

9 Transfers: Policy Options

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The two major features of Hungary's local government system are the huge disparities in size and local resource bases and the broad scope of responsibility for social services when comparable standards are expected. As discussed in chapter 7, Hungary has gradually moved from a rather simple transfer system introduced in 1990 toward a detailed transfer regulation. This is often micromanaged by sectoral ministries and has a growing number of equalization factors and an increasing use of deficit grants for distressed municipalities.

Concerned with the distribution of transfers from the state budget to local governments, this chapter proposes two versions of radical change to the transfer system and also discusses options for incremental improvement. One of the radical options would replace the normative, equalization, and deficit grants with a single equalization grant (block grant) designed to compensate for both vertical and horizontal imbalance (that is, including differences in spending need, service costs, and revenue potential). It responds to the growing pressure for effective equalization mechanisms. Another radical option would convert the entire grant into a single deficit grant similar to the British and Dutch transfer system. The incremental approach discusses possible changes to the existing system, should political will be insufficient for the more radical approaches. Finally, the chapter discusses issues related to tax sharing.

Equalization through Grant Allocation

The Council of Europe has recommended that equalization systems should enable local authorities, if they wish, to provide a broadly similar range and level of services while levying similar rates of local taxation (CoE 1985). The Council's recommendation seeks complete parity between local authorities in the service levels they can provide with a

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similar level of revenue effort. Only the British and Dutch systems attempt to achieve this parity. Others attempt partial equalization. The Danish system, for example, aims to halve the gaps between the per capita revenues of the richest local authority and those of the rest.

To achieve equalization goals, the following must be mitigated:

- disparities between the local revenue bases (that is, the potential yield of local revenues assuming a common level of effort in terms of tax rates, collection efficiency, and so forth)
- disparities in local needs for municipal services, determined by differences in, for example:
 - age structure (proportion of school age children, elderly, and so forth)
 - social structure (single parent households, unemployed, and so forth)
 - environmental and economic conditions, requiring remedial action
- disparities in the costs of providing equivalent levels of services due to factors such as:
 - differences in wage levels or the price of land
 - low population density increasing the overhead costs of institutions such as schools
 - large, high-density populations increasing unit costs of services such as refuse disposal or street maintenance.

Different approaches are possible to meet these objectives.

Options for a Single Equalization Grant

A radical departure from the present shredded equalization system would be to consolidate all equalization funds into a pool and introduce a general equalization grant allocated on the basis of selected socio-economic indicators.

A Single Grant

The most radical option would be to replace the structure of transfers (apart from the origin-based distribution of personal income tax [PIT] shares) with a single grant calculated to reduce disparities in local revenue bases and reflect differences in spending needs and service costs.

Various formulas are in use in European countries. In one category are the British and Dutch systems, which attempt full equalization and try to measure differences in need, cost, and resources comprehensively. The United Kingdom developed the revenue support grant to equalize needs and local revenue capacity. A second category, typified by the Swedish model, attempts to achieve partial equalization and uses simpler and fewer variables.

The British and Dutch formulas depend on extremely demanding data requirements. They operate in contexts that have far less fragmentation than in Hungary and where all

local authorities levy the same one or two taxes on the same base, which is nationally assessed and only the tax rates differ. Given the lack of such uniformity in Hungary, considering a simpler formula, similar to that the one used in Sweden, might be more practical.

A Simpler Grant Formula

A relatively simple model for a single equalization grant can be formulated by calculating the amount of grant allocated to each municipal area, that is, the area covered by a single municipality. The grant would be distributed among all self-government units (counties, municipalities, municipal associations, and so forth) that provide services in that area.

Using such a model, PIT shares distributed by origin would continue to be paid to municipalities just as they are now (unless they are replaced by a surcharge). The rest of the current transfers (including the PIT equalization element) would be absorbed in a block grant. The total grant would be divided by national population to yield a standard per capita allocation, which would be attributed to each municipal area.

The standard per capita allocation for each municipal area would be adjusted (without a net addition to the total state budget cost) upward or downward to reflect local variance from national norms in respect to the major factors affecting local revenue capacity and expenditure needs and costs. For example, adjustment could be made for variations in per capita PIT yields, education expenditure (measured by proportions of school age children), and health and social care expenditure (measured by proportions of elderly people, children, and the unemployed).

These adjustments to the standard per capital allocation would yield an adjusted per capita allocation for each municipal area, which would be multiplied by the municipal area's total population and allocated to local authorities as follows

- Cities with county rank: 100 percent;
- Counties and other municipalities: divided according to their overall shares of local government expenditure nationwide (excluding cities with county rank and Budapest) or in individual counties;
- Budapest capital city and districts: divided according to their respective shares of total expenditure in Budapest.

One advantage of this model is that it provides a relatively simple way of dividing the grant between levels of local government, avoiding specific normatives. Differences in service needs would be reflected in simple, uniform indicators, such as school-age population.

Another advantage of this solution is that it could be varied either nationwide or in each area to cover the introduction of districts or regional associations. For example, if five municipalities form an association, their respective adjusted per capita allocations could be divided between them and the association according to their respective shares of their combined expenditure.

Some reformers argue for using per capita PIT yields as the only basis for equalizing local revenue bases. PIT is the only revenue figure that can be compared uniformly nationwide to liability and assessment. To a certain extent, it should reflect differences in local economies that affect the potential of local revenues in general. This approach will not fully compensate for variations in the potential base of business and property taxes if they exceed the deviations in PIT. Some analysts argue that differences in business and property tax potential are matched by differences in the demands for expenditure on physical infrastructure and, therefore, should not be subjected to complete equalization.

This option provides for higher levels of revenue equalization than in the current structure. It seeks to reduce disparities in the local tax base, not in the actual local tax effort. Municipalities that make above-average revenue effort do not lose grants as a result. Therefore, the incentive to localize revenue generation is not reduced.

It would be possible, of course, to use further adjustment factors if suitable data were available to reflect relative differences in spending need or costs. Regional differences in mortality rates might be added to the calculation, for example, if they are significant. Over-complexity and the invitation to special pleading, however, should be avoided.

A comparison of the distribution of this single grant with that of the present transfer system shows that the only significant losers are municipalities that have populations of fewer than 200. This loss is probably due to the elimination of the lump-sum element of the grant to villages and could be overcome by a simple adjustment to the formula to apply a minimum multiplier in multiplying the adjusted per capita allocation by the population of the municipal area.

A radical change to this type of single grant could be phased in over a number of years to soften the impact on the losers. In a five-year transition, for example, local authorities would get 20 percent of their new grant in year 1, 40 percent in year 2, and so forth. Alternatively, the single equalization grant could be fixed as a proportion of overall transfers. For example, one-third of normative grants can be allocated using this method.

More Complex Models

A more complex model would equate with the British and Dutch transfer systems, which are sometimes described in U.S. literature as “representative revenue and expenditure systems.” Such a model would effectively convert the entire grant into a deficit grant. Each municipality would receive a grant bridging the gap between the following two elements:

- The central government’s assessment of what it should be spending (excluding capital expenditure), bearing in mind:
 - its particular range of competencies
 - standard indices of service needs (school age children, road lengths, and so forth)
 - types of local characteristics affecting service costs (for example, population density, social deprivation, labor costs)

- The product of its direct revenues, assuming it levied all permitted taxes at either an average rate or the maximum rate.

In arriving at assessments of expenditure needs and costs, such a model relies heavily on regression analysis. Regression analysis seeks to correlate actual variations in municipal expenditure patterns with differences in particular local physical, demographic, social, and economic characteristics. Such analysis would be difficult in Hungary because of the lack of uniformity in the exercise of functions (for example, management of schools, hospitals, and social care institutions) and the differences in coverage of service delivery in municipal budgets. Some municipal budgets show the full cost of a service; others may only include a net subsidy to an institution or company. By contrast, regression analysis always reflects differences in size and character more closely than simple averages. Based on the actual spending figures, planners can calculate standardized unit costs for a municipality of any size, urban character, or other factor.

Similarly, the British and Dutch systems calculate municipal revenue capacity by applying uniform standard rates to the local tax bases. This method is easy in these two countries, where local governments levy only one or two taxes on bases that are assessed uniformly. This approach, too, would be difficult in Hungary because of the lack of uniformity in the taxes levied by individual municipalities or in the assessment methods. Comparisons of nontax revenues are also difficult because in some cases those revenues are reflected in municipal budgets, but in others they are largely absorbed by institutions and companies.

Nevertheless, pilot research would be justified in seeing how far objective measurements of expenditure need, cost variation, and local revenue capacity could be developed, because these ingredients are typical of the most highly developed transfer systems.

Options for Incremental Change

Getting political and bureaucratic consensus on radical change is difficult, particularly if new legislation is required. Alternative possibilities for improving the current system involve continuing the process of incremental change that has been in progress since 1990.

Even if the present transfer system remains intact, reformers could make changes in the institutional structure, either in the assignment of competencies or in the framework of intermunicipal cooperation. Two scenarios are considered in the remainder of this chapter. The first looks at options for incremental improvement assuming no major institutional change. The second looks at the implications for transfers of the types of institutional reform that have been under discussion. Finally, possible changes in tax-sharing arrangements within the current structure are discussed.

Incremental Options without Institutional Change

The present transfer system has three bases: (a) general normative elements pertaining to types of local authority, (b) specific normative elements pertaining to particular services and payable to the authorities supplying them, and (c) limited equalization of revenue from shares of PIT.

The priority for incremental reform must focus on the present system's inadequacies that cause the most problems in practice. This focus, which means trying to eradicate (or at least severely reduce) needs for the deficit grant, is important for two reasons. First, awarding the deficit grants fairly and adequately causes the central government the most difficulty. Second, despite the absence of systematic allocation criteria, common sense suggests that the deficit grants do go to the three types of local government most likely to experience financial difficulty:

- Counties, which are increasingly taking over responsibilities for secondary education, hospitals, and social care institutions from municipalities, but which lack the municipal revenue base of local taxes, real estate, and PIT shares;
- Towns providing services for their neighbors without recompense;
- Small villages running services without efficient economies of scale.

The objective is to ensure that the combination of local revenues, grants, and revenue shares is adequate to balance the budgets of the vast majority of local governments, so that the deficit grant is needed only in the most exceptional cases. The rest of this section examines options for meeting this aim.

Normatives

The practical problems of all the deficit grant recipients would be reduced if service-related normatives were increased to meet a higher percentage of the costs of running the services covered. Although the number of normatives has been increasing in recent years, the percentage of coverage has been declining. As a result, local governments have had to contribute increasingly to the cost of these services from own revenues, general normatives, and PIT shares. But counties get neither PIT shares nor their own taxes. Regional towns get no general normatives or PIT shares in respect to nonresident users (although their regional status may enhance their business tax revenues in more prosperous areas).

Increasing the size of normatives would certainly help the counties and regional towns. Of all the possible remedies, it would also be most accurate in surmounting the lack of uniformity in service provision (that is, in assisting only those counties or towns that supply such services as hospitals and secondary schools). A 10 percent increase in grants for secondary and vocational training schools would equate with the entire deficit grant paid to counties and regional towns.

If applied to the primary school normatives, this solution would also help the small villages—although not to the same extent, because it would not cover their higher unit costs (unless the normative was weighted inversely to size or included a lump-sum overhead element).

The disadvantage of this solution might be its effect on allocation efficiency. It would further reduce local government discretion over the use of revenue and would encourage retention of surplus places in institutions, nonviable small primary schools, and the like. It would also benefit the 85 percent of towns and 75 percent of villages that do not receive the deficit grant.

If the total transfer pool is fixed by state budget policy, any increase in normatives would be at the expense of some other element. Options for cuts may be any of the following:

- A provision for deficit grants, which might become unnecessary as far as counties and regional towns are concerned
- Regular normatives allocated by the types of settlements, which would cause everyone to suffer, regardless of capacity
- PIT shares, which are logical because the biggest losers would be cities that have large PIT and business tax revenues that would gain from the increase of normatives without needing them.

Counties. What other approaches would increase county government revenues as well as—or instead of—increasing specific normatives? The options are as follows:

- Increasing the counties' general normative by 17 percent would equate with their share of the deficit grant. The general normative does not, however, relate to the scale of their actual responsibilities, which varies greatly between counties.
- Allocating to the counties the central government's 50 percent share of the vehicle taxes, roughly five times the size of the counties' share of the deficit grant. This move would simply result in some other form of transfer cut, but would introduce a new shared revenue at the county level.

The second option gives counties taxing power for accountability reasons and assumes that counties would have the same right as municipalities to increase the rates of their share of vehicle tax within prescribed limits.

Regional towns. Regional towns are municipalities that provide substantial services to residents of smaller, nearby settlements. Increasing normatives would solve part, if not all, of the problem, depending on the scale of the increase and the significance of services in their spending structure. Other options would be the following:

- Introducing a regular normative for regional service center functions
- Increasing revenue equalization, which would be logical because the more prosperous regional towns do get compensating benefits from their own tax bases. The business tax

would be the most logical base, but finding an objective statistical base for measuring potential rather than actual yield would be difficult, and the disincentive effects could outweigh the benefits.

Small villages. Increasing normatives would help if they were applied to primary schools, but this move would still fail to compensate for higher unit costs and would be particularly inefficient because it would encourage retention of unviable units. Alternative subsidies (for example, to school transportation) might be more of an incentive.

Another option to help small villages would be a larger basic lump-sum normative, regardless of population size. This normative would also benefit the 75 percent of villages that do not qualify for the deficit grant.

All these options raise the question of how much the central government wants to do to keep small village municipalities afloat and leads to a discussion of institutional change.

Conclusion. None of these suggestions is perfect; all have advantages and disadvantages. The suggestions which have the greatest advantages are the following:

- Increasing modestly the specific normatives for secondary and vocational schools (reversing the decline in these grants as a percentage of actual cost)
- Allocating to counties a share in the vehicle tax with the right to vary rates (thereby increasing revenues and accountability simultaneously).

Adjusting the scale of these two measures should eliminate the need of counties and regional towns for deficit grant aid, apart from most exceptional circumstances.

Devising solutions to the problems of deficit villages, which benefit all villages equally, however, is difficult. Although the same can be said about help for regional towns, any general increase in support to villages carries the additional disadvantage of encouraging the survival of uneconomically small service units and leads once again to a discussion of institutional change.

Incremental Options under Institutional Change

Although neither the central government nor the Parliament has reached a consensus on institutional change, the topic is under discussion. Two directions are possible if the transfer system is reformed:

- Uniform assignment of competencies for services with regional or subregional catchment areas could result in counties taking over all hospitals, social care institutions, and secondary level schools.
- To improve economies of scale, compulsory subregional associations could be formed to provide some services. This direction could include a proposal to establish multipurpose district authorities.

These two options have been discussed at the national government level. The first option was formulated as part of the changes in fiscal policy after 1995. At that time reformers believed organizing larger service delivery units by amalgamating small village municipalities and transferring regional services exclusively to an intermediate level of local governments was the most rational approach. No one evaluated the political acceptability of this option or calculated the potential savings.

The second, more evolutionary, option seems to be more realistic. The introduction and development of various flexible forms of joint service delivery organizations and associations require not only fiscal but also legal, administrative, and operational changes.

Counties. If counties and county-right towns received an exclusive mandate for certain services (for example, secondary education or hospitals), abolishing the specific norms for those competencies and incorporating the funding in a general norm would be possible. This reform might be population based, with some weighting for school-age groups and the elderly. Regional need variations could be introduced if significant differences in mortality rates, disease incidence, and so forth are found.

Subregional associations and district authorities. Predicting the financial implications of subregional association or district authorities is much more difficult because they can take many different forms. Major guidelines can only be sketched, depending on key variables. The first variable relates to the type of function undertaken by the associations and districts. If they are responsible only for public utility services, then their operating expenses would be covered by charges paid directly by consumers.

If associations and districts are responsible for tax- and grant-borne services, then they could be incorporated into the normative grant structure. If they are established uniformly with exclusive competencies, then they could receive regular norms, which would be excised from the municipal norms according to their share of previous municipal expenditure. But their regular norms could also absorb any specific norms for services they run, with appropriate spending need adjustments (for example, age group weights, and so forth). Service-related norms would have to be retained only if expenditure assignments are not uniform.

Giving associations and districts taxing power is similar to the way some British and French joint authorities function. If the governing bodies of associations and districts are elected directly or nominated by elected municipal assemblies, they could be regarded as sufficiently representative politically to exercise taxing power. The simplest way would be to allow them to piggyback on the municipal taxes. This approach assumes that constituent municipalities would be able to reduce their own tax rates because of the transfer of expenditure to the association.

If the associations and districts take over a large share of municipal responsibility, then they might be given exclusive right to levy a specific municipal tax. The business tax would

be the best candidate because of its disparate incidence within the type of peri-urban area that might typify an association's jurisdiction. Although most of the tax might be paid by businesses in a central town, most likely their staff and customers would be drawn from the wider area served by the association or district, justifying the sharing of this tax base.

The greatest obstacle to the formation of associations is their lack of access to direct revenues and consequent dependence on their constituent municipalities. Previous discussion suggests that this situation would be improved if:

- Association governing bodies were politically representative and, therefore, able to exercise taxing power, with right to the business tax base if they take over the bulk of municipal functions.
- They had the right to direct receipt of specific normatives for services they administer.

The radical changes suggested earlier would give associations and districts a share of the total transfers to their area *pro rata* to their share of local government expenditure.

Tax Sharing

Tax sharing without local decisions over tax rates (that is, without surcharging) is basically an alternative form of grant. Its impact is limited. It may stabilize local government revenue if the size of the share is fixed continuously—not the case with PIT in Hungary. Tax sharing does not enhance local discretion over taxing and spending levels. It may, however, protect local spending choices insofar as it is less susceptible than grants to overuse. It may distribute money in favor of wealthier areas, depending on the scope of equalization in the rest of the transfer system. By doing so, it affords individual local governments the psychological satisfaction of sharing in revenue produced by their local economies.

Personal Income Tax

The share of PIT distributed to municipalities by origin has declined from 100 percent in 1990 to 5 percent in 2000. Given the two-year delay in distribution in 1998, the share equated with 14.5 percent of the estimated current levels of collection. By contrast the PIT equalization grant has increased so that the minimum PIT share equals the national per capita average.

The substitution of a local surcharge for the current sharing of PIT is possible if an increase in local accountability is sufficiently desirable to warrant the administrative cost. Even without this measure, increasing the percentage of PIT distributed by origin would be possible, balanced by a proportionate increase in the minimum per capita level assured by the equalization grant.

Unless the central government decided simply to increase the total quantum of transfers, any increase in PIT shares and equalization grant would be offset by equivalent reductions in normative grants. The impact on the state budget would be neutral, but the result would be a redistribution of transfers between local governments in favor of those that have higher PIT yields.

Local government representatives frequently complain about the reduction of the local PIT share, chiefly in the context of the general fiscal squeeze they experience. Increasing PIT shares would have a highly discriminatory impact; for this reason we see it as less desirable than a general indexation of total transfers.

Value Added Tax

Another option is to share new national budget revenues with county governments and Budapest. This approach would stabilize part of the counties' transfer revenue and give them the incentive of a connection between their revenues and the commercial activities in the area. The principal candidate would be a share of value added tax (VAT), for which local government has campaigned in the past.

The geographical incidence of VAT payments is hard to determine accurately, but per capita gross domestic product, now calculated at the county level, could be a valid proxy. The percentage of VAT assigned to local government could be divided between counties on the basis of their share of gross domestic product.

We estimate that a 5 percent share of VAT distributed on this basis would contribute from 7 to 21 percent of county revenues. This degree of variation is due to differences in the size of county budgets, reflecting diversity in the functions assigned to them. Assigning a share of VAT to counties would not increase their discretion and accountability. The advantages of sharing VAT would be largely psychological.

Business Tax

The business tax has been growing both in absolute terms and as a proportion of total local government revenue. In per capita terms, major disparities occur in its incidence, mainly to the benefit of the larger urban centers. The growth and the disparity of the business tax have fueled discussion, particularly within the central government, of ways to equalize it.

Some reformers believe that the business tax base belongs to a whole urban area and its periphery, not just to the municipality where a particular firm is located. Both its customers and its employees may well reside throughout the wider metropolitan area. This view would support the kind of redistribution that takes place in Budapest between the capital city and the districts (see chapter 8). In other urban centers redistribution could take place through the operations of some form of intermunicipal association or district level body.

A national redistribution of the business tax is far less justified, however. Because the tax is not levied uniformly, it would not be easy to calculate the differences of tax potential necessary to an equalization formula. Unlike PIT, this tax is one that municipalities levy and administer themselves; redistribution could act as a disincentive to levying the tax at the higher permissible rates and assessing and collecting it strictly.

Equalization would be injurious, moreover, unless reformers make an equal effort to compare and compensate municipal expenditure needs. The centers that enjoy the highest per capita yields from this tax may well be those with exceptional needs. Larger urban centers have congestion costs (for example, greater volumes of traffic or further distances to waste disposal sites). Moreover, they frequently have the highest concentrations of social deprivation, leading to exceptional liabilities for social benefit payments and environmental rehabilitation.

Equalization or redistribution of business tax yields should not be attempted as an isolated measure. It would have a place only within a comprehensive approach to equalization which takes costs and spending needs into account equally.

References

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