Local Expertise Centre

Fundacja Rozwoju Demokracji Lokalnej im. Jerzego Regulskiego

JERZY REGULSKI FOUNDATION
IN SUPPORT OF LOCAL DEMOCRACY

OPINIONS & COMMENTS

LOCAL SELF-GOVERNMENT IN THE WORLD

ENG nr 2/2023

COMPETITION OR SOLIDARITY? USE AND MISUSE OF LOCAL BUSINESS TAX IN HUNGARY

Gábor Péteri

Local Business Tax (LBT) is the largest own-source municipal revenue in Hungary. Due to the recent centralisation of local services and reduction of related national budget transfers, it represents more than one quarter of all local government revenues. As an important discretionary local tax, it supports municipal competition for investors, profitable businesses, corporations and other economic actors. However, because of its significance, LBT is also a preferred object of regulations on intergovernmental relations aiming at fiscal equalisation.

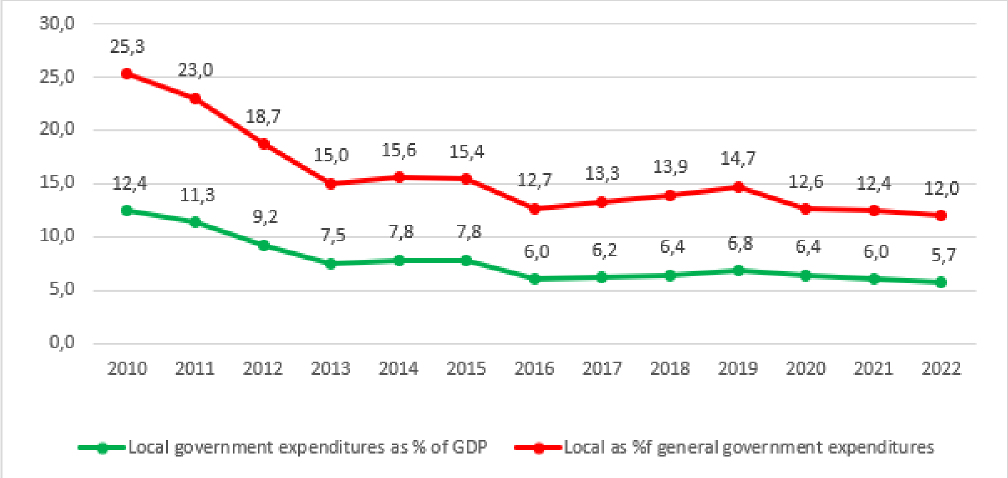
How these two objectives, namely incentives for municipal own source revenue raising and building solidarity in local finances can be harmonised? This brief article discusses the evolution of local business taxation in Hungary from a preferred local tax to a regulatory instrument, which presently is often regarded as a national government tool used for political purposes.

Re-centralisaton in Hungary

Local Business Taxation had very different roles in the past two major periods of decentralisation in Hungary. The first era, started with the political and economic changes of the late 1980s and lasted for two decades. It was characterised with radical decentralisation of public functions and finances. All public services of local importance, such as public education, social and health care services were assigned to the first tier municipalities and the elected county governments. In line with their European peers, Hungarian local governments managed one quarter of general government expenditures, which represented more than 12% of GDP. This wide group of local services was financed by diverse public revenues: own resources, shared taxes, intergovernmental transfers and loans.
Since the 2010 elections, when the conservative-populist government came into power, a new period of constitutional-administrative system was developed. The autonomous local governments were gradually weakened by transferring traditional municipal services to national level. Local governments were deprived of public education (except kindergartens), hospitals, polyclinics and various administrative services (e.g. issue of building permit). Now they all managed by central, state institutions. On the revenue side centralisation limited local fiscal autonomy by abolishing the Personal Income Tax sharingmechanism and by introducing greater control through intergovernmental fiscal relations.

This radical shift in decentralisation policy is characterised by two comprehensive indicators of local expenditures. (Figure 1)

Figure 1 Local government expenditures 2010-2022



Source: Eurostat

Local taxes in financing municipalities

Local governments in Hungary are financed mainly by grants and transfers provided by the national budget. They represent approximately half of local revenues (Table 1). These transfers are typically block grants allocated for specific groups of services by input indicators (e.g. estimated number of users) and partly general grants (allocated mostly by population number).

Table 1 Local government revenue appropriations

	2023	*2024*
Government grants	53,6%	47,3%
Local taxes	32,5%	37,2%
Operational revenues	10,6%	11,9%
Capital receipts	2,0%	2,1%
Transfers	1,2%	1,5%
Total	100,0%	100,0%

Source: National budget 2024

As local public services were reduced since 2010, consequently the national budget grants provided for these services also decreased. It resulted a two-pillar system of financing municipal budgets, where beyond intergovernmental transfers the local taxes became significant revenue sources. They represent more than one third of all local government revenues. Taking into account, that the second tier county local governments have no taxing powers, the local taxes are even more important for the first tier, municipal governments. Parallel to these changes local government borrowing was also heavily restricted after the 2008/2009 economic crisis.

Local taxation gradually evolved in Hungary since its early legislation in 1990[1]. Municipalities are authorised to levy three types of property taxes, a communal tax and the Local Business Tax. The tax base and the maximum rates are regulated by law, while the municipalities are free to decide tax allowances and reliefs. Property taxes (on buildings, plots) can be levied either by area or by assessed value. Tax on tourism is also categorised as a property tax, although it is pad by guest nights spent in the municipality (either per capita or as % of hotel charge). Communal tax is levied on rented apartment units. Among municipal taxes the Local Business Tax is the most important one, representing 84% of all local taxes (in 2023).

[1] Law on Local Taxes, C. of 1990

According to the OECD categorisation of local tax autonomy, Hungary belongs to that group of countries, which has relatively high discretion in municipal taxation. In the average of OECD countries 41% of municipal tax revenues are raised from that group of taxes, where municipalities are authorised to levy taxes within regulated minimum and maximum tax rates[2]. In Hungary, this ratio in 96%, because of the LBT dominance.

Local taxes highly differentiate municipal budgets. The per capita local tax revenues are significantly higher in the Western part of the country compared to the Eastern regions. There are further differences along the urbanisation slope: in the capital city, Budapest the per capita tax revenue is twice as high as the country average. In municipalities below population ten thousand, their share dramatically decreases, despite the fact, that per capita local tax revenues increased 5-6 folds during the two decades since their introduction.

Differences are influenced by the fragmented local government system in Hungary. The average size of municipalities is 3,100 and more than half of all municipalities have population below 1,000. These urban characteristics and the peculiar administrative structure caused unmanageable inequalities among municipalities. The small municipalities are not able to deliver the mandatory and merit based service assigned to them. Their revenue raising potential is also differentiated, which resulted rather targeted intervention through the transfer system, reallocation and restrictions in utilizing the largest own revenue, the Local Business Tax.

Local Business Tax

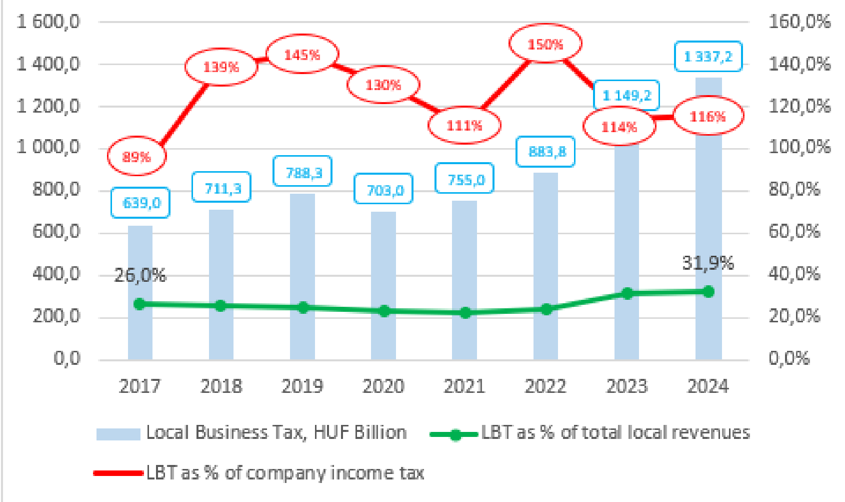
Local Business Tax is levied on all income or profit making activities implemented within the territory of the municipality. It means temporary business activities are also taxed and the tax base is shared between the company headquarter and its territorial units. The tax base is the net turnover, with further deduction of the input material and service costs, subcontractors' purchases, research and development costs. There are limitations on these deductions by setting maximum ratio of all accounted input costs in a progressive way (lower ratio in higher income groups).

The maximum tax rate since year 2000 is 2%. Local governments can introduce tax reductions and exemptions within the framework of the local tax law. LBT is administered by the municipal tax authority and it is paid in two instalments during the fiscal year.

During the past seven years Local Business Tax permanently increased – with the exception of 2020, year of the pandemic. (Figure 2) Since 2017 the amount of collected LBT has doubled, by 2024 reaching HUF 1,337 Billion (EUR 3.5 Billion at present exchange rate). The nominal tax revenues especially accelerated during the past two years, due to higher economic growth and inflation. According to the present budget estimates, it will cover 32% of local budget expenditures by 2024.

[2] Taxing power of sub-central governments, 2018

Figure 2. Local Business Tax, 2017-2024



Source: CSO, 2017-2021, MoF 2022-2024 ;
2022: expected, 2023-2024; plan, forecast

Local Business Tax is often criticised as an excess burden on businesses, which might slow down economic growth. Compared to the company income tax (9%) LBT is a significant load on companies, indeed. However, Central-East European countries usually decreased the taxes on businesses for gaining better position in the global economic competition. Hungary followed the same route, although other national budget revenues, such as VAT (27%) and labour costs increased. Local Business Tax exceeds company income tax since 2018, presently producing 15% higher public revenues. Because of its size and the regulations, LBT will incorporated in the calculation of the minimum global business tax, with the accepted rate of 15%.

LBT as a regulatory tool

This exceptionally high municipal revenue is a preferred subject of the regulations on intergovernmental fiscal relations. Not only the role of LBT in financing local governments changed during the past three decades, but the economic policy goals and tax administration rules were modified, as well.

Earlier together with the shared Personal Income Tax LBT was an indicator of local revenue capacity. The per capita PIT and LBT jointly are able to properly measure the overall development of a municipality, as they reflect both the local residents' personal income level and the size of local business activities. Personal Income Tax shared by origin was used as a simple equalisation instrument guaranteeing a minimum revenue up to the national average level of per capita PIT. The combined indicator of PIT and LBT, called local tax capacity was also incorporated in the grant allocation formula. Grants were decreased by set percentages, according to the standard local revenue capacity of a municipality.

Under the present intergovernmental system these methods do not work any more. Shared PIT was abolished and the Local Business Tax became the only indicator of local revenue capacity. However, because of its high share in local budgets and huge differentiation among municipalities it does not properly reflect the overall development of a local government. Several local tax capacity indicator based new regulatory instruments were introduced:

a)block grants of selected services (e.g. some social, child care grants, summer holiday school meals) are differentiated by the per capita amount of Local Business Tax revenue. Although demand for these services cannot be measured by the tax potential.

b)with the increase of LBT the use of former totally discretionary municipal revenue became more restricted. Municipalities are forced by law to use LBT primarily for financing social services and in the Capital City for financing public transportation. Financing the salaries of municipal office employees by LBT is also restricted.

c)municipalities successfully bidding for business locations in the form of special economic zones were deprived of these potentially high local business tax revenues. In the case of three large economic zones in Hungary the LBT was simply reallocated to the relevant county local government budget. This way - theoretically - the exceptional revenues might serve larger regions. However, it is the only own source revenue of the respective county governments, so its proper reallocation is not guaranteed. The centralised LBT revenues will not cover the environmental and social costs concentrated in the host municipality of the special economic zones.

d)Local Business Tax was used for promoting economic develop during the pandemic. The maximum rate of LBT for small enterprises was halved, while the COVID related municipal expenses increased.

e)The most significant change was the introduction of the Solidarity contribution, which is a simple local tax revenue reduction from the wealthier municipalities. Despite its name, it is a withdrawal of Local Business Tax revenue and reallocation to the general pool of grants. This restructuring does not guarantee that municipalities with low revenue base will benefit from it. Because of its increasing significance, size and the questionable deduction method of Solidarity contribution it is a highly debated financing instrument.

Solidarity contribution in the center of debates

Solidarity contribution was introduced in 2017 as a supplementary instrument of revenue equalisation. It is calculated according to set principles. Municipalities are categorised by their estimated per capita Local Business Tax revenues. The standard tax capacity is assessed by using a 1.4% rate of the actual LBT base of the fiscal year two years before the budget year (t-2). Municipalities are further categorised by this per capita standard LBT and the Solidarity contribution is levied progressively in the range of 0.4-0.75% of the estimated LBT.That is cities with the greatest Local Business Tax potential pay the highest Solidarity contribution (there is a limit with a maximum per capita Solidarity contribution). If the municipality did not levy LBT, then a flat minimum amount is set. During the first three years, when Budapest was controlled by the governing political party coalition Solidarity contribution was a discretionarily set, low amount.

Following the 2019 local elections, since the Budapest city council is dominated by the opposition parties, the rules of Solidarity contribution were modified. The limit of Solidarity contribution obligation was lowered (from HUF 34,000 to HUF 22,000) and the maximum limits of per capita standard LBT was significantly increased (from HUF 125,000 to HUF 950,000). Solidarity contribution minimum rate of the municipalities with the lowest standard LBT increased (from 15% to 36%), although in the highest group decreased by one third.

Due to these new rules and the increased Local Business Tax revenues, the Solidarity contribution gradually became an important revenue source of the national budget (Table 2). In 2020 it represented less than 6% of the total LBT revenues and contributed to the total local government transfer pool by 5.2%. In the fiscal year of 2024 it will reallocate 23% of Local Business Tax to the national budget, which will contribute to 29% of total local government transfers.

Table 2 Significance of solidarity contribution, 2020-2024		
Year	*Solidarity contribution as % of*	
	Local Business Tax	*local government transfers*
2020	5,9%	5,2%
2021	21,3%	18,7%
2022	14,7%	15,1%
2023	20,6%	24,5%
2024	23,0%	29,3%
Source: CSO, 2020-2021, MoF 2022-2024; 2022: expected, 2023-2024; plan, forecast		

The progressive Solidarity contribution represent a higher burden on Budapest City and the larger (county right) city budgets. The per capita Solidarity contribution in 2024 will be HUF 85 thousand for Budapest and HUF 38 thousand for the cities with county right (they represent 39% and 38% of their LBT revenues, respectively.) In total Budapest and the 25 cities with county rights paid 69.4% of Solidarity contribution. It is above their share of Local Business Tax (63.2%) and the country population (36.5%). (Table 3)

Table 3 LBT and solidarity contribution by local government types (%), 2022		
Local government	*Local Business Tax*	*Solidarity contribution*
Capital City & Districts	40,5	45,1
Cities with county right	22,7	24,3
Cities	26,0	23,5
Villages	10,8	7,1
Total	100,0	100,0
Source: Berczik[3]		

These proportions indicate that the Solidarity contribution might serve as an acceptable equalisation instrument. However, as it was mentioned, it is not directly reallocated to the municipalities with low revenue potential, it is only a general revenue source of the national government. The main issue is, that in some cases, the Solidarity contribution exceeds even the amount of the grants and transfers appropriated to a particular local government.

That means these cities became net contributors of the national budget. Instead of benefitting from the general and block grants allocated by a formula (typically on a per capita basis), they are obliged to pay the Solidarity contribution, which is higher than the amount appropriated by the national budget law. In the case of Budapest city that means its own source revenues are reduced (the cities with county right contribute only with two thirds of their grants, transfers received).

For stopping this unconstitutional regulation, which deprives municipalities from their own revenues guaranteed by the Act on Hungarian Local governments with constitutional power (approved by a two-third majority), court cases were initiated. They proposed to modify this regulation on forced seizure of that part of local tax revenues, which exceeds the total amount of eligible national grants. They claimed, that Solidarity contribution above the total of appropriated intergovernmental transfers is unconstitutional. This argument was rejected by the judgment of the administrative court of first instance[4]. However, the local government associations claim that it should be decreased and the national Budget Council opinion questions the sharp increase of Solidarity contribution during the past two years.

[3] Berczik, Á, 2024: Funding local governments in the 2024 national budget. Presentation at the TÖOSz general assembly on 24 May, 2024.
[4] https://enbudapestem.hu/2023/07/19/szolidaritasi-ado-budapest-fellebbez-a-torvenyszek-dontese-ellen

Balancing own-source raising incentives and revenue equalisation

There are some useful lessons from the Hungarian Local Business Taxation rules and the related fiscal regulations. The main problem of Local Business Taxation is its extremely high share among own source revenues. Relying on a single municipal own revenue with significant regional differences threatens the equity of intergovernmental fiscal relations.

However, a properly designed business tax meets the requirements of a good local tax[5]. It is a contribution to the public services consumed by the local company (meets the “benefit principle”). It finances municipal services, such as local infrastructure, environmental protection and other services preferred by investors (housing, culture, city marketing, etc.). Tax levied on net turnover (by deducting input costs) will minimise the economic distortion effect and creates incentives for attracting modern businesses producing higher added value. This tax base is less volatile, than company profit, so it creates stabile local revenue source. The costs of tax administration can be shared with the national tax authority, which manages the company tax. The limited representation of taxpayers can be compensated by transparent and inclusive local tax policy design.

Taxing business net revenues locally is an acceptable method of municipal finances. In Germany the local business tax (Gewerbesteuer) is an important municipal revenue source. The tax base is similar to the company profit taw, it is levied on the company income by deducting some costs. The minimum rate is 3.5% and municipalities set their rates within the limit set by the state governments. In France after the 2008/2009 economic crisis the local business tax („tax professionnelle”) was replaced by two contributions by businesses. One of them is based on company assets and the added value. The rent capitalisation is used for asset valuation and the maximum rates are regulated progressively. The added value component is levied on companies with larger turnover and it is not municipal, but intermediary tier government revenue (Départment, region). In Italy the regional value added tax (IRAP) rates are set by law. The territorial governments can modify the standard rate within limits. The collected IRAP is reallocated among the municipalities.

Lessons from a comparative study on OECD countries proved, that there is tax competition at sub-central government level in the case of taxes with mobile bases[6]. The research showed higher competition of business taxes (taxes on capital, capital income) as they have more mobile base. It is also an important finding, that sub-national government size matters: in countries with larger local governments mobility is lower and consequently tax rates are higher. So it is expected that in a country with small size municipalities, such as Hungary, competition will be higher. However, countries with greater local tax autonomy have lower disparities in local taxes. All these factors result limited tax competition in general - no “race to the bottom”, that is mutual decrease of local tax rates.

The real issue is the biased rules of local business tax related equalisation mechanisms. The Solidarity contribution became an important general revenue source of intergovernmental transfers. The extremely high progressivity resulted an excess burden only on a few cities. They are deprived of their own source revenues, which creates wrong incentives for local business taxation and allows political interference through fiscal rules. Municipalities might react by moving towards alternative forms of putting financial burden on businesses (e.g. introducing a general charge for infrastructure services).

[5] Bird, M. R.(2013): The VAT as a Local Business Tax. Tax Notes International 2013, Volume 72, No. 5., Péteri, G. (2015): Local taxation: a necessary bad thing? (Helyi adózás: a szükséges rossz?) KÖZJAVAK, I. évf., 2015/2. pp 32-36, DOI 10.21867/KjK/2015.2.8.; Péteri, G. (2021): Taxing local economy: international cases, lessons (A gazdaság helyi adóztatása: nemzetközi példák, tanulságok) Comitatus, 2021. Summer-Autumn, Volume XXXI., Issue 238. http://www.mrtt.hu/files/comitatus/comitatus_2021_nyar.pdf
[6] Blöchliger, H. and Pinero-Campos, J. (2011) Tax Competition Between Sub-Central Governments, OECD Working Papers on Fiscal Federalism, No. 13, OECD Publishing.

These two problems of LBT, namely high reliance on a single source and the biased equalisation policies, might be solved in several ways. Diversification of local taxation can be encouraged by decreasing Local Business Tax rate, making it a regional government revenue and supporting other, property based municipal tax efforts. Re-introducing the former shared Personal Income Tax will decrease the grant dependency and together with LBT could be used for fiscal equalisation more efficiently. Finally, the impact of Solidarity contribution should not exceed the amount of national grants appropriated. The equalisation objective should be made more transparent by allocating the earmarked revenue through a special fund for municipalities with low tax base.

AUTHOR

Gábor Péteri, Economist, PhD, presently policy researcher and international consultant. He started his career at City of Budapest, Planning and Economic Department in 1980. Then spent ten years in the Hungarian Institute of Public Administration where he was involved in the design of local government reform of the 1990s in Hungary. Since 1993 is a consultant in the areas of intergovernmental fiscal relations, local taxation, devolution of state owned assets, management of local public utilities and public education. He worked primarily in transition countries of Central and South Eastern Europe, but also in developing countries of Asia, in Turkey and Kingdom of Saudi Arabia. For four years also worked as the research director of the Local Government Initiative of the Open Society Institute, Budapest. He published extensively in the field of municipal finances and local service management.

Warsaw, October 2023
www.frdl.org.pl
Fundacja Rozwoju Demokracji Lokalnej im. Jerzego Regulskiego
ul. Edwarda Jelinka 6, 01-646 Warsaw, Poland