REFLECTIONS ON THE HUNGARIAN TAX SYSTEM AND REFORM STEPS – THE CASE OF PROPERTY TAX

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Abstract: *In Hungary the 1988 reform of taxes has resulted in a system consisting of central and local taxes. Since then tax system has been in a steady process of evolution, modification and change. In recent years one of the most heavily discussed and politically sensitive issues in Hungary is the introduction of a value-based property tax. The paper deals first the experiences with levying taxes related to properties. Local authorities are responsible for rising, administering and collecting municipal taxes. At statutory level, the parliament only regulates the general framework of local taxes. The most important feature of the Hungarian local tax system is the absence of the compulsory tax. The other special feature of the Hungarian local tax system is the predominant share of the local business tax, which is basically a sales tax. There are several local taxes related to properties, but only a few municipalities apply the adjusted market value as the base for building or land parcel tax. The paper also deals with the debate arguing for and against a mandatory value-based property tax. A variety of expectations by introducing the new system are analyzed in the concluding part.*

Keywords: *Tax Reforms, Local Taxes, Property Tax.*
JEL Classification: K 34

Introduction

In the late eighties, reform packages have included measures designed to dismantle government control over the economy in Hungary. Major steps in this direction include the reform of the banking system which began in 1987, *the 1988 reform of the tax system and the tax administration,* and the 1989 price-, wage-, and import liberalization policies. Several important laws and regulations have also entered into force, aimed at the further development of the transformation and privatization process concerning accountancy, tax procedure, business cooperation, investment funds, bankruptcy, securities, and banking.

The 1988 reform of the tax system introduced a comprehensive tax system, including an entrepreneurial profit tax, a personal income tax and a value added tax. The new tax system became effective from January 1, 1988. The entire tax structure has been deeply modified. As a result, a more transparent and simple tax system has been developed consisting of central and local taxes. It has followed the precedents set by certain Western European tax systems although with different tax rates.

The tax reform aimed at reducing distortions in relative costs and prices. It also aimed at shifting a large share of the tax burden from enterprises to individuals, and increasing the share of indirect, consumption-oriented taxes. Since the 1988 tax reform, the Hungarian tax system has

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been in a steady process of evolution, modification and change. It is important to note that since the reform, tax rates have also been subject to parliamentary laws and decrees.

The main taxes in Hungary include:

- corporate income tax;
- individual income tax;
- general turnover tax;
- excise tax;
- inheritance tax; gift tax; tax on the transfer of ownership; and
- local (municipal) taxes.

In addition to these taxes, certain contributions are required (for example, for social security and several other state funds). There is no net wealth tax.

In recent years one of the most heavily discussed and politically sensitive issues in Hungary is the property tax[1]*.* In order to have some insights to the reform questions related to introducing *value based property tax* let me overview the system of the Hungarian local taxes.

Local authorities are responsible for rising, administering and collecting municipal taxes. Local taxes are regulated by the Act on Local Taxes (Act C. 1990). At statutory level, the parliament only regulates the general framework of local taxes.

The Act lists six types of taxes that can be levied by local governments. These are:

1) Local Business Tax

Most municipal authorities have levied local business profit taxes on business activities performed within their jurisdictions. The tax base for business activities is the net sales revenues of products sold or services provided, less the purchase value of the goods sold, and the value of services provided by subcontractors.

2) Communal Tax on Private Individuals

Communal taxes may also be levied and on individuals owning dwellings or plots. The tax may not exceed HUF 12,000 per dwelling or plot.

3) Communal Tax on Entrepreneurs

Communal taxes may be levied on entrepreneurs who have a seat or permanent establishment within a municipality. The tax base is the average number of people employed. The annual maximum rate of tax is HUF 2,000 per employee.

4) Land Parcel Tax (Tax on Undeveloped Plots)

Tax can be levied on the owner of the undeveloped parcels of land situated in central areas within the area of jurisdiction of a local government. (There is also detailed specification of exemptions of tax.) Depending upon the decision of the local government, the basis for the tax is the actual area of the parcel as calculated in square meters, or the adjusted market value of the parcel. The annual maximum rate of tax is HUF 200/m2, or 3% of the adjusted market value.

5) Building Tax

The tax on buildings may be charged to the owners of all types of buildings. (The Act lists several exemptions, such as temporary residential dwellings, premises used for the purposes of social welfare, health care, child care and educational institutions, buildings owned by budgetary organizations, public service and religious organizations, etc.) The taxable base is either the useful surface area, or the adjusted market value of the building, whichever the municipality concerned decides to apply. The annual maximum rate of the tax is HUF 900/m2, or 3% of the adjusted market value.

As of 1 January 2008, *in addition to* private individuals, any owner (whose ownership is registered with the land registry) of an apartment or holiday home on the first day of the tax year, the value of which exceeds HUF 100 million (EUR 400,000), can be subject to 0.5% *luxury tax* (with the exception of organizations holding personal exemption or conditional personal exemption). The tax is to be paid on the amount exceeding HUF 100 million (EUR 400,000). The luxury tax is levied by the local governments (similarly to building tax and land tax), although they may not establish different tax rates in their territory.

6) Tourism Tax

The tourism tax may be levied on non-resident individuals who spend more than 48 hours in a municipality, or who own a holiday dwelling which does not qualify as a permanent home. The

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[1] In international literature and in many counties legal rules the term and the base of the property tax include not only real estates but any properties embedded in financial investments. At the same time these properties except real estates are exempted from tax.

tax base is the number of guest nights spent, or the lodging fee for a guest night, or the net floor space of the building. The upper limit of the rate of tax is HUF 300 per person and per guest night, or 4% of the lodging fee; or HUF 900/m2, payable annually for the building.

Out of the above listed taxes we can summaries the characteristics of those related to properties in the table below:

Table no. 1. Taxes related to properties

Tax	Tax base	Maximum measures (2009)	Taxpayer
Building tax	useful surface area or 50% of the adjusted market value of the building	900 HUF/m^2 or 3 % of the value	owner
Land Parcel tax	actual area of the parcel or 50 % of the adjusted market value of the parcel	200 HUF/m^2 or 3 % of the value	owner
Luxury tax	Calculated value of the building exceeding 100 million HUF	0,5% of the value	Owner
Communal Tax on Private Individuals	Ownership or Rent of the building or plot	12000 HUF	owner / occupant
Tourism Tax	net floor space of the building	HUF 900/m2	operator

Source: Act on Local Taxes (Act C. 1990) and actual legal regulation

Experiences with levying taxes related to properties in Hungary

The most important feature of the Hungarian local tax system is the absence of the compulsory tax. The municipal governments are empowered to decide which of the available local tax types to introduce, and to determine the rates within legal limits. There is a legal limit to the amount of local taxes that local governments can levy. However, local governments just rarely apply the maximum rates of the tax in question. In Table 2 and 3 figures show a relatively significant increase in number of local government introducing taxes and also in total local tax revenue. (In 1990 the number of local governments was 3112. It increased to 3194 by 2008). However, since levying local tax within given legal framework is the discretion of the municipalities the Hungarian local governments can even decide on not levying any taxes at all. In 2008 only about one third of the municipalities applied building taxes and about one third of these municipalities levied land parcel tax.

The other special feature of the Hungarian local tax system is the predominant share of the local business tax, which is basically a sales tax[2]. The base of this tax is very unequally distributed among the municipalities. The gap in the per capita tax base of the local business tax between the rich and poor municipalities is much wider than it would be, e.g., in the case of a property tax—the price of properties is more comparable in different municipalities than the local business revenues.

[2] The main advantage of this form is that it is consistent with the concept of benefit taxation. However, the tax on production can be passed on if the local taxpayer has great market power, so the tax burden can be transferred to the consumers. Therefore, inhabitants of other localities pay a portion of the local tax. The other negative effect is that this tax is very dependent on the economic cycle, so that planning with revenue from this source is more difficult than with a tax with a more stable tax base such as a property tax. Moreover, the fiscal federalism (decentralization) literature frequently mentions the problems arising from harmful tax competition: differing tax rates on a mobile tax base (capital, income, etc.) encourage a movement to municipalities with lower tax rates. The result is a misallocation of factors or an establishment of efficiently low rates and public services if the local government reduces tax rates because of this intergovernmental competition.

Looking at the number of municipalities introducing a particular local tax it is found what types of taxes have been preferred during the period. In the first half of the 90's local government gave priorities to communal taxes on private individuals and on entrepreneurs.

When the financial environment forced the local government to raise more revenue the local policy shifted to the introduction of business tax in the middle of the decade. However this increase in business tax has not been enough, the extension of the building tax, mainly on dwellings, has become the new source for raising local revenue.

The advantage of the *communal tax on private individuals* is that in case of high number of taxpayers the municipality can earn adequate revenue even when the tax burden per individual is low. It is easy to levy and administer and communicate because of the aim of collection can easily be understood and accepted by the residents. However, the incidence of the tax is more unjust in terms of carrying the public burden, as the same amount of tax is to be paid by all families regardless of their wealth and property. Another problem is the need for annual modification of the tax rate in time of inflation in order to preserve the real value of the revenue.

Both the *building tax and the land parcel tax* can be based on useful surface area or on adjusted market value. The logic of tax is the same, the difference is the base. Most of the Hungarian local government which have already levied this type of tax, applied the base of useful surface area. The reason is very simple. It is much easier to keep register established on the floor space than managing on market value. At the same time there are some disadvantages of this technique. It seems to be much more inequitable than taxing on a value basis. Most municipalities levied the tax at a very low rate primarily because of the unfair character of the tax. They want to protect low income families by not raising the tax rate any higher. Although the maximum rate permitted by law would give local government significant revenue capacity, in practice the local governments levy tax below the maximum rate. Any increase in tax rate would lead political debates in the local assembly.

Table no. 2. Number of local government introducing taxes between 1991-2008

Tax	1991	1996	2000	2004	2007	2008
Building tax						
Dwelling	***55***	***188***	***296***	***373***	***408***	***420***
Non dwelling	***65***	***597***	***687***	***731***	***743***	***758***
Land parcel tax	***35***	***392***	***380***	***416***	***422***	***432***
Communal tax						
on private individuals	***89***	***1296***	***1858***	***2 154***	***2233***	***2261***
Communal tax on						
entrepreneurs	*95*	*786*	*764*	*713*	*700*	*693*
Tourism tax						
on guest nights spent	*70*	*259*	*369*	*505*	*548*	*584*
on lodging fee	*0*	*11*	*8*	*4*	*8*	*9*
on building	***46***	***158***	***164***	***162***	***161***	***167***
Business tax	*132*	*1122*	*2226*	*2 548*	*2676*	*2698*
Total number of						
local government introducing taxes	**308**	**2297**	**2970**	**3 091**	**3119**	**3126**

Source: Ministry of Finance, Hungary

Table no.3. Local tax revenues between 1991-2007 in million HUF

Tax	1991	1996	2000	2004	2007
Building tax	***200***	***8 313***	***22 262***	***38 240***	***54 556***
Land parcel tax	***15***	***1 296***	***3 099***	***5 346***	***6 900***
Communal tax					
On private individuals	***304***	***1 492***	***4 557***	***7 162***	***9 069***
Communal tax on					
entrepreneurs	***646***	***1 174***	***1 192***	***1 164***	***1 261***
Tourism tax					
on guest nights spent	***646***	***1 174***	***1 192***	***1 164***	***1 261***
on lodging fee					
on building	***92***	***461***	***892***	***1 188***	***1 412***
Business tax	***2 500***	***66 130***	***186 822***	***310 536***	***427 134***
Total local tax	***4 027***	***80 371***	***221 766***	***367 184***	***505 267***

Source: Ministry of Finance, Hungary

In Hungary only a few municipalities apply the adjusted market value as the base for building or land parcel tax. Since value-based tax mirrors ability-to-pay principle better than the floor space tax it is easier to defend it in local politics. It can also provide a flexible but stable source of local revenue because changes in market value lead to tax revenue changes.

The introduction of the *luxury (building) tax* is explained by law as one of the tools by which a more equitable structure of tax burden should be promoted according to the spirit of the Constitution. The solidarity principle is being applied here, not the classical tax principles. A detailed legal framework instructs the Hungarian local governments how, when and in what circumstances they should levy the tax.

In order to avoid double taxation the law allows that the taxpayers can deduct the building tax, the tourism tax on building and communal tax on private persons from the luxury tax paid.

The revenue form the luxury tax is not significant, because on the basis of the given evaluation methods only some buildings are listed under this category. The administrative costs are too high compared to the tax revenue.

The debate: arguments for and against mandatory value-based property tax

Property tax used in most countries despite its unpopularity. People do not like it, mainly because in many cases this is the only tax they have to pay as a visible lump sum. Property taxes can generate considerable revenue for the local budgets. The tax base is not dependent on the taxpayer readiness to cooperate, because land and buildings are demonstrably there and belong to somebody. Tax evasion is therefore difficult.

If properly designed, property tax can approximate ability to pay sufficiently well so as to conform to the tax principles also in this respect. Since they mirror quite well some local expenditures, related to land and buildings, so that the benefit principle (make citizens and business pay as specifically as possible for the services) is supported. “It is widely recognized that the property tax acts as a rough form of benefit charge as well. It is well documented that the value of real property is strongly influenced by the level of local services (i.e. capitalization effect), as well as local factors, and that construction values and physical characteristics often are less significant as explanatory variables.”[3]

Also, these taxes are being felt (as opposed to VAT or excises for instance) so that the taxpayer is constantly reminded that he pays to his community. This way the principle of fiscal

[3] Szalai -Tassonyi, 2004, p. 5.

equivalence (a community makes citizens and business pay for what they demand in additional services) can work properly. At the same time this political „visibility“ of the tax makes tax rate increases more difficult and strengthens the fiscal responsibility of the community vis-à-vis its constituents. Fiscal competition between local governments is – this way – at the same time inaugurated and restricted.

“Furthermore, it is obvious that the tax burden poorly relates to cash flow, and ownership yields only potential, not realized capital gains. Although the property tax is perceived as tax on wealth, tax shifting can weaken the reality of the ‘wealth-tax view’: the tax may be passed through to tenants or to consumers to the extent that taxes on non-residential properties are reflected in prices.”[4]

The property tax is a difficult and costly tax to administer well. “It is true, of course, that buildings cannot easily run away and hide from tax officials. But it is equally true that valuation is an art, not a science, and that there is much room for discretion and argument with respect to the determination of the base of the tax.”[5]

To overcome the administrative difficulties it is required to assure uniformity of assessment method across all communities (though not of valuation and thereby of assessment outcome). Valuation and collection should be done locally, and the upper-level governments should only give technical assistance, and an unambiguous one.

The tax base should be as simple as possible. The tax should not be widened to become a general property tax (as often in the USA). Also, the tax base should not be established by a very thorough assessment, because the results would soon be outdated, as British and German history shows. And if in some region the cadastral system is not (fully) in place, this should not hamper the introduction. Simple indicators for a value should be permitted which could be easily observed by the local „inspector“. He usually knows quite well which uses and improvements occur on a property, especially in rural areas (which usually are the ones where administrative capacity is low).

As to the tax rate, it should be assisted by a wide tax base, because that allows for low rates. The danger that property tax rates might increase over time so strongly like almost-tax-revolts as in the USA or England could occur. With all this emphasis on own taxes, one danger should be avoided through the help of the central government. Local governments like to apply different small taxes, if only they acquire some net revenue above collection cost. This reasoning forgets the second part of cost: the compliance cost to the citizen and enterprise. Such taxes have been termed "nuisance taxes" and should be limited to the few which at the same time prevent undesirable behavior.

“In their present form, however, the building tax and the land parcel tax do not represent actual taxation of property at all.”[6] The property tax would seem to be the most appropriate local tax form in Hungary. This tax base’s most important positive feature is its stability and its insensibility for short term economic fluctuations. An additional argument for this tax is the conditions and specific features of the Hungarian property market. Like in other developed countries housing wealth is considered to be a decisive part of the wealth of people. However, the housing wealth of Hungarian households is high in an international comparison. Over 90 per cent of dwellings are occupied by the owners and their family (Kiss-Vadas, 2008).

The question is what sort of value-based property tax would be feasible in Hungary. Three main forms of ad valorem property tax are in use in different countries: (1) the bundled flat rate system, (2) the land value (or graded rate) system and (3) the unique English banded lump sum tax system (council tax). There is no space here to show and analyze these forms now, let me refer to authors Szalai and Tassonyi (2004) who assume that “the banded lump sum system appears to be consistent with the current practice in Hungarian local taxation. Most municipalities levy a lump sum tax on real property, as Communal Tax for reasons of administrative simplicity and cost reduction. However, this tax yields very small amounts of revenue because of the very low level of the rate limit.”[7] Furthermore, the luxury (building) tax has been introduced with this technique.

[4] Szalai -Tassonyi, 2004, p. 5.
[5] Bird, 1999, p. 12.
[6] Lóránt, 2008, 671. pp.
[7] Szalai - Tassonyi, 2004, p. 8.

Expectations by introducing the new system

One of the questions of many preparatory works is how much revenue would be generated by introducing the value-based property tax in Hungary. There have been several plans and computations applying different tax bases, different tax rates and built-in social preferences (exemptions). The tax can be introduced either simply as an additional budget revenue or combined with the current individual income taxes. Latter would probably help to "whitening" the economy with increasing burden on those who own valuable property despite a low declared income. (Kiss-Vadas, 2008). The expected revenue would range between 250 and 600 billion HUF[8] (Kopint-Tárki, 2007), to compare, the construction of the new Budapest underground line costs more.

Among the objectives of introducing value-based property tax is not only to increase tax revenues but to make tax burdens more just, to reduce opportunities for tax avoidance and tax evasion, to widen the scale of tax payers. By achieving this it makes possible to keep the level of central and local tax revenues together with reducing the average tax burdens for present tax payers.

The broadening of the base will likely include not only those who have managed to hide their income formerly, but also those who do not pay income tax (or pay a very limited amount) due to their particular circumstances. Political acceptability will require protection for such ratepayers from significant increases in their overall tax burdens. Two methods are generally used to define eligibility for tax exemptions: (1) an exemption based on income test, (2) an exemption based on defined target groups – some taxpayers become eligible for preferential treatment regardless of their income (Szalai-Tassonyi, 2004).

Parallel with the introduction of the new property tax the average tax burden should be reduced as a trade off the revenues from the new source. It could be done by a general tax reduction (including more than one tax form) or by the reduction of individual income taxes. The two solutions can also be combined. It depends on the tax rate to be set.

A general tax reduction is advised if the rate of the property tax to be introduced is low. If the rate is relatively high the second option could be feasible. It could also have two solutions. First, since the individual income tax is shared between the central and the local governments the reduction of individual income tax would provide potential sources at local level that could be used to pay for local property tax. Second, in case of tax deductions from individual income taxes those who would pay the new property tax could reduce their income tax liabilities to the extent of the paid property tax amount. In Hungary, it seems to be that the real option is the first. However, proportionality should be considered, that is, increasing burden on one side should be proportional with decreasing taxes on the other side.

One of the 'hidden' objectives of introducing the new property tax is to reduce the dominance of business tax among the local taxes. According to an estimation of Kopint-Tárki (2007) in case of the upper level revenue course, the revenue from property tax would exceed the revenue from business tax or at least the new tax would significantly ease the burden caused by business tax. Replacing business tax with property tax would (partly) satisfy the need of local government to have more stable and computable revenue source and would reduce revenue disparities between municipalities. On the other hand some experts do not consider the shift between two taxes so urgent, because of equity problems and of difficult administration (Bakos-Bíró-Elek-Scharle, 2008).

Since managing the introduction of a new tax, several foreseeable and some unexpected questions should be taken into considerations. That is why some experts recommended a gradual reform with pilot project first and after learning from the experiences the system would have been extended for the whole economy. (Now, the government is submitting the reform package to the Parliament. The opposition party declared that in case they can govern they would immediately withdraw the package.)

In any case, of course, the government must consider the basic factors and structure of the new tax. First of all, questions like who pays the tax, who (which group) takes the tax burdens, e.g. what the tax incidences are, what other effects could be calculated in the market. Debates cannot be avoided concerning the tax base, tax rate(s), or the amount payable. The same is true for the

[8] Since than the estimation has significantly been modified by 2009. In the government's proposal to the Parliament it amounts to only about 50-60 billion HUF.

tax preferences the society claims and government can or must give, for example tax exemptions for pensioners owning their flat or house what they built themselves several decades ago or exemptions for low-value property. Decision-makers should also consider items like government-owned property, vacant land, tax deferral, etc.

As far as mandatory character of the new tax concerns, it requires to set a minimum rate centrally in order to force municipalities for levying the tax. Assessment process seems to be a crucial issue for implementing the reform. The success of the introduction of the new tax depends on the correct and socially acceptable assessment of the property. Countries apply different methods, but any method would be chosen it should mirror proper relations between property values. It should also ensure that the centrally set limits could be applied within and between different settlements.

The idea of value-based property tax has already been present in discussions of professionals, academics, experts and politicians. Now this is on the agenda of politics as tax reform that has other dimensions and aspects related to major central taxes as well.

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