

Local Government Finance: General Issues

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The system of intergovernmental fiscal relations is dominated by three major features: (a) the scale of local government responsibilities, (b) the importance of transfers, and (c) the lack of uniformity in the institutional framework. Over the 1990s the system has tried to cope with these characteristics within a context of national fiscal restraint. This effort has inevitably resulted in growing volatility and complexity in the transfer structure. This chapter briefly discusses these major features and the problems to which they give rise.

Responsibilities

The scale of local government functions is exceptional, not only in the post-communist states, but in Europe as a whole. Only Scandinavia matches their scope. British local authorities have most of the same responsibilities, except medical services. In Hungarian local government budgets, education (27 percent) and health care-welfare services (27 percent) are equally important functions (table 6.1). Public utilities (4 percent) and culture and sports (4 percent) are marginal expenditures, produced mostly by commercial or off-budget entities. Administrative expenditures, debt service, and other economic services make up the balance of each budget.

More than 14 percent of total local expenditures are spent by counties, mostly for health care and social services. City level expenditure (40 percent) is proportional to urban population (43 percent). Village municipalities comprise one-fifth of local government budgets.

These expenditure allocations are not likely to change. Even if some decrease were desirable, it would require an amendment to the Act on Local Government, possible only with a two-thirds majority. One can speculate over movements of responsibilities between individual municipalities and associations, or between counties and municipalities (see

* This chapter is based on Davey and Péteri 1998.

chapter 5), but significant shifts between central and local government as a whole are unlikely.

The exceptional scale of local government expenditure results primarily from responsibilities in the social sector (such as education, social welfare, health, housing, and so forth). This allocation has two major implications for intergovernmental relations. First, national policy debate places considerable emphasis on equalization, because parity of access to medical service, education, and so forth is regarded as an important goal. Second, local government expenditure depends heavily on funding by intergovernmental transfers.

The Importance of Transfers

Grants and national tax shares allocated as grants were at 71 percent of local government revenue in 1998. The reason for this dependence on transfers is simple. Local governments' heavy social sector responsibilities require access to the tax bases that can raise at least 7 percent of gross domestic product (GDP)—personal income tax (PIT), corporate income tax (CIT), value added tax (VAT), and excise tax. Of these, only the PIT can be assigned to local government without major distortions and exporting. All these sources remain in central government hands. The same situation occurs in Britain, where transfers are almost as important as they are in Hungary. Dependence on transfers is much less in Scandinavia because local governments share the PIT base with central government through a surcharging system.

Local business tax yields have been growing in major urban centers, but only by increasing approximation to VAT. The European Union poses difficulties in the form of major expansion of this tax base. Developing a value-based property tax system holds significant potential, although both political and administrative hurdles must be overcome. Since the property tax raised only 0.1 percent of GDP in 1996, yields could clearly be increased substantially in the major urban centers.

The potential of this reform must not be exaggerated, however. The most effective property taxation in Europe raises less than 1.5 percent of GDP; even if Hungarian yields could rise to this level, they would still support less than 10 percent of local government expenditure. The property tax could never become a significant replacement for the present scale of revenues from grants and PIT sharing.

Vehicle taxes (50 percent of which accrue to local government) have been rising, and further increases may be required by European Union accession. The main potential of local business, property, and vehicle taxes, however, lies in the cities and is directly related to their greater costs of providing physical infrastructure (traffic volumes, longer hauls to waste disposal, housing rehabilitation needs, and so forth). Similarly, revenues from charges might be increased in a number of cities, either by reviewing tariffs or improving collection, but these funds would go largely to the infrastructure companies rather than to the main municipal budget.

Table 6.1 Structure of Expenditures by Legal and Size Clusters of Settlements (percent)

| <i>Settlement</i> | <i>Manu- facturing</i> | <i>Economic services</i> | <i>Administration</i> | <i>Education</i> | <i>Health care, social services</i> | <i>Public utilities</i> | <i>Culture, sports</i> | <i>Miscella- neous</i> | <i>Total</i> |
|---------------------------|----------------------------|------------------------------|-----------------------|------------------|---|-----------------------------|----------------------------|----------------------------|--------------|
| Budapest | 9.8 | 23.7 | 13.8 | 20.9 | 25.0 | 2.6 | 4.0 | 0.2 | 100 |
| County | 2.5 | 3.1 | 5.5 | 10.2 | 72.6 | 0.5 | 5.6 | 0.0 | 100 |
| Cities | 8.1 | 12.9 | 14.5 | 33.7 | 21.7 | 4.1 | 4.5 | 0.5 | 100 |
| Villages | 8.2 | 13.6 | 23.0 | 33.4 | 8.6 | 9.9 | 2.4 | 0.9 | 100 |
| Municipalities | 8.1 | 13.1 | 17.3 | 33.7 | 17.4 | 6.0 | 3.8 | 0.6 | 100 |
| Total | 7.8 | 14.4 | 14.7 | 26.9 | 27.4 | 4.3 | 4.1 | 0.4 | 100 |
| <i>Size of settlement</i> | | | | | | | | | |
| 199 or fewer | 16.1 | 30.0 | 35.4 | 5.0 | 5.1 | 4.7 | 3.1 | 0.6 | 100 |
| 200–499 | 10.0 | 22.9 | 33.6 | 16.9 | 7.9 | 5.2 | 2.5 | 1.0 | 100 |
| 500–999 | 8.6 | 13.6 | 27.1 | 35.3 | 8.2 | 4.9 | 1.7 | 0.6 | 100 |
| 1,000–1,999 | 8.5 | 13.3 | 23.3 | 35.5 | 7.8 | 8.9 | 2.0 | 0.7 | 100 |
| 2,000–4,999 | 8.2 | 13.1 | 20.9 | 34.2 | 9.4 | 10.7 | 2.7 | 0.8 | 100 |
| 5,000–9,999 | 8.2 | 14.2 | 19.9 | 32.6 | 11.5 | 8.8 | 3.5 | 1.3 | 100 |
| 10,000–19,999 | 7.9 | 11.4 | 17.8 | 30.9 | 23.2 | 5.1 | 3.1 | 0.6 | 100 |
| 20,000–49,999 | 7.8 | 13.5 | 13.0 | 29.1 | 28.3 | 4.9 | 2.9 | 0.5 | 100 |
| 50,000– | 8.1 | 12.8 | 13.0 | 37.8 | 18.2 | 3.5 | 6.2 | 0.4 | 100 |
| Total | 8.1 | 13.1 | 17.3 | 33.7 | 17.4 | 6.0 | 3.8 | 0.6 | 100 |

Source: Davey and Péteri 1998.

Improving the local revenue base of property and vehicle taxes and consumer charges will help maintain physical infrastructure (and service credit for its rehabilitation). The more substantial costs of the social sector, however, will continue to fall chiefly on the combination of grants and PIT sharing (or surcharging).

One option would be to change the balance between grants and revenue sharing within this combination, increasing revenue shares and reducing the normative grants. The incentives would be psychological rather than financial. The change would not reduce dependence on transfers or increase local accountability or discretion. It might, however, reduce the feeling of dependence, giving local government a greater sense of sharing in the fruits of the local economy.

Two methods of increasing revenue sharing could be considered. The first would be a straight increase in the percentage of PIT shared by origin, which decreased from 56 percent of current collections in 1995 to 10 percent in 2000. A second method would be to assign a share of VAT to local government.

The main objection to increasing revenue sharing at the expense of normative grants would be that revenue disparities between municipalities would increase. This increase could be partially offset by increasing the PIT equalization grants but only further reductions of the normative or special normative elements could increase the PIT equalization grants. Furthermore, reducing those elements would be difficult so long as the current lack of uniformity in the assignment of competencies, particularly in the social sector, continues.

The only change in intergovernmental financial relations that would substantially reduce dependence on transfers would be the substitution of a local income tax surcharge for the present tax-sharing arrangements. The prime objective of this action, however, would be to increase local accountability rather than to generate more revenue. Its overall effect on both national and local budgets would be neutral in the first instance.

The Institutional Framework

Three features of local government structure and the assignment of competencies have a major impact on the transfer system:

- The structure is highly fragmented, and many small jurisdictions attempt to provide services without desirable economies of scale.
- The legislation has avoided a mandatory division of functions between counties and municipalities.
- Small municipalities are not obliged by law to cooperate in service provision (except for administrative and regulatory tasks).

As a result, assignment of competencies between types of local government is not uniform, and mismatches between municipal boundaries and the catchments areas of

service institutions are frequent. Joint arrangements for service delivery and regional development have grown, but they exhibit no consistent pattern.

These conditions have had two impacts on the evolution of the grant system. First, specific service-related elements in the normative grant calculation have proliferated. The goal is to target funding on the local government unit (municipality, county, or association) running a service institution. The monetary value of these elements has been declining as a percentage of the actual service costs. These specific normative grants now cover a significantly lower percentage of regional service costs. Between 1993 and 1996 grants for social institutions decreased from 51 to 40 percent as a percentage of current expenditures, and between 1993 and 1998 grants for general secondary education decreased from 94 to 45 percent. Grants for vocational training fell from 73 to 44 percent. The second impact has been a growth in the pressure on the deficit and equalization elements within the transfer system as a whole. The changes in the structure of grants clearly shows the pressure for higher equalization. Between 1994 and 1998 grants for various equalization purposes have increased by 76 percent, while the average increase of total transfers was only 38 percent all in nominal terms.

The Consequences of Fiscal Restraint

The intergovernmental finance system has had to operate within tight fiscal restraint. Between 1994 and 1998 local government expenditure decreased by 21 percent in real terms despite increases in responsibility. The changes in the structure of consolidated primary public sector expenditures also show that local governments were not able to keep their relative position.

This squeeze on local government budgets has evoked some increase in local revenue effort, and local taxes increased from 0.8 percent of GDP in 1994 to 1.2 percent in 1997. The major source of this growth has been in the local business (turnover) tax, mainly in the larger towns. Municipalities have been filling gaps by sale of capital assets (nearly 14 percent of local government revenue in 1996), but 1998 budgets exhibited a sharp decline in this source, presumably as the disposable stock contracts.

Two changes in the transfer system reflect the pressures created by this situation. First, the element devoted to equalizing PIT shares increased from 1 percent of local government revenues in 1994 to 1.6 percent in 1998. This increase brings PIT incomes up to Ft 8,000 per capita for villages and 9,800 for cities, figures that are close to the national average PIT allocation to all local governments (Ft 8,600 per capita). It is, however, the only form of transfer that does seek, systematically, to reduce disparity in local revenue bases. The consequence of the high per capita equalizing minimum is that most of the village municipalities are eligible for the grant. In practice, PIT sharing works as a grant allocation scheme for villages based on the size of the local population, although towns still benefit from above average PIT revenues per capita. Second, the numbers of applications for, and

recipients of the deficit grant have increased (in 1993, 147; in 1997, 843 local governments). Recipients fall into three categories:

- village municipalities trying to run services that are uneconomic at their size (24 percent of village municipalities qualified for deficit grant in 1996)
- towns that do not have a major PIT and business tax base to provide extensive services (for example, secondary schools and hospitals) for surrounding settlements (15 percent of towns and cities)
- counties (11 out of 19 in 1996) that have little direct revenue.

Most recipients are small municipalities, but in financial terms the problem lies equally with the counties and cities that have regional functions. Only half of the deficit grant is allocated to the villages, 22 percent to county councils, and 28 percent to cities.

Reform Objectives

The basic structure of the local government finance system is rational. Moreover, the central government has made continual efforts over the 1990s to adjust it and to increase its fairness and efficiency. Four weaknesses, however, put increasing pressures on the central government officials operating the system and on local governments trying to live with the effects on their budgets.

First, no statutory provision, beyond the annual Budget Act, determines the overall size of the resources assigned to subnational governments. This lack leads two perpetual arguments: uncertainty and suspicion (whether justified or not) that local government bears an unfair share of the total fiscal restraint.

Second, adjustments are frequent and many, increasing the complexity and uncertainty surrounding the distribution of resources among local authorities.

Third, because of the lack of uniformity in the assignment of functions, the number and complexity of the specific normative elements of the grant calculation has increased constantly. These elements are driven both by the central government's understandable desire to see that particular service standards are met and the need to route the funding to the authorities providing the service in any given locality. At the same time, these normatives have been declining as a proportion of the costs of the services. This increase in the number of specific normatives is unpopular with the municipalities, however, because of the added bureaucracy involved in establishing eligibility. They could also have an adverse effect on efficiency by encouraging municipalities to sustain unnecessary volumes of service provision simply to earn unit-based grants.

Finally, local governments increasingly call on the deficit grant is to play the equalization role in the overall intergovernmental finance system. It is ill equipped to do so, however, because its awards are based on the budget estimates of individual municipalities

without standard criteria for assessing either local revenue potential or spending need. It runs the risk, therefore, of rewarding low revenue effort and inefficient expenditure. In particular, it may run counter to central government policy by enabling small municipalities to “go it alone” in providing services instead of cooperating with their neighbors. The deficit grant was established to deal with exceptional cases, but now a majority of the counties and a quarter of the villages use it. The ministry officials allocating the grants make strenuous efforts to avoid these risks, but they are handicapped by the volume of cases to scrutinize and the lack of objective measurements to apply. Analysts generally recognize that intergovernmental financial relations need a more systematic equalization instrument, particularly in view of local governments’ social sector responsibilities.

The first experimental change in the concept of transfer allocation was implemented in 1998. The method of deficit grant allocation compares the planned expenditures of the individual municipalities with the average per capita expenditures of local governments of similar size and administrative status. A municipality’s estimated expenditure, which is the basis of deficit grant allocation, should be in the range of 80 to 140 percent of its group average. This approach helps the really poor municipalities and does not support inefficient services with extremely high unit costs. Further progress is needed because the method of calculating the estimated expenditures is still based on line-item budgeting, the revenue capacity is not measured, and discretion remains in the allocation process. This is the first attempt to introduce a new transfer allocation system.

Fixing the Total

One cannot expect local government budgets to be immune from the fiscal pressures on the national government. Indeed, between 1994 and 1998 the decline in general government expenditure (excluding social security funds) has slightly exceeded that in local government. Nevertheless, the national economy was improving, with 4–5 percent growth in GDP between 1997 and 2000, and consolidated public debt got close to the European Union target level of 60 percent of GDP. The national budget deficit (without privatization revenues) was 3.5 in 2000.

In light of this improvement, reformers pose two major arguments for protecting local government budgets from further contraction. First, the bulk of local government expenditure is on public goods, for which funding will remain a public sector responsibility, no matter how diverse service delivery is. Second, local governments remain responsible for much of the infrastructure that needs investment if they are to conform to European Union environmental standards. Even with the present fiscal pressure, local governments spend more on capital improvement than their average share in general government expenditures.

Current procedures create at least three major problems. First, the overall pool of resources available to local governments in the state budget is determined annually

by Parliament, and no basic ground rules govern that determination. Second, resource distribution between individual local governments is subject to frequent change. Third, allowance for inflation in annual budget allocations tends to underestimate the actual rise in costs.

The second problem of intermunicipal distribution concerns later chapters. At this stage, two questions arise:

- Can the overall allocation of state budget resources to local government be stabilized?
- Can local government allocations be more buoyant in relation to inflation during the budget year?

Two examples illustrate the legal guarantees of the total volume of state budget support. In France a 1994 act stipulates that the total general grant for current expenditure (*dotation globale de fonctionnement*) will be increased annually by a percentage representing the sum of the forecast annual rate of inflation and half the real percentage growth rate of GDP, if positive. In Japan the total pool of national budget funds allocated to local government through a comprehensive needs and resources equalization formula is determined by fixed percentages of certain national taxes—32 percent of PIT, CIT, and liquor tax; 25 percent of tobacco tax; and 24 percent of consumption tax (equivalent to VAT). The French and Japanese laws are intended to provide a continuing, multiyear basis for the assignment of transfers. These guarantees could, of course, be amended by Parliament, but such amendment would require a conscious decision independent of the annual budget process, involving considerable negotiation and debate.

In other countries, such as the Netherlands, the total grant pool is defined as a percentage of national revenues, fixed for a single year as part of the annual budget. In the Dutch case it is 11 percent. This level does not provide the same long-term stability as the French and Japanese laws. Nevertheless, the volume of transfers during the budget year reflects the actual collections of the taxes in question; if these taxes are buoyant, local governments are automatically compensated for continuing increases in costs. This protection has also benefited local government in the Czech Republic and Slovakia, where transfers are based mainly on annually fixed shares of PIT and CIT.

Risks as well as benefits are attached to this type of indexation. In a deflationary situation, a fixed percentage of tax yields might produce less than the budget estimate. In 1995 Japanese local authorities received only 80 percent of the amount of transfers estimated in the budget due to tax shortfalls. This situation would be unlikely in Hungary, however, until inflation falls to negligible levels.

With greater fiscal stability in sight, the Hungarian central government might consider linking the overall size of transfers (at least for current expenditure support) to fixed proportions of state revenues, preferably for several years. As an illustration, the 1998 normative grants equate with 21 percent of the combined estimated yields of VAT, PIT, and CIT, a decline from 38.6 percent in 1992.

Normative grants for local governments decreased from 6.0 to 3.3 percent of GDP between 1990 and 1998. Because GDP and the major taxes (VAT, PIT, and CIT) follow the same trend, the normative grants declined as a percentage of these taxes (in 1991, 36.5 percent; in 1998, 21.1 percent).

If the proportion of local government normative grants to total amount of major taxes were kept fixed, then the municipal grants would be stable. For example, using the 1994 percentage (29.7 percent) as a fixed ratio, by now the normative grants would be 40 percent higher—Ft 462 billion (See table 6.2)

Table 6.2 Local Government Revenues by Sources (Ft billion)

| <i>Year</i> | <i>VAT</i> | <i>PIT</i> | <i>CIT</i> | <i>Tax total</i> | <i>GDP</i> | <i>Normative grants (actual)</i> | <i>Estimates, using 1994 percentages</i> |
|-------------|------------|------------|------------|------------------|------------|--------------------------------------|--|
| 1991 | 149.5 | 183.9 | 77.3 | 410.7 | 2,498.3 | 150.1 | — |
| 1992 | 175.7 | 205.7 | 64.1 | 445.5 | 2,942.7 | 172.0 | — |
| 1993 | 265.0 | 238.4 | 54.0 | 557.4 | 3,548.3 | 209.8 | — |
| 1994 | 336.4 | 304.8 | 75.9 | 717.1 | 4,364.8 | 213.0 | — |
| 1995 | 423.9 | 383.7 | 91.0 | 898.6 | 5,562.0 | 220.1 | 266.9 |
| 1996 | 515.1 | 490.7 | 110.9 | 1116.7 | 6,845.0 | 253.7 | 331.7 |
| 1997 | 674.7 | 560.1 | 144.7 | 1379.5 | 8,370.0 | 297.3 | 409.7 |
| 1998 | 759.3 | 618.1 | 180.0 | 1557.4 | 9,855.0 | 329.0 | 462.5 |

Source: Davey and Péteri 1998.

Other Options for Reform

However the overall amount of transfers is fixed, their distribution should be optimized and their objectives should be clear. The prime aim is not to reduce the scale of national budget support, since the personal services are of great significance to ordinary citizens and demands and expectations are not diminishing. The main objectives must be to improve equity in the distribution of resources and efficiency in their use.

A radical reform might attempt to replace the whole transfer system with an equalization-based grant or revenue share of the Dutch, British, or Swedish type. These systems attempt to balance local spending needs and costs and local revenue potential comprehensively and objectively.

Radical change will bring significant losers as well as winners unless overall state budget support increases substantially, an unlikely scenario. Serious questions arise, therefore, about whether a radical change in system would be politically acceptable. The practical alternative is to retain the present overall transfer system, but adjust individual elements to meet the most serious practical needs.

Two alternative approaches to incremental change might be used. One alternative assumes that no institutional change will occur, that is, distribution of responsibilities between counties and municipalities, or between towns and their surrounding settlements will not be made uniform, and small settlements will not be compelled to associate in providing municipal services. The second alternative assumes that institutional change could be undertaken and that some form of intermunicipal cooperation becomes mandatory. This assumption also applies to changes in the assignment of competencies between local governments.

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