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1 Introduction

The aim of the study is to review those systems of resources which, on the one hand, promote the increase of the *financial independence* of local governments in Hungary, on the other hand, allow *equalisation* among the local governments with different income capacities. The first objective belongs to the issue of the regulation of the tasks and resources of local governments, while equalisation is only partially dealt with by the *regulation of local governments*. These tools are mainly designed to moderate the present differences in the income generating capacity, partly *by the redistribution of the resources* (e.g. personal income tax, supplementary subsidy), partly *by a more efficient cost control of the supply of tasks* (e.g. the stimulation of associations). Another set of tools are to increase the income generating capacities, these belong, however, to the issue of *regional policy*, in which local (county, municipal) governments are also important actors.

The impact of the socio-economic transition was different in the large regions of Hungary. In the period of the 1990s passed so far, *regional disparities increased*, but this is the result of a multi-factor process. Due to the centrally supported programmes, equalisation processes took place in the infrastructural provision. At same time, the winners of economic restructuring – mainly as a consequence of the activity of foreign capital – are the traditionally more advanced Hungarian regions: the capital city and its agglomeration, (North-west) Transdanubia, and the large towns. This can be seen in the differences of the income generating potential, e.g. personal income tax, local tax potential.

The change of the regional disparities, either strengthening or reduction, is dominantly determined by the change in the income generating capacity of Hungary, the expected growth rate of the gross domestic product. A significant reduction, however, can only be expected if induced by a strong growth of the GDP. Independent of this, the tools and institutional system of regional development have to be made capable of the promotion of both economic modernisation and regional equalisation. This objective is served by the *Act on Regional Development and Physical Planning*, passed in the spring of 1996, by the institutional system established according to the act (regional development councils at different levels), and by the *system of central and decentralised resources* allocated to the institutional system. However, there has been but a little harmony so far among the funds which directly or indirectly (by sectoral developments) serve regional development. Both kinds of support are available for the local governments and their regional development associations, but the support system, which also requires own resources, usually favours settlements with better income positions.

After the systemic change, the regulation of the local governmental system was motivated by a comprehensive effort for *decentralisation*. This is a double process, if we look at public services. On the one hand, with building out the local governmental system, a decentralisation of tasks started between the central government and the local governments, on the other hand, state participation was gradually put into the background in those fields where the market and the private enterprises can work more effectively (this is privatisation in the broader sense of the word). Within the frameworks of the *reform of the state budget*, the objective, in order to achieve the economic balance, is to hold back communal consumption and as part thereof, to decrease the deficit of the central budget. This means a decrease in the amount of distributable resources, parallel to which the number of state tasks – and within that local governmental tasks – also decrease, and they are taken over by non-state (market and non-profit) service institutions.

2 Normative subsidy versus task financing

After 1990 a local governmental institutional system was born which had to fulfil its tasks besides shrinking financial resources. In addition, these tasks were not clearly defined and they even changed during the years. The unfavourable conditions, however, were escorted by a large-scale independence, which allowed, in fact, forced some local governments to improve the efficiency of their operation and increase their non-central incomes.

There seems to be a consensus – at least from the side of the local governments – that the tasks of the local governments are not clearly defined in the Act. The reason for that is not a legal inaccuracy, but the fact that there is no political decision on what tasks belong to the state and the local governments in the different fields of public services. During the transition to the market economy, the clear and well defined division of the tasks and competences only gradually takes form (*Hegedûs-Péteri*, 1996). Even when that is achieved, the question still remains what extent of the central supports is appropriate in the field of tasks accepted by the state but carried out by the local governments (e.g. public education). It is also an issue how this support guaranteeing an acceptable level is allocated among the local governments. This can take place either by a distribution method with general objectives but a normative basis, or by supports given for definite individual tasks, providing for a certain per cent of the estimated expenses.

One of the most progressive elements in the finance system created at the systemic change is the transition from the expenditure-oriented planning method to the resource regulation. In this system, because of their weight, *normative subsidies* are key elements. This model of financing basically works as a distribution mechanism of the government supports allocated to the local governments. However, the more keys are used for this distribution, the more vulnerable this principle. As soon as in the first year of the allocation of the general Hungarian support (in 1990), a system consisting of more than 10 elements was used in the recommended budget.

The number of these elements doubled by the year 1995. In 1996, the ground on which one could be eligible for support, decreased to 14, but, as a consequence of the differentiated support system of public education, the total of the normative elements is over 200. Their number decreased to some extent by 1997, but it still exceeds 100 (*Darázs*, 1996). No wonder that the individual normatives are slowly losing the meaning they should have (i.e. rates promoting the distribution of support for general purposes) and they are more and more treated as a partial financing for the tasks written in the specification of the given normatives. This can start a strong restoration towards the expense-oriented planning.

The system of local supports has to follow four main guidelines (*Bird and Wallich*, 1992):

1. The support is for *gap-filling*, as local governmental revenues are almost never enough to cover all expenses. So the supports are meant to “fill the financial gaps”.

2. Supports should promote the formation of a *vertical balance of the budget*. The lack of balance comes from the different structure of tasks at the different levels of local governments, touching even the richest ones.

3. The supports have to deal with the differences among the settlements at the same level (*horizontal balance of the budget*).

4. Supports have to stimulate *efforts made from local budgets* in order to make settlements grow their own resources of income.

Thus it has to be decided on what grounds tasks which are accepted by the state but carried out locally shuold operate and how the distribution of the state part in the financing of the voluntary local governmental tasks should take place. Two major concepts have been crystallised by the experts. Basically, both of them recommend the elimination of the present normative system in which equalisation and performance-linked normatives are mixing.

One solution starts from the estimated demand of the local expenditure and the local income capacity, while the other from the definition of the tasks which also involve state participation (public education, social care and benefits, health care), and from the share of state and local expenditure in these tasks. The first suggestion, in which the need for the support is defined as the difference of the demands of expenditure and the income capacity, contains all the above-mentioned characteristics of the supports. In the second model, the task-oriented support and the support designed to decrease and alleviate the significant differences in the incomes of the local governments are separated. The two versions are also identical in the sense that the so-called centralised preliminary estimates and the other individual targets of the supports (theatre, fire brigade, bankrupt local governments) should also be built into the uniform support system. Both solutions emphasise the importance of increasing the local income capacity and thus the financial independence of the local governments.

3 The increase of the financial independence of local governments through the regulation of the resources

3.1 The transition of the distribution of personal income tax

The disputes over the regulation of the resources in the recent two years – especially in the period when the support system for the local governments from the state budget is defined for the following year – has often reached their climax about the division of the personal income tax between the central and the local level. Those who urged that local governments should receive a higher share, considered the decrease of their share as a decline in the financial independence of the local governments, and the increase as a strengthening of this independence.

One of the main elements in the tax reform introduced in 1988 was the introduction of the taxation of private personal incomes in order to promote a general expansion of the paying of common charges. From the start, this type of tax was meant to help the financing of the local governments. The Parliament voted for the general introduction of personal income tax in the autumn of 1987 with the condition that after 1990 (with a two-year delay allowed for the technical implementation) the total of the incomes from the personal income tax will be allocated to the councils, in a way that the Tax and Financial Auditing Office (the Hungarian name of which is APEH), responsible for the administration of the taxation, will transfer the total amount of the personal income tax paid by the individual taxpayers to the council of their place of permanent residence.

The background of this situation is that in the early 1980s, there were several attempts to divide the so-called urban and village development contribution among the councils. It could have been carried out already at that time, according to the registration of the employees by their place of residence, but given the level of the current technology it would have been too much administrative work for the employers. It was simpler to pay this amount to the council of the headquarters of the given companies. This way, however, this income dominantly functioned as an urban income. At the same time, it was also the period when strong efforts were made in order to strengthen the income resources of the villages and to equalise the income possibilities of the urban and village councils. The introduction of the personal income tax allowed that, as tax had to be paid to the central tax authority, and the registration of the taxpayers by their place of residence offered an easy solution for the transfer of the tax to the individual councils.

The distribution mechanism of the personal income tax according to the original intentions – giving back 100% of the personal income tax to the councils, from 1991 to the local governments – only worked for one single year, until 1991. There were huge differences in the amount of personal income tax revenues per one inhabitant: while in Tiszaújváros almost 15.000 HUF was the personal income tax revenue per capita, in Gagyapáti no taxable income was made. The difference between the settlements with the highest and the lowest tax revenues was forty-fold. By the mid-1990s, this difference typically grew to more than a hundred-fold. The specifically "richest" settlement – in the beginning Tiszaújváros, after 1993 Százhalombatta – exceeded the countryside average more than three times in tax revenue per capita1. At the same time, in 90% of the settlements, the specific personal income tax index does not reach the countryside average (Table 1).

Table 1.

Personal Income Tax potential per Capita, 1988-1996

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Settlement with the highest specific personal income tax payment (thousand HUF per capita)	14,9	20,8	26,6	37,8	41,7	58,8	67,8	87,4	113,7
Budapest (thousand HUF per capita)	12,6	17,1	22,0	29,1	36,6	43,9	50,6	63,0	78,7
Countryside average (thousand HUF per capita)	5,3	7,0	9,6	12,4	15,5	19,0	21,4	27,6	34,9
Highest figure/countryside avarege	2,8-fold	3,0-fold	2,8-fold	3,0-fold	2,7-fold	3,1-fold	3,2-fold	3,2-fold	3,3-fold
Number of settlements with less than 1.000 HUF personal income tax per capita	65	32	11	8	7	3	4	3	1
Number of settlements with less than 10.000 HUF personal income tax per capita	3.066	3.013	2.848	2.539	2.026	1.417	1.205	711	396
Number of settlements below the countryside average	2.755	2.792	2.804	2.810	2.844	2.849	2.863	2.799	2.808
Proportion of settlements below the countryside average	89,4	90,5	90,7	91,0	90,7	90,9	91,0	89,5	89,7

Source: own calculations based on data from the Ministry of Finance

The reduction of such big differences in the income potential within an equalising or normative subsidy system was only possible by distributing personal income tax revenues between the central and local governmental level and spending the part remaining in the centre on equalisation purposes. The share reserved for equalisation changed several times: it was 50% in 1991-1992, 30% in 1993-1994, 30+5% in 1995, 25+11% in 1996, 22+16% in 1997 and 20+20% in 1998. *The part that remains in the centre is not an income deprivation, as it is more and more serves as a coverage for the normative subsidies* (*Table 2*.). While the centralised personal income tax covered hardly one-third of the normative grants in 1991, this share is over

80% these days. According to the figures in the recommendation for the 1998 budget, in 1998 the total amount of personal income tax remaining in the centre will serve as a coverage for the normative state contributions, in fact, it will exceed that by some 5 billion HUF. This is not a negligible amount, especially when we consider that in 1997 this much was devoted by the Government, within the decentralised regional development fund, for that part which serves regional equalisation purposes and can be applied for by the local governments.

Table 2.

Personal Income Tax Coverage for Normative Subsidies in 1991-1998

	1991	1992	1993	1994	1995	1996	1997*	1998*
Normative state contribution (in billion HUF)	148,5	169,8	207,5	210,6	232,7	231,7	260,2	275,4
Central part of the personal income tax (in billion HUF)	47,0	63,0	120,0	148,8	173,9	180,1	221,4	280,5
Normative support covered from the personal income tax (in per cent)	31,6	37,1	57,8	70,7	74,7	77,7	85,1	101,9

** 1997 – planned, 1998 – legal recommendation for the budget (?)*
Source: own calculations based on the database from the TÁKISZ (Regional Data Service)

The coverage part of the personal income tax shown in the table would be even higher if equalisation grants were not listed sometimes among the normatives and among the personal income tax items remaining in place other times. The seemingly increased local share from the personal income tax sounds good politically to some of the local governments. It would be more reasonable, however, to feature the +5, +11, +16 and +18% shares remaining in place in the normative subsidies block or in a separate equalisation support block. The argument for the first solution – in case that the system of normative subsidies lasts for a longer period of time – is that the total amount of the part of the personal income tax which remains in the centre is still a resource for normative subsidies, and for the latter solution is that the equalisation grants could be simplified and standardised this way. This also requires that the remaining equalisation type elements – municipal administration, communal and sports tasks, tasks of public education – be taken out from the normatives.

Sometimes it is argued that the tension in the financing would be less if local governments did not have to wait for two years to obtain their personal income tax revenues. As a result of different effects (tax rates, tax brackets, allowances, exemptions, inflation etc.), in the first part of the 1990s the revenues coming from the personal income tax grew by 40-50 billion HUF annually, so a transition from a system with a two-year delay of the acquisition of the resources to a system where the currently paid taxes could be used would result in an extra 100 billion HUF personal income tax revenue. This gain is only a seeming one in the present situation, as the paying out of the personal income tax paid two years ago in the same monthly instalments (?) can evidently take place from the current advance personal income tax payments. This means that the paying out of resources adjusted to the estimated personal income tax payments appears as an extra demand within the state budget in the given year. This extra demand could only be met by increasing the deficit, taking up approximately 100 billion HUF public loan. This would, on the one hand, disturb the expectations concerning the level of the deficit of the state budget, on the one hand, increase the outstanding total debt with a large item. The transition would also make the administrative procedure more complicated, as the supplementary settlement of the accounts of the transfers would be a new task (paying out according to the estimated revenue, minus settlement of the accounts according to the real revenues).

Summing up the possibility of keeping up the personal incomes as a divided revenue, the following statements can be made:

- ⇒ the divided personal income tax can be a stable resource of income for the local governments in the long run, which, because of the amount of resources known from the two-year technical delay, can be easily planned. Given the present trends, the personal income tax remaining in the centre will totally cover both normative subsidies and personal income tax supplementary subsidies;

⇒ planning would be made even easier if, one the hand, the system of personal income tax itself (tax rates, tax brackets, exemptions etc.) was more stable, on the other hand, if the proportions of the division remained unchanged for longer periods of time or if the schedule of the annual changes was made for four-year cycles;

⇒ it is not advised to mix the "clear" part of the personal income tax remaining in place and the personal income tax "burdened with tasks". The latter one should either be built in to the normative subsidy system or into a uniform and simplified equalisation system;

⇒ In the system of the divided personal income tax, local governments are interested in a passive revenues (?). Their share from this resource depends on their positions gained in the change of the rates of division, and in the rates of the normatives and equalisation grants financed from the central personal income tax. In case of an active economic development activity, however, the provision of the unemployed with jobs can amount to a surplus personal income tax resource, and parallel to that, the tension in the field of social care (benefits) can decrease.

3.2 Systems of surtaxes

In the following chapter, the possibilities of the application of surtaxes in the Hungarian local governmental finance system will be discussed in three sections. The first section is an introduction to the historical traditions in Hungary; the second one provides an international view in this field, while the third section sums up the recommendations of some expert groups concerning the levying of surtaxes on personal incomes.

3.2.1 Traditions in Hungary

Before the introduction of the council system, the surtaxes on the central taxes were an important element in local governmental management. In the period of the Compromise, those taxes that the towns could not cover from its resources, had to be paid from the borough-rates. Borough-rates were levied after the royal direct taxes (?) in a per cent that was enough for paying the uncovered expenses (*Bükki*, 1991). After 1870 the situation changed, inasmuch as tax revenues became the basis for the coverage of the expenses and other revenues became supplementary. The rates of the borough-rates were defined together with the expenditure forecast and they were jointly approved of by the Ministry of Interior. The real volume of the tax revenues could be influenced by the base and the rate of the central tax, the rate of the surtax and the efficiency of the collection of the taxes. The collection of the taxes was the responsibility of the local governments at that time, and its efficiency was rather poor in the discussed period (*Table 3*).

Table 3.

Tax Revenues and Overdues in City of Győr 1873-1876

	1873	**1874**	**1875**	**1876**
Rate of the local tax (in per cent)	55	75	60	50
Amount of approved local tax (HUF)	94.000	131.200	105.000	94.000
Total of overdues gathered by the end of the year (HUF)	113.600	74.000	83.000	88.000
Share of the overdues at the end of the year (in per cent)	120	56	79	93

Source: Bükki (1991) based on Tables 1. and 2.

Between the two world wars, the major part of the revenues of the municipalities came from taxes resigned by the state, and from local taxes, municipal duties and contributions. When the above-mentioned revenues were not enough to cover the expenses of the budget of the town, a local surtax could be levied, depending on the deficit, but not exceeding 50% (in the counties, 30%) of that, based on the amounts of the direct state taxes (land, real estate, …, and corporate taxes). It was a general rule that the total amount of state taxes and local surtaxes could not exceed 75% of the total income of the taxpayer. The joint expenses of the associating villages were divided among the individual villages according to the share from the amounts flowing in from the direct state taxes and the general income tax, or according to the burden bearing capacity of the villages. The royal tax supervisor or the Ministry of Interior made sure that the rate of the surtax should not exceed the maximum level. It was a rule that the budgets had to be handed in to the above-mentioned organs for approval (*Páll*, 1991).

In the second half of the 1920s, the state decreased the revenues of the local governments with some minor modifications. These included the decrease of some items of the direct taxes, which automatically decreased the amount of the village surtax, too. It was also typical of this period that the state tried to shift a part of their burdens to local governments, without transferring the coverage for them. These individually would not have meant a problem, but their total sum amounted to 7.5% of the annual expenditure of local governments by the late 1920s, without these extra local governmental expenses increasing the quantity or quality of the services connected to these expenses. Practically the state freed itself from some burdens and blocked local governments from the free disposition of their own revenues (*Éberth*, 1931).

The supporters of the local governmental system disputed the system in effect. They approved of the principle that the state and the villages (towns) should decide upon the volume of the taxes based on the tax paying capacities of the citizens in the future too, but they urged a taxation based on the individual interests in the villages (towns), because of the nature of the needs of the local governments and their effect on the welfare of the individuals.

It was raised that the *system of the village surtax and the share from the direct taxes* not only do not meet the demands of the villages (towns), but they also *make a significant part of the revenues dependent on the system of state taxes*. Among other things, they argued that the applied system did not make the inhabitants of the villages (towns) realise that they had to make their financial contribution to the maintenance of their public institutions.

Those who were for the independent public services argued that the revenues of the local governments should primarily come from the supply of the interest and from the independent town taxes and duties. The following guidelines were stated (*Éberth* 1931):

- freer movement in local governments;
- independence of the town taxes (?);
- decrease in the importance of the village surtax.

However, the crisis of the world economy interrupted these disputes and put these efforts aside for a while.

Summarising the preliminaries of the surtaxes in Hungary, we can say the following (*Lados*, 1997):

⇒ local governments could typically levy surtax, in a per cent of the central taxes limited from above, in order to achieve the balance of the local budget, if their other regular revenues did not cover the expenses of the public services carried out by the local government;

⇒ direct taxes, usually property or corporate income taxes served as the basis for the surtaxes;

⇒ the rate of the surtax to be applied in the given years – together with the budget of the local government – was approved of by the government organs (Ministry of Interior);

⇒ the local tax administrators administered both the taxes that could be burdened with surtax and the taxes divided between the state and the local governments;

⇒ local governments urged that the importance of the surtax be decreased, as its application was extremely sensitive to the changes of the central tax bases and tax rates – they urged the introduction of local taxes on independent bases , instead.

Conclusions for the introduction of surtaxes, based on the Hungarian traditions:

1. From the formerly used tax bases, central land tax ceased to exist in 1995, and the operating property-related taxes are all local taxes. The surtax of the tantiem tax (?) (essentially a dividend tax) and the corporate tax (essentially corporate income tax) would only be

resources for one part of the local governments today, as in the majority of the settlements, there are very few taxable enterprises. According to the tax literature, the local taxation of the businesses distorts their competitiveness, so their application is less desirable. At the same time, the industrial tax (?) can be interpreted as a surtax of the VAT. *From all central taxes, presently only the surtax of the personal income tax can be a resource for all local governments*.

2. Presently the central taxes – with the exception of the vehicle tax (?) – are administered by the APEH, so it is practical to allocate the administration of the surtax of any central tax to the APEH, too.
3. The introduction of a surtax on any base presumes that the total amount of the tax burdens does not change. This means that the introduction of the surtax can only be implemented parallel to an adequate decrease in the rates of central taxes.

3.2.2 International outlook

The international system of the surtaxation follows the same principle as the system applied in Hungary before World War II, inasmuch as the role of the surtax is the supplementation of the resource side of the local budget to the level necessary for the expenses. The base of the surtax, however, is quite different in the former Hungarian than the present international practice. The Hungarian system surtaxed the property taxes and the corporate income tax. Both of them were direct taxes. The present international practice typically surtaxes the personal income tax. This means that the two systems do not only differ in the use of different tax bases but also in the fact that the tax selected for surtaxation is a bracket tax (?), usually a progressive tax, although this does not necessarily mean bracket rates of tax in case of the surtax.

The local governmental surtaxes can have two basic types:

- a uniform increase of the central rates of tax, or
- a surtax defined in a standard percentage form, which is levied after the rates of tax in each tax bracket (?).

The first solution is used for example by the Nordic states, while the second one by Switzerland. In Sweden, the starting rate of tax is zero, so those who fall into the lowest brackets only have to pay the local surtax, which can reach 30% of the net tax base. The central government only taxes incomes in the higher brackets. However, the indicated maximum rate of the surtax is a combination of three elements, as each local governmental tier can levy surtax on the personal income tax. Each tier has a limited sphere of action as regards the rates of the taxes. The municipalities have the broadest field of action, they typically set the rate of the surtax from 14 to 20%. County governments can define a bracket of 8-12%, while the smallest local governmental units, the so-called parishes cannot go beyond 2%. Thus the total of the paid tax is combined of four elements, including the national tax. The multiple tax increases the administrative burdens of the employers and the tax authorities.

The other method defines the rate of the surtax in a standard per cent of the rates used in the individual tax brackets, i.e. the rates of the surtax show a similar progressivity as the central tax. This means that if the majority of the local governments chose the same rate for the surtax, the regional disparities of the tax revenues would increase.

Summarising the international experiences of the surtaxation of the personal incomes, we can say the following:

- ⇒ all of the surtax systems applied for the personal incomes define the rate of the surtax adjusted to the brackets of the central tax, and the same rate is used in all brackets;
- ⇒ in the Scandinavian model there is an upper limit built into each tax bracket and the same rate is used to increase the rate of the central tax, while in the Swiss model the rate of the surtax is defined in the same per cent of the adequate tax rate in each bracket;
- ⇒ the Scandinavian model allows each local governmental tier to levy surtax on the personal income tax.

Conclusions for the introduction of the system of surtaxes on the personal incomes, based on the international experiences:

1. it can provide an income for all local governmental tiers;

2. it is a possibility to expand the resources of local disposition;
3. the generation of independent resources of tax is available this way for the different types of local governments (municipality, county, or minority governments);
4. if an upper limit is built into the system, this surtax does not distort considerably the competitiveness of the local economy;
5. whatever form the surtaxation of the personal income tax takes, the supplementation of the personal income tax will be necessary in the long run, as the surtaxation can only change the regional distribution of the personal income tax to a limited extent. The main objective of the surtaxation of the personal income tax is not regional equalisation, but the increase of the financial independence of the local governments by the use of locally defined tax rates.

3.2.3 A review of the recommendations of experts for the system of sur taxes

The almost annual change of the division of the personal income tax makes the local governments defenceless and makes any financial planning for several years impossible right in the beginning, although that is required by the Act on State Finance. So from the early 1990s, recommendations and models have been made by foreign and Hungarian experts which would redeem the divided system of the personal income tax by the surtaxation of the personal income tax. We are only going to discuss those solutions in details which not only describe the advantages and disadvantages of the system of the surtaxation of the personal income tax but also try to model the effects of the transition.

A/. Recommendation of the World Bank experts[2]

Bird and Wallich placed the emphasis in their recommendation on the *increase of the resources of local disposition* and on the *transformation of* *the support system* when developing the finance system of local governments in Hungary. In their system it is not the local government that adjusts to the centrally distributed supports but the support system is derived from the difference of the *estimated demand of expenditure* and the *local income capacity*. The *simplification of the support* means that the present itemising capacity norms (?) should be replaced by supports connected to the "consumers". The support system that considers the income capacities is built on the fact that the supports from the central budget (S) should be defined by the difference of the estimated demands of expenditure (E) and the local income capacity (I) (S = E – I).

Following this logic, if the calculation of the average demands of expenditure is done in a normative way, by indices following consumer demands (number of population, age groups etc.), then the incomes exceeding the estimated capacity of the budget does not decrease state support. At the same time, the local governments really have to collect the estimated incomes, as the under-average "efforts" of the budget are not supported from the central budget.

The introduction of this model depends on whether the local governments have really significant local revenues. In the period of our study (in 1991) this was not typical, that is why the introduction of the local surtaxes imposed on the personal income tax was recommended. In our opinion this would not increase the tax burdens of the population, as the rate of the central tax could decrease, depending on the locally permitted rates of tax. So practically only the principle of the division of the personal income tax would change: the division of the resources would not take place subsequently, but it would depend on local decisions how much the local governments would "add" to the lower rates of tax.

Considering the foregoing, the authors recommended the following construction of the local government finance, as an alternative possibility:

- surtax of the central personal income tax;
- normative subsidy supplemented by an equalising personal income tax support (based on the simplified formula of the distribution of the supports, which involves the income capacity);

- increased local tax and duty capacity;
- other supplementary supports.

In the recommended model, considering the then current proportions of the division of the personal income tax, a 50% increase in the central rates of tax is necessary. The central personal income tax would completely form the basis of the normative support, which would include the supplementary personal income tax support, too. If a local government levies a 100% direct surtax on the national tax, then it would actually collect the former 50% personal income tax share from the surtax, instead of acquiring that as a divided revenue. In the calculation of the support, this rate of the surtax would be considered, but the local governments would have the possibility to levy surtaxes exceeding 100%, too. Any further increase in the local personal income tax would not change the support system but would increase local revenues. The surtax would be collected and transferred to the municipalities by the APEH. The general central/local tax burdens would not change.

On the basis of the simulation, the proportion of the personal income tax compared to the "total" of the revenues varies, but it is usually higher in large towns, urban districts and in bigger settlements than in the smaller settlements (*Table 4*). The personal income tax is essentially a revenue that favours towns, as it is mostly collected in industrially developed regions. The seeming unbalance between the urban/village personal income tax is caused by the system of the personal income tax itself (exemption from taxes on personal incomes from agriculture). The network of settlements also influences the personal income tax revenues. The network of smaller villages is denser in the North and South Transdanubian regions.

Table 4.

Proportion of Personal Income Tax in the Total Revenue

	Share of personal income tax within the total revenue, in per cent	Division ofthe personal income tax
By administrative status		
Town (169)	27,7	78,5
Village (2900)	17,5	21,5
By size of the population		
- 1.999	13,8	7,5
2.000 - 4.999	18,2	8,2
5.000 - 9.999	19,6	5,9
10.000 - 49.999	21,3	20,2
50.000 - 99.999	24,9	9,3
100.000 -	34,1	48,9
Average/Total	***24,7***	***100,0***

* Total revenue = personal income tax + normative support + supplementary support
Source: based on *Bird és Wallich (1992), p. 99.*

In the villages, rural areas and small towns, the proportion of the personal income tax within the expenditure is lower than in the big settlements. The decrease of the central rates of the personal income tax and the parallel levy of surtaxes on the personal income tax by the local governments leave local incomes intact, provided that a uniform (100%) surtax is levied. In the municipalities with less than 2.000 inhabitants, the 100% surtax would make 14% of the revenues. In the second group of settlements (2.000–10.000 inhabitants) the present revenues from the personal income tax are higher, making approximately 18-20% of the total revenues. The local surtax would mean more than 20% of the total revenues in the towns with more than 10.000 population.

The simulation resulted in a different division of the resources than in the target figures for the 1991 budget. The simulated revenues of towns and other settlements with more than 10.000 inhabitants are lower than in the target figures, on the other hand, smaller municipalities win, as their financial situation is defined by the supports that make the larger share of the local revenues. In the smallest settlements, where the proportion of the personal income tax is low, the locally levied surtax could only be increased at the expense of political losses. In these places a kind of equalisation of the differences in personal income tax is necessary.

B/. Recommendation of the IMF experts[3]

The expert committee visited Hungary in a period when the Government decided to increase the share of the personal income tax given to the local governments, instead of decreasing it. The experts emphasised that this was more favourable for the local governments with higher revenues, and did not mean a general increase – concerning all local governments – in the financial independence of the local governments. Instead of disputes over the proportions of the division, this group of experts also argued that the personal income tax should be surtaxed and the local income tax applied. The committee mainly referred to the examples taken from the Scandinavian countries (Sweden, Denmark). In their opinion, the introduction of the local income tax would be made possible by a uniform 10-12% decrease in the rates of the individual brackets of the central personal income tax.

As the committee only spent two weeks in Hungary, they did not have the possibility for model calculations. Thus in their recommendation they outlined the technical structure necessary for the application of local income tax, and the timetable (schedule) preparing the application of this tax. The committee favoured the single-bracket rate of tax, because this does not enlarge the effects of the disparities coming from the per capita tax base, the marginal rate of tax increases at the same volume both at the high and the low incomes, thus providing a protection against the appearance of extremely high upper marginal figures.

The IMF delegation also found that the administration of the local income tax should be allocated to the APEH. They did not think either that the system of advance tax payments should be changed by the introduction of surtaxation. They considered the local definition of the tax rates as an issue of higher significance. The called the attention to the fact that the definition of an obligatory standard rate of surtax is necessary, which has to be applied even by the local governments with the most unfavourable income conditions. They consider it as important because they do not think it is appropriate to start a negative tax competition with the low rates of tax among the local governments in order to create an attraction for the location of entrepreneurs. They also think that the minimal rate of surtax should be used because it guarantees a minimal effort by the local government to create local resources, which can serve as a basis for the application of supplementary subsidies. The experts did not initiate the definition of an upper limit for the rate of surtax.

The report also contained some considerable technical recommendations concerning surtaxation. In order to guarantee that the next year revenue of a local government and the connected rate of tax should be plannable, the central government has to finalise (by the end of July) the calculations about the expected tax base concerning the given local government. Then the local government has to make a decision concerning the rate of tax, about which, together with the calculated revenue, they have to inform the central government (by the end of September), partly because of the monthly transfer of personal income tax in the next year, partly in order to inform the employers (the payers of the advance tax payments) in time. As there will be differences between the transferred personal income tax instalments and the actual tax revenue, a supplementary settling of the accounts according to the actual tax payments is necessary between the local government an the tax administration.

C/. The recommendation of Davey-Péteri[4]

The authors made their calculations by the actual data of 1993, but for the redemption of the local governmental part (25%) of the personal income tax valid for 1995. They used the following presumptions when modelling the shift from the division to the surtaxation:

1. local governments would obtain 25% of the actual personal income tax revenues, if surtax were levied besides a normative rate;
2. the central rates of taxes would be decreased to such an extent that in case of an average rate of the surtax the position of the taxpayers does not change;
3. the local governments would be given authority to levy surtax between a minimum and a maximum rate.

The authors talked about two kinds of supplementation. In the first case, the supplementation takes place by the uniform increase in the central personal income tax rates. In order for the local governments to keep their 25% proportion within the total of the personal income tax revenues, they should use a rate of approximately 7%, according to the authors, so the rates for the brackets of the central personal income tax should be decreased by so much (*Table 5*). In the second case, the supplementation related to the rates of the individual tax brackets is standard. In order to keep the 25% proportion of local governments in the personal income tax revenues, the rates of each tax bracket should be decreased by 20%. This method would keep up the progressivity of the personal income tax at the level of the local taxes, in a distribution identical with the central personal income tax.

Table 5.

Changes in Personal Income Tax Rates in course with Supplementary Taxation %

Tax brackets	Uniform increase of the central tax rate	Uniform surtax in per cent of the personal income tax

(HUF)	Central rates	Rate of local surtax	Central rates	Rate of local surtax
0 - 110.000	0	0	0	0
110.001 - 150.000	13	+7	16,0	+4,0
150.001 - 220.001	18	+7	20,0	+5,0
220.001 - 380.000	28	+7	28,0	+7,0
380.000 - 550.000	33	+7	32,0	+8,0
550.000 -	37	+7	35,2	+8,8

* based on the tax table for 1993
Source: after *Davey-Péteri (1995), p. 18-19.*

In our opinion, the introduction of the surtax is the simpler solution, if its effect is neutral for both the taxpayers and the local governments, given a standard rate (second version). This means that the local governments would levy a stndard percentage of surtax on the total amount of the tax paid. If the standard rate were 25%, then each bracket of the central tax should be decreased by 20% in order to keep the former central-local proportion. At the same time, the local governments would be free to define rates higher or lower than the standard rates, so they could have surplus revenues of loss of revenues compared to the tax revenues generated by the standard rates. This would mean higher or lower tax burdens for the taxpayers of the individual settlements than before. If a standard rate different from 25% were used, this would result in the redistribution of the resources between the central and the local governments. This can also make the transformation of the support system necessary. The deviation from the standard rate is possible with the total freedom of decision of the local governments, or with building limits into the system. The authors suggested that the rate of the surtax range from 20-35%. This way the extreme rates of the surtax would range from 80 to 140% of the present share from the personal income tax. The calculations were made by using the estimations at the extremes, with the assumptions that

1. all local governments where the share of personal income tax per capita is higher than the average, would levy the maximum 35% rate of the surtax, and
2. all local governments where the share of personal income tax per capita is lower than the average would levy the minimum 20% rate of the surtax.
3. Budapest was neglected in the model, because of the uncertainties of the division between the two local governmental tiers.

Given the above conditions, the personal income tax revenues of the local governments with weaker income generating capacity would decrease by 20% compared to the present situation, while those local governments with more favourable situation would increase their tax revenues by 40%. On the whole, the total of the personal income tax revenues of the local governments would increase by 19% compared to the resources that they are given from the division of the personal income tax, and the local proportion would increase from 25 to 37%. (The authors emphasise, however, that the main argument fro the introduction of the surtax is not the possibility to create supplementary revenues, but the accountability of the decisions concerning local taxation and expenditure).

The authors also dealt with the issue of the administration of the taxation. Based on consultations with officers responsible for personal income tax matters, they stated that the introduction of the surtaxation would not require a significant modification of the present procedure of tax administration. Administrative burdens would mainly appear at the employers, as the advance personal income tax payments would have to be drawn from the salaries of the individual workers at different rates, because of the different places of residence. On the other hand, this cannot be a problem for those employers that use a computerised wages accounting system.

Summarising the recommendations of the experts concerning the surtaxation of the personal incomes, we can say the following:

⇒ the starting point of each recommendation is to replace the share of the local governments from the actual central/local government division of the personal income tax by a surtax on the personal income tax with local disposition, by decreasing the central marginal rates to an extent resulting in the required division of the revenues. It was emphasised that this way the total of the personal income tax burdens would remain the same.

⇒ At the same time, local governments would have the possibility to deviate in both directions from the standard (normative, average) local surtax rate of the personal income tax, defined by the centre.

A) The deviation from the standard rate downwards results in the decrease of the total tax burdens of the individual taxpayers, which can further reinforce the tension between the present demand of the expenditure and the income capacities (own resources + state transfers). In case of an unchanged demand of the expenditure, the decreasing personal income tax revenues have to supplemented. This strengthens the need for the increase in the other elements of resources (supplementary personal income tax support, or a more intensive increase of the normative subsidy, increase of the income capacities of other local taxes, consumption of the assets etc.). A solution for the problem can be the requirement of a minimum marginal tax rate, which would mean a minimal tax effort which could be expected from the local governments. In other words, the surtax on the personal income tax would increase the number of the optional local taxes, as it would be obligatory. The decrease of the general marginal personal income tax rate could have positive effects, as well, e.g. the willingness of taxpaying can improve, as can the efficiency of the tax collection.[5]

B) The deviation from the standard rate upwards can result in a surplus revenue for the individual local governments. However, as the starting point of the surtaxes has always been the system of the actual marginal rates, a raise of the taxes above the standard rates would amount to marginal rates higher than the actual ones. The political price of that might be bigger than the visible advantages coming from the improving services. It can also happen that the taxpaying willingness and the efficiency of the collection deteriorate because of the increasing rates. A solution for the problem can be the definition of the maximum rates of the surtax. (The experts of the World Bank and the Davey-Péteri recommendation define the upper limit for the system of the surtax on the personal income tax, but the IMF report does not impose such an upper limit for the local surtaxes.)

C) The solutions for the division of the personal income tax are discussed by each expert group embedded into the general frameworks of the local government financing. They emphasise the possible expansion of the own resources. *In addition to the surtax on the personal income tax, they emphasise the development of the real estate tax based on the local value*. This tax is a so-called material tax (?), but the taxpaying is influenced also in this case by the paying capacity of the taxpayers, as the tax is mostly paid from incomes that do not derive from the use of the taxable real estate. If the surtax levied on the personal income tax and the development of the taxation of the local real estates are done at the same time, then both taxes have to be taken into consideration in the modelling of the decrease of the central personal income tax rates, as the real estate tax can mean an additional tax burden for the personal income tax payers. This implies that *in case of the parallel development of these two tax categories we can only start from a total of personal income tax revenues lower than before*.

⇒ All three recommendations allocate the administration of the surtax to the central tax office, which shows that the shift is more likely to cause problems in the beginning at the employers transferring the advance personal income tax payments. At the same time, the two-year delay of the appearance of the tax revenues in the local budget can be a problem (the surtax is meant to serve the balance of the budget in the given financial–planning period), as can be the date of the decision on the rates of the surtaxes valid for the following year.

A) Problems coming from the two-year delay

In the present system, this problem is a bit overrated, as it is an established system. It as acceptable from the aspect of planning, as it is a stable resource which does not change during the year. In theory, the financing cannot be a problem, either, as its coverage is the current payments, the monthly instalments of which evidently exceed the current transfers which the local governments are eligible for based on their payments made two years ago. The problem is caused by the annual changes of the proportions of the division, about which the Parliament only decides in November. This conflict, however, can be well solved with programmes announced for several years (e.g. the method applied for the 1996-1998 period), or at least for the periods between the election cycles, the division should not be changed.

B) The date of setting the surtax rates

The IMF experts recommended that these rates be set by 30 September the latest, allowing each concerned party to have enough time to prepare for the change. The implementation is strongly influenced by the fact that the frameworks defining the rules of the game will probably change a lot in the coming few years. These frameworks, however, are only defined by the Parliament in November–Dcember every year. The date written in the recommendation would only be realistic if the general frameworks of the regulation (changes in the central taxes, state budget) were available as soon as the end of August in each year.

Problematic points concerning the surtaxation of the personal income tax:

- in Hungary there are significant allowances decreasing the tax base or the tax itself;
- the concealment of taxable incomes is common;
- the incomes of the agricultural employees are only taxed to a limited extent.

All three factors distort the regional distribution of the tax revenues. The first two factors are concentrated in the economically stronger areas (capital city, large towns), while agricultural population is more concentrated in the villages on the one hand, on the other hand, in the settlements of the Great Hungarian Plain. *The above-mentioned distortions are reproduced by the surtaxation of the personal income tax. The tax burdens would be suffered by the same layer – dominantly those employees who live on salaries and wages.*

3.3. The system of local taxes in Hungary

The reformed *system of the local taxes* is just becoming mature. This is beyond doubt, despite the rates relatively low in the beginning. It can be seen in several municipalities that they are starting to consciously shape their tax policies, and – often on the pressure by the local taxpayers (transparency, accountability) – they are *starting to harmonise it with the local settlement development and economic development policy*. The revenues flowing in from the local taxes are also more and more significant, but the rapid development of the tax revenues is dominantly the result of the industrial tax revenues (83.9% in 1997), aside from the gradual increase in the number of local governments introducing local taxes and the number of different tax categories (*Figure 1*). However, this kind of tax means – ever more significant – revenues only for the municipalities with considerable economic capacities.

On the other hand, several problems can also be raised in connection with the otherwise successful system of the local taxes. These are the following:

- half of the local taxes that can be levied tax the population, the other half the enterprises. Unfortunately, the present system – partly because of the heavy central tax burdens – makes the local governments tax the enterprises instead of the inhabitants. Industrial tax, the communal tax of the enterprises and the property-based taxes paid after the buildings and sites of the enterprises make more than 90% of the local taxes.

- Unfortunately it cannot be defined how much tax the population and how much the enterprises pay, because the central software which is obligatory to use for the summary of the taxes does not pay attention to that. The software should be transformed in a way that it should be able to treat separately the payments coming from the real estate tax, land tax and the communal tax of both the inhabitants and the enterprises. The central report still could be made in a division according to the five tax categories, but this information, which is very important for the formation of the local tax policy, would not be lost at least at the local level.
- The revenues from the industrial tax are concentrated in the capital city, the big towns and other settlements with more advanced economic base. Because of the large-scale concentration, it was raised that a part of the industrial tax should be withdrawn for equalisation purposes (French example). Another version recommends the transformation of this kind of tax into a surtax of the corporate income tax (*Illés*, 1996). Neither recommendation is acceptable within the present frameworks, because the levying of a tax – according to the present regulation of the local taxes – is only a possibility which the local governments can use. This would practically punish those local governments which try to expand their own resources. The transformation into a surtax is problematic also because the levying of the industrial tax is not obligatory. In addition, local governments are free to define the tax rates up to the upper limit set by the law.
- Within the narrow possibilities of the taxation of the population, the taxation of the *real estates* is still very rare. The possibilities that lie in this kind of tax is worth reconsidering. As there are real estates in each settlement, this is the type of tax that covers the widest layer of the population, besides the personal income tax. In addition, as real estates are visible, and the owner can be easily found, this tax can involve those layers of the inhabitants into the taxation who managed to evade the personal income tax. It is also an argument that the value of such real estates involves the level of the services provided by the

local governments. It is considerable that the real estate property of the Hungarian population is very large compared to the development level of the economy and the (known and admitted) income level.

- We have discussed several times the measures to be done in connection with the development of the taxation of real estates (*Illés*, 1994, 1996; *Lados*, 1993, 1995). They are still valid, with one exception (the significant decrease in the exemptions, which was made possible by the amendments of the Act on Local Taxes in 1995):
  ⇒ *modernisation*, upgrading *of the registrations of real estates*, completion of the computerisation (it should be assessed how far the implementation of the land office programme, which was started years ago with support from the German government, has got, as the originally planned deadline was 1998, and it is extremely important from the aspect of the development of real estate tax);
  ⇒ the establishment of reliable and generally accepted *value assessment procedures* is necessary (in the United Kingdom, the system of poll tax could be replaced within a year by the taxation of the real estates based on their fair market value, using the method of *mass value assessment*);
  ⇒ *both local governments and the population have to be prepared* for the paying of real estate taxes, and this is the most urgent of all the tasks connected to the introduction of the system – a good preparation takes three to five years, so the introduction of the value-based taxation of the real estates is hardly possible before 2002, given the present conditions.
- The local governments less frequently use the possibility that lies in the *land tax*. The majority of the local governments start from the fact that they have little of such areas, where higher tax revenues could only be collected by using high tax rates which could be defended with difficulties politically. So this kind of tax is seldom used, due to its weak income potential. In preparatory programmes it should be emphasised that the objective of the levying of taxes does not necessarily have to be to gain revenues, but it can be used as a tool of

settlement policy, a very good example for which is the land tax, which can accelerate the development of some underdeveloped areas and can also be used to prevent the speculation-led land purchases in the neighbourhood of major community investments. (The tax decreases the price of the lands and the real estates.)

4. The system of supplementary subsidies

When increasing the role of local resources – e.g. local taxes, surtax systems –, it is necessary to examine to what extent the distribution of the own resources of the local governments contributes to the reduction or strengthening of the disparities among the regions and the settlement types. So the construction of the supplementary subsidies, their transparency and the maintenance of the stimulation to use the local resources are issues of primary importance. In the resource-oriented financial planning, the divided personal income tax and the normative subsidies are complementary elements. The part of the personal income tax which remains in the centre becomes the basis of the subsidies distributed in a normative way. Does the decrease of the present proportions of division really amount to equalisation? It seems that in the recent years it was mostly the resource breakdown of the richest local government, the capital city, which has followed this principle. Parallel to the decrease in the share from the personal income tax, the weight of Budapest in the normative supports decreased, too (*Table 6*).

Table 6.

Personal Income Taxes and Normative Subsidies by Levels of Territorial Administration, in per cent

	personal income tax + personal income tax supplementation				**Normative state contribution**			
	1993	**1994**	**1995**	**1996**	**1993**	**1994**	**1995**	**1996**
Budapest	30,8	31,6	28,3	27,5	16,9	16,8	16,4	15,8
Counties	0,0	0,0	0,7	2,5	9,0	9,1	9,3	10,1
Big towns**	21,3	21,9	21,0	20,4	21,0	20,7	21,3	20,8

Other towns	22,4	21,9	22,7	22,3	23,9	24,0	24,5	24,6
Villages	25,5	24,6	27,3	27,4	29,2	29,5	28,5	28,7
Total	***100,0***	***100,0***	***100,0***	***100,0***	***100,0***	***100,0***	***100,0***	***100,0***

* According to the administrative division in effect in the given year
** All county seats and other towns with county rank
Source: own calculations after the database of the TÁKISZ (Hungarian Regional Information Service)

It is worth noting that this phenomenon can only be seen in case of the personal income tax, because of the supplementary subsidy of that. In case of the normative subsidies, the resources are mostly relocated towards the local governments of the counties and the towns. This is the consequence of the normative system which in many respects takes the urban, or medium level services into consideration, and usually sets the rates of those services in the range closer to the average level of the given service. At the same time, in case of the responsibilities also present in the village environment, the normative is further away from the average expenses.

In reality, there are several subsidies in the finance system of local governments which totally or to a significant extent serve equalisation purposes. In a sense, the task-oriented subsidies can be taken here, as they provide the same amount of grants after each student, or person in need of social benefits or health care. Besides these effects, however, these subsidies are mainly connected to individual tasks taken up by the state, and their main purpose is not equalisation but the completion of concrete tasks.

In another part of the subsidies, the equalisation function is dominant. These subsidies, however, are fragmented are dislocated. Some factors could be found in 1997 in that group of the personal income tax “remaining in place” which is, so to say, burdened with tasks. These are the following:

- supplementary subsidies for the personal income tax (19.0 billion HUF – villages: up to 7.073 HUF per capita, towns: up to 8.643 HUF per capita;

- general support for the villages (5.8 billion HUF – 2 million HUF per village);
- subsidy for the municipal administration, communal and sports tasks of the local governments (19.3 billion HUF – 1.842 HUF per capita);
- subsidies for those local governments – defined in a government decree – which are underdeveloped from socio-economic and infrastructural aspects, and for those with serious employment problems (2.7 billion HUF – 1.600 HUF per capita).

The latter three purposes were elements in the former normative support system. On the above-listed equalisation purposes, thus within the frameworks accountable from the personal income tax, 46.8 billion HUF would be spent. The personal income tax remaining in place is burdened with some subsidies given to the county governments, which seems to be a bit strange, an odd man out here. It would be more reasonable (but it does not sound so nice politically) that the proportion of the division is 22%. The 78% that remains in the centre serves as the basis for the financing of certain elements of the normative subsidies. In the present construction, the central government could account for 16% of the personal income tax in 1997 and 20% of that in 1998, but the channels where the remaining 62 and 60% of the personal income tax was spent is unknown, without transparency. (Naturally, as we have already mentioned in the chapter dealing with the divided personal income tax, we calculated the personal income tax remaining in the centre as if it all served as the basis of normative subsidies[6]. From this aspect, the coverage of the normative subsidies is not transparent, either, as we have not seen yet a division where e.g. 80% of the resources divided under the heading "normative subsidies" was covered by the centralised personal income tax and 20% by the VAT payments.)

From the normative state contributions, two objectives can be listed among the equalisation elements in the narrower sense:

- subsidy for the municipal administration, communal and sports tasks of the local governments (3.0 billion HUF – 312 HUF per capita);
- subsidy for public education (1.5 billion HUF – 157 HUF per capita).

Different subsidies assisting developments and operation are listed as independent items in the state budget, making a further 69.0 billion HUF:

- targeted and addressed grants (39.0 billion HUF);
- subsidies with development purposes, serving regional equalisation (8.0 billion HUF);
- supplementary subsidies for bankrupt local governments (6.0 billion HUF);
- subsidies for local governments in handicapped situation, with lack of funds through not their own fault (6.0 billion HUF).

This fragmented system, consisting of some 10 support elements, allocated approximately 110 billion HUF for the local governments in 1997, which is more than 10% of the expected total resources of the local governments. This amount can further grow with resources awarded from the Regional Development Fund, at the same time, the targeted grants should not be put into this category, as they typically demand own resources up to at least 60% of the developments, which could hardly be fulfilled by the local governments with weaker income positions, so they would get into a disadvantageous position in the competition. (It can cause further problems if they manage to collect the coverage of the investment, but there is no coverage for the operation in the future.)

In the 1991-1994 period, the more developed counties (e.g. Gyõr-Moson-Sopron) essentially did not receive any resources from the 18.5 billion HUF of the Regional Development Fund. At the same time, their share is considerably high from the system of targeted grants requiring substantial own resources, which used 52.3 billion HUF in the given period. (In the period in question, Western Transdanubia, which consists of Gyõr-Moson-Sopron, Vas and Zala counties, only received 2.7% of the grants awarded from the Regional Development Fund, while 17.7% from the targeted grants.)

This fragmented system should be put into a more comprehensible framework, or collected into a single equalisation support fund. The order of magnitude of the subsidies is as much as is covered by the local and the central part of the personal income tax in both the divided and the surtaxing system of the local personal income tax.

A) Separate development and operational equalisation support system

The equalisation support objectives listed above could be divided into two main groups. One of them would provide resources of equalising character for the continuous operation of the local governments, while the other would equalise the chances for the access to development possibilities.

1. The local governments that are awarded equalisation grants on different grounds usually overlap each other. Thus in the first case it is advised to integrate into the supplementary subsidy of the personal income tax the former elements of the subsidies: supplementary subsidy for the personal income tax, general support for the villages[7], subsidy for the municipal administration, communal and sports tasks of the local governments, subsidies for local governments in handicapped situation, with lack of funds through not their fault, and supplementary subsidies for bankrupt local governments. This amount of approximately 60 billion HUF should be distributed through a support form, the supplementary subsidy for the personal income tax.

   In the present personal income tax equalisation mechanism, more than 90% of the local governments are involved, so this circle is wide enough to cover all the settlements belonging to the former fragmented system of equalisation purposes. After this, only the average personal income tax per capita should be defined, with which the subsidy distributed through the equalisation of the personal income tax would triple.
2. Development supports could still be operated as targeted grants. The category called addressed grants is not necessary by all means, if the grants are rendered individually to the objectives to be supported. A matrix could show the level of the subsidies that the objectives to be supported could reach at the individual local governmental types. This

way both horizontal and vertical fairness can be asserted in the supports, as each local government can get support for development purposes, but the extent of the support can vary, taking the special situations into consideration.

It could be declared that the basis of both supports is the part of the personal income tax which remains in the centre. On the whole, the personal income tax revenues should be spent on four kinds of purposes by clear division principles, if we maintain the pattern of the divided incomes:

- *personal income tax remaining in place*: because of the equalisation concerning an extremely wide circle, the 20% from the direct personal income tax planned for 1998 seems a bit too little. From 1999, this figure should be raised to 30 or 40% of the net personal income tax revenues[8];
- *supplementary subsidies*: essentially this is the total of the operational, and development equalisation supports gathered in the individual support labels, the supplementary subsidy of the personal income tax and the targeted grant. This total makes 35 or 30% of the net personal income tax revenue. (The higher figure would be the proportion in case of the lower share of the personal income tax directly remaining in place and vice versa.)
- *normative or task-oriented supports*: they make 35 or 40% of the net personal income tax revenue. (The higher figure would be the proportion in case of the lower share of the personal income tax directly remaining in place and vice versa.) If this should not cover the total of the necessary supports, the missing part could be filled from the VAT revenues.
- *coverage of the expenses of the central tax authority*: the APEH is a central budgetary organisation, thus its operation is financed from the tax revenues. That is why it is reasonable to expect that a part of the personal income tax revenues, which appear as a local governmental resource but is administered centrally, should contribute to the maintenance costs of the APEH. The maximum amount of this

contribution can be the difference between the gross and the net personal income tax.

If the central and the local personal income tax were separated, the formula would only change inasmuch as a clear proportions of division among the individual support types should be declared.

B) Standard equalisation fund

The distribution of the support fund serving equalisation purposes could take place based on relatively few indices, which characterise well the situation of the local governments. Five such indices could be taken into consideration (*Illés*, 1996):

1. The difference of the operational costs of the local government and the realistic coverage that can flow in from the local resources;
2. population of the settlement, or the municipality;
3. properties of the local government which require maintenance, renovation and management;
4. non-real estate property of the local government, which is a potential material–financial resource;
5. length of the inner roads, which is more or less proportionate to the road, public utility, lighting and public area maintenance tasks and the tasks of the local transportation.

The other branch of the subsidies could be task-oriented grants, which is different from the equalisation grants both in function and economic political character:

- In case of the task-oriented grants, the central government takes responsibility for and a certain share of the expenses from the provision of a concrete task. In this case it might be reasonable to define the guidelines for the proportion of the burdens, e.g. in the branches that are state responsibilities (public education, health care, social care) the division could be 2/3 state subsidy and 1/3 own resources of the local governments.

- The equalisation grant is a “monetarised” support, in which the central budget does not take any responsibility or burden in one concrete task or sectoral development, all they do is to contribute to the maintenance of the operation and the reduction of the differences. The indices and the normatives are only rates, based on which the individual support funds – defined depending on the burden bearing capacity of the national economy and the budget – can be divided among the individual local governments.

4 Summary, recommendations

Starting point:

The role of the governmental (budgetary) participation in regional development at territorial and local level are:

- *the reduction of regional disparities;*
- *the stimulation of processes desirable at national level.*

A real equalisation only takes place if the local governments in the backward regions have development resources, too. The precondition for that is, however, the stable provision for the running operational needs.

The desirable situation in the future could be guaranteed by the application of a resource system at local governmental level which, on the one hand, promotes the *increase of the financial independence* of the Hungarian local governments, on the other hand, enables the *equalisation* among the local governments with different income capacities. The first objective could be guaranteed by the expansion of the resources of free discretion, in the second case the fragmented system should be made more comprehensive, transparent and efficient.

The experts’ opinions seem to reach a consensus that two ways are recommended for the increase of the financial independence in the given Hungarian conditions. One direction is the transformation of the divided personal income tax revenue system into personal income tax of central and local discretion, the other is the development of the local real estate tax and the use of value-based tax on real estates. Lately the role of the industrial tax in the long run has been appreciated. According to the Hungarian traditions, local surtaxes were levied in a certain per cent, approved of by the Ministry of Interior, of the central direct taxes. These included both property taxes and (personal and corporate) income taxes. The presently accepted international practice favours the surtaxes levied on the personal incomes. This can be a resource for all of the local governments, at the same time, it could expand the right to levy taxes to the medium level of the local governments, as well.

The system can be created in a year or two. The years of 1997 and 1998 are enough for the preparation, as the rules of the division of the personal income tax has been set for these years in a three-year programme, and this should not be disturbed. This would allow enough time for the introduction of the surtax on personal income tax from 1999.

It is not recommended to levy surtax on the corporate sales tax and corporate income tax, as this would deteriorate the competitiveness of the local economy in the long run. It should be set, instead, to what extent the individual governmental transfers are financed from the individual central taxes. The surtax on the corporate income tax is also not recommended, among other things because in the list of local taxes we find the industrial tax, which can operate as a kind of local corporate sales tax. Its role, however, should not be increased but decreased in the long run. The industrial tax operating with higher and higher rates distorts the competitiveness of the local enterprises on the one hand, on the other hand, it can spur the tax competition among the settlements to an unjustifiable level.

Among local taxes, the development of the tax on real estates, within that the tax on the residences is recommended. Certain element necessary for the shift to a value-based taxation of the real estates have been realised (elimination of central exemptions), others are under implementation (computerised real estate registration, expiration of former exemptions, privatisation of the real estates of the local governments), while there are some elements which are still missing (act on the assessment (?), training programmes, preparation of the inhabitants). The shift can last for a period of four or five years, during which the preparation of the population for this type of tax is the most essential task (this should be implemented similar to the expansion of the personal income tax to the whole circle of income-earners in 1998). Presently it is important from the aspect of the value-based real estate tax to look at where we are in the implementation of the recommended processes and the often mentioned strategic programme measures.

The personal income tax will remain one of the fundamental elements in the financing of the local governmental management in the long run. In the 1990s, as a consequence of the processes connected to the transformation (unemployment, regional differences of the economic decline or growth) and for demographic reasons, an *increase is expected in the coming medium-term period of time in the disparities of the incomes of the population in the different regions and settlements*. This emphasises the importance of the operation of the income equalising mechanism in the field of local government finance.

The resources of equalisation are extremely fragmented and scattered in the present system of financing. Their transformation can take place the following way: the beneficiary local governments largely overlap each other as regards the equalisation grants received on different grounds. Only *two types of equalisation grants* should be used. One of them could serve the equalisation of the financial conditions of the operation, in the frameworks of the personal income tax equalisation support, while the other one would promote developments through the system of targeted grants. The resource for both supports would be the central personal income tax (or the part thereof that remains in the centre).

The personal income tax would serve four purposes altogether. The local or surtaxed personal income tax would make 30-40% of the total of the net personal income tax, while the centralised or central personal income tax would be divided equally between the equalisation grants and the normative or task-oriented supports. In the latter case the proportion should be defined which the government will cover not from the personal income tax but from other tax revenues. The difference between the gross and net personal income tax revenues would contribute to the coverage of the budget of the APEH.

The reform of the state budget concerns the management of the local governments in several places. The reform of the large systems of provision, such as public education, social care, health care, influences the local governmental tasks and the macro-level resources allocated to these, and also the transformation of the distributing and regulating system. This is the most palpable for the local governments through the system of normative supports. It is necessary to decide in which direction the system of normative supports should be developed. If normativity is meant to handle the regulation of the resources and the equalisation together, then a distribution formula consisting of only four or five indices would be enough. If task-oriented financing is given the priority, then this form of financing only has to address three fields, namely those in which state participation is significant: public education, social care and health care. All other fields – with the exception of the financing of the ethnic and minority local governments, which requires a special regulation – would be taken out of the system of the normative rates of distribution. Their coverage has to be achieved by the individual local governments, from the local personal income tax or the part thereof remaining in place, from the local revenues and though the equalisation systems assisting the operation.

The pressure on the resource side could be alleviated by the more rational organisation of the services. This does not necessarily mean the forced creation of larger local governmental units. The effective operation is promoted mainly by two processes: one of them is the decentralisation of the local governmental tasks, i.e. the strengthening of the private sphere in certain local community services; the other one is the stimulation of the formation of local government associations for the common implementation of tasks. This should be achieved by financial regulation and not by administrative means, by obliging the local governments to associate with each other.

Notes

[1] If we did not consider the capital city as a whole but looked at the districts separately, then District 2 would lead the list of the settlements in each year. The personal income tax per capita generated here exceeds the countryside average by more than fivefold.

[2] The report of the World Bank on Hungary, made in 1992, focused on the budget and the operation of the sector of public services. The report ("The Financing of Local Governments in Hungary") was made by Richard Bird and Christine Wallich. Their work was assisted by Gábor Péteri, expert of the financial matters of Hungarian local governments.

[3] In representation of the Department of Tax Affairs of the IMF, a four-member delegation visited Budapest and a few countryside settlements in 28 August – 14 September 1994. The aim of the visit was to provide technical assistance for the reform of the financing systems of the Hungarian local taxes and local governments. The members of the committee were Emil M. Sunley, Deputy Director of the Department of Tax Affairs; P. Bernd Spahn, fellow of the Department of Tax Affairs; Robert D. Ebel from the World Bank; and Jorgen Lotz, member of the experts body on tax affairs. The work of the committee was assisted by the Városkutató Kft. (Urban Research Ltd.), as an expert group of the financing of local governments in Hungary.

[4] The recommendation ("Reform of the Hungarian Local Governmental System") was done by the authors on request of the Ministry of Interior, in the frameworks of the British Know-How Fund, in 1994-1995.

[5] In connection with the recent raises of the rates of tax, those who are against the raises like to refer to the so-called Laffler-curve, according to which after a certain point the increase of the tax rates does not increase but decrease the total of the tax revenues. In their opinion, in Hungary the upper margins of the tax schedule have exceeded this point, so in international comparison the concealment of the taxable incomes is higher in Hungary. However, no published analyses have been conducted examining how the decreases of the marginal tax rates to different extents can change the attitude to taxpaying and whether the personal income tax revenues can grow even with decreasing rates. Naturally, the volume of the tax revenues is defined not only by the rates and the connected willingness to pay, but also the width of the tax brackets, the scales of the items decreasing the tax base or the tax, and inflation.

[6] As a matter of fact, the division of 100% of the personal income tax among the local governments is unrealistic, as in this case this income is not burdened by administration costs. At the same time it can be expected that a part of the budget of the APEH should

be covered from the personal income tax revenues. This might work this way, but we do not know, as the accounting is not public and transparent.

[7] This support element was created at the introduction of the system of normative supports. Its amount per village has not changed since then: 2 million HUF for each village. In 1991, this resource made approximately 50% of the revenues of some 50 local governments. By 1997, the real value of this resource dropped to one-fifth of the 1991 value.

[8] In the essays evaluating the budget of 1997, the local governments expressed their grievance that the central government, when defining the proportion of the local governments, did not start from the gross, i.e. the total revenues, but from the net revenues, i.e. the personal income tax revenues specified for the individual settlements. In my opinion, the starting from the net personal income tax is acceptable if it is known what happens to the "remaining" personal income tax. This could be the easiest made transparent by the system handling this part as a proportion serving the operation of the APEH, although it still remains a question how they will account for the surplus personal income tax revenues flowing in from the tax controls.

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