Zoltán Lóránt

Local public finance and local taxes

I wish to provide an overview of the role and weight of an increasingly important source of income of the nearly 3200 Hungarian local authorities, i.e. local taxes. Local public finance represents 12–13 per cent of GDP expenditures, and 23–25 per cent of public finance expenditures.

Regarding income centralisation, the proportion of slightly over 2 per cent of local taxes compared to the GDP in Hungary is lower than in other countries. However, these taxes are predominantly paid by enterprises. Enterprises are obliged to pay corporate income tax and local business tax, the former after their profit, adjusted in accordance with the provisions of the Act on Accounting, the latter after their revenues, which, naturally, affects the competitiveness of enterprises. In OECD countries, applying the principle of equitable contribution to public revenues based on property, property-type taxes comprise 3–4 per cent of the GDP, while in Hungary, together with other property-type contributions to public revenues, they remain under 1 per cent.

EUROPEAN OVERVIEW

Legislation regarding the finances of local authorities does not fall under Community competence in the European Union. As a result, the financial regulations concerning local authorities are characterised by differences originating in historical and national traditions. However, the widely accepted common values of local governance appear in the legislation of all EU Member States. These common European values of local governance were recorded in a document ("European Charter of Local Self-Government") adopted by the Council of Europe, which was comprised of numerous European countries besides the fifteen EU Member States. The Charter was ratified[1] by Hungary, too.

Article 9 of the Charter deals with the financing of local authorities, and with issues of finance, economy, and financial management. It states that the basis of financing local authorities is their being entitled to adequate financial resources, obviously limited by the indicators of the given national economy. Part at least of the revenues shall derive from local taxes and charges of which, within the limits of statute, local authorities have the power to determine the rate.

Another central thesis of financing local authorities is the recognition of the autonomy of their financial management, i.e. of their relative freedom of allocating and spending the funds collected. Within the framework of the fulfilment of the obligatory tasks of local authorities, the funds distributed by the state may entail restrictions on what they can be spent on. To thwart the unnecessary expansion of that trend, it is required that the proportion of earmarked sums, which entail restrictions on what they can be spent on, should preferably not exceed an absolutely necessary extent.

Internationally, we can see that certain EU Member States have a separate act regulating the financing of local authorities (United Kingdom, the Netherlands, and Austria). In these countries the Local Authorities Act does not contain an in-depth treatment of financing issues. At the same time, each EU Member State is free to decide the operation of which taxes to entrust to local authorities, and what sort of limitations to set for them. Only *that there is to be a tax type in the tax system whose rate, within the limits of the statute, is determined by local authorities is generally expected. The Hungarian Act on Local Taxes, allowing local authorities* considerable latitude, almost unparalleled in Europe in fact, is characterised by that latter notion.

The structure of resources of the budgetary revenues of local authorities has evolved similarly all over Europe. Accordingly, these three major forms of financing can be found in all Member States:

- supports from the central budget,
- "shared" or "transferred" revenues, from taxes or other payment obligations, and
- local authorities' own revenues.

However, among the Member States, there is considerable divergence with regard to the status of the sources of revenues within the national economy and the system of public finance, their share in these, and the relative weight and proportion of the different financing solutions.

The significance of the sources of revenues available for local authorities within the national economy and public finance is best indicated by their share from the annual GDP of the given country. In this respect, we find considerable differences between the states opting for the *Northern European model of local governance*, endowed with a wide scope of responsibility (where the sphere of local self-governance is deemed the largest provider of public services), and those implementing the *Southern European model of local governance*, relying on the sphere of local self-governance regarding public services to a lesser degree. The former group is comprised of countries where the share of the sphere of local self-governance from the GDP exceeds 10 per cent; for instance the Scandinavian countries (nearly 30 per cent in Sweden, and as high as 20 per cent in Denmark), Finland (approx. 18 per cent) or the Netherlands (nearly 20 per cent). By contrast, the model of local governance which has evolved in the Southern European Member States is characterised by a GDP share of under 10 per cent. Among these countries, the share of the sphere of local self-governance is around 2–3 per cent in Greece, 5 per cent in Portugal and Spain, 7 per cent in Italy, and it does not exceed 9 per cent in France, either. (The Hungarian local authorities with their share of over 12 per cent are somewhere between the two models. Their structures and authorities are characterised by midway solutions relying on both models.)

Examining proportions *within the structure of resources* available for local authorities, it has been found that as far as the support received from the state is concerned, the proportions of the sums awarded

- on a normative basis (normative support received from the state) and on a different basis (non-normative support received from the state – with quite wide-scale availability and titles), and
- with restrictions on what they can be spent on (earmarked sums) and without such restrictions (supports received from the state to be utilised freely) are far from insignificant.

Shared or transferred revenues represent a share of local authorities – of a determined extent – in the payment obligations centrally stipulated for public finance (i.e. those uniformly regulated within the whole country). Typically, these are taxes; however, there may exist payment obligations with different names (e.g. "duty" or "contribution"). The terms "shared" and "transferred" refer to what characterises the route of the public revenue in question – in the case of the former, it is the local authorities that levy the tax and "share" it with the central budget, while in the case of the latter, it is the state that "transfers" a statutorily determined part of a central tax revenue to local authorities.

The diverse group of *local authorities' own revenues* is typically comprised of the following financial resources and titles:

- local taxes (tax type set by local authorities, i.e. unilateral payment obligation),
- local charges (charge type set by local authorities, i.e. payment obligation due for local services), revenues from fines,
- revenues deriving from properties of local authorities (e.g. privatisation revenues, concession fees, rental fees, dividends, interests, capital gains),
- funds received, and
- loan revenues (bank loans, revenues from bond issues).

The financial regulatory solutions regarding the systems of local governance of the Member States differentiate between *support-based financing,* and *tax-based financing.* In the former case, over 50 per cent of the funds available for local authorities is comprised of state budget supports (e.g. in the Netherlands and Great Britain). In the latter case, it is taxes (i.e. central and local taxes) that play a decisive part. For instance, such tax-based financing is adopted in Denmark and Sweden.

THE FINANCIAL AND LEGAL ENVIRONMENT OF LOCAL TAXES IN HUNGARY

In order to create the economic basis of local governance and further expand it, the Hungarian tax system has had local taxes for nearly 20 years. Upon the coming into effect of Act C./1990 on Local Taxes, it became a basic constitutional right of municipalities to issue decrees on the introduction of various local taxes (such as tax on buildings, land parcel tax, communal tax payable by private individuals, communal tax payable by entrepreneurs, tourism tax, and local business tax).

Pursuant to the Act on Local Taxes, *the representative bodies of municipalities*[2] have the competence and authority

- *to determine* the date of the introduction and the duration of local taxes within their area of competence, and *to make* detailed regulations on local taxation,
- *to set* the tax rates to be introduced, taking into consideration certain local characteristics, the requirements of the financial management of the municipality, the burdenability of the taxpaying entities, and the upper limits of tax rates determined statutorily (they may also extend the regulations regarding tax exemptions and allowances at their discretion),
- *to supervise* the levying of taxes through calling for notary's reports, and *to inform* the inhabitants on the local tax revenues annually.

It also needs to be highlighted that, pursuant to the Act on Local Authorities, the administrative supervision of local authorities is undertaken by the Regional Public Administration Offices. It is their task to assess whether the decisions of local authorities (including local tax regulations) are in compliance with the law. In addition, *regarding the different bodies of local authorities acting as authorities of public administration* and undertaking tasks of public administration, *the Public Administration Offices are entitled*

- to call professional co-ordinatory meetings, and
- to conduct audits at town halls, offices of district notaries, offices of county assem-

blies, administrative associations of settlements, and the Municipality of Budapest pursuant to their supervisory authority.

In addition to such audits, they offer professional assistance highlighting changes in the legislation and calling attention to infringements of the law experienced in local legislation in circulars and at notary's meetings. That latter forum is especially important because the performance of the tasks relating to local taxation is indeed de-centralised, delivered within the organisational structure of each settlement, which sometimes entails considerable differences in terms of personal and material standards and conditions. It is worth noting that due to the compulsion of taxation, the representatives of the settlements concerned have to face both the attitudinal factors negatively affecting the inhabitants and the "given" economic opportunities of the region the latter interacting with the economic and social circumstances of the micro-region.

Within the area of competence of local authorities, immovable properties and the relating rights of property value, the employment of workforce, the performance of business activities, and being provided with accommodation not as an inhabitant permanently dwelling in the settlement are deemed taxable. Consequently, local authorities may introduce land parcel tax and tax on buildings, local business tax, communal tax payable by enterprises and private individuals, and tourism tax. Naturally, actual tax payment obligation may only arise from decrees issued by local authorities, whose taxation licence relates to introducing and modifying different taxes, as well as setting the tax rates, defining the applicable exemptions and allowances, and setting out the rules of local taxation within the limits of the statute. On the other hand, the law prohibits the modification of the rules relating to a tax already introduced within the calendar year, i.e. a mid-year increase of a tax burden. Another restriction is that tax-paying entities may only be obliged to pay one type of tax (either property-type tax or communal tax) on one taxable property.

The Amendment of the Act on Local Taxes, effective as of January 1, 1996, created an opportunity to expand funding for voluntarily undertaken local tasks by diminishing central exemptions and allowances, and raising the applicable tax rates, thus, indirectly, by increasing local authorities' own revenues, which opportunity municipalities have opted to take to a larger and larger extent. Due to the widening range of the public tasks to be performed, the decrease of the real value of budgetary support, and further financial difficulties, both the number of local authorities introducing local taxes, and the proportion of local tax revenues significantly increased after 1996. (The proportion of local tax revenues within the total revenues grew from 5.7 per cent in 1996 to 15 per cent in 2007.) Local taxes accounted for 0.8 per cent of the GDP in 1993, and 2 per cent of the GDP in 2007 while the rate of income centralisation also increased as a result of the effects of the measures implemented in 2007, which caused an increase of revenues and affected central taxes. *Table 1* demonstrates changes in local tax revenues.

The EU law harmonisation required the abolishment of local business tax exemptions and allowances as of December 31, 2007. Thus, since January 1, 2008, only enterprises whose tax base does not exceed 2.5 million HUF may receive tax exemption or tax allowances – under conditions set out in a decree issued by the local authority. The abolishment of allowances and exemptions has significantly increased the tax burden of enterprises, which has led several local authorities (e.g. those of Kecskemét and Debrecen) to decide to gradually decrease the local business tax rate. Such steps may induce a tax competition among local authorities wishing to attract enterprises.

Pursuant to Article 2 (4) of Act XXXVIII./1989 on the State Audit Office of

Table 1

CHANGES IN LOCAL TAX REVENUES (NATIONWIDE FIGURES)

(million HUF)

Name of tax	1995, actual	Proportion, %	2007. actual	Proportion, %
Tax on buildings	4,145	8.9	54,556	10.8
Land parcel tax	813	1.8	6,900	1.3
Communal tax payable by private individuals	747	1.6	9,069	1.8
Communal tax payable by entrepreneurs	1,075	2.3	1,261	0.2
Tourism tax paid after stays	768	1.7	4,935	1.0
Tourism tax paid after holiday houses	363	0.8	1,412	0.3
Local business tax	38,472	82.9	427,133	84.5
LOCAL TAXES, TOTAL	46,383	100.0	505,266	100.0

Source: Hungarian State Treasury

Hungary *it is the task of the State Audit Office to supervise the taxation-related activities of local authorities.* The State Audit Office has audited[3] such activities of local authorities twice: first in 1996, then in 2001. Below, I wish to review the weight and role of local taxes in the financial management of local authorities based on the preliminary study drawn up to summarise the findings and serve as a basis for a new thematic audit.

TAX POLICY AND THE MAJOR MACRO-ECONOMIC IMPLICATIONS OF LOCAL TAXATION

Income centralisation with question marks

Professionally speaking, prior to any analysis it is necessary to ask whether it is possible to increase the current extent of income centralisation in public finance. If we merely consider the unexploited opportunities, the state budget deficit, the legal and illegal evasion of contributing to public revenues, and the funds requirements of public expenditures, the answer is, unambiguously, yes. However, if we emphasise the effect of excessive levies strengthening the black economy, the capital requirements of SMEs, and last but not least, the decrease of taxpayers' real incomes, then the answer is, unambiguously, negative. Today, the Hungarian economy is characterised by overregulation and overextensive income centralisation: we are compelled to ensure heavy redistribution. The measures of a thoroughly prepared tax reform implemented with proper gradualness ought to serve to establish a stable and predictable system of taxes and contributions, which can be made valid assumptions on for several years ahead, eradicating the negative effects of frequent changes on business calculations, and securing the predictability of the revenues of the central budget within the harmonised systems of central and local taxes.

Is it possible to find the right solution? Economically speaking, a reform of public finance, references to which have been made for decades, without its long-term effects ever being thoroughly considered, as well as the modification of the current, paralysing system of taxation, and, above all, the long-term, serious reconsideration of the expenditure side of all four subsystems of public finance[4] have become “compelling needs” by now.

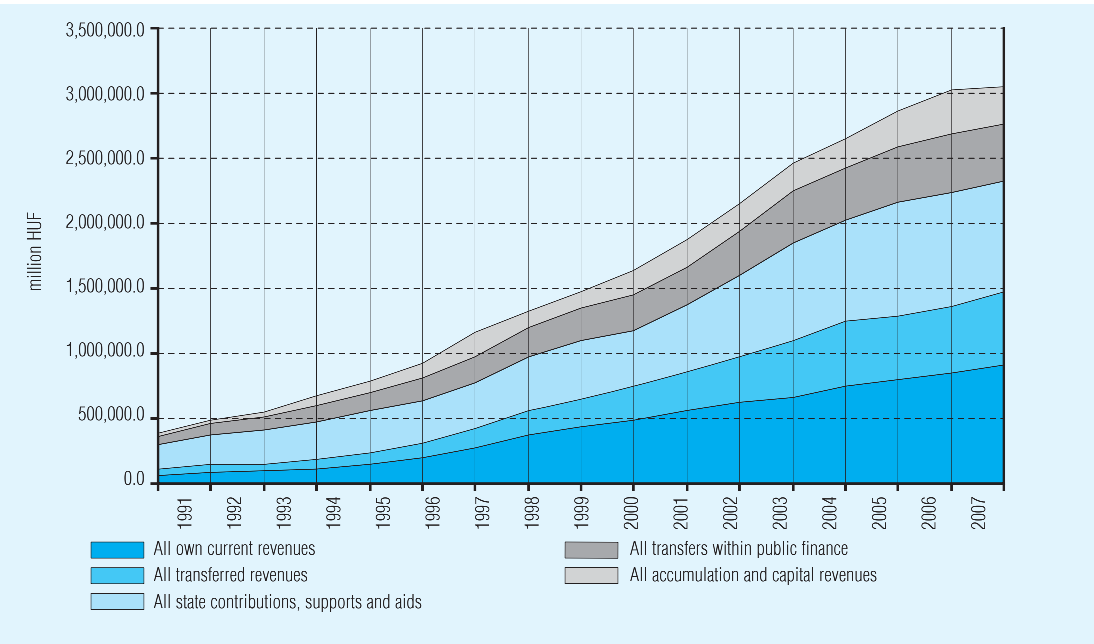
It is necessary to make it clear for the whole society which tasks the state is able to undertake to perform and to what extent it is ready to finance them. The same requirement is especially important regarding the subsystem of public finance comprised of local authorities as nowadays the nearly 3,200 local authorities and the 13,000 budgetary institutions directly supervised by them need to undertake several public tasks as "services" on a daily basis, while their annual budgetary financial management is not provided.

It cannot be treated as a piece of macroeconomic determinism that the fiscal policy should implement a system of self-provision of an ever-widening scale, extended to the whole population, while drastically draining incomes. Consequently, in today's changing economic and social setting, it seems necessary to define the extent and scope of the performance of public tasks, and to make stipulations on their direct or indirect financing in the Act on Public Finance. Or, to put it more simply: who is going to perform certain public tasks in the long run and how (i.e. drawing on what resources)? Or, should they fail to be performed, what economic and social consequences are expected in health care, public education, culture, public administration, or even public transport, etc.? It is also important to note that the redefining of classical public tasks has been discussed for years now; on the one hand, there has been a "concise" revision of tasks, usually entailing a decrease of funding without conducting impact studies, while, on the other hand, there has been the continuous collection of the more and more easy to levy tax forints going on. *Chart 1* illustrates all that from the point of view of available funds, demonstrating the changes in the distribution of revenues of local authorities.

Appendix 2 illustrates the changes in the real value of the revenues and expenditures of local authorities, the analysis of which is not an objective of the present study. However, it

Chart 1

DISTRIBUTION OF GFS[5] SYSTEM REVENUES OF LOCAL AUTHORITIES (1991–2007)



is necessary to emphatically state that on the local level of public finance (where, after all, it should be necessary to enable 13 thousand budgetary institutions to perform public tasks) positive changes in the consumer price index and the real value index are the prerequisite of quality operation, while that group of institutions has not even managed to secure "operational automatism" over nearly two decades.

In the financial management of local governance, accelerating bond issues have played an increasingly important part, especially in the last three years. *Local authorities undertook to issue bonds of a value of 4.5 billion HUF in 2005, 24.4 billion HUF in 2006, and 180 billion HUF in 2007* (with capital repayment moratoria of 3–5 years and of terms of 15–18 years on average). This process has continued in 2008. The portfolio of the bonds issued has grown by a further 96 billion HUF in the first half of 2008. To make sure that an increase of bond issues of such an extent will not cause local inhabitants long term financial difficulties, they will need to be used in long-term development projects within "Economic Programmes", and are not to be spent on operational expenses or on financing the repayment of older, less advantageous credits.

Let us provide a new basis for the tax system

It is necessary to provide a new basis for the tax system,[6] hitherto characterised by unpredictable changes. It is to be done by devising and unambiguously determining the long-term means to be used to finance the tasks necessitated by the reform: what may be the optimum weight of taxes within that framework, how much leeway ought to be provided for them, and, naturally, how the relation of central and local taxes is to change within the system. It should be done by drawing the limits of central taxes and defining the applicability of potential local taxes in order to avoid "clashes" within the tax system or tax accumulation. Regulations may only be successfully adopted provided "these two" mutually recognise and complement each other. It can be easily understood that the stronger central taxation is, the less leeway local taxes will have.

Professionally speaking, another important expectation may be that a *"shift" in any direction regarding one element of the tax system almost inevitably entails the modification of the elements directly not affected by the change.* This statement is not only valid regarding central and local taxes, but also within each "central regulatory" unit. For instance, if the introduction of a centrally controlled property tax is approved of, that in itself makes it necessary to reconsider the current weight and focus of central taxation. The reason is that it is hardly conceivable that a property-type tax of a significant range and weight should leave the current structure of levies untouched. Should the level of levies stay unchanged regarding the generation of incomes, final consumption, and accumulation, this lack of change will render the operation of a new type of local tax system impossible.

The decision may be well-founded if, firstly, it adopts a system approach towards possible solutions, and secondly, it takes into account the effects beyond the tax system: in order to promote economic growth, and not less significantly, regarding social issues (the social safety net). Jointly, these factors make it necessary for economic, legal, and not less significantly, sociological impact studies of high standard to be conducted. Naturally, it is only possible to modify local taxes without major political conflicts if the local authorities concerned demand the changes, and state how they should be implemented themselves.

Limits to increasing local taxes

Examining the macroeconomic implications of imposing local taxes, it is necessary to face the fact that *the possibility of increasing local taxes is limited by several economic and political circumstances amplifying each other.* The increasingly harsh economic circumstances call for moderation as the representatives making the local tax regulations undergo a rigorous test at the municipal elections every four years. The tax burden to be borne by potential taxpaying entities (enterprises and private individuals) is largely affected by central taxes, unemployment, the increase of the proportion of the inactive population, and the decrease of real incomes. These require serious consideration, if not regarding the introduction of the individual local taxes, then when selecting taxpaying entities (entrepreneurs and/or inhabitants), setting tax rates, and deciding on allowances and exemptions.

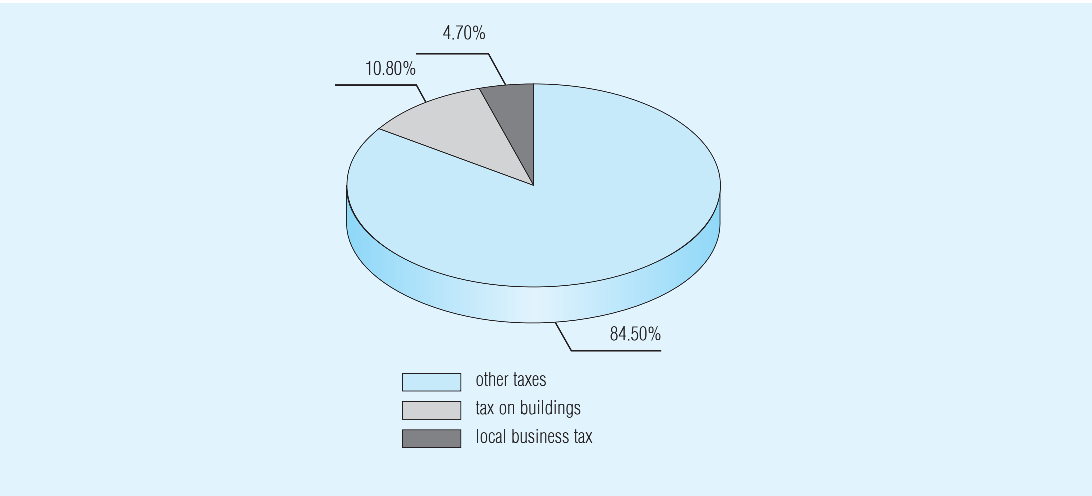
Finally, the question concerning the volume of "reserves" within the local tax system cannot be evaded. Potential reserves are best demonstrated through the examination of the factual figures of the payment of the tax on buildings and of local business tax as these are of a substantial volume. These two tax types are determining factors within the revenue structure, as it is illustrated by *Chart 2.*

In 2007, revenues from taxes on buildings amounted to nearly 55 billion HUF, while only nearly one third of local authorities took the opportunity to introduce that tax type, and among them, twice as many imposed it on real properties not used for permanent accommodation as on real properties used for permanent accommodation. Nowadays, flats and houses in rural areas, of a lower value and level of conveniences, tend to be more likely to be burdened by the tax on buildings, while the more valuable urban flat and house portfolio is hardly or not at all affected by it. Regarding that issue, it is also thought-provoking that slightly over 10 per cent of all taxes on buildings (i.e. 6.5 billion HUF) is paid by private individuals. This in itself, and especially together with local business tax, renders the operation of the tax system disproportionate, i.e. a substantial part

Chart 2.

PROPORTION OF LOCAL TAXES, COUNTRYWIDE FIGURES, 2007

(total amount: 505 bn HUF)



Source: Hungarian State Treasury

of local taxes burdens enterprises. As I have mentioned above, local government representatives tend to exempt potential voters, or, to put it another way, their decreasingly solvent taxpaying entities from paying local taxes. Still, even in settlements where tax on buildings is imposed, with statutorily stipulated and locally complemented allowances, its rate typically slightly exceeds half of the maximum imposable rate. *Chart 3* demonstrates reserves in the local tax system.

To increase revenues, tax on buildings is a suitable and applicable tool for years to come, offering an estimated annual revenue surplus of nearly 200 billion HUF even through an application that fulfils the requirement of fairness at a local level.

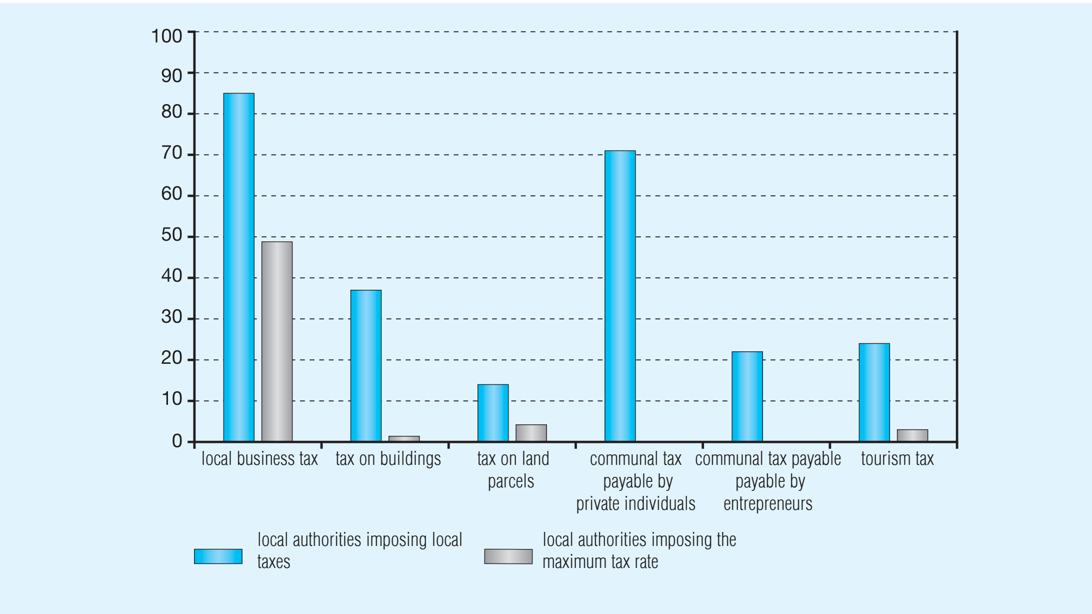
Local business tax is applied more widely. In 2007, as many as 2705 local authorities did impose it, thus, practically speaking, the potential tax revenue reserve is smaller than in the case of tax on buildings, considering the number of local authorities. However, the tax burden amounts to approximately 80–85 per cent of the maximum imposable level, so local business tax reserves may be estimated as approximately 100 billion HUF. Apart from these two tax types, no tax revenue can be expected to provide significant surplus funds for local authorities.

THE ROLE OF LOCAL TAXES IN THE FINANCIAL MANAGEMENT OF LOCAL AUTHORITIES

Over the past decade, as a result of inflation and economic growth, net turnover, which forms the basis of the calculation of the tax base of local business tax, has increased.[7] To boost their budgetary revenues, local authorities have been increasing the number of local tax types introduced as well as the tax rates (primarily that of local business tax). Also, the number of local authorities that have introduced some type of local tax has been growing:

Chart 3

PROPORTION OF LOCAL AUTHORITIES IMPOSING LOCAL TAXES / IMPOSING MAXIMUM TAX RATES, 2008



1640 local authorities seized the opportunity in 1995, 2970 in 2000, and 3114 (98 per cent of all local authorities) in 2007.

Over almost two decades, the revenues of local authorities deriving from the central budget (state supports, contributions, the part of personal income tax "transferred"), as well as their own revenues and local tax revenues have been growing continuously. This is demonstrated by *Table 2.*

Quantitative growth is clearly reflected in Table 2; however, these amounts, in real value, have failed to keep up with the cost surplus necessary for the performance of public tasks. The Appendix contains data on the changes of the real value of the revenues and expenditures of local authorities (between 1991 and 2007). Consequently, local authorities' own revenues, including local tax revenues, which have slightly grown in real value, have had a more and more significant part in the (compulsory and voluntary) financing of the performance of the tasks of local authorities, and in ensuring their financial stability. This is demonstrated by *Chart 4.*

Nominally, local tax revenues have been growing continuously and dynamically since 1996: from an annual 46.4 billion HUF in 1995 to 222.8 billion HUF in 2000, and 505.3 billion HUF in 2007. As a natural consequence of the growth, their proportion compared to the subject year revenues has changed significantly, increasing from an annual 5.7 per cent in 1995 to 13.0 per cent in 2000, and 15 per cent in 2007.

Disproportionateness and regional inequalities in local tax revenues

Among local taxes, local business tax paid by enterprises is obviously the most significant one. Its proportion has always been high, approximately 85 per cent. The total local business tax levied showed a 5-fold increase between 1995 and 2000, and a nearly eleven-fold increase between 1995 and 2007. During the same period, other local tax types (the total of tax on buildings, land parcel tax, communal tax, and tourism tax) also showed a manifold increase, but they have a smaller weight owing to their rates. Due to the local business tax concentration in economically more developed regions, considerable differences have arisen regarding the tax capacity of different settlements.[8] Before 1999, for want of a balancing mechanism, the differentiating effect of local business tax on the financial situation of municipalities was profound. (Outstanding settlements include Székesfehérvár, Győr, Százhalombatta, and Paks.)

Changes in total revenues in different settlement types, including changes in revenues deriving from budgetary relations and local taxes, are illustrated by *Table 3.*

The figures show that on average, villages had a share of 11 per cent of local tax revenues, while 36 per cent of the whole population live in them. The share of the capital city and the districts amounted to nearly 41 per cent of tax revenues, while the proportion of the inhabitants is 18 per cent. Finally, the tax share of towns and cities is approximately 32 per cent, while the proportion of the inhabitants is 48 per cent.

There are considerable differences among the per capita local tax revenues in Budapest (the capital city plus the district local governments) and the counties; as well as among different settlements. In industrially developed regions (settlements) local tax revenues accounted for 40–70 per cent of the budget, representing 20–24 per cent of the financial resources on average, whereas in regions stricken by high unemployment, struggling with tensions deriving from the unfavourable economic situation, at a disadvantage both socially and economically, local tax revenues represent a mere 6–10 per cent of all revenues.

Table 2

REVENUES OF LOCAL AUTHORITIES

Year	GFS-system revenues, billion HUF	Own currnt revenues*		Local tax revenue**			
		billion HUF	percenage of local revenues	billion HUF	local business tax, billion HUF	percenage of local revenues	percenage of own revenues
1991	386	81	20.9	9	2	2.3	11.1
1992	502	91	18.1	17	12	3.4	18.7
1993	581	106	18.2	27	22	4.6	25.5
1994	730	126	17.3	34	27	4.7	27.0
1995	813	146	18.0	46	38	5.7	31.5
1996	963	206	21.4	81	66	8.4	39.3
1997	1 168	290	24.8	111	93	9.5	38.3
1998	1 304	339	26.0	146	124	11.2	43.0
1999	1 499	443	29.5	198	171	13.2	44.7
2000	1 656	488	29.5	222	187	13.4	45.5
2001	1 904	560	29.4	267	226	14.0	47.7
2002	2 181	627	28.7	297	253	13.6	47.4
2003	2 501	661	26.4	323	272	12.9	50.3
2004	2 673	748	28.0	367	311	13.7	49.1
2005	2 891	795	26.4	398	334	13.5	51.1
2006	3 053	854	26.3	449	380	13.8	52.5
2007	3 081	914	27.2	505	427	15.0	55.2

*Local authorities' own revenues (revenues from institutional activities including VAT, interest revenues, duties, local taxes, dividends, concession fees, other special revenues. fines)

** Local taxes (local business tax. communal tax payable by private individuals, communal tax payable by entrepreneurs, tourism tax, tax on buildings, land parcel tax)

Source: Appropriation Accounts of the Republic of Hungary (1991–2007)

Chart 4

GFS SYSTEM REVENUES, OWN REVENUES AND LOCAL TAX REVENUES OF LOCAL AUTHORITIES AT 1991 PRICES

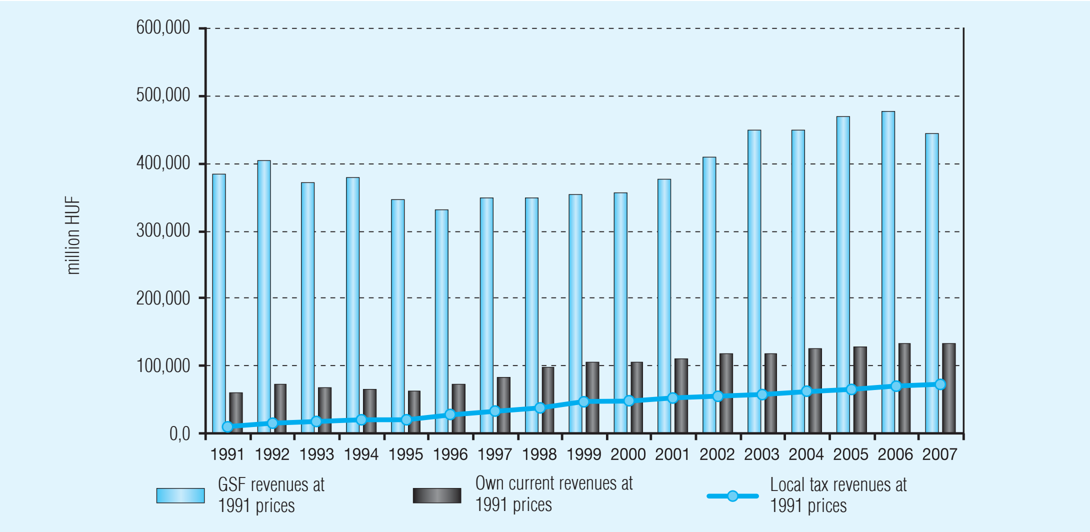


Table 3

DISTRIBUTION OF TOTAL REVENUES

2007	All revenues m HUF	Share in total (%)	From that: state contribution and personal income tax	Share in total (%)	Local taxes	Share in total (%)
Capital city + districts	879,490	26.7	215,372	15.8	209,005	41.4
Cities of county rank	559,621	17.0	236,479	17.5	110,532	21.9
Other cities and towns	787,239	23.8	369,640	27.3	129,885	25.7
Villages	654,053	19.9	409,684	30.3	55,843	11.1
County level local authorities	413,370	12.6	122,888	9.1	0	0
Total	3,293,773	100	1,354,063	100	505,265	100

To illustrate the end values of regional inequalities, in Budapest the per capita local tax revenue was 123,225 HUF in 2007 (51,673 HUF in 2000), accounting for 24 per cent of the total revenues (22 per cent in 2000), whereas in Szabolcs-Szatmár-Bereg county it was 19,885 HUF in 2007 (8,687 HUF per capita in 2000), accounting for 6 per cent of the total revenues (5 per cent in 2000). As for county (countryside) averages, in 2007 there was also a nearly fourfold difference between the lowest (Szabolcs-Szatmár-Bereg, Nógrád, and Békés counties) and the highest (Fejér and Komárom-Esztergom counties) per capita local tax revenues. (The difference was nearly three-fold in 2000.)
The three-fold difference between Szabolcs-Szatmár-Bereg county's annual 45 per cent and Tolna county's 145 per cent compared to the countrywide average in 2000 is still unchanged (Tolna county's average is primarily related to the outstanding data of Paks).

All this clearly demonstrates the disproportionateness within the spatial structure of the country, reflected in the revenues of local authorities, and within those, in the local tax revenues. One relevant characteristic feature is the sharp division of a macro-regional scale between Transdanubia and Eastern Hungary. The nine Transdanubian counties (with the exception of Baranya county), have over-the-average values, while in the Eastern region all county data is below the average.

Unlike the considerable differences between the capital city and the countryside, and between east and west in the macro-regional and county data, the situation is far more differentiated in the micro-regions. This is because in the case of some micro-regions, centres, and municipalities, the dissolution of an important tax payer or the closure of the premises of a major business may shatter the local budget (e.g. in Nyírbátor). Parts of settlements' becoming independent undermined the financial stability of certain municipalities due to a loss of local business tax revenues. (For instance in 2000, the local tax revenue of Kazincbarcika decreased by 490 million HUF due to the separation of Berente, and the town received an instant ÖNHIKI[9] aid of 208.5 million HUF. At the same time, due to the substantial amount of local business tax, only part of the surplus stayed at the Berente local authority – based on tax capacity, as in 2001 it was possible to withdraw 325 million HUF from personal income tax.)

Over the past decade, local authorities have also made continuous attempts to increase their own revenues through local tax revenues. Characteristically, they have only moderately increased the inhabitants' tax burdens, whereas, regarding the taxes to be paid by enterprises (communal tax payable by enterprises and local business tax), many of them have taken the opportunity to set the statutorily determined maximum tax rates.

There is larger divergence in the county figures regarding per capita average local tax revenues than per capita GDP averages, which latter figures reflect economic performance. In the period examined, there smaller differences among the figures of per capita GDP growth than in the changes of local tax revenues in the county breakdown compiled by the Central Statistical Office. While the per capita GDP growth is of a rather similar extent in the counties, there are significant differences in the increase of local tax revenues, which is illustrated by *Chart 5.*

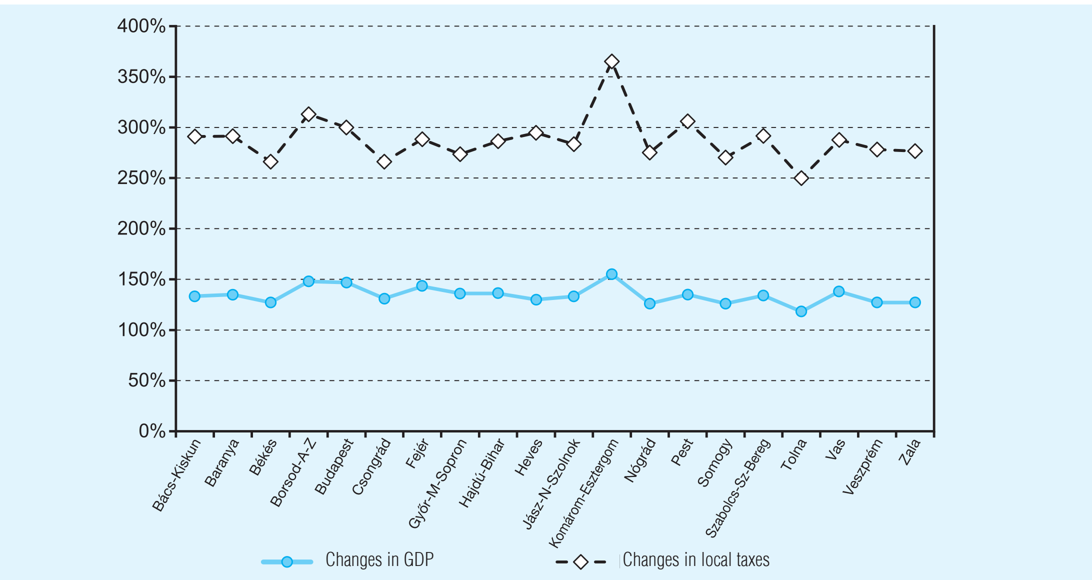
> Due to its weight and role, local business tax deserves one more thought: the local business tax revenue amounted to 27 billion HUF in 1994, 124.3 billion HUF in 1998, 187 billion HUF in 2000, and 427 billion HUF in 2007, but its regional distribution, as it has already been mentioned, reflects larger inequalities. In 1998, local business tax per inhabitant was 28.4 thousand HUF in the capital city, 14 thousand HUF in towns and cities, and 3.5 thousand HUF in villages, while in 2007 the same figures amounted to 108 thousand HUF in the capital city, 40 thousand HUF in towns and cities, and 13 thousand HUF in villages. The latter data shows that the capital city has 8 times and towns and cities have 3 times higher values than the village average.

Due to a significant increase in local taxes, especially regarding local business tax, differences of such an extent appeared in the revenues of local authorities that, in order to promote equal opportunities, it became necessary to introduce a system of revenue support within resource regulation. In connection with that, the need to put more emphasis on the aid provided for the most underprivileged local authorities was made prominent in the 1999 central budget. For the first time, pursuant to

Figure 5

CHANGES IN PER CAPITA GDP AND PER CAPITA LOCAL TAXES IN THE DIFFERENT COUNTIES

(2006/2002)



Article 20 (4) of Act XC./1998 on the 1999 Central Budget, if the local business tax capacity and the per capita personal income tax calculated did not reach a threshold value determined according to settlement type, the personal income tax revenues were to be supplemented to reach that level. Otherwise, the contribution of the state was to be decreased. At the beginning, their underprivileged status entitled 94 per cent of settlements to receive a supplement, and 2.6 per cent were concerned by the decrease. The source of the supplement was a part of the "transferred" personal income tax, as determined in the Budget Act (37.9 billion HUF in 1999, and as much as 108 billion HUF in 2008). Changes in the tax capacity caused a constant increase in the number of local authorities concerned by the decrease, and in the amount of the state aid withdrawn. (2.3 billion HUF was withdrawn from 55 local authorities in 2000 and as much as 8.7 billion HUF from 83 local authorities in 2001.)

It is important to emphasise that depending on the tax policy of local authorities, the local business tax collected may differ from the actual tax capacity due to decisions about introductions, tax rates, exemptions, and allowances. To calculate the amount of revenue withdrawal and supplements, the tax capacity calculated in the manner determined in the Budget Act is to be applied.

Since its introduction, the rules of calculating tax capacity have changed. Instead of data from the Hungarian Tax and Financial Control Administration (APEH), it is based on local business tax returns. The difficulties in the planning process are illustrated by the fact that due to bad estimates, 6.9 billion HUF was withdrawn from 1288 municipalities in the course of the year-end financial settlements in 2007. In 2008, 94 per cent of settlements are receiving supplements, while 3 per cent are concerned by withdrawals due to their tax capacity taken into account, which is to alter the differences in personal income tax and local tax revenues per inhabitant among the counties. In 2008, an amount of 108.6 billion HUF from the personal income tax is used to soothe the differences in revenues. As a result, tax capacity and per capita personal income tax in the capital city decrease from 90,198.6 HUF to 76,545.4 HUF, while in the villages, they increase from 15,332 HUF to 37,945 HUF. The amounts of personal income tax and state contributions that local authorities are entitled to are published in the form of a breakdown by municipalities and titles in a joint decree by the Ministry of Finance and the Ministry of Local Government, drawn up based on the annual Budget Act.

Figure 6 demonstrates the distribution of local authorities according to local business tax figures in tax returns.

Among local authorities levying local business tax in 2000, 11.5 per cent had local business tax revenues of under 100 thousand HUF. By comparison, 10 per cent had local business tax revenues of over 50 million HUF.

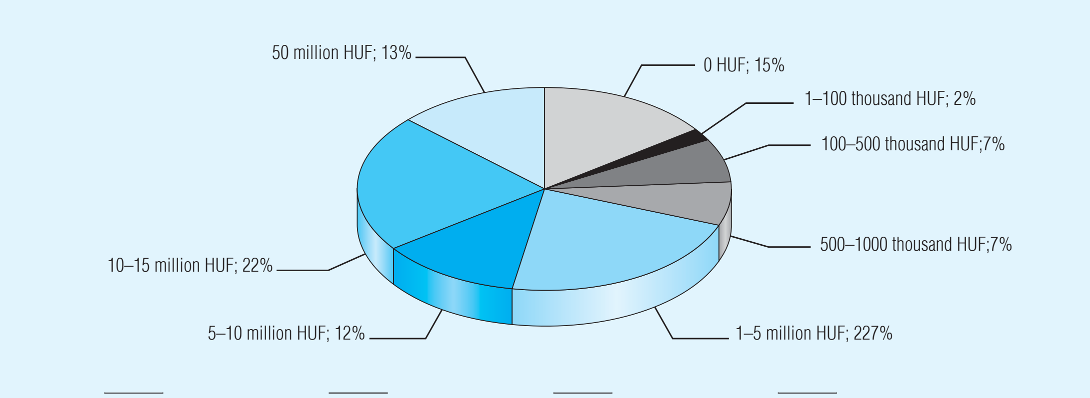
According to the 2007 local business tax returns processed, the countrywide average tax rate was 1.88 per cent (as opposed to 1.47 per cent in 2000), which represents a 94 per cent tax rate exploitation (as opposed to 86.5 per cent in 2000) in view of the statutorily provided 2 per cent (1.7 per cent in 2000).

Regarding communal tax payable by enterprises, the average tax rate compared to the statutorily provided maximum was 90 per cent in 2006 (as opposed to 87.6 per cent in 2000). By contrast, regarding communal tax burdening inhabitants, tax rate exploitation was of 51 per cent (as opposed to 15 per cent in 1996 and 30 per cent in 2000).

Increasing local tax revenues regardless of economic performance has primarily been due to local authorities' budgetary revenue "constraints". As a result, huge differences have

Figure 6

DISTRIBUTION OF LOCAL AUTHORITIES ACCORDING TO LOCAL BUSINESS TAX FIGURES IN 2007



developed among the local tax burdens of different settlements (areas). Local authorities with considerable other resources of their own (primarily sale of assets revenues) had created more favourable investment and entrepreneurial environments, relying on the tools of tax policy (rates, exemptions, allowances), which practice was later "restricted" by Hungary's EU accession.[10]

SUMMARY AND LESSONS TO BE LEARNT

Since 1990, local public finance has been characterised by an ever increasing (public) task decentralisation (further extended by specific, sector-related Acts in certain cases), decreasing representatives' freedom of decision regarding budgetary issues. The audits conducted by the State Audit Office have shown that the sum left to finance voluntarily undertaken tasks amounts to an average of 2–3 per cent of the annual expenditures in the case of county level local authorities, an average of 3–6 per cent in the case of the village municipalities, and an average of 10 per cent in the case of town and city municipalities.

Local authorities provide public services, and quality public services, primarily depending on financial (budgetary) constrains. Apart from the general tasks deemed compulsory by the Act on Local Authorities, (such as primary and secondary education, provision of standard health care and social services, provision of healthy drinking water, maintenance of local public roads, operation of public cemeteries, etc.), specific, sector-related acts may also charge them with compulsory tasks relating to public services and official authority. State supports and contributions for the so-called compulsory (public) task performance are provided by the central budget based on task indices, and through 200 different titles and normative contributions. The term itself renders it obvious that the total funds requirement of compulsory (public) task performance is not fully provided by the central budget. (Nor is it expected to be in the next few years.) Consequently, regarding local public finance, the role and weight of local taxes and local authorities' own revenues are further increasing.

Support value revenues received from the central budget and other sub-systems of public finance (mainly from social security and the Labour Market Fund) still have a part, albeit to a decreasing extent, in the budget of the over three thousand local authorities and their annual financial management. As part of a contrary process, the proportion of local authorities' own revenues, and within these the weight of local taxes, have been growing steadily. The proportion of local authorities' own revenues in the financing of their compulsory and voluntary (public) task performance has also been growing continuously. *Since the establishment of the system of local governance, the proportion of local authorities' own revenues has grown from 21 per cent in the first years to 27.5 per cent.* Steady growth is especially important as it is a prerequisite of the existence of local authorities' own funds necessary for the different investment and development projects to be implemented within the approved "Economic Programmes", which is the "entry ticket" necessary to be able to avail of any EU development money.

The Hungarian tax system is characterised by the predominance of central taxes. Local taxes- except for local business tax – play an insignificant part. Among local taxes, it is necessary to highlight property-type taxes. In their present form, tax on buildings and land parcel tax do not represent actual taxation of property at all. The necessity of equitable contribution to public revenues based on property, and thus the increase of local authorities' own revenues are a recurring theme of fiscal policy. *In the next few years, it will be impossible for the economic policy to avoid introducing property tax;* however, careful preparation and inserting it into a system are both necessary.

Unfortunately, it must be mentioned here that so far no appropriation account closing balance has included a full and ad valorem inventory of the financial situation of the state and local authorities regarding properties (whereas the same is a financial-legal requirement towards natural persons as taxpayers), even though that should be a prerequisite of equitable contribution to public revenues based on property.

The international practice of taxing real properties, which is traditionally most typical of Anglo-Saxon countries, where imposing a tax on real properties is value-based, and is thus equitable, may offer Hungary several lessons regarding social issues and tax law. Having no experience in this field, we have been averse to imposing a value-based tax on real properties so far, partly because it requires changes in tax management.

Regulating, managing and operating the whole tax system, and (for example, due to the overestimation of expected tax revenues from luxury tax) revising some of its structural elements is a financial, legal requirement, in the course of which *it is necessary to determine what sort of system of tax, contribution, charge, and duty regulations we wish to maintain in the future.* It is widely known that both the impact of the EU budgetary and economic determinations[11] and our Constitution in effect require that our tax system be reassessed. Regarding the scope of basic rights and obligations, the Constitution stipulates that "in the Hungarian Republic all Hungarian citizens have the obligation to contribute to public revenues on the basis of their income and wealth". For various reasons, *the requirement of equitable contribution to public revenues is not fulfilled as it should be expected to be,* and there exists no flat property tax. Equitable contribution to public revenues, securing public expenditures, durability, traceability, and especially the provision of allowances for "those in the tattered social safety net", i.e. those in need mostly existed at the level of goal setting.

A predictable tax system may only be constructed together with a reform of public finance, provided that their timing and contents are in harmony. These two will naturally affect the role and weight of local taxes, and thus the operation of local public finance and the financial management of local authorities. The Hungarian State Audit Office attempts to promote changes pointing in this direction through their audits, reports and suggestions.

Notes

[1] Act XV./1997 on the Proclamation of the Convention entitled "European Charter of Local Self-Government", done at Strasbourg on October 15, 1985

[2] In Budapest, both the Municipal Assembly and the representative bodies of the individual districts are entitled to introduce local taxes; however, the districts are not entitled to impose a local tax type already introduced by the Municipal Assembly on their taxpayers.

[3] To read the reports see www.asz.hu.

[4] The four subsystems are the central budget, local authorities, social security, and separate state funds (such as the Labour Market Fund, the Central Nuclear Fund, the Wesselényi Miklós Flood and Inland Waters Protection Fund, etc.).

[5] Without loan revenues and revenues deriving from the sale of securities, and filtering out accumulations within public finance.

[6] In 2007, there were 52 different titles in effect relating to our obligations to contribute to public revenues. (See Appendix 1.)

[7] The tax base of the local business tax is calculated based on the net turnover of the products (services) sold. (Factors that decrease the tax base to take into account are: the value of stocks purchased solely for resale, subcontractor's performance (for mediated services), and material costs).

[8] Tax capacity of the local authority: 1.4 per cent of the tax base determining the advance payment of local business tax in the budgetary year.

[9] ÖNHIKI: acronym for municipalities disadvantaged due to circumstances beyond their control, for the aid of which municipalities the central budget has annually separated funds.

[10] As far as the provision of different central and local aids and supports is concerned, subsequent to Hungary's EU accession, the country was provided with a grace period until the end of 2007.

[11] The convergence criteria relate to inflation, the interest rate, the budgetary deficit, the proportion of the government debt to the GDP, and the stability of the exchange rate. All these set limits to the resources received by local public finance from the central budget.

Literature

Csecserits, I. (Mrs.), Németh, G. – Lóránt, Z. (2006) On the financial management of local public finance, *SALDO Local Governance Booklets, Budapest*

Kovács, Á. – Lóránt, Z. (2003): The functioning of public finance and state assets and their audits, *ELTE Institute of Postgraduate Legal Studies, Budapest*

Local authorities and their finances, *Consulting Rt., Budapest, 1998*

Preliminary study for the audit of the tax collecting activities of local authorities, *State Audit Office of Hungary, Budapest, 2008*

Reports on the audit of the tax collecting activities of municipalities, *State Audit Office of Hungary, 1996, 2001*

Appendix 1

TAX AND PUBLIC REVENUE TYPES IN EFFECT IN 2007

1.	personal income tax
2.	value added tax
3.	corporate income tax
4.	solidarity tax
5.	financial institutions' contribution
6.	simplified entrepreneurial tax
7.	simplified public charges contribution
8.	spirits tax
9.	tax on buildings
10.	land parcel tax
11.	communal tax payable by private individuals
12.	communal tax payable by entrepreneurs
13.	tourism tax
14.	local business tax
15.	luxury tax
16.	motor vehicle tax
17.	vehicle registration tax
18.	energy tax
19.	duties
20.	excise duty
21.	environmental protection product charge
22.	emission charge (emission charge for air pollution, emission charge for water pollution, emission charge for soil pollution)
23.	innovation contribution
24.	training levy
25.	rehabilitation contribution
26.	employers' contribution
27.	employees' contribution
28.	entrepreneurs' contribution
29.	health care contribution
30.	employers' pension insurance contribution
31.	employers' health insurance contribution
32.	employees' pension contribution
33.	employees' health insurance contribution
34.	health care service contribution
35.	gambling tax
36.	cultural contribution
37.	mining royalty
38.	breeding contribution
39.	water resource contribution
40.	forest maintenance contribution
41.	game preserving contribution
42.	land protection contribution
43.	land protection levy
44.	television operation fee
45.	fishing development contribution
46.	medicine distributors' payments
47.	medicine dealers' payments
48.	pharmacy solidarity charge
49.	medicine presentation payment
50.	medical appliances and equipment presentation payment
51.	risk of medicine support surplus
52.	customs duties

Appendix 2

CHANGES IN THE REAL VALUE OF THE REVENUES OF LOCAL AUTHORITIES, 1991–2007

Year	GFS system revenues of local authorities (HUF bn)	Value index (%)	Consumer Price Index (%)	Volume (Real value) index (%)
1991	386	–	–	–
1992	502	130.1	123.0	105.7
1993	581	115.7	122.5	94.5
1994	730	125.6	118.8	105.8
1995	813	111.4	128.2	86.9
1996	936	115.1	123.6	93.1
1997	1 168	124.8	118.3	105.5
1998	1 304	111.6	114.3	97.7
1999	1 499	115.0	110.0	104.5
2000	1 656	110.5	109.8	100.6
2001	1 904	115.0	109.2	105.3
2002	2 181	114.5	105.3	108.8
2003	2 501	114.7	104.7	109.5
2004	2 673	106.9	106.8	100.1
2005	2 891	108.2	103.6	104.4
2006	3 053	105.6	103.9	101.6
2007	3 081	100.9	108.0	93.4
2007/1991		798.6	692.4	115.3

CHANGES IN THE REAL VALUE OF THE EXPENDITURES OF LOCAL AUTHORITIES, 1991–2007

Year	GFS system revenues of local authorities (HUF bn)	Value index (%)	Consumer Price Index (%)	Volume (Real value) index (%)
1991	374	–	–	–
1992	498	133.3	123.0	108.4
1993	599	120.4	122.5	98.3
1994	750	125.2	118.8	105.4
1995	800	106.7	128.2	83.2
1996	913	114.1	123.6	92.3
1997	1 135	124.3	118.3	105.1
1998	1 348	118.8	114.3	103.9
1999	1 476	109.5	110.0	99.5
2000	1 651	111.9	109.8	101.9
2001	1 902	115.2	109.2	105.5
2002	2 286	120.2	105.3	114.2
2003	2 533	110.8	104.7	105.8
2004	2 690	106.6	106.8	99.8
2005	2 972	110.5	103.6	106.7
2006	3 210	108.0	103.9	103.9
2007	3 135	97.7	108.0	90.5
2007/1991		844.1	692.4	121.9

Forrás: Pénzügyminisztérium, Központi Statisztikai Hivatal