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The theoretical and practical issues of local authority taxation

The arguments of a PhD thesis

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I

The set aims of the research and the structure of the paper

The basic elements of our new democratically based local authority system are the local authorities of the individual settlements. The political independence ensured for the local authorities can only be realised if they also have *appropriate economic bases*. The financial legal legislation answered the challenges deriving from this by ensuring the possibility of local taxation, as the economic-financial foundations of the operation of the local authorities may only be created by giving them the *right to independent taxation*.

Ensuring the local authorities of settlements the right to impose taxation, as a way of doing away with the state taxation monopoly, is a general characteristic of the taxation and local authority systems of developed states. However, *in practice*, significant differences can be observed in the concrete solutions applied and in the theoretical methods recommended by the *specialist literature* dealing with the topic. This is convincingly proven by the Hungarian and foreign literature processed in this thesis and the number of the techniques used in the individual states, as well as the relatively large number of differing points of view and solutions.

The thesis of some 230 pages examines the *theoretical bases* of local taxation, the *international solutions* used in practice, the role of local taxes within *the tax system and the local authority budget*, the *various types* of local taxes theoretically possible and actually used, as well as the practices of the *constitutional court* relating to them.

Hungarian public law science has only processed the foreign taxation models used by the local authorities and the solutions used in Hungary to date separately and only in connection with individual short periods. With regards to the theoretical and constitutional points of view of independent settlement taxation, a comprehensive analysis has not yet taken place from a legal point of view, let alone from an economic point of view. The paper is *aimed at* making up for these deficiencies, and, over and above the theoretical conclusions that may be drawn from this, it may contribute to the future transformation of the law material in connection with local taxation that is on the threshold of reformation.

The aim of the research basically was not to work out new theories, to expound revolutionary new ideas, but to systematically formulate the *theoretical background* of local authority taxation, to present and analyse a few *new financial concepts* (tax capacity, value-based property taxation), and to call attention to the weaknesses of the present regulations, trusting that with these it will be possible to contribute to the development of legal science thinking in connection with local authority taxation and local authority financing in its widest sense.

The thesis, taking into consideration the above starting points – also including the introductory and summarising thoughts – is broken up into eight parts. Section One contains *the specification of the research topic and the justification of its selection*. Section Two examines not just tax law finances theory but *the theory behind local authority finances* in the wider sense, and also attempts to present the *typical local taxation models* that have been set up (French, German, British, Scandinavian) and their actual forms of implementation. Section Three reviews the *Hungarian history* of local taxation from the Compromise of 1867, through the solutions applied during the time of the socialist system up until the introduction of the still valid regulations of 1990. Section Four deals with the *position* of local authority taxes *within the tax system*, the *theoretical requirements* of the local tax system and with the *theoretical suitability* of the application of certain payment obligations as local tax. Section Five reviews the role of local taxes *in local authority budgets*, also spending time on a number of other local budgetary sources (shared taxes, budgetary support, etc.). Section Six of the paper partly shows the provisions relating to finances of the *European Charter on Local Self-Government* and their implementation in Hungary, and also deals with the general characteristics of the *1990 Hungarian regulations* relating to local taxes and with the main criteria of certain types of local tax, also referring to the more significant changes that have taken place over the last 15 years. At the end of this part, over and above a critical examination of our existing local taxes, a *concrete recommendation* is made regarding the local authority taxes to be applied, *the “ideal” tax system*. Section Six of the work shows, theme by theme, Hungarian *Constitutional Court and normal court practices* in connection with local taxes, specially emphasising the resolution confirming the conformity of our local

taxation with the constitution. Section Eight is a short summary referring to certain of the more important conclusions of the work.

II

Research methods and sources used

The objectives set and the research task in themselves determined the examination methods. It seemed by all means necessary to go back to the roots in order to determine the modern local taxation principles and methods. On presenting the subject most academic works – even if they are not expressly papers on comparative law – usually provide a review of the regulations of the developed Western European legal systems that act as an example for Hungary (also), and the tendencies and points of view realised there. The application of this *historical method* is characteristic of this work as well, with the difference that besides the example-setting European solutions it will – due to their special nature – give a short presentation of the solutions used in the USA and Australia.

As in the case of local authority taxation we are talking of something that was a part of our tax system for a long time before the Soviet-type state system, it is certainly of interest to review this indirect *domestic historical* background. This indirect historical background is presented in section III of the thesis.

The basic regulations of our legal system were and still are created as a result of a “constitutional revolution”, always taking into consideration the principle of legality with the step-by-step transformation of the earlier, socialist law started at the time of the change of political regime. The local authority system, ensuring the finances for the operating conditions of the local authorities and the regulations relating to the local tax system were no exception to this. At the same time if these are not exceptions, then this direct *socialist historic background* may be of good use in the learning and recognition of the system in effect today. These direct historical preliminaries may also be found in Section III of the work.

However, writing on local authority taxation is not as simple as it would seem. Neither its dogmatic, ideological bases, nor its solutions used in practice are simple. Over and above giving a *comparative and analytical* presentation of this varied theoretical and practical background, the place of our current local taxation system within the constitutional regulations will also be examined. In the scope of this the norms of our Constitution and our law on Local Authorities relating to the sum total of local finances *will be compared* with the financial provisions of the European Charter of Local Self-Government. Light will be thrown on how much the Hungarian regulations conform to the minimum standard required by the Charter, and also on how the effective Hungarian regulations can and should be evaluated from a content point of view over and above the formal conformities.

The possibilities lying within the *historical, comparative, analytical and dogmatic methods* have helped in the interpretation of local taxation institutions and in the clarification of their unique features.

The thesis, as it presents all models that have legally and actually existed, both concentrates *on academic sources* and on the regulations of *law no longer effective*. Besides this, the present regulations are also presented, due to which the related *new theoretical explanations* and *effective norms* also form the subject of the examinations.

III

The main conclusions and results of the thesis

1. From the point of view of local authority finances, even in Hungary *the central role is played by the national assembly*. Parliament is not only responsible for the decentralisation of state tasks, but also for the creation of the basic conditions required for the operation of local authorities. It should introduce and operate a finance and support system that ensures sufficient money for the local authorities at the *macro-level* and at the level of the individual settlements, i.e.: the *micro-level* for the performance of the tasks,

and in such a way that the majority of the support be predictable and open, and also realise the *equalisation* of the financial differences between local authorities if possible. Decentralisation of political power assumes that the large part of the finances comes from *the settlements' own incomes* (taxes, fees). The central governments exhibit a tendency of resistance in connection with the introduction of unrestricted local taxation; they prefer central (state) support. It can be observed that the decentralisation and political power and the *decentralisation of tax collection rights* go hand in hand.

2. In most countries state housekeeping has many levels and is divided vertically. This arrangement can, theoretically be one of two types. The two possibilities largely depend on the constitutional architecture and the type of the political system. The *one possibility* is centralisation, concentration, which, in essence, is based on the dominance of central state budgeting and in which the function of the lower level of the vertical scale is execution. The *other solution* is decentralisation, where the lower levels of the vertical scale have real budgetary independence. The system based on the principle of decentralisation is a public spending system where within a country the power to impose (tax) income is distributed among the various governmental levels. The theories examining this first appeared in the USA, as a consequence of which these aspects are called *fiscal decentralisation* or *fiscal federalism*.
3. On examining the typical routes of local authority taxation it can be seen that *the significance of local taxation is not in relation with* the state being unitarian or federative, this has much more to do with historical roots and is determined by the traditions of the public administration and financial system of a given state. In general in *federative* states the local authorities have more room for movement and taxation rights, but as the Australian example shows, this is not absolutely applicable. What is more, the marked presence of independent local taxation can also be observed in the case of *unitary* states e.g. Sweden, where there is, in actual fact, the international rarity of local income tax.

The idea that the most important tax income from a fiscal point of view (personal income tax, corporation tax, duty, VAT) is due to the state is only

realised in a restricted way, as in recent times local authorities have been receiving such monies (just think of the VAT of the German local authorities and the income tax share that can be derived from the constitution or the income taxation imposed by Swedish local authorities).

In connection with the traditional elements of local tax systems, *property taxes*, it can be observed that their fiscal significance is in retreat, the basic justification for their maintenance over and above historical roots (USA and France) is their stability and, good predictability (United Kingdom).

4. *The earlier conviction* according to which local authority taxes function only as taxes resulting in a low income *has been overruled*. Now income deriving from local taxes represents *a permanently increasing proportion of local authority budgets* within the state. However, it has resulted in a new problem, namely that *there are significant financial differences between individual local authorities*, which imposes a new task on the central power, that is the state, in the scope of which it must take measures to apply appropriate *financial equalisation mechanisms* between the settlements. It is also reflected by the domestic regulation of the institution of “*tax capacity*”.
5. The Hungarian system of local authorities before World War II was divided into two main types of local authorities: *municipalities* (small municipality, large municipality, town with a council organisation) and so-called *local governments* (county, municipal town). The financing rules of local authorities were not determined generally, but in a *local authority specific* way. About 40% of the income of municipalities with an independent right of taxation derived from these taxes. Municipality taxes were collected partly in the form of *independent* taxes and partly in the form of *supplementary* municipality taxes. One of the special features of this system was that *the amount of supplementary taxes was not restricted*, they could exceed even the amount of extra direct state taxes. Supplementary taxes could be applied mainly in relation to direct and in exceptional cases to indirect taxes. Furthermore, county towns were also entitled to introduce *new local tax types and independent town taxes* – with the government’s permission – although this happened very rarely.

6. The period of the socialist council system (1950-1990) itself was divided into different periods. The 1950's and 1960's were characterised by that the councils *did not have any* independent taxation rights or financial independence at all. The reform of the classic expense-orientated system of regulations was started in the 70's and 80's, but *even then there was no* local financial independence or independent right of taxation. Councils *were not authorised* to determine independent tax types, but there were a few sources of income (e.g.: dog tax, land plot tax) in the case of which it belonged to the local organisations' sphere of authority to determine the amount of the taxes or allow exemption from the taxes. Furthermore – as a specific form – a superior legal act (law-decree) made it possible for councils to introduce an obligation called settlement development contribution (TEHO), but only in the case that the local residents gave their *preliminary* approval to this in the scope of a referendum. Apart from the above, in the case of other local tax types the local councils were only executors of the central will, and they did not have an independent taxation right.
7. Tax system is a *country-specific* phrase, the different tax systems of the individual states derive from the different economic and historical development of the states. At the same time in today's different modern tax systems *local taxes are characteristic elements everywhere*, which local taxes used to represent the greatest proportion in settlement budgets around the turn of the 20th century. Then, following a period of centralisation, due to the appearance of welfare states the expenditure of state housekeeping increased rapidly, and at the same time burdens imposed on settlements also increased spectacularly. Local authorities had to face increasing financing demands themselves to a greater extent, which resulted in the general application of local taxes.

The *requirements relating to local tax systems* were determined by ideologists (Popitz, Musgrave, Messere), which requirements are completed further in the present thesis in connection with analysing local taxes (for example, because of suppressing the income differences between settlements a linear taxation level should be used in the case of local taxes and local additional taxes linked to progressive central taxes should be avoided as should granting different allowances and exemptions). It must be understood

that in reality none of the local taxes fulfils all of the requirements, still, in the lack of a better solution, a harmonised system of local taxes could have a satisfactory final result suiting most expectations.

8. Examining the suitability of certain tax types to be used as local taxes it can be stated that *head-tax* type payments, disregarding the burden-bearing abilities of taxpayers, as the only type of local tax imposed cannot be suggested, or it can only be suggested to complement other taxes more significant from a fiscal aspect. On analysing turnover taxes, it can be seen that in the states of the Union there are rules prohibiting the introduction of a *second multiple-phase turnover tax* as local authority tax beside the value-added tax due to the state. At the same time both *property* (real-estate) taxes and *income taxes* can be used and are recommended as local taxes and even as the central elements of local taxation.
9. Studying *the weight of local authorities within the state budget* and the *financial independence* of settlements it can be stated that these financial categories are in *reciprocal proportion* with each other. This means that the greater the share of local authorities is within the state budget, the less self-financing local authorities are, and the other way round, the less their share is within the state budget, the more self-financing they are and the less they depend on support. In countries where, similarly to Hungary, *loss-making operation* is allowed for local authorities, the budget system at the local level may have a basic influence on central governmental, state stabilisation economic and financial policies. For this reason with different prescriptions states restrict local budget deficits within certain limits.
10. The *financial independence of local authorities* is an organic part of local authority self-administration law, and its central element is the *independent taxation right* of local authorities. The independent taxation right of local authorities clearly results in *differences* between their actual financial possibilities, which need to be suppressed by the state by operating a *financial equalisation system* providing settlements that have a low income with the financial means needed to perform their obligatory tasks.

The sovereignty of the financial management of local authorities basically depends on two things: *on the one part* it depends on *how reliable the creation of the income is* (whether it is income from local taxes, different types of state support, divided tax, etc.), and *on the other part* it depends on *the degree of freedom* local authorities are allowed to have over the available sources.

From the aspect of making the financial management and budget of local authorities predictable, one of the most important tasks in Hungary would be to create preliminary legal regulations relating to *the annual amount and distribution of state support and divided taxes allocated to local levels in relation to the GDP* and to strengthen local budgets by expanding the scope of local taxation and local tax bases in order to increase local tax income.

11. Studying the financial provisions of the *European Charter of Local Self-Government*, it can be stated that *our domestic rules* relating to the financial affairs and taxation of settlements are in compliance with the – not very high – expectations of the Charter. However, beside formal compliance a much more essential factor is the extent to which our norms themselves contribute to the financial independence of local authorities and the predictability of their financial management. On analysing these it can be stated that *our local authorities are exposed to the current fiscal policy of the state*, as the relating constitutional and other prescriptions only use phrases (e.g.: “adequate own income” and “proportionate state support”) from which it is impossible to derive the concrete demands of local authorities relating to the state financing rules regarding their obligatory tasks.
12. In Hungary too local taxation, which is growing more intensive, has resulted in *increasing financial differences between local authorities*. In Hungary they tried to suppress this process by introducing the institution of the so-called “*tax capacity*” in the financing system of local authorities in 1999. The tax capacity of each settlement is the sum total of the personal income tax per capita and the calculated income from business tax. Then on the basis of the index number obtained in this way it is decided whether the individual local authorities can be granted further support on top of the general support (“poor” settlements) or they lose a part of the endowments they are otherwise

entitled to (“rich” settlements). As a result of this, beside the earlier “*task-based*” method an “*income-based*” method also appeared, which became possible when one of the basic principles of the Htv. [Act C of 1990 on local authorities] was abrogated (the extent of local taxes must not influence the extent of local authority support), and which caused great worry in professional circles.

13. In the course of analysing our valid local taxes it can be stated that *on the one part* they are not in compliance with many requirements in connection with local taxation, and *on the other part* our individual rules of positive law also need to be made more accurate. In order to overcome the faults or a significant number of them, *in the present thesis a proposal is made for establishing a local authority taxation system on new foundations*, which includes the taxation of properties taxable on a value basis (building projects and plots of land), profit of enterprises, taxation of tourists and Hungarian vehicles on completely new value-based foundations, which, after the termination of registration tax, would also incorporate this payable tax.
14. Our local taxation rules are *in compliance with the European Union’s* not very large number of prescriptions relating to local taxation. In order to achieve this the domestic regulations did not need to be amended a great deal, as they only needed to be adjusted to the community’s norms in the field of tax allowances and tax exemptions, because they are regarded as anti-competitive prohibited state support even in the Union.
15. *The role of the Constitutional Court* needs to be emphasised in respect of the development of local authority taxation and tax legislation in Hungary. This body of judges has created something of abiding value with its resolutions made both in connection with *the constitutional foundations of local taxation* and its *individual strategic issues* (the definition of tax payers, the subjects of taxation, tax allowances, exemptions from taxation, rules of tax capacity and the prohibition of multiple taxation). Now, with these resolutions, it has been achieved that our local authorities in charge of tax legislation are provided with “auxiliary material for legislation” that is completely in compliance with the constitution.

16. In summary it can be stated that the independence of local authorities ensured in a *political* sense can only be completely developed, if it is also given appropriate *economic* support. And the undoubtedly best way to do so is *to ensure the independent local taxation right of settlements*. At the same time it is not enough, if the state renouncing its monopoly of taxation provides local authorities with the possibility of imposing taxes independently, it is also necessary to fill this basic right given to local authorities *with content* based on valid tax law regulations, providing a *real basis* for the economic foundation and financial independence of local authorities. In the interest of achieving this there is still a lot to be done in Hungary.

IV

Using the results of the thesis

I believe that the principles and requirements regarding the taxation of local authorities, the summary of the advantages and disadvantages of the individual local taxes that can be imposed, and the description of the elements of a local tax system regarded as “ideal” can all be used *for the due reform of the statutory regulations* relating to our local taxes.

Due to the two-stage regulations relating to local taxes they can also be used *for the permanent legislation activity of local authorities* authorised to make decrees on taxation.

At the same time, beside legislation this thesis may also provide much useful practical information for *tax law jurisdiction*, that is for local tax authorities and tax payers, too.

In the scope of *university education* the theses of the present dissertation may be used within the framework of the High College of Financial Law.

The thesis *provides a new approach to several tax law problems* (value-based property taxation, value-based vehicle taxation, exemption from property taxation on the “additional” rooms of homes). By giving more thought to the problems raised these results and proposals may also play a role in *tax law research*.

V

Publications in the subject of the thesis

- Az önkormányzati /helyi/ adók rendszere Németországban.
[The system of local authority /local/ taxes in Germany.]
Pénzügyi Szemle, vol XXXVII, 1993/1, pp. 33-50
 - A német alkotmány pénzügyekre vonatkozó előírásai.
[Prescriptions of the German constitution relating to financial affairs]
Jogtudományi közlöny, 1993/2, pp. 50-61
 - Helyi adóinkról kritikusan
[About our local taxes – critically]
Délmagyarország, issues of 14th and 15th December 1993
 - Adóerőképeség - mint a pénzügyi jog új kategóriája
[Tax capacity – as a new category in financial law]
Collega, 2000/12, pp. 69-70
- Eladósodás és pénzügyi önállóság a települési önkormányzatoknál
[Debt and financial independence at settlement local authorities]
Acta Jur. et Pol. Tom. LXII., Fasc. 11, pp. 1-26
- Az önkormányzati pénzügyek hazai történetének adójogi megközelítése
[The history of local authority financial affairs in Hungary, from the aspects of tax law]
Acta Jur. et Pol. Tom. LXIII.