HUNGARY IN THE PROCESS OF EUROPEAN TAX HARMONIZATION

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Abstract: After the political changes of 1990, Hungary’s main objective in foreign policy became accession to the European Union as soon as possible. The first significant step taken to achieve this goal was the signing of the Association Treaty in 1991. In the Treaty Hungary assumed an obligation to harmonise its legislation with that of the European Union, which includes tax harmonisation as well.

The paper gives an overview of the state of Hungarian tax harmonisation, concentrating on the events of the recent past, the differences still existing, and on the expected changes. It examines in detail the derogations Hungary applied for together with their reasons and the derogations finally received.

After the political changes of 1990 an opportunity presented itself for Hungary to modernise its economic system, and harmonise it with the developed western democracies. The main aim in Hungarian foreign policy became accession to the European Union as soon as possible. The first significant step taken to achieve this goal was the signing of the Association Treaty between the Hungarian Republic and the member states of the European Union in 1991, which became effective in 1994. In the Treaty Hungary assumed an obligation to harmonise its legislation with that of the European Union. This engagement is a soft one, which means that Hungary has to fulfil it as far as possible. The modification of the legal system includes tax harmonisation as well.

Tax harmonisation is a modification process of the legal system, aiming to secure the proper functioning of the common market through establishing the legal conditions of taxation in the member states and the Community.

The economic, social and tax systems of the member states of the European Union are rather heterogeneous, there are a great number of differences in the liability of taxation as well, so harmonising the tax systems is not an easy task, and it can be performed only step by step. The process can be completed smoothly only if the economies of the member states are harmonised as well.

The paper gives an overview of the state of Hungarian tax harmonisation, concentrating on the events of the recent past, the differences that still exist, and on the expected changes. Then it examines in details the derogations Hungary applied for, the reasons for them and the derogations finally received.
1. Indirect taxes

The Treaty of Rome, which came into force on 1 January 1958 states that the members assume an obligation to harmonise their consumption, excise duties and other indirect taxes at Community level. The Committee attached great importance to these tax categories, as the system of indirect taxes has a major impact on product prices, and can hinder the free trade of products in the common market through the tax borders.

1.1. The value added tax

The value added tax system, introduced in Hungary in 1987/88, was not entirely EU-conform. This system was replaced by a new one in 1993, which was created to meet internal (budget and price policy) pressures and external obligations (the obligation to harmonise Hungarian legislation with that of the European Union, as assumed in the Association Treaty). The main aim of introducing the new system was to achieve a higher level of harmonisation with the regulation of the European Community, as one of the conditions for accession to the European Union is to implement a practice of taxation established on the same principles as in the Community. Today’s Hungarian value added tax system is harmonised with the European standards. The process of harmonisation was carried out step by step in recent years, refining the details of the regulation.

The characteristics of the Hungarian value added tax system are the same as those of the European Union, i.e., it:

- is indirect,
- is consumption-based (paid only by the final consumer),
- is general (it is borne by every sale of a product or a service),
- is all-phased (it appears in every phase of production and distribution),
- is net based (it is borne by only the value added in the relevant phase),
- follows the destination-country principle.

1.1.1. The place of performance

Regarding the place of performance, Hungarian regulation is harmonised with the practice of the European Community, the only exception was the place of performance of telecommunication services. The changes executed in this field through an amendment of the legislation that came into force on 1 January 2002, were needed not only because of the harmonisation obligation, but for economic reasons as well.

1.1.2. The rate of tax

According to the original regulations, the member states set the rates of taxes themselves. Directive 92/77/EEC changed this situation, as it stipulated that the member states are to set an ordinary tax rate at a minimum of 15%. Beyond this, the states are entitled to use one or two preferential rates, but these cannot be lower than 5%, and can be used only for a definite range of products and services. The zero and very low (below 5%) rates could have theoretically been used only until 1997.

The Hungarian value added tax system is harmonised with the regulations of the European Community, considering the rates of taxes and its structures. The general rate is above the minimum (15%), but is lower than the recommended maximum (25%). Though it is quite
high in international comparison, this does not mean a problem regarding Hungary’s accession, as the directive sets only the minimum level. Though the Hungarian government is committed to lowering the general rate in the long run, for a high level of VAT has a negative impact on consumption, international trade and the competitiveness of the country, this step cannot be taken in the short run since Hungary needs the tax revenues that cannot be replaced by other sources.

1.1.3. Preferential rates, range of preferential products and services:
Hungary has problems with the products taxed by a highly preferential rate of 0% (for example: human medicines, textbooks). The tax rate for these products has to be raised to 5% until the date of accession, as the directive prohibits the use of any rates lower than that. At the same time, some of the present member states (the United Kingdom, Ireland, Finland) violate this regulation, as they use a rate lower than 5% for some products. Hungary plans to introduce a rate not lower than 5% for the products taxed by 0% today. As these measures only have to be taken to fulfil the requirements of harmonisation, and the social preferences that provided the reasons for their introduction are still existing, the introduction of the higher tax rate can only be expected at the date of Hungary’s accession. In case of the preferentially listed products the problem is that their range is not entirely the same in Hungary as in the EU. There are some products that are preferential in the Community, but are not in Hungary, e.g. soft drinks. This does not cause a problem, as it is not required to grant every tax allowance included in the regulation. There are some products and services that will be taxed by the general tax rate as soon as Hungary achieves accession to the European Union.

The government would have liked to keep some of the preferential products at the lower tax rates, so it submitted its application for derogation. Hungary applied for a 5 year long period of transition, while keeping the following products and services at the preferential (12%) tax rates:
- coal, fuel for domestic heating,
- provision of domestic heating,
- foodstuffs served or sold in canteens or in similar establishments operating for social policy purposes,
- transport of goods,
- storage of goods.

The European Committee allowed Hungary the derogations below:
- Until 31. 12. 2007 Hungary can use a preferential tax rate not lower than 12% for some fuels used for heating. Then it will have to change the tax rate in one step to the general level on 01. 01. 2008.
- Until 31. 12. 2007 Hungary can use a preferential tax rate not lower than 12% for restaurant services and foodstuffs served or sold in canteens or in similar establishments operating for social policy purposes. Then it will have to change the tax rate in one step to the general level on 01. 01. 2008.

Hungary intends to avail itself after accession of the possibility provided for in Article 12(3)(b) of the Treaty of Rome to apply a reduced rate to supplies of natural gas and
electricity. Upon accession Hungary is ready to provide the European Commission with the necessary information in this respect.

1.1.4. Exemptions
The following types of tax exemption appear in the value added tax system of the European Community:
- Objective tax exemption: it refers only to the value added in the relevant phase of production or sale. The directive sets two types of this kind of exemption:
  - Exemption for activities serving the community (for example: human medical services, education, political and religious activities, cultural services, etc.)
  - Other exemptions (for example: insurance, renting real estates, banking, postal services). According to the Hungarian regulation, the range of these exemptions is broader; it includes legal services and the protection of monuments as well. At the same time, the Hungarian regulation does not give the taxpayer any optional opportunities to choose being taxed.
- Subjective exemption: the member states may give subjective exemption to the taxpayers whose revenues do not exceed 5 000 Euro. This measure is higher in Hungary (8 000 Euro). This field is still not closed as according to EU experts Hungary should lower the measure, but we think this measure is necessary because of the economic conditions in Hungary.

1.1.5. The right for tax deduction
The Hungarian regulation of tax deduction satisfies completely the EU principles regarding domestic taxpayers as well as the efficiency requirements. The deadlines for refunds used in the Hungarian practice are extremely short in international comparison. The regulation is harmonised with the EU directives in view of the refunds for foreign taxpayers as well, irrespective of their homeland. This is established through bilateral treaties. Hungary has such a treaty with almost every member state of the European Union, except Ireland, Greece and Portugal. Theoretically, the problem can be solved by signing bilateral treaties with these countries as well, but until the accession, Hungary will have to change its regulation anyway, as a differentiation will have to be made between the member states of the EU and third countries.

1.1.6. Paying the tax, the person who is obliged to pay the tax
The definition of the person who is obliged to pay the tax in Hungary is harmonised with the regulation of the European Community. Though the law does not include the definition of ‘tax representatives’, which can cause problems as foreign trade increases.

As can be seen from the above, the Hungarian value added tax system is highly harmonised with the regulation of the European Union. The obligation Hungary assumed in the Association Treaty is fulfilled, as it is a soft obligation, which means that the law must be harmonised as far as possible. The details of the regulation are constantly adjusted to the standards of the Community. The current value added tax system of the EU is a temporary one, and the one that will replace it will be of a rather different character, so when it is introduced, Hungary will have to face new tasks (together with the present members of the European Union).
1.2. Excise duties
1.2.1. The horizontal directive
The law on excise duties that came into force in 1993 was not quite in harmony with the standards of the European Union, but it took over the regulation about the conditions for production. It extended the excise duty regulation over a wide range of products (e.g.: pepper and coffee), but because of the difficult allowance and controlling system the battle against the black economy could not be efficient.

The new law on excise duties that came into force on 1 January 1998 reformed the regulation. The amendments were needed not only to make the battle against the black economy more efficient, but also to fulfil the legal harmonisation requirements of the European Union that Hungary assumed in the Association Treaty. The new law introduced the institution of tax stores, which includes only the sphere of production today; it is not possible for wholesalers to become a tax store, except for mineral oil wholesalers. To be able to receive products that come from the Community with tax suspension, the institution of tax stores has to be extended to the complete system of wholesalers, so other amendments can be expected in this field. The procedure of tax suspension and certificates that meets the EU standards has been introduced recently. The range of products that bear excise duties is defined in harmony with the EU standards. Grape was not treated as an excise duty product, but in 2000 the regulation was changed to meet Community law.

The Hungarian law does not give a definition of ‘registered dealers’, ‘unregistered dealers’ or ‘tax representatives’.

1.2.2. The vertical directives
a.) Mineral oils
The Hungarian regulation includes a wider range of products than the EU standards (it includes all types of mineral oils). This step was necessary because of the abuses of fuels. Independently from this, the regulation can be regarded as harmonised, as the Horizontal Directive says the range of products bearing excise duties can be wider than what is included in the directive. This may cause a problem only after Hungary becomes a member of the European Union, for the excise duty co-operation only refers to the products included in the directive.

The fuels used for heating do not bear excise duties in Hungary. During the negotiations, the European Union accepted Hungary used a lower tax rate for these oils than the community standards.

b.) Alcohol
The regulation on alcohol has been brought into harmony with the EU standards, though the use of a higher excise fine has been introduced to hinder illegal sales and distillation. Grape became a product bearing excise duties in 2000, so the range of these products is the same in Hungary as in the European Union.
According to the directive only one rate of tax can be used for pure alcohol, but Hungary uses two today. Until the accession Hungary will have to unify the tax rates by decreasing the difference between them step by step.

Hungary requested recognition as a specific national regime in Council Directive 92/83/EEC of 19 October 1992 on the harmonisation of the structures of excise duties on alcohol and alcoholic beverages for the following procedure, which may be called in English 'hire distillation'. The regime can be described as follows:

- Private persons are entitled to bring fruits gathered from trees of their own to distilleries authorised by customs authorities in order to have them distilled.
- The authorised distillery produces an alcoholic beverage the quantity of which is limited. The produced alcoholic beverage is handed over fully to the owner of the fruits who must pay a reduced excise duty. (The rate at present is 44.6 % of the normal duty.)
- The distillery delivers a certificate of origin, which must accompany the product. The beneficiary of the operation and the quantity of the product is entered into a register which is regularly checked by the competent customs authority.
- The product is solely for the private consumption of the beneficiary of the operation. It is prohibited to place the product on the market.

The number of authorised distilleries is now about 700 and 60-70,000 people regularly use them. The abolition of this regime would lead to a widespread use of illegal distillation, which would have a negative impact on the excise duty revenue and might carry health risks for the population. It would also result in waste of the fruits in question.

The European Union did not give recognition as a specific national regime to ‘hire distillation’, and accepted only a transitional period for the procedure at the close of the negotiations. According to this the preferential tax rate can be used:

- Until 31. 12. 2005. by the distilleries that do not produce more than 200,000 litres of pure alcohol per year;
- Until 31. 12. 2007. by the distilleries that do not produce more than 100,000 litres of pure alcohol per year;
- After 01. 01. 2008. by the distilleries that do not produce more than 10,000 litres of pure alcohol per year.

The EU regulation states that the preferential tax rate cannot be lower than 50% of the standard rate. (This measure is 56.7% today).

c.) Tobaccos

In the case of tobaccos Hungary has problems only with the tax rates, as the Hungarian ones are much lower than the EU standards. According to the Community regulation, the tax should be 57% of the retail price, while the Hungarian tax content is only 41%. If Hungary implements the required tax content until the date of accession to the Union, it will face an increase not lower than 71% in the retail price, which may lead to an expansion of the black market and may cause an increase in inflation. In spite of these facts, Hungary has not applied for derogation in this field.
At the same time the problem is likely to worsen as the European Community plans to introduce a tax, defined on a quantitative basis. This is expected to be 60 Euro/1,000 pieces, which is higher in itself than the retail price of the most popular cigarettes today (265 HUF/packet). The European Union is also aware how dangerous this step is for the joining countries, and seems to be willing to negotiate about granting derogation from the new requirements.

As the regulation on excise duties of the European Union can be regarded as permanent, the objectives Hungary has to achieve are unambiguous (unlike the case of value added tax, where the EU system is likely to change in the long run). Hungary knows the deficiencies of its system, so it can get closer and closer to the Community standards step by step. As can be seen from the above, there is only one point where the Hungarian regulation is not in harmony with the EU standards, i.e., the minimum tax rate on cigarettes, and everything else is in conformity.

2. Direct taxes

2.1. Corporate tax


Hungary requests a transitional period of five years from accession, during which it would be authorised not to apply Paragraph 1 Article 5 of Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states. The withholding tax applied by Hungary during this transitional period would not be higher than 20%.

Given the situation of the country, which is characterised by a large volume of foreign investment from countries of the European Union, the exemption from withholding tax would result in a significant deterioration of the budget deficit. This could reach about 0.2% of the GDP. It would also have a negative impact on the balance of payments of the country. Such negative effects should be delayed until Hungary, as a result of the expected economic growth and the reduction of the budget deficit, is in a better situation to face them.

Hungary cancelled the claim for derogation during the negotiations, so from the date of the accession the dividends paid to the member states of the Community will be guaranteed to be free from tax. The required amendment of the law is expected in 2002.

2.1.2. The transition directive

The directive was accepted by the Council in 1990 to establish an opportunity for international fusion without tax consequences, but the company law directives that stipulate the conditions for its application have not yet been drafted. The Council is negotiating an alternative proposal that would attach the operation of the directive to the fulfilment of the conditions for being a taxpayer. This would make it much easier to use the directive in practice.
Hungary adopted part of this directive by amending company law in 2000. As Hungary has no law on the international fusion of companies, the regulation includes only the transfer of assets and shares. The regulations will come into force on the date of Hungary’s accession to the European Union.

2.1.3. ‘Code of Conduct’
During the bilateral consultations the Committee examined the Hungarian system of state supports, subsidies and preferences, and found it not being in harmony with the standards of the European Community at some points. The tax privileges given by the Hungarian legislation to investments into production facilities above 10 billion HUF (40 million Euro) expire in 2002 except one, so these are in harmony with the regulations of the Code of Conduct, since, accordingly, these privileges have to be cancelled by 2003. The other investment advantages could have been applied until 2011 originally. Some of these do not violate the Code of Conduct, as their aim is to help underdeveloped regions close up. The law was amended in 2001; the date until one could obtain the right for advantages was limited to the date of Hungary’s accession to the European Union. This amendment does not restrict those who have already been granted the right to use the advantages.

On the same date that current advantages expire, a new, EU-conform tax advantage will be introduced: the development aid. This aid can be applied for by the taxpayer in an individual procedure, and every single case will be judged by the government authorities. The conditions for obtaining the development aid are as follows:

- The investment has to be carried out in a development project that is of outstanding importance for the national economy;
- Its realisation has to cost at least 10 billion HUF (40 million Euro), or at least 5 billion HUF (20 million Euro) if the investment is made in particular underdeveloped regions;
- At least 50% of the investment value must be used to buy new assets;
- The renovation costs cannot be more than 20% of the investment value, except when it is made in particular underdeveloped regions,
- And finally, one of the following conditions has to be fulfilled:
  - The company has to employ at least 500 workers more than before the investment was carried out (At least 300 workers more if the investment is made in particular underdeveloped areas),
  - More than 50% of the economic partners have to be small or medium-sized enterprises

2.2. Taxation of individuals (Income tax)
2.2.1. 94/79/EEC Recommendation on income taxes
According to the Hungarian regulation, the bilateral treaties about avoiding double taxation must be used when taxing the incomes received by foreign individuals in Hungary. (Hungary has already signed such a treaty with each member state of the European Community, and they all include equal treatment without the 75% limit mentioned in the recommendation.)

The Hungarian law on income taxation does not differentiate between domestic and foreign employees. In general, the provisions indirectly violate the equal treatment principle in two
instances. In case of the privileges (with one exception) the regulations referred to above exclude foreigners from using them. Furthermore, the same regulation differentiates only between domestic and foreign institutions, and not individuals. The definitive proposal is expected to be elaborated in the year 2002.

Tax advantages usually have social or economic objectives. There are substantial social differences within the European Union as well, so in the case of the advantages, granted in order to achieve social objectives, it is questionable whether it is justified to grant them to foreigners. At the same time, as the European Community’s main objective is to achieve economic union, granting advantages that serve economic objectives to foreigners (coming from other member states) can be established, especially if they concern areas that have already been harmonised. The Community could be indeed unified only if income taxes and preferences were regulated at the Community level, for taxation and preferences represent a highly important factor in the free movement of workers, and through this in the realisation of the four freedoms.

2.2.2. Taxation of individuals’ savings
The interest incomes of individuals are not taxed in Hungary today. On the date of accession to the European Union Hungary can decide whether to introduce a tax on these incomes (20%) or to provide all the necessary information to the other member states of the Community.

3. Regulation of cooperation in taxation
Most of the bilateral and multilateral agreements signed by the member states of the European Union and the OECD include the co-operation of the competent authorities of the signatories for the purpose of the efficiency of taxation.

An amendment of the Hungarian regulation made in 2001 introduced the European regulation of co-operation in taxation. The new legislation will become effective on the date of Hungary’s accession to the European Union.

3.1. The legal aid directive
The exchange of information was founded on a different legal basis in Hungary until 2001. The bilateral agreements aimed at avoiding double taxation signed by the member states of the European Union and Hungary included the possibility of exchange of information in question.

An amendment of the Hungarian regulation made in 2001 introduced the possibility of exchange of all kinds of information.

3.2. The value added tax information exchange system (VIES)
According to this regulation, the candidate countries (like Hungary) have to establish some institutional improvements. Hungary has to create the Central Liaison Office (CLO) and the value added tax information exchange system (VIES). The implementation of the computer system, development of the infrastructure and the training of the employees are in progress today. The Office will start operation in December 2002.
3.3. The collection directive

The Central Liaison Office (CLO) makes arrangements for the collection of value added tax debts. The Hungarian regulation did not include international collection, however, this situation was changed by the amendment of legislation, which became effective on 1 January 2002.

3.4. The Fiscal Program

This program is of outstanding importance for Hungary, as through language courses and professional training Hungarian experts can learn the Community standards more easily. The tax officers who work indirectly with the law can best apply the Community regulations, which is why it is of such great importance for Hungary to take part in these programs.

4. Summary

The European Union has fifteen member states today. Because of this, the tax harmonisation of the European Community means that fifteen tax systems, based on different traditions, have to be brought in harmony. This situation will become even more difficult when the Eastern European states gain accession to the Community, since this step will not merely increase the number of tax systems to harmonise, for the economies and societies of the candidate countries are less developed than the European average. The harmonisation of the tax systems cannot be carried out smoothly without harmonisation of the economies. The process is made even more difficult by the fact that each state insists on its financial sovereignty, and the right for imposition of taxes is one of the main pillars of this sovereignty. Looking at it this way, it can be easily understood that no state is happy to give this right to an institution at Community level.

To create a market without tax borders within the European Union may seem to be a very ambiguous plan even if the aim is not to establish a federal tax system, but to harmonise the tax legislation of the member states. Until the overall harmonisation of the tax system is completed, the conditions for competition will differ in the individual member states. This distortion of the conditions for competition will be balanced in most cases by the arrangements of the authorities and the rates of exchange, so the mobility of companies within the European Union to find more auspicious tax circumstances will not be typical.

As can be seen from the above, there has been substantial development in the field of tax harmonisation in Hungary in the past few years: the Hungarian tax system can be regarded as harmonised. This can be seen from the fact that in the course of the accession negotiations the chapter on taxation was closed on 12 June 2002. In the controversial issues Hungary managed to come to an agreement with the European Union. However, at the same time Hungary has other important problems to solve: on the one hand, because the regulations are still not entirely harmonised with the Community’s tax system, and, on the other, because there are numerous proposals for directives on the agenda in the Union, which Hungary will have to follow when they become effective. Nevertheless, this must not be seen as a burden, for we can save efforts by making use of all the experience gained by the member states of the European Union. Naturally in the process of harmonisation, one
has to take into consideration the local specialities and Hungary’s significant arrears from the countries of the Community.

**Literature**

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