

## 29 FISCAL EQUALIZATION AMONG THE HUNGARIAN LOCAL GOVERNMENTS – AUTONOMY V. EQUITY

*Decision No. 3383/2018. (XII. 14.) AB of the Constitutional Court of Hungary*

*Gábor Kecsó\**

### **Keywords**

European Charter of Local Self-Government, financial resources of local authorities, fiscal equalization, solidarity levy, Constitutional Court of Hungary

### **Abstract**

The 2017 budget of Hungary contains a regime on fiscal equalization among local governments that diverts funds from the municipalities with relatively high taxing power within the country. The respective norms were reviewed by the Constitutional Court from the perspective of international law, since Hungary is one of the member parties to the European Charter of Local Self-Government. This note highlights the essence of the abovementioned decision and discusses some underlying issues of allocating public tasks and funds between the governmental layers in a unitary country where the per capita revenue of local taxes is very divergent.

### 29.1 THE FACTS OF THE CASE

The Hungarian Parliament adopted the Act XC of 2016 on the 2017 Central Budget of Hungary (2017 Budget) that laid down a new arrangement for equalizing the revenues of municipalities. The top governmental layer of the capital city and the counties are beyond the scope of the regulation. The fiscal equalization regime can be summarized as follows.<sup>1</sup>

Complex rules provide for diverting some intergovernmental grants from local governments the hypothetical taxing power of which is above 32,000 HUF per capita. The grants covered are expressly defined by the 2017 Budget. Hypothetical means in this context that local taxing power is calculated as if the municipalities levied the local business tax at a

---

\* Gábor Kecsó: senior lecturer, ELTE Law School, Budapest; counselor, Constitutional Court of Hungary.

1 Based on Budget 2017, Annex 2, Point V.

GÁBOR KECSŐ

rate of 0.55%. Therefore, the calculation is irrespective of the actual facts, *i.e.* whether the municipality actually taxed at that rate or not. (The rate is capped at 2% in the central act on local taxes.)

If the hypothetical taxing power is higher than the intergovernmental grants covered, the margin shall be paid by the local governments to the central budget. This payment is called ‘solidarity levy’ in the 2017 Budget. The equalization ratio and the rate of the solidarity levy increases as the hypothetical taxing power grows. 2017 saw 166 municipalities obliged to pay the levy in a total sum of 26.5 billion HUF, meanwhile the overall sum of the intergovernmental grants given to the 3178 Hungarian municipalities<sup>2</sup> exceeded 700 billion HUF in the same year.<sup>3</sup>

The equalization regime provides for extra funds for municipalities with under 10 000 HUF per capita hypothetical taxing power. The 2017 Budget implemented the net method of fiscal equalization, since an additional fund for the aforementioned local governments comes from the solidarity levy. Nevertheless, it should be noted that the solidarity levy is not only meant to finance municipalities with a low hypothetical taxing power, but to finance the central budget. In other words, the regime blends horizontal (local-local) and vertical (local-central) fiscal equalization.

The Members of Parliament initiated the annulment of the diversion rules including the provisions on the solidarity levy before the Constitutional Court. The petitioners asserted the violation of Article 9 of the European Charter of Local Self-Government (Charter) on the Financial resources of local authorities. Hungary has signed and ratified the full text of the Charter.<sup>4</sup> The petitioners argued, on the one hand, that the fiscal equalization regime restricts local autonomy, because it diminishes the discretion local authorities may exercise within their own sphere of responsibility. On the other hand, the Charter states that local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law. In contrast with this rule, the Hungarian regime equates local financial resources with the hypothetical taxing power. While fiscal equalization is mentioned by the Charter, it cannot be construed as a justification for the solidarity levy, because the Charter does not allow local governments’ net payments to the central budget.

2 Hungarian Central Statistical Office: Gazetteer of Hungary 2018, Budapest, p. 19.

3 Act LXXXIV of 2018 on the Discharge of the Budget 2017, Annex 1, Point IX.

4 It applies from 1 July 1994 to Hungary. Act XV of 1997 on the Implementation of the Charter, Section 3.

## 29.2 THE DECISION OF THE CONSTITUTIONAL COURT

According to the Fundamental Law of Hungary, the Constitutional Court shall examine any law for a conflict with international treaties.<sup>5</sup> Proceedings of the Constitutional Court may be initiated by – among others – one quarter of Members of Parliament.<sup>6</sup> The petitioners complied with this condition, however, their petition did not contain an express request in full. Therefore, the petition was not appropriate to review the fiscal equalization regime in light of the full text of Article 9 of the Charter. Nevertheless, it made it possible for the Constitutional Court to decide on the petition in respect of Article 9(1), (2) and (5).<sup>7</sup> The decision was made unanimously before Christmas of 2018, without any concurring or dissenting opinions.

The Constitutional Court has taken into account the Explanatory Report to the Charter and attributed high importance to the revenue inequality among Hungarian municipalities. Approximately half of the tax base of local business tax is at the disposal of municipalities whose inhabitants make up merely 20% to the Hungarian population. According to the ministerial explanation to the 2017 Budget, this is why the legislator aimed to reduce fiscal differences. Furthermore, since certain public tasks were centralized in Hungary after 2010, the financial resources were to follow the costs. This means that the solidarity levy is considered to be a component of the reallocation of revenues within the public household (sector general government).

The decision emphasized the concept of the ministerial explanation and recalled that the regime allocates extra funds to municipalities with a low hypothetical taxing power. Consequently, the fiscal equalization system is not contrary to the Charter. Article 9(5) expressly says financial equalization procedures or equivalent measures are necessary in order to mitigate the differences in the distribution of financial resources among local governments. The decision concludes that restricting this system would be a violation of Article 9(1) and (2). Nevertheless, these paragraphs do not require that the sum of the horizontal fiscal equalization grant reach the sum of the solidarity levy. In other words: these Charter rules do not prohibit that the solidarity levy flow partly into the central budget. The Constitutional Court stated that since the Hungarian regime is sufficiently

5 Article 24(2)(f) of the Fundamental Law.

6 Act CLI of 2011 on the Constitutional Court, Sections 52(1) and (1b).

7 The text of these paragraphs is the following: “(1) Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers. (2) Local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law. [...] (5) The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.”

GÁBOR KECSŐ

refined – meaning that it charges only the municipalities with outstanding per capita taxing power and supports municipalities with a low per capita taxing power – the fiscal equalization is in line with the abovementioned two paragraphs of the Charter.<sup>8</sup>

### 29.3 COMMENTS

What is notable about the abovementioned decision? In my view, three reasons are worth mentioning. Firstly, this is the first case in which the Hungarian Constitutional Court interpreted Article 9(1), (2) and (5) of the Charter. As such, it may contribute to the primary sources of academic literature on fiscal equalization among local authorities from a Hungarian perspective.<sup>9</sup> Secondly, the decision dealt with the status of the Explanatory Report. It does not have binding effect. Instead, it belongs to the context in which the Charter must be interpreted by the sovereign national bodies according to Article 31 of the Vienna Convention on the Law of Treaties. In Hungary, the Constitutional Court has empowered to interpret international treaties when the question is whether domestic law violates rules of international law. Finally, the decision confirmed the validity of the fiscal equalization regime within a unitary state where the taxing power of local governments differ to a large degree.

It is well known that local autonomy results in outstanding differences in various respects, including taxation. Yet this room for divergence is not without limits. Equity among the constituents of the nation (*e.g.* citizens, families and local governments) must also be respected. Buchanan's thoughts on equalization are on point, were we to, for the purposes of our topic, replace 'states' with 'municipalities':

“The mere acceptance of the equity principle in discussions concerning the fiscal problem of federalism can yield important results. First of all, upon its acceptance inter-area transfers do not represent charitable contributions from the rich to the poor and are not analogous to the concept of ability to pay in

8 Decision No. 3383/2018. (XII. 14.) AB, Reasoning [35]-[37].

9 Fiscal equalization is a frequently discussed topic in the literature. See *e.g.* Peter Swan & Gerald Garvey, *The Equity and Efficiency Implications of Fiscal Equalization*, Sydney, Mimeograph, 1992; Ehtisham Ahmad & Jon Craig, 'Intergovernmental Transfers', in Teresa Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice*. Washington, 1997, pp. 73-108; Hansjörg Blöchliger *et al.*, 'Fiscal Equalisation in OECD Countries', *OECD Working Papers on Fiscal Federalism*, 2007, No. 4; Robin Boadway, 'Fiscal Equalization: the Canadian Experience', in Núria Bosch & José M. Durán (eds.), *Fiscal Federalism and Political Decentralization*, Edward Elgar, 2008, pp. 109-139; Jeffrey Petchey & Sophia Levchenkova, 'Fiscal Capacity Equalization and Economic Efficiency: The Case of Australia', in Jorge Martinez-Vazquez & Bob Searle (eds.), *Fiscal Equalization: Challenges in the Design of Intergovernmental Transfers*, New York, 2007, pp. 13-30; Daniel Bergwall *et al.*, 'Intergovernmental Transfers and Decentralised Public Spending', *OECD Network on Fiscal Relations across Levels of Government*, 2006/3.

29 *FISCAL EQUALIZATION AMONG THE HUNGARIAN LOCAL GOVERNMENTS – AUTONOMY  
v. EQUITY*

the inter-personal sense. The principle establishes a firm basis for the claim that the citizens of the low-income states within a national economy possess the «right» that their states receives sums sufficient to enable these citizens to be placed in positions of fiscal equality with their equals in other states. A transfer viewed in this light is no sense a gift or subsidy from the citizens of the more favored regions.”<sup>10</sup>

Finally, we should not forget that the Hungarian regulation reviewed by the Constitutional Court has a special feature. Fiscal equalization extends beyond the horizontal level. The solidarity levy – at least in part – serves vertical fiscal equalization purposes, from the local governments to the central government. This element may be puzzling for the theorists, even though the decision itself is unambiguous. Theoretically, one can argue that the scope of the review was restricted owing to the deficiencies of the petition (lack of express request). If all rules of the Charter and the ‘spirit’ of the Charter would have been taken into account, the Constitutional Court could have rendered a different decision.

---

10 James M. Buchanan, ‘Federalism and Fiscal Equity’, *The American Economic Review*, Vol. 40, Issue 4, 1950, p. 596.