

# THE LOCAL TAXATION IN THE EUROPEAN UNION – THE HUNGARIAN LOCAL BUSINESS TAX (HIPA) CASE

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**Abstract:** *The tax sovereignty arises from the supreme power of the Member States. In Hungary the local taxation is the guarantee of the self-governing autonomy, but the local governments could impose taxes within an Act. The harmonisation of the local taxes elementary allude to the local business tax, which tax category is the most important self source of income of the Hungarian self – governments. The European Union made the local business tax a subject of examination from two standpoints. In one respect the European Court decided about the EU-conformity of this tax category, on the other hand the tax allowances were the subject matter of the examination by the EU-accession.*

*I show in my study the followings:*

- 1. Tax law sources, to which the local business tax should be harmonize.*
- 2. Which were the arguments of the European Court by the judgement of the Hungarian local business tax, whereas this isn't inconsistent with the regulations of the Sixth VAT Directive – Article 33 ?*
- 3. What is the meaning the “harmful tax competition”, and what are the legal harmonisation tendencies concerning to the tax allowances?*

**Keywords:** *Local taxes, European tax law, Tax harmonisation, European Court, Tax allowances, Harmful tax competition*

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It is not easy to give a simple answer to the question how much the local governments are affected by the obligation for the harmonisation of taxation; however I will attempt it during my paper.

The right to the assessment of taxes that is the tax sovereignty – in most countries – is reckoned as the privilege of the supreme states.

The tax is a historical category, which has always been connected to the existence of a state; the types, kinds and scope of taxes, their rate, the tax allowances and exemptions are determined by the scope and quantity of state tasks and the demands for state expenses.

The taxation system of a given state - that is the jointly applied taxes – is influenced by the taxation policy of the state.

The taxation policy, which is determined by the society and economy, constitutes a part of the economic policy formed by the government in power. Although government policies mostly depend on the economic and social system of a state, a new determining factor has appeared during the progress: this is globalisation, which has a significant influence on the tax sovereignty of the states.

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As a result of globalisation the frontiers have been removed, trade has become international, the free movement of capital, persons and workforce has commenced, which has led to a conflict of the sovereign states' taxation systems. The phenomenon of *double taxation* has appeared and the problem of *harmful tax competition* has come to light. International taxation law has always been attempting to find solutions to absolve conflicts and the European Union also intends to eliminate the conflicts between member states arising from the differences of the national taxation systems. Globalisation has quite a few economic advantages, however, its negative effects have undoubtedly become apparent, too, the solutions of which the countries are looking for by means of international cooperation.

As a consequence of globalisation, today the tax policy of a country is influenced not only by its national conditions but also by international tendencies; the types of taxes applied, the persons subject to taxation, the tax base and rate, and mostly the tax allowances and exemptions are no longer the internal affairs of a country. Notwithstanding, certain countries may significantly depart in these questions.

The European Accession of Hungary has assigned legal harmonisation tasks for 15 years, and although the state has *the tax sovereignty* and the legal harmonisation of taxation assigns obligations concerning mainly central taxes, the requirements set by harmonisation affect the tax legislation of local governments as well.

Since local governments have no independent tax sovereignty, that is they may not introduce taxes, give tax allowances and exemptions on its own authority just within the framework of the Act C of 1990 on Local Taxes<sup>1</sup>, during my presentation I would primarily like to outline the elements of legal harmonisation of taxation which affect and in connection with the right to local taxation of municipalities.

The harmonisation of local taxes concerns primarily the local business tax, which tax category is the most important self source of the Hungarian local governments. The European Union made the local business tax a subject of examination from two aspects. On the one hand, in 2007 the European Court decided about the EU-conformity of this tax category, on the other hand the tax allowances were the subject-matter of the examination by the EU-accession of Hungary. Tax allowances were abolished due to the avoidance of harmful competition.

In my paper I will examine the followings:

1. Which are the communal and international taxation law sources, to which the local taxes – especially the local business tax – shall be harmonised?
2. Which were the arguments of the European Court by the judgement of the Hungarian local business tax, whereas that is not inconsistent with the regulations of Article 33 of the Sixth VAT Directive?
3. What does “harmful tax competition” mean and what are the legal harmonisation tendencies concerning tax allowances?
4. What is the effect of the changing taxation policy on foreign investments?

### **I. The legal regulations of taxes and local taxes of the European Union**

In the European Economic Community the demand for the approximation concerning taxation law that is the basis of legal harmonisation appeared even in Articles 95-99 of the Treaty of Rome – Articles 90-93 of the EC Treaty – which stipulate that *taxation policies of member states resulting in protectionism and distortion of competition are prohibited*.

These Articles also draw up the principles – widespread in international taxation – of equal treatment and the prohibition of negative and positive discrimination.<sup>2</sup> It is reckoned as negative discrimination when the tax imposed on the products of other member states is higher than the one levied on domestic products and it means positive discrimination when more tax allowances are granted by a member state to foreign investors than to domestic taxpayers.

*Article 99 of the Treaty of Rome* stipulated obligation for the harmonisation of legislation only concerning turnover taxes, since the effects distorting competition first appeared in the field of

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<sup>1</sup> In the subject of the limits of the local governments' right to levy taxes, see the decisions of the Constitutional Court (AB). 2/1992. (I.23.) AB decision, 7/1996. (II.23.) AB decision, 25/1997. (IV.25.) AB decision, 59/2001. (XII.7.) AB decision.

<sup>2</sup> See Dr. Éva Erdős: Questions of International Taxation Law, In: Sectio Juridica et Politica, Tomus XI., Jubilee Volume published on the 260th Anniversary of the University of Miskolc, University of Miskolc Publishing House, 1995. pp. 49-50.

indirect taxes.<sup>3</sup> Therefore, the legal harmonisation mainly started in the field of turnover taxes and during the harmonisation of value added taxes more directives were issued and unified legal practice was established, too.

Since local governments take part only in imposing local taxes and do not participate in the legislation of central taxes, local governments are affected only by *the legislation of the EU concerning the harmonisation of direct taxes*; therefore, I will not deal with the harmonisation of indirect taxes.

The harmonisation of direct taxes – such as the company tax levied on the profit of undertakings and the personal income tax – is not yet in a much progressed state as turnover taxes.<sup>4</sup> In this field – contrary to indirect taxes – there are no primary legal sources, not even secondary special taxation provisions concerning the harmonisation of the whole sphere. An exemption from the above is Article 293 of the EC Treaty which obliges member states to initiate negotiations in order to avoid double taxation of their citizens. As a result of these negotiations new agreements on the avoidance of double taxation have been made and due to this provision the already existing bilateral and multilateral agreements have been incorporated in the European Taxation Law.

Besides this regulation, the EC Treaty provides only general references, thus *Article 93 of the EC Treaty refers to the harmonisation of legislation concerning direct taxes and stipulates concerning direct taxes that the Council shall – acting unanimously on a proposal from the Committee – adopt provisions for the harmonisation of legislation relating to direct taxes. Furthermore, Articles 94., 95., and 96. of the EC Treaty obliges member states to approximate – to a necessary extent - such laws, regulations and administrative provisions which directly affect the establishment or functioning of the common market.*

The grounds for the approximation of direct taxes can be deduced from the above regulations.

Pursuant to Article 94 of the EC Treaty the Council – acting unanimously on a proposal from the Committee – issues directives for the purposes described above.

The requirement for unanimity is considered by many member states as the most important restraint to the harmonisation process. It is due to this strict provision that there is still not a unified regulatory system of the direct taxes.<sup>5</sup> In order to compensate such a lack, more and more regulations have appeared, which are not of obligatory nature, however, they are accepted and kept by member states.<sup>6</sup>

It can be stated that there are significant differences between the national taxation systems mainly in the types of taxes, the persons subject to taxation, the tax rates, the system of tax allowances and the maintaining special benefits related to certain business activities.<sup>7</sup>

The differences between the taxation systems of the member states may result in such a tax competition which has a harmful effect on the common market of the European Union. In order to eliminate this, the following EU regulations have been made in the process of the harmonisation of direct taxes: the regulations concerning state aids, the Code of Conduct for Business Taxation.<sup>8</sup>

Finally, Articles 87-88. of the EC Treaty, which *constitute the basis* for the regulation of the above described state aids and establish the requirement for the transformation of the aiding system, must be mentioned. *Pursuant to Article 87 of the EC Treaty it is prohibited to grant any aid by a member state or through state resources which distorts competition. The regulations concerning state aids* are related to all provisions, including those concerning tax allowances, which have distortional effects on the competition and trade within the European Union.

Pursuant to the EC Treaty the general rules concerning aids granted by member states are applicable to *state aids granted through the taxation system* that is to *tax allowances*, too. This

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<sup>3</sup> János Kakuk: Harmonisation of Legislation concerning Taxation in the European Union, European Mirror, Workshop study pp. 66-74.

<sup>4</sup> János Kakuk: i.m. p. 81.

<sup>5</sup> János Kakuk: i.m. p.82.

<sup>6</sup> Such a document which is not qualified as a legal source, however, it has an effect on regulation: OECD's Report on Harmful Tax Competition, Communiqué of the European Council, The Code of Conduct for Business Taxation.

<sup>7</sup> Péter Tárnoki: The Closing of the Monitoring of Taxation Law – the Proceeding Harmonisation of the Legislation concerning Taxation Law, European Law 2001/3. p. 26.

<sup>8</sup> Gabriella Erdős - Dr. Tamás Óry: Some Questions of the Harmonisation of Legislation and Constitution concerning the Tax Allowances Applied at Present, European Law 2002/4. p. 27.

has not been expressed explicitly by the EC Treaty; however, today it may not be questioned any more.

Tax allowances and state aids are regulated in the Chapter on Competition Law of the Hungarian negotiations concerning the harmonisation of legislation (Article 24 of the Accession Treaty, that is Act XXX of 2004, Chapter 4 of Annex X entitled 'Competition Policy') and *since all aids and tax allowances granted by regional or local governments come under this heading, the benefits ensured in the circle of local taxes - especially tax allowances provided for foreign investors – fall within this category, too.*<sup>9</sup>

The legal regulation of the financial matters of local governments does not fall within Community's competency directly. As a consequence of this and the principle of subsidiary formulated in the Treaty of Rome, the regulatory systems of local governments of the member states are multi-coloured and characterized by historical and national traditions, and also influenced by the philosophy of the state system to a large extent.

Notwithstanding, the values of local self-governments are acknowledged throughout Europe, and present in the legal regulations of all EU member states. These common values appear in *the European Charter of Local Self Government* adopted by the European Council, too.<sup>10</sup>

The most important principles laid down in the Charter: the principle of income side, the principle of expenses side and the tax sovereignty of local self-government.

The third section of Article 9 of the Charter emphasizes the importance of the right to taxation of local self-governments, their right to discretion concerning self-source incomes and the importance of power. Accordingly, a part of the sources of the financial assets of local governments should be assured from self-source incomes. (the principle of local tax sovereignty) The Charter names two kinds of self-source incomes: the local taxes and local fees. An important requirement set for both the taxes and the fees is that they should be applied within the framework of acts by acknowledging the right of local governments to determine the tax rates.<sup>11</sup>

The Judgement of the European Court passed on October 11, 2007 in the case of the Hungarian Local Business Tax (hereinafter referred to as 'HIPA') (Act C of 1990 on Local Taxes) in the joined Cases C-283/06 and C-312/06 is one of the important legal sources – among the above described – in the sources of local taxation in the European Union. The Judgement has stated the HIPA is in compliance with the community law, within that with Article 33 of the sixth Directive on Value Added Taxes. (VAT)

## **II. The system of the local taxes in Hungary**

In the next part of my presentation I would like to outline the essence of the Hungarian reference and on what arguments the European Court has founded its Judgement in the case of HIPA.<sup>12</sup>

Pursuant to Act C of 1990 on Local Taxes (hereinafter referred to as Act C of 1990), the local governments' right to levy taxes is limited within the framework determined by this Act. Consequently, local governments have the right to decide within the framework of Act C of 1990 and are not only an executive branch of the government in local taxation. The right of taxation of local governments includes the right to introduce, amend and repeal taxes, to determine the date of introduction and the period of levying a tax, to define the tax rate and supplement the sphere of exemptions and tax allowances in observation of the provisions of Act C of 1990.

The limits of local governments' right to levy taxes are also provided by Act C of 1990 (Section 7 of Act C of 1990):

- The prohibition of multiple taxation; within the sphere of wealth taxes the tax base shall be assessed in a consolidated form; no tax rate may be introduced above the tax ceiling; the exemptions granted by the Act may not be restricted; district governments may not administer taxes introduced by the Budapest City Council; any amendment of taxes instituted during the year may not increase the tax obligations of taxpayers in the same

<sup>9</sup> Erdős G. - Dr. Óry T.: i.m. p. 27. see also: the referred Section 3 a) entitled 'Local Authority Fiscal Aids' of Chapter 4 of Annex X in Article 24 of Act XXX of 2004 on Accession

<sup>10</sup> Gábor Bende-Szabó – Tibor Szalay - László Péntek: Aspects of the Financial Matters of Local Self-Governments in the European Union, Municipium Hungary Foundation, 2003, p.18.

<sup>11</sup> Bende Szabó G-Szalay T-Péntek L.i.m pp. 13-18

<sup>12</sup> The case of an Italian tax 'IRAP' reckoned as a similar regional tax, that is Case C-475/03 Banca Popolare di Cremona preceded the Hungarian case. (Judgement passed on October 3, 2006 by the European Court).

calendar year; entrepreneurs/undertakings may be granted tax allowances and exemptions only within a restricted sphere.

There are 6 types of local taxes that may be levied in Hungary:

- Taxes levied on wealth: building tax, property tax.
- Community taxes: personal community tax, corporate community tax, tourism tax.
- Local Business Tax (HIPA).

The largest part of local tax incomes comes from HIPA. Though the introduction of this kind of local tax is not obligatory, most local governments take the advantage of introducing it. Local business tax is an important means of economic policies of local governments; the means of development, investments and it stimulates economy.

Local business tax constitutes the self-source of local governments and may not be deprived.

HIPA is applied to every economic activity carried out on a permanent or temporary basis in the territory of the local government concerned. In practice all kinds of economic activities belong here and whether an activity is carried out on a permanent or temporary basis is important primarily in order to determine the tax base. The basis of assessment is the net turnover corresponding to the goods sold and services provided during a given period, less the purchase price of the good sold, the value of the intermediary services and the costs of the materials. The tax is levied on the turnover and not on the profit. The maximum annual rate of the HIPA is fixed at 2 % of the tax base. There is no legal provisions concerning exemptions, however, local governments – in their decrees – may grant reductions in a restricted circle in observations of EU regulations – to undertakings whose basis of assessment does not exceed HUF 2.5 million.

### **III. The Case of the Hungarian Local Business Tax, the HIPA Case in front of the European Court of Justice**

The debate on the EU conformity of HIPA aroused a great public interest. The basic question was whether after Hungary's Accession to the EU those obliged should continue to pay HIPA or the view that HIPA is incompatible with Community law on the basis of Article 33 of the Sixth Council Directive 77/388/EEC, therefore HIPA has no legal basis since the accession proves to be confirmed.

Article 33 of the Sixth Directive prohibits a member state to maintain more turnover taxes of the same type as the value added tax simultaneously.<sup>13</sup>

The European Court gave its judgement on the EU conformity of HIPA in the proceedings based on Article 234 of the EC Treaty about preliminary ruling.

The reference in the joined cases C-283/06 and C-312/06 was submitted in the context of proceedings between nine companies governed by Hungarian law and the Administrative Services of the concerned counties by the competent County Courts.

The subject of the main proceedings was the HIPA payments on account made in respect of the fiscal period of the year 2005. The Applicant companies argued that HIPA could be characterised as a turnover tax and therefore since the Accession of Hungary to the EU, that is since May 1, 2004, they had no longer been subject to the HIPA because of the direct applicability of Article 33 of the Sixth Directive because they were obliged to pay a turnover tax, the VAT and thus no other tax of this character might be in force.

The Zala County Court referred the following two questions to the Court for a preliminary ruling:

1./ By the Accession of Hungary to the EU, by means of point 3 (a) of part 4 of Annex X to the Act of Accession Hungary was granted a temporary derogation on reductions of HIPA until 31 December 2007. By granting the possibility to maintain reductions in HIPA, did the EU acknowledge that Hungary had the right to maintain HIPA? Does the acknowledgement of the temporary derogation of HIPA in the Act of Accession mean that HIPA is in compliance with the Community Law?

2./ The second question was that should Question 1 be answered by the European Court in the negative then on a correct interpretation of the Sixth Directive what are the criteria on which a tax may be considered not to be characterised as a turnover tax?

As suggested by the European Commission, the European Court examined first of all the second question. The Court established the essential characteristics of VAT. According to the interpretation of the Court there are four such characteristics: VAT applies generally to transactions relating to goods or services; it is proportional to the price charged by the taxable person in return for the goods and

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<sup>13</sup> Imre Forgács: Why shall we pay Local Business Tax? European Mirror, No. 2006/2.

services which he has applied; the tax is charged at each stage of the production and distribution process; the amounts paid during the preceding stages of the production and distribution processes are deducted from the VAT payable by a taxable person (the final burden of the tax rests ultimately on the consumer).

On the contrary, the HIPA – according to the Judgement of the European Court can be characterised as follows:

1. It is not neutral. The HIPA is based on the difference between the turnover linked to the goods sold or services supplied during a fiscal period, on the one hand, and the purchase price of the goods sold, the value of the intermediary services and the costs of the materials, on the other. Since the HIPA is calculated on the basis of periodic turnover, it is not possible to determine the precise amount of that charge which may be passed on to the client when each sale is effected or each service supplied, such that the condition that this amount should be proportional to the price charged by the taxable person is not satisfied.

2. It cannot be characterised by the second characteristic of VAT, either, since the HIPA is not proportional to the price. This is supported by the fact, too, that the HIPA, with regard to a number of situations, is based on a standard rate, thus the basis of assessment for the HIPA is determined by criteria other than the price paid by the clients for goods or services. Upon these conditions, such a tax may not be regarded as a tax proportional to the price of the goods and services supplied.

3. The right to deduction concerning the HIPA is different in its content from that of the VAT. In the case of the HIPA, the deduction, which is made at the stage when the basis of assessment of the tax is established, is limited to the purchase price of the goods sold, the values of the intermediary services and the costs of the materials and such costs as those of experts' services, and those linked to services provided to the taxable person ('purchased' services) cannot be deducted. The basis of assessment for the HIPA is therefore not limited to the value added at a particular stage in the production and distribution process, but concerns the overall turnover of the taxable person, minus only several elements.

4. The HIPA is not in all cases ultimately borne by the final customer. Although it may be assumed that the taxable person who provides goods or services for the final consumer determines his prices taking into account the HIPA involved in his general expenses, it is not possible for all taxable persons to ultimately pass the burden of the HIPA on to the final consumer.

In the light of the foregoing considerations, the European Court stated that the HIPA differed from VAT to such an extent that it cannot be deemed as a tax which can be characterised as a turnover tax for the purposes of the Sixth Directive. Consequently, such a public burden with the same characteristics as those of the HIPA is in compliance with the Sixth Directive on VAT.

#### **IV. The concept of Harmful Tax Competition and the Harmonisation of Legislation concerning Tax Allowances**

In 1997 the European Union adopted the Code of Conduct for Business Taxation<sup>14</sup>, which is not a legal source but is acknowledged by the member states by way of unilateral and voluntary obligation undertaking. The Code of Conduct represents a new means of regulation in the harmonisation of the legislation concerning direct taxes, which replaces the difficult regulatory system based on unanimity; however, it is not legally binding.

The Code of Conduct reminded the unsolved problem of *state aids and tax allowances*, and as a result of this, at the end of 1998 the European Committee issued a Communiqué clarifying what *provisions are qualified as harmful* with respect to the operation of the single market.<sup>15</sup>

Before the adoption of the Code of Conduct, the OECD's Report<sup>16</sup> was issued, making OECD the forum of the general international action against tax allowances and tax heavens. OECD launched its project in 1998 with the aim of repressing the *harmful tax policy instruments*, which influence business decisions in an incorrect way.

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<sup>14</sup> Code of Conduct (Resolution on a code of conduct for business taxation adopted on December 1, 1997 by the ECOFIN Council) Celex No. 398Y0106 (01).

<sup>15</sup> The detailed interpretation of the Communiqué see: Carlo Pinto: EC State Aid Rules and Tax Incentives: AU-Turn in Committee Policy? (Part I-II.) European Taxation 8-9. (1999) In: Erdős G. - Dr. Óry T.: i.m. p. 32.

<sup>16</sup> Harmful Tax Competition: An Emerging Global Issue OECD, Paris 1998; In: Dr. Kakuk János: The Most Recent Results in the Field of International Taxation, Financial Review No. 2002. 8., p. 734.

Such are the tax allowances granted to foreign investors different from national treatment and thus regarded as discriminating, positive and negative discrimination, and *investment incentives*. This way the given country stimulates foreign capital to flow into the country, however, economically the aim is not to attract working capital, but *to avoid taxes*.

Globalisation, international trade and the boom of investments have resulted in re-shaping the tax systems of the countries; the stimulation of investments by granting tax allowances has become the main goal of tax reforms, and as a result the extension of the circle of taxpayers and incomes on which taxes may be imposed.

To decide whether a tax allowances is a harmful means of taxation or on the contrary, it stimulates investments is not simple. Therefore, the Report attempts to clarify the concepts in order to promote differentiating.

The OECD's Report classifies the taxation systems, which maintain harmful tax incentives, into 3 categories:<sup>17</sup>

1. When a given country generally imposes no or only nominal tax on incomes.
2. When a country collects significant revenues from tax imposed on income at corporate level, however, the tax system applies such incentives as a consequence of which the incomes from the geographically mobile economic and financial activities are subject to very low taxation.
3. When a country collects significant revenues from tax imposed on income at individual and corporate level, but the effective tax rate that is generally applicable at that level in that country is lower than that levied in another country.

The *third category* – appropriately – may not always be regarded as an incorrect tax policy, primarily because the given country imposes *real tax burden* on its taxable persons and has revenues from that and does not aim at a certain activity.

Whereas, it reckons especially the tax heavens, the establishment of off-shore companies and tax systems belonging to the second category described above *harmful*. When a certain investment incentive or state aid should be regarded harmful can be decided with a view to criteria as follows:

1. It distorts international investment flows.
2. It discourages voluntary compliance by taxpayers.
3. It re-shapes the desired level of mix of tax and public spending.
4. It causes other countries to increase the tax burden of other tax basis in order to make up for the loss of revenue and
5. Such measures increase the administrative costs burdens of other countries.

If in addition there are closed stimulating systems not allowing domestic taxpayers to take advantage of these special benefits besides the above, and the country does not take part in the exchange of information, and its administrative and legislative system is not open and transparent and moreover, where the taxable person is entitled to compromise with the tax authority on the tax rate to be paid, it can be stated that that tax system may provoke harmful consequences.<sup>18</sup>

Pursuant to the regulations of the European Union concerning state aids, *tax and tax base allowances shall be reckoned as state aids, too, which are regarded harmful – according to the EU's Communiqué issued in 1998 – if they assure preferential treatment for the entitled, that treatment is granted by the state, the regulation distorts competition at the market within the Community, the regulation is concrete and selective, and from the aspect of taxation the regulation results in the decrease of the tax burden by way of the preferential treatment.*<sup>19</sup>

In the Hungarian taxation law the *investment incentives*, the *tax allowances of selective characters*, like the ones related to production activities and accommodation assurance or the local business tax reductions are reckoned as such regulations.

The Hungarian tax system abolishes the differentiation in regard to foreign and domestic taxpayers continuously and has established the principle of national equal treatment concerning foreigners.<sup>20</sup>

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<sup>17</sup> Dr. Kakuk János (12) i.m. p. 736.

<sup>18</sup> Dr. Kakuk János (12) i.m. pp. 736-739.

<sup>19</sup> Erdős G. - Dr. Óry T.: i.m. p. 27.

<sup>20</sup> The tax allowances already granted shall be abolished by 2011 and the off-shore advantage had to be eliminated right after the Accession.

At local level, local governments have a great interest in *attracting capital* and therefore, although they impose local business tax, they *granted investors many tax allowances besides using the maximum rate of the local business tax*.

It is the local business tax which means real expenses among local taxes and as a result its avoidance involves in significant cost savings for the foreign investor. Generally *the local business tax provides the largest income* among local taxes, and therefore, there is a fierce competition for acquiring more and more investors.

*Local business tax allowances developed and applied in a region in order to attract capital and investors – similarly to company tax allowances – distort competition and thus realize the 'harmful tax competition'.*

## **V. The obligations of local governments in connection with the harmonisation of legislation concerning local business tax**

1. Local governments are still entitled to determine tax rates, but until the Accession they were obliged to abolish tax allowances granted for an indefinite period of time not compatible with the new regulation.

2. New tax allowances may not be granted any more, and the previously granted local business tax reductions given for a limited period of time were allowed to be applied by local governments for a temporary period of 5 years up to and including December 31, 2007.

3. The Accession Act reinforced the temporary exemption of the local business tax reductions, but only up to and including December 31, 2007.

4. Differently from the main rule, the possibility for local governments to grant tax reductions remained only in the cases of small undertakings, whose basis of assessment does not exceed HUF 2.5 million.

The following solutions may be considered in order that local governments may not lose their incomes deriving from the local business tax and at the same time their decrees on the local business tax may be in compliance with the provisions of the European Union:

1. Since the reductions are chiefly *available for foreign investors, the operation of many undertakings become unprofitable in the lack of tax reductions*.

2. *EU-confirm tax allowances could be introduced* and granted for small and medium-sized enterprises, the research and development activities, which also could open a way for large-investors, small entrepreneurs and sole traders.

3. *To compensate the eliminated incomes, it would be a good solution to make use of the financial supports granted by the European Union, by means of which the undeveloped regions could be improved*.

4. It would also bring a solution in increasing local governments' income and eliminating investment incentives if the basis of the assessment of the local business tax was modified by decreasing the tax base rate. At present the basis of the assessment for the local business tax is much wider and the taxpayer can deduct much less expenses in Hungary than in any other member state. The costs deductible from the basis of the assessment should be widened. By decreasing the basis it may appear that the tax income will decline, but this could attract more investors and thus the circle of taxpayers would be extended instead of the eliminated regional tax reductions.

5. The possibility of the elimination of the local business tax has arisen many times. The prospective will not make it possible since there is no other form of taxes which could compensate the loss the local governments' incomes would suffer.

All these suggestions could support that local governments would not give up attracting investments and at the same time their local decrees could be in compliance with the requirements of the harmonisation of the legislation made by the European Union.