

## Local Taxes in Large Hungarian Municipalities

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**Abstract** Hungarian structure of local governments consists of two tiers. Municipalities have had power to tax within the confine of the central acts according to the closed-list approach since 1990. The open list method of local taxation for municipalities was introduced in 2015. There are no differences in the substantive law with respect to how municipalities – even if small villages or large towns – can exercise their taxing power. Counties gained power to tax in the Covid19 legislation in 2020. This new power is limited within their territory. The jurisdiction to tax covers only the area of the special investment zone over which the original taxes imposed by the respective municipality shall be replaced by the new taxes of the respective county. Contrary to the tax revenues, public services were not reallocated among local governments. Effective fiscal equalization should be implemented by the legislator to achieve balanced budget in the new pattern.

**Keywords:** • division of power to tax • local taxation • fiscal equalization

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## 1 Introduction

One can easily argue that the topic of this paper is almost hypothetical, because there are no large municipalities in Hungary except Budapest. Indeed, nine cities<sup>57</sup> have almost or more inhabitants than 100 000 people, and these local governments can be considered as “large” municipalities, if the fragmented spatial pattern of the Hungarian localities (Vigvári, 2011:54) is taken into account. The capital is a big city even on international level. In spite of that Budapest power to tax is beyond the scope of this paper, because its legal regime is special (*lex specialis*).<sup>58</sup> Its analyses would require a separate research. I deal with the general central rules (*lex generalis*) on local taxing power focusing on recent changes in Hungary. As written below, counties’ opportunity to impose local taxes made the fiscal equalization between the two tiers of local governments as important as ever. That is why the vertical and horizontal fiscal equalization is stressed here via the method of legal analyses blended with public finances. The extent of this paper does not allow to analyze the whole issue deeply, but it makes possible to highlight some thoughts. This article relies on an associated paper which was published just recently in the topic of Hungarian local taxation.<sup>59</sup> Repetitions are avoided except a short text on the special investment zone.

## 2 Literature review

The power to tax derives from the sovereignty which is strongly connected to the concept of state. (Troper, 2012: 354-356) This power, however, can be divided by the constitution or by the ordinary law with constitutional mandate among the governmental layers in three different ways. (Norregard, 1997:51; Ter-Minassian, 1997:9) Firstly, full tax centralization means that all taxes shall be imposed by the highest governmental level. Secondly, full tax decentralization exists when the lowest governmental layer shall levy all taxes, but this is not more than a mere theoretical version of taxation. It lacks the reality. Thirdly, taxation power may have under the competence of multiple governmental layers within the state. This is a very common arrangement in federal states in which the regulation on taxes is exercised in parallel by the legislative bodies of the federation and of the member states at the same time. This third version has been applied also in many unitary states. Hungary is an example of that.

What does local tax mean internationally? The international “minimum” definition which is suitable for comparison of different tax jurisdictions derives from the European Charter of Local-Self Government (hereinafter referred to as Charter). Article 9 Para (3) of the Charter<sup>60</sup> represents the essential (*sine qua non*) condition of local tax to comply with. (Messere, 2000:133) This is a tax imposed at the rate decided by the local government. The definition does not include for instance that local governments should administrate the local tax, or they should have alternatives to levy the tax or not. This guarantees only the local decision-making policy over the tax rate within the limits of law. Yet this is more than nothing. At least one element of the power to tax shall be decentralized to create a

local tax. This makes the local tax own tax. This minimum definition can be supplemented by the national law with further conditions.

Shared taxes are different to local taxes. The precise distinction between the two concepts is a complex issue (Blöchliger, Petzfold, 2009; Bahl, Wallace, 2007). It is enough to note here that tax sharing is a distinct arrangement from the decentralization of power to tax. Tax sharing only means that the budget revenues from certain tax is distributed by law among the layers of governments, but the given tax as such is imposed fully by the legislative body of one governmental level that is the central in most of the cases. In other words: shared tax is one of the transferred resources to local governments; local tax is an own resource to them.

According to the theory of public finance elaborated by Richard Musgrave, the functions of government can be separated into three parts such as 1) resource allocation 2) macroeconomic stabilization 3) redistribution of income. (Musgrave, 1959: 21-33) Regarding allocation, responsibility for providing local public services should be decentralized to local layers of government based on the so-called decentralization theorem written by Oates. (Oates, 2008: 314) Oates argues that potential welfare gains derive from decentralization, because it can increase efficiency by improving the fit between services provided and demands by people residing in a jurisdiction. The theorem applies to public services without substantial economies of scale and intergovernmental externalities associated with provision of a particular public service. (Musso, 1998: 355)

Equal well-being of citizens within a country depends on plenty of interrelated factors. In comprehensive approach for instance, over income and wealth other indicators such as average life expectancy, graduation, working condition, place of accommodation, and public services received have to be taken into account when enquiring about inequalities among people. (Ferge, 2008:4) It can be recognized without long reasoning that inequality can cause disturbance in the society. Consequently, a well-fare state aims at equalizing the conditions of life and on that score aims at redressing territorial disparities to hold the nation together. This function of state is of paramount importance owing to the socio-economic crisis during which centrifugal forces increased. (Bird, Ebel, 2007:7-11)

Decentralization of power to tax may cause inequalities. Fiscal inequity arises when persons in comparable situation, but in two different territorial units (e.g. municipalities, counties) within a country are treated differently by the fiscal system. (Boadway, Shah, 2009:323) The fiscal residua<sup>61</sup> of the citizens may vary to a large extent. Furthermore, decentralization of governmental responsibilities might result in individuals receiving a different level of public services for the same fiscal burden. (Dafflon, 2008:288) The point is that public services provided by the local layer of government to residents affect their living standard. There is a need for equal access to the provision of certain local public services at comparable level within the country. Therefore, fiscal capacity of local governments is to be equalized in order to balance their potential for providing equal public services.

Horizontal fiscal imbalance refers to the situation when own fiscal capacity of various sub-national governments at the same level differ. Horizontal fiscal equalization can be defined as transfer of fiscal resources among units at the same level of government to mitigate horizontal fiscal imbalance. Fiscal disparities can be evolved for two reasons such as differences in revenue raising capacity and differences in costs of services. Therefore, one of the main rationales for horizontal fiscal equalization is the presence of unequal economic conditions – narrowly unequal tax base – that produces disparities in the capacity of local governments to generate fiscal revenues. Next rationale is attached to costs. Costs of providing public goods and services can be unequal because of differences in geographic location and population size. The costs also vary due to differences in demographic characteristics and trends. Policy to compensate both kinds of differences is justified by equity concern. Namely, all citizens of the country should have approximately the same quantity and quality of public services independent the place where they live. Unlike regional development policy, equalization is a corrective fiscal policy with no direct growth and development strategy behind it. In other words, fiscal equalization aims at equalizing local governments' public revenue, not GDP. However, it does not mean that fiscal equalization has no effect on the GDP anyway. (Bird, Vaillancourt, 2007: 259-269; Ahmad, Craig, 1997:73-90)

### **3 Research**

This paper intends to answer two questions in connection with the decentralization of power to tax in Hungary. Do large Hungarian municipalities have different status in taxation compared to their small counterparts? What is the effect of the new amendment allowing counties to levy taxes on fiscal equality?

With respect to the first question, the two-tier structure of the Hungarian local governments (municipalities and counties) should be presented firstly, but it has been published in an other paper referred above (Kecsó, 2020a:332-334). The Fundamental Law of Hungary says that in connection with local public affairs local governments shall decide on the types and rates of local taxes within the framework of law. Hungarian Parliament adopted the Act C of 1990 on the local taxes (hereinafter referred as to Local Tax Act). This is in force from the 1<sup>st</sup> of January 1991. According to the original concept, Local Tax Act empowered the representative body of the municipalities to levy none, one or more local tax(es) from a closed-list containing the building tax, plot tax, communal tax, tourism tax and local business tax. An amendment to the Local Tax Act introduced the open list approach of local taxation for the municipalities in 2015. Over the five closed-list local taxes, the so-called municipal tax can be imposed by the municipalities on any basis of assessment, provided that it is not covered by mandatory public duties of any kind. Consequently, double taxation within the country is avoided. Municipal tax may not be imposed on the state, any local governments, any organizations, or on any entrepreneurs. Consequently, natural persons can be the subject of the municipal tax. Local Tax Act provides equality for all municipalities as to their power to tax. It does not

make any distinction how they can exercise their constitutional mandate to tax. Thus, at first glance inequalities in taxation power are avoided among Hungarian municipalities.

With respect to the second question, the special investment zone is to be scrutinized.<sup>62</sup> Hungarian counties did not have power to tax from 1990 till summer 2020. Covid19 legislation made counties possible to impose any local taxes from the closed list. Counties did not gain power to introduce municipal taxes. Counties' local taxation is restricted to and connected to the so-called special investment zone. The Government can declare by decree a territory of one or more municipalities partly or fully as special investment zone, if the economic activity within that area is very significant and has a decisive effect on the county's economy (Act LIX of 2020). The Government shall decide on the list of "the municipalities more directly affected by the investment" in the decree.

The establishment of a special investment zone has many legal consequences. Changes in taxing power is one of those. The county gets right to impose taxes in this special area and if does so the county tax replaces the respective tax of the municipality or municipalities. If a local government where the special investment zone is located levied a local tax, the county government should not increase the burden of taxpayers during the fiscal year. The decree of the local government where the special economic zone is located on local taxes apply until the county government adopts a decree relating to local taxes, not exceeding 120 days after the date of entry into force of the Government decree on the establishment of the given special investment zone (Local Tax Act Section 42/G). Two special investment zones have been established so far. These are situated in the area of Göd [Government Decree 136 of 2020 (IV. 17.) superseded by Government Decree 294 of 2020 (VI. 18.)] and in the area of Mosonmagyaróvár [Government Decree 44 of 2021 (II. 5.)].

It is of paramount importance that no additional public services are given by law to the counties when special economic zone is established. Public services stay at municipal level. Despite this fact, if the zone is done by the Government, county win all local tax power and all local tax revenues generated in the territory of the zone. What this "free" budget source can be spent on? Local Tax Act Section 8 Para 4 states that the county government where the special economic zone is located shall use tax revenue – by way of the means specified in its decree – for supporting investment projects in the county where the special economic zone is located, in particular in municipalities more directly affected by the investment according to the government decree on special economic zones, as well as organizations and municipalities in that county, and not more than 3 per cent of such revenue may be used for covering its operating expenses arising in connection with carrying out the delegated tasks of the county government.

The Hungarian Constitutional Court found that the abstract rules on the special investment zone and the establishment of such zone in the territory of Göd are not in conflict with the Fundamental Law.<sup>63</sup> Nevertheless, it laid down a constitutional requirement stated that local governments have constitutional right to intergovernmental

grants and to other fiscal resources in proportion with their mandatory public services. These sources can be decreased by the Parliament – and by the Government in extraordinary legal order –, but the reduction shall not endanger the exercise of the local competences enshrined in the Fundamental Law Article 32 Para 1.<sup>64</sup>

#### 4 Discussion

It is written above that at first glance inequalities in taxation power are avoided among municipalities in Hungary. Is it true at second glance? The differences come from the economic situation in which the municipalities operate. For instance, the most important Hungarian local tax is the local business tax that represents approximately 80% of the whole local tax revenues nationwide. Nevertheless, the legal opportunity to impose local business tax is not enough to acquire budget revenue. Local business activity within the jurisdiction of the municipality is an indispensable economic factor to make the legal opportunity real. Narrow part (about 10%) of the municipalities disposes big share (about 80%) of the whole local business tax revenues nationwide. The beneficiaries of the local business tax revenues are the municipalities where multinational and medium-sized enterprises have been established, because those taxpayers have big(ger) tax base. Typically, these municipalities are not villages or small towns, but medium-sized (between 20 000 and 100 000 inhabitants) and large towns. The diverse spatial distribution of the local business tax revenues makes the equalization scheme among municipalities necessary.

Horizontal fiscal equalization regime to mitigate the effect of the economic imbalance of local taxation power is in force in Hungary. Its legal source is the annual budget act. The equalization rules provide extra funds for municipalities with low taxing power. Net method of fiscal equalization is applied since the extra fund comes from the municipalities with high taxing power. Nevertheless, it should be noted that equalization regime is not only meant to finance municipalities with low taxing power, but to finance the central budget. In other words, the Hungarian regime blended horizontal (local-local) and vertical (local-central) fiscal equalization.<sup>65</sup>

The counties' power to tax is too immature to arrive at a final opinion about to what extent it causes fiscal inequalities in Hungary. The abstract rules are younger than one year old and based on these rules just two special investment zones have been established so far. The first one (zone Göd) was established in April 2020, the second one (zone Mosonmagyaróvár) was established in February 2021. As far as I am concerned the point is how counties will reallocate the local tax revenues among municipalities “more directly affected by the investment”. Thus, equalization between the respective county and the municipalities are going to be a hot topic in the Hungarian local finance. If the reallocation of the local tax revenues managed by the county was just, the fiscal equality among the affected municipalities would be guaranteed.

## 5 Conclusions

The tight scope of this paper allows brief conclusions. Hungarian municipalities have equal power to tax from the aspect of the law. From the very small villages to the large towns – except Budapest – have the very same rules to levy local and municipal taxes. Taxation, however, heavily depends on economic conditions and from this aspect the Hungarian municipalities are not equal, but diverse. Counties’ brand-new power to replace local taxes in the territory of the special investment zone redraw the old pattern. Especially because the fiscal revenues do not follow the expenditure needs. Counties have local tax revenues without additional public services responsible for. Municipalities lost local tax revenues retaining all public services. These tendencies raise the significance of the fiscal equalization vertically (county-municipality) and horizontally (municipality-municipality). Comprehensive and just regulation should be made for the equal well-being of the Hungarian citizens regardless what the zip code of their home is within the national border. This is how national solidarity would come true.

### Notes:

<sup>57</sup> In descending order: Budapest, Debrecen, Szeged, Miskolc, Pécs, Győr, Nyíregyháza, Kecskemét, Székesfehérvár. Last city has less inhabitants than 100 000 people (96 529). Hungarian Central Statistical Office: Detailed Gazetteer, available at [https://www.ksh.hu/apps/hntr.telepules?p\\_lang=EN&p\\_id=14827](https://www.ksh.hu/apps/hntr.telepules?p_lang=EN&p_id=14827) (10 March, 2021)

<sup>58</sup> Budapest has a dual self-government system, the districts and the capital as a whole. Budapest is treated as a municipality and as a county at the same time. Local taxing power is divided between the districts and the capital as a whole. It has to be highlighted that the general assembly of the capital is entitled by law to impose the local business tax.

<sup>59</sup> The basic information on the structure of Hungarian local governments and on local tax system – including closed-list and open list approach to local taxation – can be read here: Kecsó, 2020a.

<sup>60</sup> Charter Art 9 Para 3 Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

<sup>61</sup> Fiscal residua means the difference between the sum of the levies paid to the government and the returns in cash and in kind got from the government. (Buchanan, 1950:583-599)

<sup>62</sup> The text of this paragraph and of the next paragraph comes from Kecsó, 2020a:343-344.

<sup>63</sup> Decison No. 8/2021. (III. 2.) AB of the Constitutional Court of Hungary

<sup>64</sup> Fundamental Law of Hungary Article 32

(1) In connection with local public affairs the municipal government shall, within the framework of law:

- a) adopt decrees;
- b) pass resolutions;
- c) autonomously administer its affairs;
- d) determine its organizational structure and rules of operation;
- e) exercise ownership rights with respect to the property of the municipal government;
- f) determine its budget and autonomously manage its financial affairs on the basis thereof;

- g) have the option to engage in business activities using its assets and revenues, these activities, however, may not jeopardize the performance of its statutory tasks;
- h) decide on the types and rates of local taxes;
- i) have the right to create its own symbols and institute local honors and titles of merit;
- j) have the right to request information from the competent organ, initiate the delivery of a decision, and express its opinion;
- k) have the right to freely associate with other municipal governments, set up associations for the representation of its interests; cooperate with municipal governments from other countries in matters falling within its competence, and seek membership in international organizations of municipal governments;
- l) perform other tasks and exercise other competencies laid down by law.

<sup>65</sup> The Hungarian equalization scheme is discussed in an other paper. (Kecsó, 2020b)

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