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Determining factors of tax-morale with special emphasis on the tax revenues of local self-governments

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Abstract

Based on my assumption, tax morale significantly depends on a country's legal, historical, social and cultural background and circumstances.

In the first part of the paper, I introduce shared state taxes and local taxes in Hungary, I focus on the changes in allocation of personal income tax and vehicle tax between the state and local budget.

In the second part of the paper, I provide empirical evidences which factors (e.g. personal characteristics, commitment for paying local taxes, knowledge about the distribution of paid taxes between central and local authorities, etc.) determine significantly the individual level of tax morale.

The paper discusses these complex connections either from the viewpoint of law or economics in order to find out whether it is possible to develop the tax morale of individuals, or can the legislator adequately rule the different forms of tax evasion.

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1. Introduction

The state has the sole right to specify and allocate state taxes, and has the right to give power for local governments to lay down the rules of local business taxes, so the taxing power of local governments is derived and limited by the state.

Accepting the importance and role of taxation at level of local government several alternatives may be distinguished depending on who should tax, what are the shares of tax revenue, etc. Local governments may derive revenue from local taxation by any of the following (Davey-Péteri, 2004, p. 217.):

- Laying taxes independently;

- Imposing a locally decided surcharge on a revenue laid and collected by other levels of government;
- Receiving a fixed share of state taxes collected within their jurisdiction.

Different models can be mentioned to analyse the fiscal connection between state budget and local government budget. We can mention a model in one hand, *where all incomes of local government rise from the state*. In this model only the central state tax system exists, there are no possibilities for local governments to lay down rules of local business taxes, they have no taxing power. The second model is the *solidarity model*, the local government has taxing power, has the right to lay down the rules of taxation, but some taxes are centralized by the state budget, where the state has the sole right to decide the share of local governments for the tax incomes. One advantage of this model is that structural differences can be lower by this way, but disadvantage is, because governments – cardinally the rich governments (they have enough incomes from other sources) are not interested in increasing their incomes as a certain share will be the income of state budget.

The third model, liberal model, where local governments are free to lay down the rules of taxation, the state has no right to centralise tax incomes from the local government, the main incomes are the local business taxes for the local governments.

In Hungary, there is a mixed model, where the characteristics of liberal and solidarity model are being combined, certain taxes are incomes of state budget, and then the decision is for the state to allocate the tax income between the level of central and local budget. The cooperation and harmony is realised between the levels, the local governments has taxing power and besides they gain tax incomes from state budget as well (the so-called shared state taxes).

Hungary has been a pioneer in local government reform among transition economies. Through a series of legal reforms introduced since 1990, Hungary has established local governments with full autonomy, legal and regulatory framework for ensuring and tightened budget constraints by regulating municipal bankruptcy. So in Hungary after the *change of regime this mixed model is used, but the borders of the framework is continuously being modified by the state*.

Increase or decrease the autonomy of local government was the two-directional tendency since the change of regime by the state. This tendency has an effect on fulfilling task and on fiscal frame too.

As an example for this tendency we can mention the allocation of personal income tax (PIT) and vehicle tax. When personal income tax was introduced in 1987, the allocation of this tax income was very simple: it was the income of the so-called “tanács” (the forebear of local government). In 1990 there was a claim to change this allocation structure, the state had to decide two issues:

- How to allocate personal income tax between state and local government budget?
- Will it be still the income of the local government, or shall we introduce a quota, guarantee sufficient income for the state and local government too?

The Budget Act of 1991 (Act CIV. of 1990 on the State Budget of Hungary) introduced a different allocation system in Hungarian Law. In 1991 the local government received the income raising from paid personal income tax by local taxable person in 1989.

In my opinion local governments are able to levy taxes on unseen income and to collect these revenues in greater proportion in generally, because of e.g. the local relationships are generally tighter.

In the 90’s, the proportion of shared state taxes descended, in 1993 the local governments received the 30% of PIT, while in 1998 only 20% of PIT was returned to local level. Since 2000 this proportion of local government was permanently below 10%. Since 2013 the local governments has not receive a certain percentage of PIT as earlier, only the revenue comes from the leasing of soil remains at local level.

At the beginning vehicle tax was also a shared state tax, which was collected within the jurisdiction of local governments and was the revenue of local budget. In the 90’s there were different shares between local and state budget (100-0%, 50-50%). In 2015 the revenue from vehicle tax is divided between local and state budget as follows: state budget has a proportion 60%, local government’s share is 40%.

2. Local taxes in Hungary

In Hungary the 1990 Law on Local Taxes declares the possible types of local taxes local governments may levy, maximum size of local tax rate is also set centrally. Local governments are entitled to introduce any or all of the following taxes: property tax, communal tax, tourism tax and business tax. *Property tax* can be imposed on residential and non-residential buildings and plots. Local governments may decide free whether the assessment of tax burden will be area-based or value based. A value-based property tax is applied only by a few local authorities recently. *Communal tax* is levied on private residents, it is a special property tax, since it can be levied on household dwellings (owned or rented). *Tourism tax* is one of the most conventional local taxes in Hungary, it can be levied based on turnover (per capita accommodation fee). *The business tax*^{*} is a turnover tax levied on manufacturer's and retail sales' net turnover.

3. What is tax morale – How can we measure tax morale?

In the specialized literature firstly Frey-Weck-Hannemann (1984) defined **tax morale**[†] in 1984. Nowadays several publications are concerned with the question of tax morale[‡]. The significant problem of making people paying taxes: the individual is unable to punish the cheaters efficiently. The isolated individual would be only able to punish the cheater if he himself didn't pay tax.

Shadowing the situation we can say that the interpretation of more, strongly related definitions (hidden economy, informal economy, 'grey' economy, informal working) are disputed and can be separated to more branches. This is also the case for the dominant and significant factors of informal work. We can separate two main branches in the literature: according to the first, the rational estimation on the relative gain from tax fraud is the decisive, the other considers the role of tax morale as a prior (see Torgler, 2003).

Earlier researches by Allingham-Sandmo (1972) and Yitzhaki (1974) consider tax evasion as gambling. They examined how much of the income is declared by people who are avoiding paying taxes at a given probability of tax evasion and at a given rate of punishment. Hungarian researches are initiated after the regime change in this area[§]. The main courses of the researches were hidden economy, norm following behaviour and the new tax system developed by the changing economic system. We can say that the number of specialized literatures studying the measurement of tax morale is significant, too. Some research considers the tendency of the number of enforcements in taxation as a tool of measuring tax morale. According to this, tax morale has been declined. Nowadays in Hungary approximately more than 360 000 enforcements are still in process. Furthermore debts in connection with enforcements were up to a thousand billion forints till the end of July, 2013.

In the opinion of OECD experts the citizens responses reveal socioeconomic and institutional factors that may influence tax morale. (OECD, 2013)

The World Values Survey gives data to help build a better picture of tax morale. The OECD used data from WVS, which covered around 90 countries^{**}.

* Business tax has a dominant place in the Hungarian local tax system, it constitutes more than 80% from total local tax incomes of local governments.

† Tax evasion is usually explained by the Laffer curve, which shows income from taxes as a function of marginal tax rate. Frey-Weck-Hannemann (1984) states that tax morale is as much important as tax rate concerning tax revenue.

‡ Tax morale is a complex phenomenon, it concerns law, macroeconomics, behavioural economics, sociology, etc.

§ However we should also mention the name of Schmidt, who had examined tax payers' behaviour and the causes in the 1940's.

**Hungary was not involved in the survey, for Eastern Europe Bulgaria, Moldova, Poland, Romania, Russia, Serbia, Slovenia, Ukraine was involved.

Some very interesting observations can be found in this paper, like: “Individuals are more likely to perceive tax obligations more favourably when their government is seen to be acting in a trustworthy manner”. (OECD, 2013. p. 7.)

When state strengthens and clarifies the links between revenue and expenditure it can help to improve tax more of society. Increase the transparency of tax policy making, increase the number of tax administration procedures: these measures would reduce opportunities for corruption and the willingness the cheat with tax revenues.

4. Empirical results

A comparative study of two Eastern-Central European countries was carried out by me during the first half of 2014. An electronic questionnaire was filled out by 120 Hungarian and 60 Romanian subjects, mainly students but in both countries there were also officials from the national tax offices among the responders.

In the questionnaire after collecting some demographic variables I had either direct or indirect questions. The direct questions concerned personal tax paying habits while indirect questions related the social tax morale. Finally also some personal characteristics (e.g. Machiavellian personality test) were collected. The age and gender distribution of subjects in Hungary and in Romania was almost the same. About two-third of the subject were female and a little bit more than half were under 25. Note that almost half of the responders are full-time workers and a significant share of under 25s is continuously working beside their studies.

Concerning the question “*Why do you think the tax morale is low in your country?*” *it is important to emphasise that almost half of the subjects do not feel the return on paid taxes, i.e. they are not satisfied with the level of public services compared to the level of taxation.*

Two more frequent answers were – about one-fifth answered both – the lack of trust in the state and the low living standard. Maybe the lack of trust is linked with the feeling of poor return since in both case the responders believe that paid taxes are not entirely and properly used for public services. The three typical answers and their relative frequencies are not significantly different between Hungary and Romania.

Next question was linked logically to the previous one because accepting the fact that tax morale is low and *it asked the reasons which would make the responder to pay taxes more properly.* In this case it is worth to differentiate between the answers of the two countries, since on the one hand in Romania a significantly higher share of subjects answered that a more developed welfare state and higher living standards could motivate them for more proper taxpaying. In both countries about 40-45% of the responders stated that **higher level of efficiency and transparency (dividing centralised money better and giving information about the division of it) would result in more proper taxpaying.**

On the question concerning *the most significant problems of taxation in the responder’s country* almost half of the subjects answered in both countries that too many people avoid paying taxes and the tax rates are too high.

In both countries the responders typically believe that the tax morale is low because people don’t feel the return of collected taxes in healthcare or education, the living standard is too low, furthermore people generally do not trust the state. About the 30-45% of the subjects said that they would pay their taxes if the welfare state was more developed.

Concerning the personal characteristics, Machiavellian personality shows indirect relation with willingness of taxpaying ($r = -0.43$; $p = 0.013$).

Studying these behavioural aspects of the responders, an idea arose about the main characteristics of tax morale. I think it is cultural dependent on the one hand (however it is necessary to test this effect on a large sample), and on the other hand it depends on individual characteristics as well, like Machiavellian personality, etc. Another important fact based on the answers of responders is that higher level of efficiency and transparency (dividing centralised money better and giving information about the division of it) would result in more proper taxpaying. I thought this fact is worth to study on, so in my new questionnaire I involved this aspect, and what is more, the whole questionnaire was set up in the way that the transparency of shared taxes took a central role. My main idea was to test – concerning the fact that responders in 2014 typically said, they do not feel the return of collected taxes in healthcare or education, they do not trust the state – whether they trust the local government more. Are people willing to pay taxes more

adequately or pay even more tax when they experience higher efficiency in tax revenue utilisation by the local self-government? The questionnaire was run in February 2015, in Hungary, at Budapest Business School.

Out of the 95 participants 75 answered that there exist shared state taxes. According to them the local self-governments receive on average 29% of the total vehicle tax while this ratio is much lower, only 10.82% on average in case of PIT. (Note, that the right answer was 40% in case of vehicle tax and 0% in case of PIT.) However it is noteworthy that the standard deviation of the answers is rather large either in the case of vehicle tax or in the case of PIT: 31.75 and 17.55 percentage point respectively (which means that the coefficient of variation is above 100% in both cases, meaning that the answers are quite heterogeneous). Generally we can say that respondents are not really aware of the right share of state taxes but they mostly consider lower shares of the total tax revenue of the state, however there are a few exemptions as well (e.g. there were also responders who believe that 100% of the vehicle tax and PIT is received by local self-governments).

Not only the measure of shared state taxes are not clear for most of the responders but even the 20 cases out of the 95 can be considered as too lot who answered that there are no shared state taxes in Hungary at all. My assumption was that adult students of economics (not freshmen) who are 30 years old on average know the fact that either the vehicle tax or the PIT are shared state taxes which form the income of tax systems both on state and local level. This significant ignorance may cause the high level of variation in the answers concerning the shares of local governments from the mentioned two state taxes.

It is important to emphasise that exactly half of the responders would accept even higher tax rate if they were sure that the surplus above the official tax rate is the exclusive revenue of the local self-government. As it is visible in Table 1, males have significantly higher willingness to accept higher tax burden for this reason. Compared to the current 16% PIT rate, males would accept even more than two percentage point higher tax rate in order to help the functions of the local self-governments. In case of females this extra tax burden is almost one percentage point lower on average which difference between the two gender is significant ($F=5.31$; $p=0.023$).

It is generally accepted that payments in connection with local services are typically more accepted since the relation between the payment and the service is more appreciable (Tiebout, 1956). According to this model the individuals appear as consumers who decide to which local self-government they move based on the possibilities they have to offer^{††}. As a result, inhabitants and enterprises with the same preferences will be concentrated in the same district. The theory of Tiebout resulted in several models of efficient inter-governmental race for mobile resources of economy.

Table 1. Willingness of paying extra tax burden (percentage point)

<i>Gender</i>	<i>Mean</i>	<i>St.dev.</i>
Male	2.13	2.55
Female	1.16	1.55

Source: own calculation

Table 2 contains the correlation matrix of the observed variables. Those correlation coefficients are marked by bold which are significant at the 5% level. In the following the most important ones are discussed which are interesting for the research topic.

^{††} As long as the payable taxes are in line with the marginal cost of expanding the local services to a newcomer, the result can be considered as Pareto optimal like in the case of private sector. For example the local business tax may support those developments and local services which are offered to entrepreneurs by the self-governments.

Table 2. Correlation matrix of the examined variables

vehicle tax	<i>Local self-gov. share from</i>		Extra tax burden for self-gov.	<i>Pay for fictive inv. if the risk is</i>				Mach. score
	PIT			0%	25%	50%	75%	
Share from vehicle tax	1							
Share from PIT	0.2382	1						
Extra tax burden	-0.1016	-0.0368	1					
Fictive inv. (risk: 0%)	-0.1875	0.0374	-0.0601	1				
Fictive inv. (risk: 25%)	-0.1402	0.0230	-0.0326	0.6209	1			
Fictive inv. (risk: 50%)	-0.0765	0.0203	0.0415	0.2900	0.6214	1		
Fictive inv. (risk: 75%)	-0.0043	-0.0701	0.0084	0.1648	0.4485	0.8010	1	
Mach score	0.0431	0.0586	0.0750	0.3462	0.2215	0.1685	-0.0024	1
Gender	0.2023	0.3042	0.2325	0.1590	0.1633	0.1724	0.1899	0.144
Age	0.0495	0.0241	-0.1153	-0.2458	-0.1510	-0.2339	-0.1657	-0.273

Source: own calculation

It seems that men support the finance issues of local self-governments more than females, since they are not only willing to pay higher tax burden in order to increase local revenues but they assume that self-governments receive higher shares from vehicle tax and PIT. However this is only an assumption at their side, which is possibly a higher share than the actual real rate, it is noteworthy. I do not consider it as a systematic failure of overestimation by males. In connection with the males' willingness of paying higher tax burden, I think it shows rather the pursuit that males support more the delegation of the use of public resources at the local level.

Responders were asked to imagine the situation that the general PIT burden is 30% and they have realised 1 million HUF income for an extra work which is similar to their general occupation but not part of their job. They have the possibility to buy a fictive invoice of half million HUF which can be considered as cost and this way it reduces the income to its half. The question was, how much percent of the nominal value of the invoice are they willing to pay in case of different risk levels of being caught. The answer at 0% of risk is considered as the individual level of tax morale. The possible maximum for this question is 30% since it would be totally against the rational decision making if anyone paid more than 30% of the nominal value of the invoice in case of 30% tax burden. If someone is willing to pay the total tax burden (30%) to a third party instead of the state then his/her tax morale is considered as zero (0%). If someone refuses to pay anything for a fictive invoice even in a riskless option then his/her tax morale is considered as full (100%). So the answers for the riskless option (between 0 and 30%) were transformed to a scale between 100 and 0%.

Maybe it is surprising that 29.5% of the responders would pay even the total tax burden for a fictive invoice instead of paying it to the state budget... Even if there is no risk of being caught it must be clear for all that this behaviour is immoral and causes damages for the society.

As it was expected there is direct relationship between the level of Machiavellian personality and the maximum amount paid for a fictive invoice in a riskless option ($r=0.346$). It can be explained by two reasons: on the one hand it is not a dilemma to reach individual gain at the expense of the society for people with strongly Machiavellian

personality, while on the other hand these people consider the state leaders typically as opportunistic and self-serving persons which may justify their behaviour of decreasing the tax revenues.

There is a less than intermediate strength, indirect relationship between the age of responders and the maximum amount paid for a fictive invoice in a riskless option ($r = -0.246$). Anyway, it has to be emphasised that it does not mean at all an increasing tax morale as time passes. This research compared the answers of people as cross-sectional data and it shows that the tax morale of older people is significantly higher at the date of observation. Obviously it does not mean that the tax morale of the younger people will be better as they are getting older. The appalling thing is that after several years, as the older people of now will retire and get out of the sphere of active tax payers, their place will be taken by this younger generation with its lower tax morale. All in all, the current situation does not support the increase of tax morale in the next years. In my opinion some important steps are necessary to reverse this negative tendency concerning the tax morale of the younger generation. Without a successful intervention of the state the tax morale will not get better (e.g. “I was not caught so far, why should I pay in the future?”) and what is worse, this rather negative tax morale will be the example for the next generations.

The maximum amounts paid for a fictive invoice in case of different levels of risk are not independent of each other. Obviously only those people will pay for a fictive invoice in a risky option who would do this also in a riskless option, however vice-versa it is not necessarily true. It can be seen in Table 2 that strong relationships are only between the low risk options and between the high risk options. There is a more than intermediate strength direct relationship between the maximum amounts in case of the riskless and low risk options ($r = 0.621$), while there is a strong direct relationship between the maximum amounts in case of the high risk options ($r = 0.801$). Naturally the risk of being caught influences negatively the maximum amount paid for a fictive invoice which can be observed in Table 3.

In case of no risk the responders are willing to pay on average even the half of the tax burden for a fictive invoice. If the risk is 25% then this amount decreases to its half. As the risk increases the amount decreases exponentially (see Figure 1). This indirect relationship is strong and significant even below the 1% level ($F = 48.56$; $p = 0.000$).

Table 3. Relation between the risk of caught and tax morale (percentage point)

<i>Risk level</i>	<i>Mean</i>	<i>St. dev.</i>
Fictive invoice (risk: 0%)	15.07	12.47
Fictive invoice (risk: 25%)	7.03	9.44
Fictive invoice (risk: 50%)	2.80	5.71
Fictive invoice (risk: 75%)	1.33	4.57

Source: own calculation

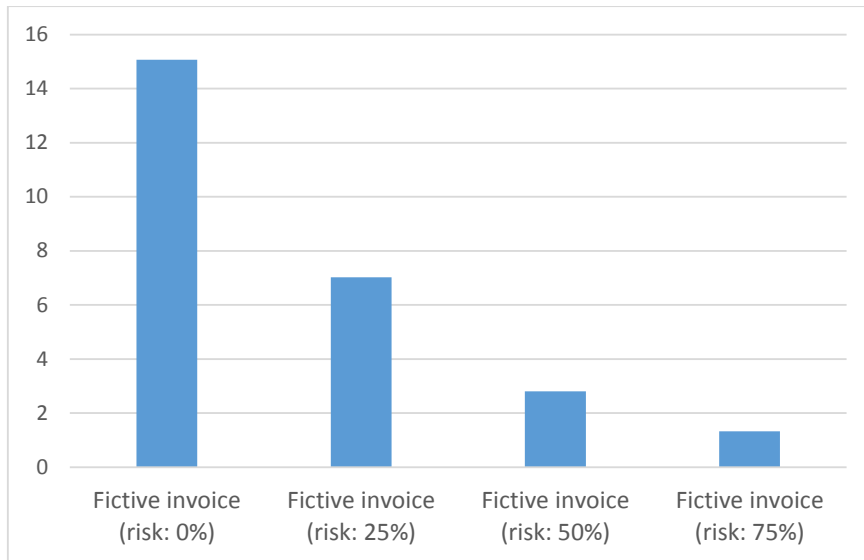


Fig. 1. The maximum ratio of the nominal value paid for a fictive invoice in case of different levels of risk

Source: own calculation

Even though the sample is not representative, it is visible that in case of no or minimal supervision the fictive invoice is a real option to reduce the tax base for those who have some extra income. However the willingness for this kind of manipulation intensively decreases if the risk level reaches at least 50%. Considering that there are no exact data for the tax payers about the real risks, these are more-or-less some kind of subjective probabilities, there is a good possibility to reduce tax evasion by strengthening the general belief about the efficiency of supervision and the higher and higher risk of being caught.

The Hungarian National Tax and Customs Administration (NTCA) has introduced a more efficient and more powerful supervision system after its organisational transformation in 2011. In 2012 there were 2029 supervision processes concerning private asset growth which is almost double than in 2011. Out of the 2029 supervisions 1578 (78%) finished with a sanction, resulting altogether 20.6 billion HUF tax difference that is 89% higher than in the previous year. *I do not believe that tax morale can be strengthened only by increasing the number of supervision processes or by increasing the level of tax fines, however it may have enough restrictive power for tax payers with “vacillating” tax morale in case of significant risk of being caught.*

The regression coefficients of those explanatory variables which are in the closest relation with the tax morale can be seen in Table 4.

Table 4. Explanatory variables of tax morale

Coefficients	b_i	$s(b_i)$	t-value	p-value
Constant	56.974	20.443	2.787	0.006
Mach score	-0.775	0.274	-2.830	0.006
Gender	-9.273	8.175	-1.134	0.260
Age	0.804	0.494	1.627	0.107

Source: own calculation

The Mach score of the responder influences indirectly and most significantly the individual tax morale. Both variables are measured on a scale between 0 and 100. In case of 1 point higher Mach score (more Machiavellian personality) the tax morale is on average 0.78 points lower according to the regression, which effect is significant below the 1% level ($p=0.006$). It is easy to realise how strong and deteriorative is this effect: compared to a generally well-meaning person (let's suppose a low Mach score of 20) a person with more or less Machiavellian personality (a Mach score of 70 is not rare) has on average cca. 40 points lower tax morale.

Generally speaking the tax morale of males is a little lower than females, however the effect of gender is not significant ($p=0.26$).

In case of the effect of age we can repeat that the tax morale of older generations is currently significantly better than the younger generations (a one year older responder's tax morale is on average 0.8 points higher), which effect is significant at the 10% level.

The multiple coefficient of correlation for the total regression function is $R=0.4$ ($F=5.63$; $p=0.0014$). So we can conclude that the exploration of some further influencing factors is necessary, however the Mach score is a significant determinant of tax morale and possibly the generation effect is also important.

5. Conclusions

In my paper I analysed the Hungarian tax morale in connection with personal aspects, my main question was concerning 'Would people pay more tax if the local government received more revenue from shared state taxes?'

Out of the 95 participants 75 answered that there exist shared state taxes. Generally we can say that respondents are not really aware of the right share of state taxes but they mostly consider lower shares of the total tax revenue of the state, however there are a few exemptions as well. Even the 20 cases out of the 95 can be considered as too lot who answered that there are no shared state taxes in Hungary at all. Maybe a less complicated, more transparent and easier to understand tax rules would be able to strengthen the willingness to pay taxes properly.

It seems that men support the finance issues of local self-governments more than females, since they are not only willing to pay higher tax burden in order to increase local revenues but they assume that self-governments receive higher shares from vehicle tax and PIT. In connection with the males' willingness of paying higher tax burden, *I think it shows rather the pursuit that males support more the delegation of the use of public resources at the local level.*

There is a less than intermediate strength, indirect relationship between the age of responders and the maximum amount paid for a fictive invoice in a riskless option. Anyway, it has to be emphasised that it does not mean at all an increasing tax morale as time passes. This research compared the answers of people as cross-sectional data, all in all, the current situation does not support the increase of tax morale in the next years. In my opinion some important steps are necessary to reverse this negative tendency concerning the tax morale of the younger generation.

Concerning the personal characteristics, Machiavellian personality shows indirect relation with willingness of taxpaying. The Mach score of the responder influences indirectly and most significantly the individual tax morale. (It was the situation in the survey made in 2014 too, so it can be a strong aspect of individual tax morale.) Naturally this survey was not representative, however it is still able to show which points of the system are to be changed urgently. A less complex but more proportional tax system which is easier to understand for most people, with a more transparent and effective redistribution of collected taxes, besides an efficient tax control could significantly increase the general level of tax morale.

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