected local officials must have the authority to determine the tax burden at the margin (the levying of the next forint collected) and be in a position to do so. This fundamental feature of decentralization only requires the ability to set tax rates at the margin. It does not rule out a central role in defining the tax base or in tax administration.

Non-recurring Revenues and Credit

There is a solid rationale for focusing on, and in the case of the central government, monitoring, the topic of municipal creditworthiness and the financial risks of local authorities. In order for a locality to develop economically (create private sector income and growth), it must incorporate into its fiscal planning process a public capital base (infrastructure) that complements and leverages private capital. In order to do that one must use (borrow) other people’s money. This in turn, demands a creditworthy jurisdiction.

There are three public sector axioms that accompany this rationale: (i) recurrent (operating) spending must not be financed with non-recurrent revenues as such a process is not sustainable; (ii) since the benefits of services from capital accrue over time and thereby benefit future generations, both equity (the tax payment obligation) and efficiency (services match benefits) require some debt financing; and, (iii) because it is ultimately responsible for stabilization policy and for monitoring the fiscal viability of the local governments is has chartered, the central authority has a responsibility to regulate municipal borrowing, and debt (bankruptcy laws may suffice).

At present, municipalities generate non-recurring revenues from two sources: sales of assets through the privatization of publicly owned enterprises, and borrowing. The relative importance of asset sales has doubled since the early 1990s, and now accounts for just over half of current receipts. Borrowing, however, has been very modest, and except for one year (1993 and 4% of total receipts), has been 2% or less of total receipts.

That the size of the municipal credit market is small, a fact that is largely part attributable to the regulation that municipalities can only use own sources of revenue to service debts. In practice this has limited debt issuance to all but the largest municipalities and the Budapest district governments. Although there are no legal restrictions on commercial banks (national or foreign) to the municipal credit market, the National Savings and Commercial Bank (OTP) is the dominant player, holding 92 percent of municipal debt. This is in part a hold over of pre-reform days when the OTP was a monopoly holder of the current accounts of municipalities, a position is still largely hold today.
As of March 1995, the credit market was estimated to be about 49 billion forints, with short term loans (one year or less) representing about 65 percent of the market and medium to long term loans (three to seven years) accounting for the remaining 35 percent. Since total municipal capital expenditure was 148 billion forints in 1994, this suggests that the bulk of such spending was financed not by borrowing, but by recurrent revenues. This apparently fiscally conservative behavior reflects two features of the system: the short term nature of most of the borrowing and (even the “long term” of 7 years is short compared to Western standards) and that municipalities, which are not yet able to accumulate capital, rely largely on national grants for capital spending.

At the same time, the numbers serve to highlight the relatively conservative behavior of municipalities. Despite widespread anxiety over municipal borrowing strategies (in 1995 four small municipalities approach bankruptcy), OTP lists only 1.5 percent of its municipal loans as non-performing. This is a much lower level than the norm for the banking system as a whole. 13

Municipal Budgets

Whereas the importance of the sector relative to the total economy has increased from its 1990 level (spending equal to 13.8 percent of GDP) to a decade peak in 1994 (17.1 percent of GDP), it is now exhibiting relative decline (14.9 percent in 1996) and expected to fall to 13.3 percent in 1997 and 11 percent by 2000. The reason for this decline has yet to be adequately explored; but, several explanations exist, the two most plausible being relatively larger growth in the private sector component of the denominator (the share of total government to GDP has been relatively constant), to a reduction in the real expenditures of the sector.

Overall, the position of the local sector has decreased on both side of the budget. In when local government revenues are compared to the cumulative price change in recent years (e.g., 1993-1997est), there is a clear evidence of a decline in the local sector in real terms. The numbers are reveled in the far right column of Table 3, which provides the difference between the nominal percent change in receipts and expenditure by type, and the cumulative price change (Table 3).

What strength there is in the revenue system is largely attributable to receipts from the gross turnover tax on business receipts (see below), privatization of state-owned enterprises (asset sales), and borrowing. Though both these components exhibit large percentage increases in both terms of actual revenues and share to total receipts (Table 4), those increases reflect a low initial base.

Thus, the revenue story is three-fold. The first is the decline in the two largest central transfers, the shared personal income tax (down 55 percent in real terms) and the unconditional “per capita” grant (which has been halved in real terms). The second is...
contribution of borrowing; but again, although the real percentage increase is dramatic (Table 2), the total amount is not large (5.7 percent of total receipts in 1994). The other story, which is not directly revealed in, but clearly implied by, the table is the weakness of local efforts to generate any significant new own-source taxes. Each of these three issues is discussed in greater detail below.

A review of the expenditure side reveals that in order to adjust to falling revenues, the spending data reveals that the declines have been across the board, with the largest cuts in transportation and communications and the health and social sectors. When viewed in terms of capital vs. capital expenditures, the overall story of declining real expenditures is repeated, with capital falling faster than current spending.

**Policy Options**

Two themes emerge from the foregoing discussion. The first is a failure of local to mobilize own-source revenues. The second is the continuing importance to assess the fundamentals of the emerging intergovernmental (central--local) relationships that have been well laid out in statute but that, in practice, still needs substantial sorting out.

Within this five context there are five closely related issues. The first three go to the question of local tax revision (business turnover, PIT, and property tax). The other two are the structure of the normative grant and the size of local governments.

**Business turnover (receipts) tax.**

The local business tax is the main own-source for governments. Largely limited to non-retail business, the tax on non-financial institutions is based on net sales revenues of products sold and services reduced by the purchase value of good sold and value of services provided by subcontractors. In the case of financial institutions the tax is on gross turnover--the total interest received in the case of banks (with a deduction for interest paid) and, for insurance firms, the total revenue with a deduction for claims settled. For all types of business, the tax is apportioned by share business receipts for firms operating across local boundaries. The tax rate may be varied by type of business, as long as it does not exceed a present State mandated maximum of 1.2 percent (or Ft 5,000 per day in the case of occasional activities). Localities may also grant deductions and exemptions for various types of business.

There are few problems with respect to the tax. As noted above, it is consistent with the concept of benefits taxation. And, although there is probably some cascading of taxes --the repeated taxation of value created at earlier stages of the production and distribution process--the effect is probably quite minor in view of the low tax rate. Similarly, although a case can be made for like treatment of financial and non-financial businesses (banks should be allowed a deduction for interest paid and insurance companies a deduction for claims settled), the distortions are probably not large.
The one issue that merits consideration is the cap on the tax rate. As discussed above, with respect to taxes, the essence of fiscal decentralization is that local officials must have choice in setting tax rates (but not necessarily the tax base). Thus one option is to simply abolish the tax rate cap and let localities begin to experiment with rate changes. Under present circumstances the rate could probably be doubled without any major distortions or effects on business activity. If this turns out not to be case—e.g., a locality raises the rate sufficiently to cause a business to relocate some of its investment to a competing jurisdiction—then the tax rate increase can be undone. What is important is to use this one local tax that now “works” as vehicle for implementing the practice of local self-government. At present plans are to ease up on the statutory cap.

**Personal Income Tax Sharing.**

Several studies have recommended that the central government vacate part of the PIT base (e.g., the non-equalizing component of the current locally shared tax) and let the local governments take on the role of, and responsibility for, levying the local portion up to the vacated amount. Central vacating of the tax base is important for the obvious reason of the need to provide room for localities to maneuver without raising overall effective tax rates and thereby undercut the nation’s overall strategies for private sector development and macrostability. Indeed, since not all localities would levy up to the vacated potential (the response of Budapest, which accounts for about half of all present collections would be important to watch), it is likely that this so-called local “piggybacking” of the centrally defined, administered and collected the PIT would lead to a reduction in the total effective tax rate.

The vacating/piggybacking fits the concept of fiscal decentralization as a mechanism for furthering the key national objectives of efficiency and accountability. Again it should be stressed that to move in this direction does not require either local tax administration or local control over the definition of the tax base (which, particularly in the case of administering and complying with tax base sharing, would be another bad idea).

But, there are two caveats to giving localities tax rate setting authority at this time. The first is technical. If PIT piggybacking is to be adopted as part of the Hungary’s intergovernmental fiscal strategy, the manner in which the normative grant is distributed to localities would have to take into account the degree of tax effort (effective tax rate response) of each municipality. This point is further addressed below.

The second is more important: whereas in concept piggybacking is an ideal way to promote more truly autonomous local governments, the timing is not right and probably will not be right for another few years. This is true for three reasons. The first is one of sequencing. Recognizing that in practice the capacity based normative grant and PIT have developed as package that provides flexibility to target central-local aid the
basis of capacity (the normative) while at the same time permitting the further phasing in of a (PIT source) equalization component, for at least the next two to three years, the central government should retain first claim on PIT revenues. Second, there is still a sorting out of subnational expenditure responsibilities to be made. For example, there is still a matter of accession to the European Union, which operates through many regional (as well as local) directives, that may require policy makers to re-evaluate past decisions on which type of subnational government is most appropriate for a own-source PIT. And third, there is a more logical and appropriate tax base to develop, the property tax.

Property Taxation

There are two competing choices for the definition of the property tax base. The first is the currently employed area approach. The tax is based on parcel size and levied on a per square meter basis. The second is a tax based on the observed market value of real estate. In both cases the tax liability rests that the property owner, or in cases of difficulty in identifying owners, the user(s) who have pecuniary rights over the property. This latter circumstance is particularly relevant for a society that is transitioning out of socialism and has yet to completely sort out property ownership rights.

At present, there is almost exclusive use of the area approach. There are two such taxes. The Building Tax is levied at FT 300 per taxable square meter net of several centrally-mandated exceptions, both specific and institutional. The specific exemptions include, for every residential dwelling, a minimum exemption of 25 square meters per person for family members permanently registered in the home. Institutional exemptions include those for social health, child welfare and educational purposes and various facilities associated with animal husbandry.

A plot (land) tax may be levied on unimproved privately-owned land at a maximum rate of Ft 100 per taxable square meter or one percent of adjusted market value. The institutional exemptions provided for buildings generally apply to the land tax. Similarly, the tax may be on the owner or user of the plot.

The alternative approach, which is widely used in modern economies that have made the transition to market economies, is the *ad valorem* property tax. Both the tax base and tax rate are determined by the local government. Unlike an income or consumption tax, for which the base is identified by a flow of private economic activity, the property tax base, which is the stock of property value (thus wealth based), must often be estimated when market transactions are unavailable. Therefore, transparent assessment procedures and a taxpayer appeal process must be integrated into the process.

The merits of the competing approaches can be judged by against the generally accepted criteria for a "good "local tax—simplicity, efficiency, fairness, and revenue productivity.
At first glance an area based tax would seem to pose fewer administrative problems than one based on market value to property; but, in fact, there is a great deal of complexity in Hungarian tax law. This is especially true for the building tax which, rather than just being a straightforward measuring of parcel size, requires the local assessor to make building-by-building judgments on condition of and use. These judgments go to such matters as internal height of interior walls, the degree to which a structure is enclosed, and useful of life of the structure. In contrast the market approach involves a systematic and periodic process that allows (in fact, often requires) the assessor to avoid making parcel-by-parcel judgments. This is particularly true now that computer assisted valuation technologies have been developed.

The efficiency test centers on the degree to which a tax facilitates (or inhibits) local economic development. The ad valorem approach tends to accomplish this objective by sending a tax-price signal of the value real estate will have it its “next-best” or alternative use. As a result, property owners are periodically given information regarding the opportunity cost of their site. This facilitates decisions with respect to parcel use. In contrast, the area approach fails to develop this key “opportunity cost” information. That is it hides, rather than reveals, information that could generate economic change.

With respect to revenue productivity, the area based approach is the inferior choice. This is because it is nearly devoid of the ability to automatically reflect economic changes that occur in the local economy. That is, there is no elasticity (buoyancy) built into the tax base. In order to generate real revenue growth, officials must routinely adjust the statutory tax rate. In contrast, the ad valorem tax has a great potential for tax productivity. If all Hungarian properties were taxed at a uniform rate of one percent of market value, which is about the international average for developed countries that use this tax, local government as a whole could generate annual revenues on residence alone equal to 1.3 percent of GDP.\textsuperscript{15}

Normative Grant

The normative grant receives nearly unanimous high praise for its formula based and unconditional character. But is also regularly criticized for the fact that (i) the formula is expenditure capacity rather than fiscal capacity (needs) driven; (ii) promotes municipal fragmentation (too many small jurisdictions);and (iii) is too complex.

The policy choice is between the current system by which the grant is largely distributed according to capacity-use (e.g., number 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).

It is argued that the capacity use normative, while appropriate to the extent minimum service levels may be mandated, by the center, 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 corrupt the record keeping process whereby local
officials inflate the expenditure measures (e.g., lie about the number of pupils in a school
in order to qualify for larger grants).16 A further result of the capacity-use approach is that
the grant itself is still 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 that efficiency requires should just
shut down or voluntarily consolidate with a neighbor.

Each of these arguments has merit. And, in principle, a solution - which is to
move from a formula based on use to one 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 and expenditure and a tax dimension.

But it may also be argued that such an approach is overly complex, runs the
danger of becoming highly non-transparent, and would probably result in not large
efficiency gains. Accordingly the Hungarian approach will be to maintain its current
normative based system, while considering two ways for further development. The first
one; a reasonable reconsideration of duties and competency in which the norms are less
differentiated and their number is reduced A second say is to look at the fundamental
issues of government size and structure, and address equalization by decreasing fiscal
 disparities (widening of incomes) by providing incentives for municipal associations in
taxation and services delivery.

Size of Jurisdictions

There is little disagreement that there are too many too many small local
authorities. More than half the local authorities have a population less than 1,000. And,
for 300 authorities, the population is less than 200. Notwithstanding, each such authority
has been assigned nearly the same full set of duties of larger jurisdictions. The result is
that many communities cannot meet what many consider a minimal standard of services,
and if they tried, they would not be fiscally administratively able to do so.

There are several options to be considered as to how to address this problem. One
option is to follow the path many Western democracies 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 the Germany (24,512 to 8,500 by 1980) and Belgium (2,663 to 589
between 1961 and 1980). Britain went even further, where there are no local authorities
in the villages, with the basic unit being the district with an average population of
120,000. Recognizing that the consolidation such an option may have some economic
merits, it is, at present, politically not appropriate for Hungary. In 1990 there was a
political imperative to give citizens control over local affairs, and that is the way it remains.

This leaves Hungary with two other options, each of which is being pursued. The first 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 (special districts are not permitted under Hungarian law). This may not only make sense in terms of the local public sector principles of economic of scale, appropriate size benefit areas, and administrative feasibility, but also conforms to the European Union’s use of regional governments to carry out various Union directives.

A second option is to provide for the central government to provide incentives for intergovernmental cooperation and privatization in local service delivery. This is already happening 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 to nongovernmental and nonmunicipal organizations (in 1996 nongovernmental human service institutions will receive Ft 8.5 million in normative subsidies), and the municipalities own decision to cooperate (200 association of local governments already provide some common functions (not unlike special districts).17

Concluding Comment

As Hungary proceeds along the certain path that it began in the 1980s in the transformation to market economic development and political union with its Western European neighbors, it must continue to effect often bold reforms in many of its economics institutions and relations. Among these, and, indeed, key to the accomplish of most of its broad reform objectives, is the development of a well functioning intergovernmental system.

Now a model for other transition economies in respect to how to lay out basic legal framework for local self government and to go about the process of sorting out fiscal roles and responsibilities among different types of governments, there is still much to be accomplished. That these yet to be accomplished fiscal changes are in interest of Hungarians in their dual roles of national and local citizen requires that the process be fully transparent and consultative.

The series of yet to be accomplished reforms include the strengthening of local revenue systems (and, here, local officials must start taking on more responsibility), reconsideration of the assignment of functions and authorities among different types of subnational (e.g., local and country or other regional) governments, and a continued experimentation with the system of central-to-local fiscal transfers.
While these are all very important matters, they are not all equally urgent. A key purpose of this chapter is to suggest what the ordering might be. However, regardless of what set of priorities are established by the citizens, the reforms will often be complex and, in many circumstances, their outcomes uncertain. Mistakes will be made and have to be undone. But, the successes will be far greater in number. To date the Hungarian transition has been not only gradual and systematic, but also bold and creative. We have no doubt that this will continue.

1 Economic Development Institute, World Bank; Head of Department, Hungarian Ministry of Finance, and Deputy Head of Department, Ministry of Finance.


4 The reforms included an enterprise or corporate profits tax, progressive personal income tax, value added tax, social security tax, and a solidarity fund tax (on business gross salaries) and central development fund tax (on previous year profits).

5 For a discussion of the “old” vs. “new” systems, see Richard Bird and Christine Wallich, Chapter 2 in Bird et al. Decentralization.

6 The special topic of Budapest is not addressed in this paper. For a discussion see Robert D. Ebel and Peter Simon, “Budapest: Financing a Large Municipality,” in Bird et al., Decentralization, Chapter 3.


10 This misunderstanding of the normative as a series of earmarkings is reinforced by the practice of association cost figures with each of the components of the formula.

Local governments may issue general obligation municipal bonds; however the market is quite small. In addition, international financial institutions such as the European Investment Bank and the European Bank for Reconstruction and Development have extended lines of credits to municipalities. Furthermore the central government has entered into bilateral loan agreements with many OECD countries, and these can be accessed by municipalities for infrastructure and environmental projects. This discussion of credits draws on the work of Carlos Silva-Jauregui and Tamar Shapiro, "Local Government In Hungary: A Changing Environment." World Bank, 1996.

Plus two types of local building fees on the transfer of property. For residential dwellings, counties levy a two-tier fee based on transfer value plus a recording charge. In the case of non-residential structures, there is single fee (also based on value) and a lump sum registration charge.

Metropolitan Research Institute, Budapest, 1994.

Lutz, et. al. in Ter-Minassian, Fiscal Federalism. page 670.

Table 1
Local governments in Hungary
(January 1, 1995)

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<tr>
<th>Type of local governments</th>
<th>Number of local governments</th>
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<td>Village municipality</td>
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<td>Of this: villages under pop. 1,000</td>
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<tr>
<td>City</td>
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<tr>
<td>Of this: cities with county rights</td>
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<tr>
<td>Capital city districts</td>
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<td>County local governments and capital city</td>
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Source: Ministry of Finance
### I. Shared personal income tax, used as grant

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<tr>
<td>1. PIT equalization grant</td>
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<td>- villages: up to 7,037 Ft/cap.</td>
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<td>- cities: up to 8,643 Ft/cap.</td>
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<tr>
<td>2. Transfer to county local governments</td>
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<td>- 321 Ft/cap.</td>
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<td>- 956.3 for regional institutions</td>
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<td>- 150.0 Million Ft</td>
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<tr>
<td>3. Grants to communal, administrative, cultural and sport functions 1,842</td>
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<td>Ft/inhabitant</td>
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<tr>
<td>County and Capital city administrative, regional, defense, cultural and</td>
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<td>pedagogical functions 360 Ft/inh.</td>
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<td>4. General grants for villages 2 Million Ft/village</td>
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<td>5. Municipalities in depressed areas (1,600/inhabitant)</td>
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### II. Grants

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<td>3. Social welfare grants 3,500-10,500 Ft/inh (allocated by complex social indicators)</td>
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<td>5. Permanent and seasonal rehabilitation homes 246,900 Ft/person</td>
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<td>a) primary, secondary school 70,000 Ft/pupil</td>
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<td>b) vocational training school 60,000 Ft/pupil</td>
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<td>a) secondary school 87,000 Ft/pupil</td>
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<td>a) at classes 9-11 in special schools 20,000 Ft/pupil</td>
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<td>b) at classes 9-11 in vocational training schools 40,000 Ft/pupil</td>
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<td>c) class room training in vocational training and special schools 70,000</td>
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<td>d) class room training in secondary school for training 90,000 Ft/pupil</td>
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<td>f) practical training in special schools for training 28,000 Ft/pupil</td>
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<td>15. Dormitories 126,000 Ft/person</td>
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Note: All figures are in Hungarian Forints (HUF) and are presented for the years 1990-1997.
## Table 4
Municipal Budget Percent Composition
By Year, 1991-1997

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Exhibit: CPI Change (%)

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Source: Ministry of Finance

Note: Other revenue includes other central transfers and company transfers.
Fiscal Decentralization in the Russian Federation: Main Trends and Issues

Jorge Martinez-Vazquez and Jameson Boex

December 1998
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