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POLICY ADVICE REPORT

Hungarian Local Government Finances: The impact of the Local Business Tax and the Solidarity Contribution

CEMGPAD(2024)4

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LIST OF ABBREVIATIONS

CEMG	Centre of Expertise for Multilevel Governance of the Council of Europe
CoE	Council of Europe
Congress	Congress of Local and Regional Authorities of the Council of Europe
Charter	The European Charter of Local Self-Government
DG REFORM	Directorate-General for Structural Reform Support, European Commission
EC	European Commission
EU	European Union
HST	Hungarian State Treasury
IKIR	Integrated Public Services Information System, hosted by Ministry of Interior
IMC	Inter-Municipal Cooperation
KGR-K11	Budgetary Management System, hosted by the Hungarian State Treasury
LBT	Local Business Tax
LGs	Local Governments
MoF	Ministry of Finance
MoI	Ministry of Interior
MoPARD	Ministry of Public Administration and Regional Development
PIT	Personal Income Tax
Rec	Recommendation of the Committee of Ministers to member states
ÖNET	National Cooperation Council of Local Governments
TSI	Technical Support Instrument
TÖOSZ	Hungarian National Association of Local Authorities

EXECUTIVE SUMMARY

The Policy Advice provides an analysis of the local government finances in Hungary, concentrating on the Local Business Tax (LBT) and the solidarity contribution mechanism. It aims to offer recommendations for improving the institutional and fiscal framework in line with European standards, in particular Article 9 of the European Charter of Local Self Government (ECLSG) and the Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities CM/Rec(2005)1. The Policy Advice was produced as part of the project *Local Government Public Finance Development and Municipal Capacity Building In Hungary,* co-funded by the European Commission (DG REFORM) under the Technical Support Instrument and the Council of Europe.

Local Government Finances in Hungary

Hungarian local governments rely on a mix of intergovernmental grants, own-source revenues, and other funding, with significant dependence on transfers from the central government. Intergovernmental grants form the largest portion, while own-source revenues, dominated by the Local Business Tax (LBT), comprise about one-third of local budgets. Municipalities have the competence to set and impose various local taxes, within legally established maximum rates. However, this competence is constrained by the solidarity contribution mechanism, which requires municipalities with high LBT revenue to transfer part of their LBT revenues to the national budget. This is viewed by government counterparts as an important equalisation measure.

Intergovernmental Grants, constituting 47.3% of local government revenue in 2024, primarily consist of earmarked, task-based funds. The majority of the task-based grants are allocated on the basis of estimated service users and spending needs. Data on specific allocations by types of grants have not been accessed during the preparation of this Policy Advice, but according to stakeholder consultations up to 80% of total grants are task-based. Operational grants, supporting specific municipal costs, account for about 20% of total transfers, and are allocated to local governments based on estimated service needs.

The **Local Business Tax (LBT)**, levied on business net turnover, is the main source of local tax revenue, making up over 80% of all local tax revenues and nearly 32% of total local revenues. Municipalities can adjust LBT rates between 0% and 2%, offering exemptions or reductions. LBT revenues have doubled since 2017, driven by increased economic activity and higher prices.

Since 2017, local governments must contribute a share of the LBT revenues to the national budget via the **Solidarity Contribution** mechanism. The solidarity contribution aims to support financially weaker municipalities, with contributions varying between 0.4% and 0.75% of the estimated LBT capacity per capita, with higher capacity municipalities paying more. This contribution is essential for the national budget. It finances 29% of all transfers to local government.

Findings and Challenges

The **Local Business Tax (LBT)** is a vital and highly valuable component of Hungary's local tax system, providing local governments with significant discretionary revenues and autonomy over tax rates and exemptions. It aligns with European standards for local taxes, serving as a good practice in line with the European Charter on Local Self-Government and CM/Rec(2005)1, on the financial resources of local and regional authorities.

Nevertheless, the dominance of the LBT in the local tax system, accounting for up to 80% of local tax revenues, exposes local finances to external economic risks due to its procyclical nature. The LBT is very buoyant, but diversification for stability and predictability is lacking. Other local taxes, such as property taxes, are underutilised, and the vehicle tax was centralised.

Additionally, legal restrictions require municipalities to primarily allocate LBT funds for social services and – in the capital city – public transportation, further limiting their fiscal autonomy. Despite its benefits, the LBT's current structure and usage constraints present challenges to the financial independence and flexibility of local governments in Hungary.

Recent changes have increased the solidarity contribution obligation, resulting in higher shares of LBT revenues being transferred to the national budget. By 2024, it is estimated that up to 23% of LBT revenues will be redistributed to and through the national budget, a significant increase from 5.9% in

2020. This gives the LBT more of a character of a shared tax. Consequently, the overall pool of local own source, non-earmarked revenues decreases, constraining local fiscal autonomy.

The Solidarity Contribution has increased significantly in recent years. The minimum threshold was lowered to HUF 22,000 from HUF 34,000 in 2020, while the maximum threshold rose to HUF 950,000 from HUF 125,000. Consequently, the total value of the solidarity contribution, which was equivalent to 5.2% of the total amount of central grants for local governments in 2020, is planned to reach up to 29.3% of local government grants by 2024[1]. Some local governments have called for a decrease of the solidarity contribution, arguing that the current levels exceed their financial capacity. In its most recent delegates meeting, the Hungarian National Association of Local Authorities (TÖOSZ) adopted a resolution calling for a reduction of the solidarity contribution starting from the 2025 budget year.[2]

The fiscal burden of the solidarity contribution is particularly heavy for cities with greater capacity to raise LBT. Budapest and the 25 cities with county rights contributed 69.4% to the solidarity mechanism in 2022, while raising only 63.2% of LBT revenues.[3] In some cases, the net solidarity contribution surpasses the amount received from government grants, which has prompted legal challenges from Budapest and Budaörs.

The calculation of the solidarity contribution is currently based solely on the LBT, which does not fully represent the overall wealth of municipalities. For some local governments, other taxes such as the building tax and communal tax are more significant. Demographic changes, such as a declining population, can also disadvantage cities in these per capita based calculations.

In its present form, the Solidarity Contribution is not directly linked to the downstream redistribution/equalisation measures that financially weaker local governments are entitled to. During the consultations for this Policy Advice, central government stakeholders reported that these contributions are returned to local governments via task-based grants and that municipalities with lower incomes are entitled to additional support for administrative and municipal management tasks as well as additional grants for social and child welfare. In turn, some local government interlocutors expressed that they would like to see a clearer connection between the Solidarity Contribution and results of equalisation measures.

Within **intergovernmental transfers,** Hungarian local governments are highly dependent on earmarked grants from the state budget, expected to comprise up to 50% of their revenues in 2024. The national government determines municipal service delivery through the task-based financing model, with approximately 62.3% of these grants being earmarked for recurrent expenses in education, social protection, and culture. The allocation of these grants relies on a complex system of indicators. According to the consultations for the Peer Review and this Policy Advice, actual service delivery costs and inflation are not comprehensively reflected in the current system. While such adjustments are important, they should, in line with CM/Rec(2005)1, be based on standardised, statistical costs to incentivise efficiency.

For the purposes of this Policy Advice, a detailed analysis of the task-based financing mechanism was out of scope. However, the TSI project is currently supporting – under a separate workstream – the piloting of the Standard Expenditure Needs (SEN) methodology to analyse financing and performance of local services. This is expected to generate insights based on which possible adjustments in this area can be considered.

Hungary has a solid foundation for professional **intergovernmental dialogue** which can be enhanced through better systematisation and structuring. As an example, within the current TSI project, extensive collaboration is taking place between central and local government stakeholders, local government associations and experts to facilitate analytical use of the valuable data on local government statistics,

[1] In feedback the Ministry of Finance emphasised that a change took place in the overall equalisation system in 2021. Until 2020 the solidarity contribution was described as only one element in the system, with certain budgetary support measures being reduced based on per capita tax capacity. According to the Ministry of Finance, taking into account the entire equalisation process, the redistributed revenues were approximately the same proportion in 2021 as in 2020.

[2] See 'TÖOSZ's expectations and initiatives regarding the functioning of the local government system 30/04/2024' https://xn--tosz-5qa.hu/news/911/73/A-ToOSZ-elvarasai-es-kezdemenyezesei-az-onkormanyzati-rendszer-mukodesevel-kapcsolatban/

[3] Péteri, G., (2023): Competition or solidarity? Use and misuse of Local Business Tax in Hungary, Local Expertise Centre, Jerzy Regulski Foundation in Support of Local Democracy https://frdl.org.pl/static/upload/store/frdl/ENGLISH/TAX_BUDAPEST_(1).pdf

budgets, and performance held by central ministries and agencies. This has significant potential to contribute to greater access, use and increased interoperability of key data sets. In turn, this can foster better policy decisions, improved intergovernmental dialogue and increased transparency, ultimately benefiting all citizens.

Compared to European countries with regular mechanisms for dialogue on municipal financing, Hungary's intergovernmental dialogue and cooperation on this topic are more limited. The National Cooperation Council of Local Governments (ÖNET) could provide an important platform for such dialogue, for example for coordination on the solidarity contribution and a joint review of mandatory municipal tasks to reflect the real financing needs of municipalities.

Recommendations

Based on the status quo of the local finances as well as the findings and challenges, this Policy Advice offers the following set of recommendations, divided into short-term, mid-term and further recommendations. Alongside the recommendations, information about relevant European practices is included. These examples are detailed in the Annex.

Short term recommendations

Relaxing restrictions on the use of the Local Business Tax

The Local Business Tax (LBT) is a crucial revenue source for Hungarian local governments, and preserving its local tax characteristics is essential. Current restrictions mandating that LBT revenues be used for social services and public transportation should be lifted to enhance local fiscal autonomy. This change would align the LBT system with Article 9.1 ECLSG. It would also adhere to the principles of CM/Rec(2005)1, emphasising that local authorities should have adequate resources that they may freely use in exercising their responsibilities.

Adjusting the Solidarity Contribution

Establishing the level of equalisation remains a decision to be taken in each country in respect of the prevailing conditions and policy priorities. In many contexts in Europe, vertical equalisation is looked upon more favourably by local authorities than horizontal equalisation which can lead to jealousy or resentment. With a view to achieving the same desired equalisation effect, it could therefore be preferrable to reduce the solidarity contribution and to pivot more towards the use of central grants. Adjusting LBT capacity thresholds and rates could also help preserve its local tax nature in line with Article 9.4 ECLSG.

Equally, a transparent solidarity fund could be set up as recommended below. Grants for equalisation purposes should be unearmarked, and equalisation should be based on one or two complete formula(s) taking into account fiscal capacity and spending needs to 'ensure a fair distribution of public financial resources between the different tiers of government, taking account of the responsibilities assigned to each of these tiers and changes in those responsibilities, as well as economic circumstances' as stipulated in CM/Rec(2005)1.

Broadening the calculation basis for the Solidarity Contribution

To better reflect the fiscal capacity of municipalities, it is recommended to broaden the basis for calculating the solidarity contribution. Currently, the assessment of fiscal capacity relies solely on the Local Business Tax (LBT). Including other local taxes, especially where LBT revenue is not significant, would improve fairness and capture fiscal disparities more accurately. Policymakers could consider incorporating Personal Income Tax (PIT) revenues as a proxy which reliably indicates local economic activity. For example, in Bulgaria, the equalisation system takes into account a broad pool of 'fixed tax revenues' basically including all local tax revenues. A broad calculation basis for fiscal and financial capacity is also in line with the Rec(2005)1 which provides that the estimate of financial capacity of local authorities should preferably include all sources of revenue, with the aim of gauging overall financial capacity.

Fostering data exchange and interoperability

Enhancing the transparency, credibility, and predictability of Hungary's intergovernmental finance system as recommended in CM/Rec(2005)1 requires regular improvements in the quantity and quality of information shared with local governments and their associations. This can be achieved by ensuring access to and interoperability of government databases relevant to local government services.

Increased use by local governments will yield valuable feedback and contribute to improved data quality. It also strengthens the case for sustained investments into data infrastructures and interoperability.

This is an area where central and local government in Hungary are already demonstrating significant collaboration. This Policy Advice encourages all stakeholders to sustain these important efforts, which can also contribute to wider digitalisation and economic development imperatives.

Conducting an evaluation of intergovernmental fiscal relations

A comprehensive evaluation of Hungary's intergovernmental fiscal relations, going beyond the Local Business Tax (LBT) and the Solidarity Contribution, is recommended in line with CM/Rec(2005)1 which advises regular reviews – as necessary – of the legal and administrative frameworks for local taxation, grants and equalisation. Such an evaluation should involve the government and local government associations, assessing learning from the past decade of centralisation and exploring improvement opportunities. Key areas to examine include shared tax systems, enhancing the potential of existing local taxes, increasing revenue flexibility for local governments, and assessing equalisation systems for better financial equity and resource distribution.

Additionally, reviewing the current intergovernmental grant system and findings from the Standard Expenditure Needs (SEN) pilot can contribute to transparency, predictability, and local autonomy in fiscal management.

Mid-term recommendations

Enhancing the own source revenue system

A diversification of the local governments' revenue sources beyond the dominant LBT is recommended, for example by utilising asset revenues, property taxation, settlement taxes, and re-devolving the motor vehicle tax. This would reduce economic vulnerability and disparities in revenue-raising capacities, aligning with Article 9.4 ECLSG, which calls for dynamic financial systems to meet evolving local government costs, and the guidelines appended to CM/Rec(2005)1 stipulating that ‘to the greatest extent possible, each local authority should finance, from its own resources, the expenditure it decides on (fiscal equivalence at the local authority level).’

Further systematise the dialogue, coordination and cooperation among levels of government

To further enhance dialogue, coordination, and cooperation among government levels, the National Cooperation Council of Local Governments (ÖNET) provides a foundation that can be further developed. In line with Article 4.6 ECLSG, This would involve formalising consultation frameworks, involving local authorities early in policy development, and focusing on key areas such as the solidarity contribution, fiscal equalisation, grant allocation, and transparency in finance systems. The government and local government associations should closely cooperate, ensuring effective representation from both sides. Expanding data exchange and establishing formal agreements, similar to those in European countries with decentralised governance, will further support these efforts.

Increasing transparency and predictability of the local government finance system

Building on the existing cooperation between local government associations and central agencies, Hungary's intergovernmental finance system could be further improved through better information sharing with local governments and their representative associations. This would involve regular publishing of more detailed data on intergovernmental finance flows and indicators; joint agreements on indicators; grant allocation criteria and methods for grants; and making data on various grants and local finance indicators more accessible. This would also demonstrate practice in line with Principle 6 ‘Openness and Transparency’ of CM/Rec(2023)5 on the principles of good democratic governance which call for efforts to make decision-making processes publicly available and accessible within legally defined limits, including through the use of digital tools as appropriate. Additionally, developing and publishing annual and multiannual projections for intergovernmental grants, similar to Austria's practice of providing regular forecasts of shared tax revenues, would enhance local government planning and efficiency.

Transforming the solidarity contribution mechanism into a solidarity fund

To enhance the transparency, predictability, and equity of the intergovernmental grant system as recommended in CM/Rec(2005)1 and its guidelines for grants to local authorities, establishing a solidarity fund could be considered. This fund would pool revenues from solidarity contributions paid by local governments and the resources dedicated from the state budget to support financially weaker municipalities with non-earmarked financing. It would increase system transparency by clearly showing contributions and support for financially weaker municipalities, helping the central government reduce fiscal disparities. Initially, a budget line for the solidarity fund could be set up, covering income and expenditure. Gradually, this could then be developed into a comprehensive fiscal equalisation system. A step-by-step approach, starting with a portion of the solidarity contributions, can be used to launch the fund and expand it after evaluation.

Considering the use of other possible funds to support climate change adaptation and digitalisation in municipalities

To support climate change adaptation and digitalisation in municipalities, it is recommended to explore whether other funding streams, for example from the EU Recovery and Resilience Facility (RRF) could be integrated into a solidarity fund in the future. This fund would then pool revenues from solidarity contributions, state budget contributions, and – for example – eligible EU funds. Specified in the annual budget law, this approach could ensure a stable and predictable funding source, allowing municipalities to plan long-term projects confidently. Regular disbursement aligned with the EU multiannual financing period would prevent disruptions in ongoing projects.

Enabling voluntary intermunicipal cooperation and redistribution of LBT revenues in functional regions

Interviews with stakeholders during the consultation pointed to ongoing discussions on regionalising the distribution of Local Business Tax (LBT) revenues, especially among neighbouring local governments where economic integration is significant. Implementing a common tax distribution system in such regions can help ensure that all areas benefit from economic activities, promote balanced development, reduce fiscal disparities, and support shared public services. By pooling resources and fairly distributing tax revenue, regions can undertake larger-scale projects, fostering equitable access to services and more efficient resource use. Such local equalisation systems are provided for in paragraph 45 of the local taxation guidelines appended to CM/Rec(2005)1.

Further recommendations

Developing the solidarity contribution mechanism towards a fiscal equalisation system

Given the fragmented nature of Hungary's local government system, an effective equalisation system is needed to address disparities in fiscal capacity and service delivery costs. In line with Article 9.5 ECLSG and the financial equalisation guidelines of CM/Rec(2005)1, policymakers should consider enhancing the solidarity contribution mechanism with clear policy objectives and rules for the financial support for financially weaker municipalities. A balanced equalisation mechanism should address both fiscal capacity and spending needs disparities, with objective allocation criteria that consider natural differences in municipalities' revenue-raising capacity and service delivery costs. Establishing a dialogue with local governments to determine system parameters is essential. Learning from European models where equalisation grants come primarily from higher government levels could improve Hungary's approach.

Increasing local discretion for task-based grants and the Local Business Tax (LBT)

Hungarian local governments are highly dependent on earmarked state grants, limiting their discretion and ability to plan and deliver local services effectively. To increase local autonomy and improve service delivery, the government could replace some task-based subsidies with sectoral block grants, providing more flexibility in spending within specific sectors.

Additionally, reducing restrictions on the use of Local Business Tax (LBT) revenues, particularly the limitations on using these funds for municipal office salaries, would enhance local governments' ability to tailor spending to local priorities and needs, fostering greater efficiency and effectiveness in public fund utilisation.

I. INTRODUCTION

I.1. Context of the Policy Advice

This Policy Advice was prepared as part of the joint European Union and Council of Europe project *Local Government Public Finance Development and Municipal Capacity Building in Hungary (2022-2024).* The beneficiary of the project is the Hungarian National Association of Local Authorities (Települési Önkormányzatok Országos Szövetsége – TÖOSZ). The Hungarian Ministry of Public Administration and Regional Development (MoPARD) and the Hungarian Ministry of Finance (MoF) are involved throughout the project as members of the Project Advisory Group, as well as in the consultations for and as recipients of a Peer Review Report and a Policy Advice. The project receives financial support from the European Commission (DG REFORM) under the Technical Support Instrument (TSI) and from the Council of Europe. It is implemented by the Centre of Expertise for Multilevel Governance (CEMG) at the Congress of Local and Regional Authorities.

The aims of the project are to support the strengthening of administrative and financial capacity of the municipalities in Hungary, by assisting the Hungarian authorities to improve the institutional framework related to the good democratic governance of municipalities; and to improve awareness, knowledge and skills of relevant authorities on good democratic governance.

To meet these goals, the Centre of Expertise for Multilevel Governance of the Council of Europe (CEMG) deploys tools such as a Peer Review, the delivery of a Policy Advice, and the implementation of instruments like the Local Finance Benchmark (LFB), the Public Ethics Benchmark (PEB) as well as a series of capacity development activities such as the Leadership Academy Programme (LAP) and the European Label of Governance Excellence (ELoGE). The design and test development of a local government data platform and support for local-central dialogue on intergovernmental finances and data are key components of the project.

I.3. The Policy Advice

This Policy Advice builds on the recommendations from the Peer Review conducted in the context of the project in September-November 2023,[4] as well as consultations with the project's Advisory Group. Its focus is on possible improvements concerning local finances and intergovernmental financial relations.

Specifically, the Policy Advice aims to provide recommendations to central and local authorities for improving the institutional and fiscal framework governing local governments, based on European standards and best practices, and focusing on two overarching questions:

1. In line with Article 9 of the European Charter of Local Self-Government,[5] what measures can be introduced to the Local Business Tax (LBT) to help develop this revenue source so as to enable local authorities to keep pace, as far as practically possible, with the real evolution of the cost of carrying out their tasks?

2. What changes can be introduced to the Solidarity Contribution that can help ensure a fair distribution of public resources in line with CM/Rec(2005)1[6] on the financial resources of local and regional authorities?

The project beneficiary TÖOSZ had further identified specific interests as expressed in the following guiding questions:

[4] The Peer Review report *Intergovernmental Fiscal Relations, Data Access and Use, and Local-Central Policy Dialogue* is available at https://rm.coe.int/peer-review-report-2023-on-intergovernmental-fiscal-relations-data-acc/1680ae6aa3
[5] ETS 122 https://rm.coe.int/european-charter-of-local-self-government-eng/1680a87cc3
[6] CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities (19 January 2005), https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=09000016805db09e

Regarding Question 1 on the Local Business Tax: How might local business taxation be further developed within the established system of local taxation? How can local business tax (LBT) revenue be made more equitable, either by modifying tax regulations or by regional sharing of tax revenue?

Regarding Question 2 on the Solidarity Contribution: What methods can be proposed to renew the system of Solidarity Contribution formation (withdrawal) and reallocation, ensuring incentives for municipal revenue mobilisation, transparency and predictability?

To develop a thorough and actionable Policy Advice, the following activities were carried out:

1. Desk Review: A series of publicly available materials including the relevant legislation, budget documentation, the project's Peer Review report, expert papers and TÖOSZ consultations and recommendations were reviewed (April-May 2024).
2. Stakeholder Interviews: Consultations were conducted with key stakeholders during a visit to Budapest on 23-25 April 2024. This included senior representatives from the Ministry of Finance, Ministry of Public Administration and Regional Development[7], the Hungarian State Treasury, the State Audit Office, TÖOSZ, and elected local representatives. These interviews provided in-depth insights into the current challenges and opportunities within Hungary's local government finance system (April-May 2024).
3. Good Practices: The expert team researched and documented a series of good practices from other European countries, illustrating effective solutions to common challenges in local government finance. These case studies can serve as examples for Hungary to consider in its reform efforts (April-July 2024).

I.4. Purpose of this report

The report offers recommendations for consideration to improve the institutional and fiscal framework governing local governments, based on European standards and best practices.

These are closely aligned with the provisions of the European Charter of Local Self-Government (ETS No. 122), in particular Article 9 concerning financial resources of local authorities as well as relevant other European standards and reports, in particular:

- CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities (19 January 2005)
- CM/Rec(2023)5 - Recommendation of the Committee of Ministers to member States on the principles of good democratic governance and its explanatory memorandum (6 September 2023)
- Report CG-FORUM(2021)01-03final - Monitoring of the European Charter of Local Self-Government in Hungary, Congress of Local and Regional Authorities (12 February 2021)

[7] Due to scheduling requirements, the meeting with the Ministry of Public Administration and Regional Development (MoPARD) was held on 23 May 2024, online.

II. POLICY ADVICE FINDINGS

II.1. Status Quo, Key Findings and Challenges

Local Government Finances in Hungary

Hungarian local governments rely on a mix of intergovernmental grants, own-source revenues, and other funding. Currently, there are no taxes that are formally shared between levels of government.

Table 1 illustrates the revenue trend for local governments in 2023 and 2024, with intergovernmental grants comprising the largest portion, indicating significant financial dependence of local authorities on the central government. Own-source revenues make up about one-third of local budgets. Local governments can impose various taxes, including the Local Business Tax (LBT), along with others like the property tax, communal tax, tourism tax, and the settlement tax. In practice the LBT by far dominates local own source revenues.

Table 1: Local government revenue appropriations

	2023	2024
Government grants	53,6%	47,3%
Local taxes	32,5%	37,2%
Operational revenues	10,6%	11,9%
Capital receipts	2,0%	2,1%
Transfers	1,2%	1,5%
Total	100,0%	100,0%

Source: National Budget 2024, as quoted in Péteri (2023)

Hungarian municipalities enjoy significant autonomy in setting local taxes. The law establishes maximum tax rates, allowing municipalities to choose rates, offer tax reliefs, and decide on allowances. Local governments have the authority to determine which local taxes to impose.

Intergovernmental Transfers – Government Grants

Intergovernmental grants (government grants to the local level) primarily consist of earmarked task-based grants. Some of the task-based grants are allocated on general criteria such as population, however the majority is allocated on the basis of estimated service users and spending needs. Based on the interviews with stakeholders, task-based grants estimated on the basis of user costs constitute the majority of total grants from the central government.

Data on the allocation of grants across municipalities based on the different criteria was not available to the expert team, but according to the stakeholder consultations it is generally accepted that they may make up around 80% of the total. For 2023, in Annex 2 of the Budget Law, grants are allocated to municipalities for about 157 tasks and subtasks, on the basis of approximately 150 indicators with a multitude of task specific multipliers differentiated by population size or other criteria, such as standard LBT capacity. For example, according to these indicators, kindergartens with a daily opening time of 8 hours are allocated HUF 137,000 per person per year, while kindergartens with a daily opening time of 6 hours are allocated to receive HUF 68,500 per person per year (Annex 2 to Act LV of 2023).

Operational Grants

Grants can have an operational nature to support specific municipal operational costs. The peculiarity of these operational grants is that they are allocated to municipalities not only based on the spending criteria (standards) for the specific tasks, but also on the basis of fiscal capacity (the local business tax capacity).[8] From the interviews with the stakeholders, it is estimated that these operational grants may account for up to 20% of the total of intergovernmental transfers.

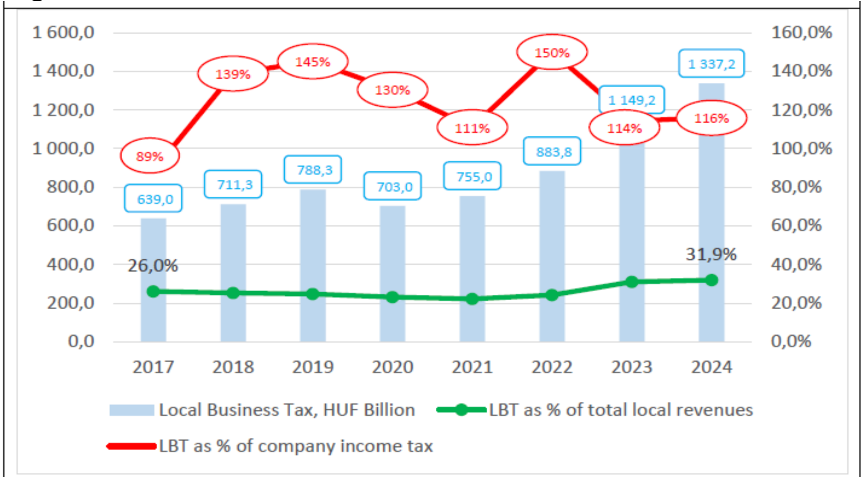
[8] According to the Act LV of 2023 on the Central Budget of Hungary for 2024, such types of grants include the following: 1.1.1 Supplementary grant of local utility management (differentiated by standard LBT capacity up to per capita standard LBT revenue of HUF 15,600)

The Local Business Tax (LBT)

Local own source revenues consist mostly of tax revenues and service delivery fees. Although local governments in Hungary are authorised to levy various taxes (e.g. property taxes, municipal taxes, tourism taxes, etc.), the local business tax is the most frequently used and the main revenue source. Over 80% of all local tax revenues are generated by the LBT, and constitute almost 32% of all local revenues (Peer Review Report, CoE 2023).

The LBT is levied on the net turnover of businesses within the territory of a municipality and can vary between 0% and 2%, depending on the municipality. Local governments can introduce tax reductions and exemptions. For example, in small villages with few businesses, a municipality may choose to not levy the LBT to avoid burdening small businesses. The LBT is administered by the municipal tax authority and is paid in two instalments during the fiscal year. During the COVID-19 pandemic, the government introduced a threshold on the maximum rate of the LBT to up to 1% for certain categories of taxpayers to reduce the tax burden on local businesses. The affected municipalities received additional financial assistance in the form of a 81.7 billion HUF subsidy in 2021 and 76.4 billion HUF subsidy in 2022 to help offset the impact of the tax cut.[9]

Figure 1: Local Business Tax, 2017 - 2024



Source: CSO, 2017-2021, MoF 2022-2024 ;
2022: expected, 2023-2024; plan, forecast

Source: Péteri (2023)

The revenues from the LBT have been steadily increasing during the past seven years, except for 2020 because of the impact of the global COVID-19 pandemic. Nevertheless, LBT revenues have doubled since 2017, and the growth has accelerated even more in the past two years due to both increased economic activity and higher prices.

1.1.1.6. Support for other municipal tasks: the lump-sum grant is conditional on the number of population number and tax capacity
1.3.1.1 Other support for the social and child welfare functions of municipalities: for municipalities with a business tax capacity not exceeding HUF 35,000 per inhabitant
1.4.2. Subsidy for holiday catering: decreasing in steps based on local business tax capacity per inhabitant up to HUF 40,000, then fixed.
In a number of further cases, Act LV of 2023 mentions standard LBT capacity, however, allocation is not specifically linked to it:
1.1.1.3.2. Settlement management grant - operating support for public lighting) – municipalities with a maximum local business tax capacity of HUF 15 600 receive subsidies (supplements) based on an inverse relation to their local business tax capacity per inhabitant.
1.2.1.3. Kindergarten operation support - provided to local governments also by taking into account the local business tax capacity per inhabitant.
1.3.3.2. Nursery operating support – allocated to municipalities by taking into account the type of municipal settlements and their local business tax capacity per inhabitants.
1.3.4.2. Institution management support – allocated by taking into account the type of settlement and their business tax capacity per inhabitant.
1.4.1.2. Institutional child catering - operating aid: provided on the basis of the type of local government and their local business tax capacity.
[9] Information provided by Ministry of Finance.

The Solidarity Contribution Mechanism

Since 2017, Hungarian local governments have been obliged to contribute solidarity transfers to the national budget based on their assessed Local Business Tax capacity per capita. The aim of this transfer is to support financially weaker municipalities. A specific formula categorises local governments by their 'estimated' local business tax capacity per capita, assuming a standard tax rate of 1.4% on the actual LBT base from two years prior (t-2). As per the most recent changes, these calculations result in six distinct categories of municipalities, each required to make a solidarity payment ranging from 0.4% to 0.75% of the estimated LBT capacity per capita. The table below outlines the basis for calculating this solidarity contribution for each municipality.

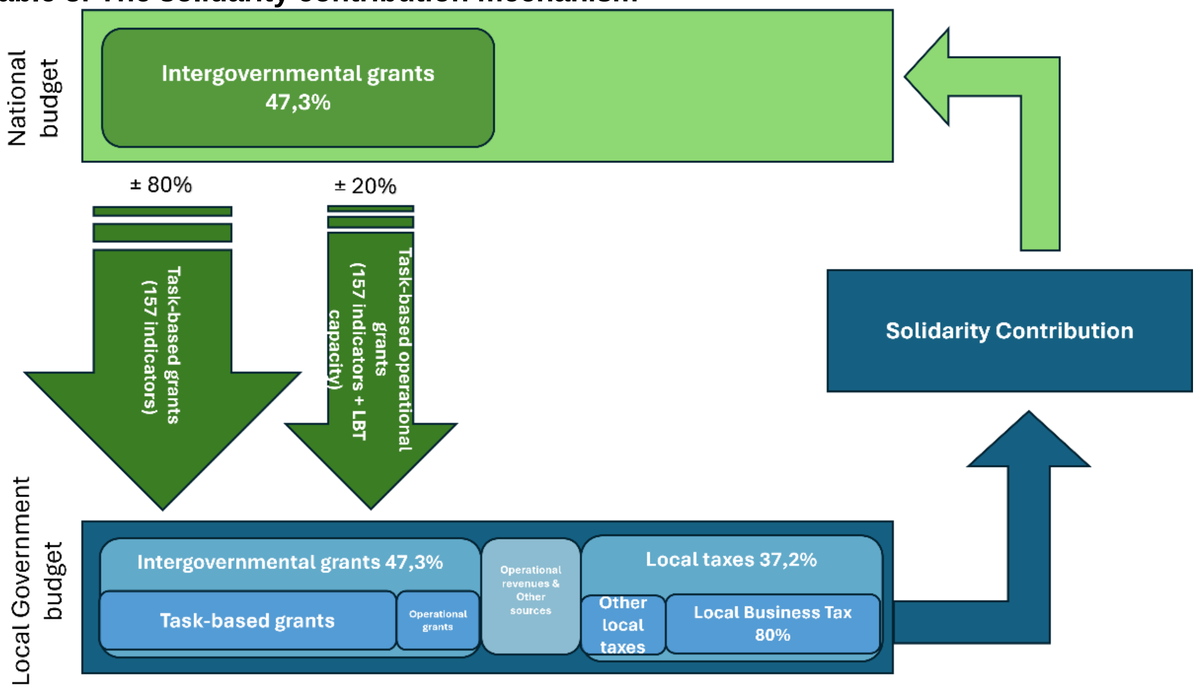
Table 2: Parameter table for calculating the solidarity contribution, 2024

	A	B	C	D
	Categories by the local government's business tax capacity per inhabitant (HUF)		**Contribution rate as a percentage of the solidarity contribution base**	
	lower limit	**upper limit**	**minimum**	**maximum**
1	0	22 000	0	0
2	22 001	50 000	0	0,40
3	50 001	58 000	0,40	0,50
4	58 001	78 000	0,50	0,60
5	78 001	102 000	0,60	0,67
6	102 001	950 000	0,67	0,75

Source: Act LV, 2023 on the Central Budget of Hungary for 2024

The solidarity contribution is levied based on the estimated local government LBT capacity per capita. The rates vary: those with estimated capacity between HUF 50,001 and 58,000 pay 0.4% to 0.5%, while those with assessed capacity between 102,001 and 950,000 pay 0.67% to 0.75%. If a municipality does not charge the Local Business Tax (LBT), its tax base is determined by a nationally set per capita revenue (HUF 22,000 in 2023) and population size. Once paid, the solidarity contribution becomes part of the national budget.

Table 3: The solidarity contribution mechanism



Source: KDZ own representation

Findings and Challenges

The main findings and challenges identified in the current local government financing system were identified and grouped into four distinct areas: Local Business Tax, Solidarity Contribution, Intergovernmental transfers, and Intergovernmental Dialogue.

1 The Local Business Tax

- **The Local Business Tax (LBT) is a relevant and valuable local tax.** It provides local governments with significant discretionary revenues and autonomy over the tax rate and exemptions. The tax incentivises local governments to become more active in attracting and creating a better enabling environment for businesses and investors, all of which contributes to greater national economic growth and prosperity. The tax also fosters accountability of local governments towards their taxpayers. Hungary's neighbouring countries show that local taxes on local economic activity play a fundamental role in the financing of local governments (see for reference the examples of Austria and Germany in the Recommendations section). The Hungarian Local Business Tax fulfils the European standards for local taxes and can be seen as a good practice in line with Article 9 of the European Charter on Local Self-Government and in Section 3 of Recommendation Rec (2005)1 on local taxation guidelines[10].
- **The LBT dominates the local tax system.** The Local Business Tax (LBT) is a major component of the local tax system, accounting for up to 80% of local tax revenues. This strong reliance on the LBT and its procyclical nature exposes local finances to external risks. In contrast, other local taxes, such as property taxes, are underutilised, and the vehicle tax is centralised. Since the LBT is tied to economic activity, it creates territorial disparities, necessitating substantial equalisation efforts.
- **Restrictions on how municipalities can use their LBT revenues are in place.** By law, municipalities are obliged to primarily allocate LBT funds for social services and in the capital city for public transportation.[11]
- **Higher shares of LBT revenues are transferred to the national budget.** The recent changes that increased by seven-fold the solidarity contribution obligation maximum threshold (to 950.000 HUF) imply that higher shares of LBT revenues are transferred from local budgets to the national budget. Consequently, while in 2020, the solidarity contribution redistributed only 5.9% of LBT revenues, by 2024 it is estimated to redistribute up to 23% of LBT revenues.
- **The LBT is showing an increasing character as a shared tax.** The LBT appears to become more of a shared tax. As more LBT revenue is redirected towards the central budget and subsequently redistributed, the overall pool of local own source revenues decreases.

2 The Solidarity Contribution

- **The solidarity contribution is increasing significantly.** The solidarity contribution obligation minimum threshold was lowered to HUF 22,000 (from HUF 34,000 in 2020), while the maximum threshold increased to HUF 950,000 (from HUF 125,000 in 2020). Consequently, if in 2020, the solidarity contribution constituted only 5.2% of government grants for local governments, by 2024, it is estimated to constitute up to 29.3% of government

[10] CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities (19 January 2005), https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=09000016805db09e
[11] Cf. Peteri, 2023

transfers.[12] Some local governments have called for a reduction of the solidarity contribution. TÖOSZ member local governments expressed in their 2023 Members Meeting Resolution that the current contribution level exceeds the solvency limit of municipalities. The most recent TÖOSZ Declaration (dated 17 June 2024) also calls for a reduction of the solidarity contribution starting from the 2025 budget year.

- **The solidarity contribution places a significant fiscal burden for cities with higher LBT capacity.** This burden affects particularly Budapest, the major cities with country rights, along with other cities with higher tax capacity. Notably, in 2022, Budapest and the 25 cities with county rights contribute 69.4% to the solidarity mechanism, exceeding their share of LBT revenues (63.2%).[13]
- **In some local governments, the net solidarity contribution surpasses the amount they receive from government grants.** In recent years, Budapest and Budaörs have in separate cases presented legal challenges due to this concern.
- **The solidarity contribution is calculated solely based on the Local Business Tax**. While the LBT provides insight into economic activity within municipalities, it does not fully represent their overall wealth. For smaller local governments, the LBT is less significant compared to other local taxes like the building tax and communal tax. Demographic changes can influence the distribution of funds. With a declining population and stable LBT, the LBT per capita changes to the city's disadvantage, affecting their solidarity contribution calculations.
- **There is no clear link between the solidarity contribution and a formal equalisation system.** While it is clear how the solidarity contributions are estimated, it is not entirely clear how these are then distributed to financially weaker local governments for solidarity purposes. The government confirms that solidarity contributions are returned to local governments via the task-based grants. Interviews with stakeholders reveal limited information at the national level regarding the redistribution of the solidarity contribution. Currently, there are no easily accessible data available on the amount of grants allocated for each specific task at national level making it difficult to assess how much of the solidarity contributions paid by municipalities are redistributed to which types of municipalities for cost or revenue equalisation purposes. In the government's view, the solidarity contribution is a crucial funding source for local government responsibilities and equalisation purposes. At the same time, municipalities that make substantial solidarity contributions request greater transparency concerning the equalisation measures and effects.

3 Intergovernmental transfers

- **Compared to other European countries, Hungarian local governments are highly dependent on earmarked grants from the state budget.** These funds are expected to make up to 50% of local government revenues in 2024. The national government closely determines municipal service delivery through the task-based financing model.[14] The methods for determining and allocating task-based grants are complex. The task-based grants, constituting the core of the intergovernmental finance system, are determined by the central government, based on estimated standard costs. During the consultation for the Policy Advice and previously, the Peer Review, local government representatives cited cases

[12] In feedback on this comparison the Ministry of Finance emphasised that a change took place in the overall equalisation system in 2021. Until 2020 the solidarity contribution was described as only one element in the system, with certain budgetary support measures being reduced based on per capita tax capacity. According to the Ministry of Finance, taking into account the entire equalisation process the redistributed revenues were approximately the same proportion in 2021 as in 2020.
[13] See Peteri, 2023
[14] For instance, approximately 62.3% of grants in 2021 were earmarked for recurrent expenses in education, social protection, and culture. See OECD/UCLG (2022) 2022 Country Profile les of the World Observatory on Subnational Government Finance and Investment.

where estimated service delivery standard costs are not in line with the average or real delivery costs of municipalities. Some were calculated as far back as 2013 and have not been updated to reflect inflationary pressures. The allocation of the task-based transfers is prescribed in the annual budget law annex. The government claims that the system is transparent and that municipalities can re-calculate on their own their task-based transfer. However, municipalities claim that while the method of allocation is published, the determination of the standard costs is performed by the central government without local governments' involvement nor clarifications. Additionally, the high number and complexity of indicators and coefficients used for task-based grant distribution complicates understanding. While the task-based financing system was outside the scope of this Policy Advice, a separate activity in the project is testing the Standard Expenditure Needs (SEN) approach to evaluate its potential to inform further development of the task-based standard expenditure costs.

- **Task-based financing is complemented by operational grants.** According to interviews with stakeholders, approximately 20% of the intergovernmental transfers are operational grants, but their distribution across municipalities is not publicly disclosed. Further analysis of these transfers was outside the scope of this Policy Advice.
- **Hungary also benefits from specific grants for urban, rural, and regional development, some funded by the EU.** From the interviews with stakeholders, it appears that greater predictability of such funding would increase the ability of municipalities to absorb such funding.

4 Intergovernmental dialogue

- **In Hungary, there is a solid foundation for intergovernmental dialogue, which can be strengthened through systematisation and structuring.** The National Cooperation Council of Local Governments (ÖNET) represents an important platform towards this direction. Within the current TSI project, and building on strong working relationships between TÖOSZ and the central authorities, collaboration among central and local stakeholders in particular on data exchange has been very close. However, compared to European countries that have established mechanisms for dialogue and negotiation on municipal financing systems between levels of government, Hungary has room for improvement in intergovernmental dialogue, coordination, and cooperation regarding the development of its intergovernmental finance system. For example, while Hungary's task-based grant system — covering approximately 150 municipal tasks — is comprehensive, there is an opportunity to enhance the effectiveness of dialogue and coordination within this framework. In its 2023 Membership Meeting Resolution, TÖOSZ has also emphasised the need for dialogue and coordination on the solidarity contribution and the joint review for mandatory municipal tasks, reflecting the real financing needs of municipalities.

- **Central government information systems hold valuable data on local government statistics, budgets, and performance.** While limitations exist in terms of access and interoperability, collaborative efforts are underway (including as part of the TSI project) to enhance these systems and support the use of data by local authorities and their associations. Continuation of these efforts can foster better policy decisions, improved intergovernmental dialogue and increased transparency, benefiting all citizens.

II.2. Recommendations

Based on the status quo of the local finances as well as the findings and challenges, this Policy Advice offers the following set of recommendations, divided into short-term, mid-term and further recommendations. Alongside the recommendations, information about relevant European practices is included.

Short term recommendations

Relaxing restrictions on the use of the Local Business Tax

The Local Business Tax (LBT) is a crucial revenue source for Hungarian local governments, and preserving its local tax characteristics is essential. Current restrictions mandating that LBT revenues be used for social services and public transportation should be lifted to enhance local fiscal autonomy. This change would align the LBT system with Article 9.1 ECLSG. It would also adhere to the principles of CM/Rec(2005)1, emphasising that local authorities should have adequate resources that they may freely use in exercising their responsibilities.

Box 1 – Austria: The Austrian local budget and the Municipal Tax (Kommunalsteuer)
In Austria, the most important source of revenue for municipalities are shared taxes, which make up about 40% of total local government revenues. Among the shared taxes, the most important are the Value Added Tax (VAT), the Personal Income Tax (PIT), and the Corporate Income Tax (CIT). Own local taxes and fees represent an important income for municipalities, representing about 17% of total municipal revenue. The two most important local taxes are the property tax and the municipal tax (Kommunalsteuer). The latter is a local business tax for which companies based in Austria have to pay a tax of 3% of the total amount of wages of all employees. The Municipal tax is levied by the municipalities and regulated by federal law. The tax rate and base are the same for the whole country. *Source - KDZ Centre for Public Administration Research (2023): Structure of local revenues: a comparative analysis of Italy and Austria* https://www.kdz.eu/en/news/blog/structure-local-revenues-comparative-analysis-italy-and-austria

Box 2 – Germany: The local financing system and the local business tax
In Germany, the local financing system is mainly based on shared taxes and own taxes. The main shared local taxes (about 40% of local tax revenues) are the PIT and interest tax, and marginally the VAT. Own local taxes include the local business tax and property tax. The local business tax is a trade tax levied on local business profit. The baseline rate is 3.5% of the profit. However, the local council can decide on a multiplier of the baseline tax rate. Currently, the average tax rate is 14% of profit. The LBT and the PIT (shared tax) accounted for 33% of all local revenues in 2019. The LBT accounted for 17% and the PIT for 16%. *Source - Herrmann, B. (2022): Local taxes on economic activity in municipalities in EU Member States, European Commission* https://publications.jrc.ec.europa.eu/repository/handle/JRC129095

Adjusting the Solidarity Contribution

Establishing the level of equalisation remains a decision to be taken in each country in respect of the prevailing conditions and policy priorities. In many contexts in Europe, vertical equalisation is looked upon more favourably by local authorities than horizontal equalisation which can lead to jealousy or resentment. With a view to achieving the same desired equalisation effect, it could therefore be preferrable to reduce the solidarity contribution and to pivot more towards the use of central grants. Adjusting LBT capacity thresholds and rates could also help preserve its local tax nature in line with Article 9.4 ECLSG.

Equally, a transparent solidarity fund could be set up as recommended below. Grants for equalisation purposes should be unearmarked, and equalisation should be based on one or two complete formula(s) taking into account fiscal capacity and spending needs to 'ensure a fair distribution of public financial resources between the different tiers of government, taking account of the responsibilities assigned to each of these tiers and changes in those responsibilities, as well as economic circumstances' as stipulated in CM/Rec(2005)1.

Box 3 – Austria: The Consultation Mechanism
In 1999, the so called 'Consultation Mechanism' (Konsultationsmechanismus) was adopted in Austria, under which the federal and state governments are required to provide information on the administrative and financial impact of proposed laws or statutes on the other levels of government. The Consultation Mechanism can be invoked if one of the contracting parties intends to adopt legislation that imposes financial obligations on the others and a Consultation Committee, composed of representatives from all levels of government, can then be convened to discuss the proposed new law or statute. If no agreement is reached, the party that intends to adopt the legislation in question will be responsible for financing its own legislation. The Consultation Mechanism is an important tool, especially for Austrian local governments, which allows for the examination of legislative proposals and facilitates direct dialogue with other levels of government, thus avoiding financial burdens for municipalities. *Source - KDZ Centre for Public Administration Research*

Box 4 – Denmark: The extended total balance principle
An important feature of the Danish system of local government finance is the extended total balance principle (Det Udvidede Totalbalanceprincip - DUT), which guarantees a balance between the tasks assigned to municipalities and their financial resources. The 'DUT' balance principle means that the state allocates funds to municipalities and regions in line with their expenditure needs. In more concrete terms, it implies that in the event of a change in the distribution of expenditure or tasks between the central government, the municipalities and the regions, as well as in the event of changes in the binding state regulation of the activities of the municipalities and regions, there must be an adjustment of the general state subsidy (the block grant) to municipalities and regions for the financial consequences thereof. The DUT principle means that the rule-issuing ministry finances regulatory changes within the ministry's own framework. The total framework of the ministry in question is reduced/increased in accordance with the adjustment of the block grant. At the same time, adjustment may be made in the event of changes in the taxation of goods, services, real estate or payroll if the change is aimed at, and significantly affects, the municipalities' and regions' expenses. *Source - Ministry of Finance of Denmark (2024): Det udvidede totalbalanceprincip (DUT), Link: https://fm.dk/arbejdsomraader/kommuner-og-regioner/aftalesystemet/; and the DUT Guideline (2007): https://www.retsinformation.dk/eli/mt/2007/63*

Broadening the calculation basis for the Solidarity Contribution

To better reflect the fiscal capacity of municipalities, it is recommended to broaden the basis for calculating the solidarity contribution. Currently, the assessment of fiscal capacity relies solely on the Local Business Tax (LBT). Including other local taxes, especially where LBT revenue is not significant, would improve fairness and capture fiscal disparities more accurately. Policymakers could consider incorporating Personal Income Tax (PIT) revenues as a proxy which reliably indicates local economic activity. For example, in Bulgaria, the equalisation system takes into account a broad pool of 'fixed tax revenues' basically including all local tax revenues. A broad calculation basis for fiscal and financial capacity is also in line with the Rec(2005)1 which provides that the estimate of financial capacity of local authorities should preferably include all sources of revenue, with the aim of gauging overall financial capacity.

Box 5 – Bulgaria: The Equalising Subsidy System based on broad pool of fixed tax revenues
In Bulgaria the equalisation system is based on an equalising subsidy**.** The main purpose of the equalising subsidy is to ensure that each municipality can provide a minimum level of local services in their territory. It is the only grant over which local governments have full autonomy and can freely distribute and spend (by decision of the Municipal council). By law, the annual size of the general equalising subsidy cannot be less than 10% of the own source revenues of all municipalities in the previous year. The mechanism for the distribution of the subsidy among the municipalities has changed in 2019 and the 'new' mechanism is based on a broad pool of fixed tax revenues (*fixed taxes are considered the immovable property tax, the tax on vehicles, the visitor tax, licence tax and tax on passenger transport by taxi*). In practice this includes all types of local taxes that local governments in Bulgaria can charge. The distribution mechanism consists of five components: a) revenue potential (based on fixed tax revenues); b) expenditure needs (based on natural indicators such as population, the no. of children, no. of adults, the size of territory and length of municipal roads); c) support for municipalities with a very low fiscal capacity (where own source revenues constitute less than 25% of total municipal revenues); d) a lump sum payment determined in annual budget law; and e) support for municipalities with a tax effort above the national average (by comparing the actual average ratio of the fixed tax rates of a certain municipalities and the corresponding average rates set by law). *Source - NALAS & KDZ (2024): Fiscal Decentralisation in South-East Europe Report. 9th Edition. Edited by Stafa, E., Prorok, Th. & Elezi, Sh.; Link: https://nalas-observatory.eu/publications/23 and https://www.kdz.eu/en/knowledge/studies/fiscal-decentralization-indicators-south-east-europe*

Box 6 – Austria: Tool for assessing the fiscal health of municipalities, the KDZ Quicktest
The Austrian Centre for Public Administration Research (KDZ) has developed a tool called the 'KDZ Quicktest' to calculate and assess the financial strength and wealth of Austrian municipalities. The Quicktest uses a multidimensional approach and considers four areas for the assessment of fiscal health: the earning capacity, the self-financing capacity, the financial performance and debt of municipalities. Each area is measured by one indicator; the last one, debt, is measured by two indicators: 1. Public savings ratio – ÖSQ 2. Freely disposable budget ratio – FSQ 3. Rate of self-financing – EFQ 4. Duration of indebtedness – VSD 5. Debt service ratio – SDQ The data may come either from Statistik Austria, the national statistics office, or from the municipalities themselves. The results of the key indicators are then assessed using a differentiated scoring: for each area, (earning capacity, self-financing capacity, financial performance and debt) a total of 25 points can be achieved. In this way, a total of 100 points can be obtained in the financial quicktest, which, evaluated according to an overall key, leads to a score for the municipality. As it is calculated on several dimensions, it provides a comprehensive overview of the financial capacity of municipalities. *Source: KDZ Centre for Public Administration Research*

Fostering data exchange and interoperability

Enhancing the transparency, credibility, and predictability of Hungary's intergovernmental finance system as recommended in CM/Rec(2005)1 requires regular improvements in the quantity and quality of information shared with local governments and their associations. This can be achieved by ensuring access to and interoperability of government databases relevant to local government services. Increased use by local governments will yield valuable feedback and contribute to improved data quality. It also strengthens the case for sustained investments into data infrastructures and interoperability.
This is an area where central and local government stakeholders in Hungary are already demonstrating significant collaboration. This Policy Advice encourages all stakeholders to sustain these important efforts, which can also contribute to wider digitalisation and economic development imperatives.

Box 7 – Croatia: Open Data Portal
Croatia created an Open Data Portal (https://data.gov.hr) which is used by national and local governments to provide various data sets to a wide audience. The Ministry of Finance publishes disaggregated local government financial reports (revenue and expenditure, balance sheets) on their web site (https://mfin.gov.hr/istaknute-teme/lokalna-samouprava/financijski-izvjestaji-jlp-r-s/203). The Ministry of Finance (including the State Treasury and Tax administration) also offers to the Association of Cities (AOC) a wide range of raw data and financial reports, on a regular annual basis or on request. The Association uses various tools and platforms for processing and analysing such information. Local governments also have access to Tax Administration data on property transactions (by request) and instant access to various citizen records, vehicle records and individual personal income records. *Source - Centre of Expertise for Good Governance, Council of Europe (2023) Peer Review Report: Intergovernmental Fiscal Relations, Data Access and Use, and Local-Central Policy Dialogue*

Conducting an evaluation of intergovernmental fiscal relations

A comprehensive evaluation of Hungary's intergovernmental fiscal relations, going beyond the Local Business Tax (LBT) and the solidarity contribution, is recommended in line with CM/Rec(2005)1 which advises regular reviews – as necessary – of the legal and administrative frameworks for local taxation, grants and equalisation. Such an evaluation should involve the government and local government associations, assessing learning from the past decade of centralisation and exploring improvement opportunities. Key areas to examine include shared tax systems, enhancing the potential of existing local taxes, increasing revenue flexibility for local governments, and assessing equalisation systems for better financial equity and resource distribution.

Additionally, reviewing the current intergovernmental grant system and findings from the Standard Expenditure Needs (SEN) pilot can contribute to transparency, predictability, and local autonomy in fiscal management.

Mid-term recommendations

Enhancing the own source revenue system

A diversification of the local governments' revenue sources beyond the dominant LBT is recommended, for example by utilising asset revenues, property taxation, settlement taxes, and re-devolving the motor vehicle tax. This would reduce economic vulnerability and disparities in revenue-raising capacities, aligning with Article 9.4 ECLSG, which calls for dynamic financial systems to meet evolving local government costs, and the guidelines appended to CM/Rec(2005)1 stipulating that ‘to the greatest extent possible, each local authority should finance, from its own resources, the expenditure it decides on (fiscal equivalence at the local authority level).'

Further systematise the dialogue, coordination and cooperation among levels of government

To further enhance dialogue, coordination, and cooperation among government levels, the National Cooperation Council of Local Governments (ÖNET) provides a foundation that can be further developed. In line with Article 4.6 ECLSG, This would involve formalising consultation frameworks, involving local authorities early in policy development, and focusing on key areas such as the solidarity contribution, fiscal equalisation, grant allocation, and transparency in finance systems. The government and local government associations should closely cooperate, ensuring effective representation from both sides. Expanding data exchange and establishing formal agreements, similar to those in European countries with decentralised governance, will further support these efforts.

Box 8 – Austria: The Fiscal Equalisation Act
In Austria the Fiscal Equalisation Act is a central instrument in intergovernmental relations. It regulates fiscal relations between the federal government, the states and the municipalities. The act is revised every three to six years and provides for negotiations between the three Austrian levels of government on the redistribution of intergovernmental grants and shared taxes to sub-national governments. The Austrian local government associations (the Austrian Association of Cities and Towns and the Austrian Association of Municipalities) participate as representatives of local governments. In this context, the federal government holds the final authority, and the legislation does not require the consent of the states or municipalities when the Fiscal Equalisation Act is passed. However, municipalities could appeal the fiscal equalisation act at the Constitutional Court. The enactment is preceded by three-level negotiations in which the two local government associations are involved. During the negotiation phase, the local government associations have the chance to directly intervene and discuss the distribution mechanisms of the funds. This creates a crucial opportunity to facilitate and promote dialogue and coordination between levels of government and increases awareness of service costs. *Source - KDZ Centre for Public Administration Research*

Box 9 – Poland: The Joint Commission on Intergovernmental Affairs
Since the late 2000s, Poland has created a unique institution for intergovernmental discussion and deliberation called the Joint Commission on Intergovernmental Affairs. The most important aspect of the Commission is that no legislation affecting either local government competencies or finance can be submitted to parliament without first being subject to the non-binding review of the Commission. The Commission is composed in equal measure by representatives of the national government –mostly line ministries—and representatives from each level of local government. It has a permanent secretariat funded by the national government, as well as both standing and ad hoc committees tasked to review and comment on draft legislation. *Source - Mirska, A. (2021): Local Government in Poland. Responses to Urban-Rural Challenges. Zenodo: https://doi.org/10.5281/zenodo.5728281* *Congress of Local and Regional Authorities of the Council of Europe (2019): Local and regional democracy in Poland. CG36(2019)13final; Link: https://rm.coe.int/local-and-regional-democracy-in-poland-monitoring-committee-rapporteur/1680939003*

Increasing transparency and predictability of the local government finance system

Building on the existing cooperation between local government associations and central agencies, Hungary's intergovernmental finance system could be further improved through better information sharing with local governments and their representative associations. This would involve regular publishing of more detailed data on intergovernmental finance flows and indicators; joint agreements on indicators; grant allocation criteria and methods for grants; and making data on various grants and local finance indicators more accessible. This would also demonstrate practice in line with Principle 6 'Openness and Transparency' of CM/Rec(2023)5 on the principles of good democratic governance which call for efforts to make decision-making processes publicly available and accessible within legally defined limits, including through the use of digital tools as appropriate. Additionally, developing and publishing annual and multiannual projections for intergovernmental grants, similar to Austria's practice of providing regular forecasts of shared tax revenues, would enhance local government planning and efficiency.

Box 10 – Finland: The Local Government Finance Programme

The Finnish Local Government Act foresees a negotiation process between the central and local government, where local government is represented by the Association of Finnish Local and Regional Authorities. As part of the negotiation process between the central and local level, a programme for local government finances shall be prepared. Its development forms part of the preparatory work for the general government fiscal plan and the central government's budget proposal. The Finnish Ministry of Finance plays a pivotal role in ensuring a transparent and adequate system of local government as well as a sound framework for intergovernmental dialogue and negotiation on local government finance.

The Ministry of Finance prepares a Local Government Finance Programme, which further details the analysis on local government finance presented in the public finance plan and the state budget proposal regarding municipal finance. The purpose of the programme is to:

- Assess the state and prospects of municipal finances as well as the government's measures affecting local finances;
- Assess the ability of municipalities to cope with the delivery of their responsibilities;
- Assess adequacy of funding and the development of local finances;
- Prepare development plans and legislative projects concerning the finances and administration of municipalities;
- Prepare the state budget proposal for the parts concerning municipal finances;
- Prepare proposals regarding the finances and administration of municipalities before their consideration in the Government Council;
- Assess cost sharing between the state and municipalities; and
- Address other matters concerning the finances and administration of municipalities.

The municipal finance programme is prepared by the Advisory Committee and the Working Group for Preparing the Programme for Local Government Finances. The Advisory Committee is composed of representatives of the ministries of Finance, Social and Health Affairs, Education and Culture and the Local Government Association. The working group includes experts from the same organisations plus other line ministries that have responsibilities connected with municipalities. Twice a year, this working group prepares a report including lists of different measures concerning municipalities and their financial effect on local finance. In addition, the report contains a prognosis on future developments on local finances and its effect to different types of municipalities categorised by size.

There is also a pressure calculation on how this is going to affect the municipalities. It shows pressure on municipal tax revenues and their ability to take out new loans. The aim of the calculation is to give to municipalities advance information, guidance and time to take necessary measures.

Source: Ministry of Finance of Finland (2024): The Municipal Finance Programme for the years 2025-2028. Link: https://vm.fi/kuntataloushjelma

Box 11 – Denmark: Annual Financing Framework
The Danish' government system is one of the most decentralised in Europe. The annual financing framework for municipalities and regions is negotiated every year by the national association of municipalities (KL) and the national association of regions vis-à-vis the government of Denmark as part of the general budget cooperation between the government and the municipalities and regions. The economic agreement between KL and the government contains, among other things, the framework for the service and capital expenditure as well as objectives for municipalities' tax collection. With the agreement for 2024, the municipal service framework is adjusted by a total of DKK 1.4 billion, to account for inflationary pressures on local governments as well as the government efforts to reduce municipal administration expenses towards 2024. *Source - Local Government Denmark / KL (2024): Government Agreement on the municipalities' finances 2024*

Transforming the solidarity contribution mechanism into a solidarity fund

To enhance the transparency, predictability, and equity of the intergovernmental grant system as recommended in CM/Rec(2005)1 and its guidelines for grants to local authorities, establishing a solidarity fund could be considered. This fund would pool revenues from solidarity contributions paid by local governments and the resources dedicated from the state budget to support financially weaker municipalities with non-earmarked financing. It would increase system transparency by clearly showing contributions and support for financially weaker municipalities, helping the central government reduce fiscal disparities. Initially, a budget line for the solidarity fund could be set up, covering income and expenditure. Gradually, this could then be developed into a comprehensive fiscal equalisation system. A step-by-step approach, starting with a portion of the solidarity contributions, can be used to launch the fund and expand it after evaluation.

Box 12 – Italy: The Fund of Municipal Solidarity
The Stability Law of 2013 (Law no 228/2012) set up the Fund of Municipal Solidarity (Fondo di Solidarità Comunale) which is an *ad hoc* fund for financing municipalities for equalisation purposes. The fund was initially financed by the municipalities themselves, through a share of the local property tax (IMU) and redistributed among the municipalities, resulting in a horizontal redistribution of resources. However, with the last three budget laws, the fund was incremented with state resources. As a result, nowadays the fund is partly financed by municipalities and partly by the State. Due to the gradual transition from the previous system, a part of the fund's resources are still currently distributed according to 'historical expenditure' (i.e. on how much a local authority historically spends on a given function), while a part is already redistributed according to the new system, namely according to 'standard expenditure needs and costs' (i.e. what services a local authority should offer given the characteristics of the territory and population and the costs needed to finance them). By 2030, 100 per cent of the fund will be distributed according to the new system. *Source - Camera dei Diputati (n.d.): Le risorse per i comuni: il Fondo di solidarietà comunale. Link: https://temi.camera.it/leg17/temi/il_fondo_di_solidariet__comunale_e_la_perequazione*

Box 13 – Netherlands: Municipal Fund (Gemeentefonds)
In Netherlands, the 1996 Financial Relations Act regulates intergovernmental financial relations. Grants to municipalities are divided between a general grant coming from the Municipalities Fund or Gemeentefonds, (i.e. 36% of municipal revenue), an integration grant, a decentralisation grant (including a new fund for social affairs) and specific grants meant to cover the expenses of obligatory delegated tasks. The Municipal Fund (Gemeentefonds) has a strong equalising function (60 different criteria are used for its allocation). The formula takes into account spending needs and tax capacity of municipalities, with the aim to enable all municipalities to finance equivalent service levels at equivalent tax rates. *Source - OECD/UCLG (2022): Country Profiles of the World Observatory on Subnational Government Finance and Investment, Link: https://www.sng-wofi.org/country-profiles/;* *Ministry of Finance of the Netherlands (n.d.): The Municipal Fund. Link: https://www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/gemeentefonds*

Box 14 – Croatia: Fiscal Equalisation Fund (FEF)
According to Article 138 of the Constitution of Croatia, the state is obliged to provide financial assistance to weaker units of local and regional self-government in compliance with the law. This process is managed through a fiscal equalisation fund (FEF). The financial equalisation system is based on collection by the central government of 17% of PIT revenues of self-government units which is then pooled in the special equalisation fund set aside for decentralised functions. As of 2021, the aforesaid 17% share in PIT was allocated to local and regional governments as a compensatory measure for central government decision to reduce PIT rates. Due to this change, the FEF is funded from central government revenues and recorded as a general grant as of 2021. Funding from FEF is allocated to local governments according to individual shares which are set in advance of the budget year. Local governments' individual shares are calculated as a difference between the (5-year average) target per capita PIT revenues and the (5-year average) actual per capita PIT revenues. The introduction of the FEF is considered to be a significant positive development given that it reduces disparities across local government PIT allocations, as well as increases the transparency and predictability of local government revenues. *Source - NALAS & KDZ (2024): Fiscal Decentralisation in South-East Europe Report. 9th Edition. Edited by Stafa, E., Prorok, Th. & Elezi, Sh.; Link: https://nalas-observatory.eu/publications/23 and https://www.kdz.eu/en/knowledge/studies/fiscal-decentralization-indicators-south-east-europe*

Considering the use of other possible funds to support climate change adaptation and digitalisation in municipalities

To support climate change adaptation and digitalisation in municipalities, it is recommended to explore whether other funding streams, for example from the EU Recovery and Resilience Facility (RRF) could be integrated into a solidarity fund in the future. This fund would then pool revenues from solidarity contributions, state budget contributions, and – for example – eligible EU funds. Specified in the annual budget law, this approach could ensure a stable and predictable funding source, allowing municipalities to plan long-term projects confidently. Regular disbursement aligned with the EU multiannual financing period would prevent disruptions in ongoing projects.

Enabling voluntary intermunicipal cooperation and redistribution of LBT revenues in functional regions

Interviews with stakeholders during the consultation pointed to ongoing discussions on regionalising the distribution of Local Business Tax (LBT) revenues, especially among neighbouring local governments where economic integration is significant. Implementing a common tax distribution system in such regions can help ensure that all areas benefit from economic activities, promote balanced development, reduce fiscal disparities, and support shared public services. By pooling resources and fairly distributing tax revenue, regions can undertake larger-scale projects, fostering equitable access to services and more efficient resource use. Such local equalisation systems are provided for in paragraph 45 of the local taxation guidelines appended to CM/Rec(2005)1.

Box 15 – Austria: The inter-municipal business cooperation
Several intermunicipal cooperations exist in Austria that deal with business attraction and taxation. In Upper Austria, the INKOBA (Interkommunale Betriebsansiedelung): Inter-Communal Settlement Projects and Business Parks initiative was launched to economically stimulate the business environment in peripheral regions of Upper Austria. In INKOBA several municipalities form a municipal association (Gemeindeverband). Building areas are prepared and made available to the companies as business locations. Infrastructure costs and the taxes derived from the businesses' activities (municipal tax) are shared between the municipalities involved. Since 2001, 30 companies have been established through INKOBA. About 69% of local governments in Upper Austria participate, mainly small and medium-sized municipalities in less developed regions. Managed by the publicly owned company Business Upper Austria and supported by the Regional Government of Upper Austria, this intermunicipal cooperation provides optimal conditions for businesses and strengthens regional economic development. Municipalities involved benefit from joint financing, increased purchasing power and reduced competition among municipalities. The initiative bridges urban-rural gaps, distributes financial risk, and enhances local governments' negotiating power, leading to mutual benefits for all involved. *Source - KDZ Centre for Public Administration Research*

Further recommendations

Developing the solidarity contribution mechanism towards a fiscal equalisation system

Given the fragmented nature of Hungary’s local government system, an effective equalisation system is needed to address disparities in fiscal capacity and service delivery costs. In line with Article 9.5 ECLSG and the financial equalisation guidelines of CM/Rec(2005)1, policymakers should consider enhancing the solidarity contribution mechanism with clear policy objectives and rules for the financial support for financially weaker municipalities. A balanced equalisation mechanism should address both fiscal capacity and spending needs disparities, with objective allocation criteria that consider natural differences in municipalities’ revenue-raising capacity and service delivery costs. Establishing a dialogue with local governments to determine system parameters is essential. Learning from European models where equalisation grants come primarily from higher government levels could improve Hungary’s approach.

Box 16 – Switzerland: The Fiscal Equalisation System
The Swiss financial equalisation system is based on two instruments: Resource equalisation improves the financial performance of financially weak regional governments, while cost equalisation supports central and mountainous regions by providing funds to cover additional structural costs. Based on 2023 data, resource equalisation grants make up to 80 percent of total grant payments in the system, which is funded to about 60 per cent by the federal government and 40 per cent by financially strong local/regional governments. Cost equalisation transfers account for almost 20 percent of total transfers and are paid entirely by the federal government. The equalisation of resources aims to mitigate financial differences between regional governments and ensures that all regional governments can effectively fulfil their public tasks and services. The amount of

the transfers is determined based on the comparison between the regional government's resource potential and the national average. Regional governments with lower-than-average resource potential (below 100 per cent of the national average) receive funds from the resource equalisation system, while regional governments with higher-than-average resource potential (above 100 percent) contribute to the system.

Cost equalisation aims to support regional governments that have 'special' costs, due to specific developments in the economy, the population or due to natural events. The special costs are divided into two categories: basic and optional requirements. The basic requirement includes the legally prescribed expenditure for basic services such as social security and health. The optional requirements refer to expenditure that go beyond basic needs and reflect preferences of the regional governments. The equalisation of the costs is based as much as possible on the basic requirement, as it is based on indicators that reflect the structural causes of special costs and not on the actual expenditure itself.

Source - Mair, L., Mosler, M. & Schaltegger, C. (2024): Finanzausgleich in der Schweiz. Forum Public Management 1/2024, Link : https://www.kdz.eu/de/wissen/fpm/nachhaltig-gestalten

Box 17 – Netherlands: Balancing expenditure needs and fiscal capacity

The equalisation system of the municipal fund (Gemeentefonds) takes into account the costs incurred by municipalities (cost orientation) and the income that they are capable of generating (fiscal capacity). As regards cost orientation, the equalisation system looks at objective cost-determining features of municipalities, such as the number of inhabitants, young people, seniors and benefit recipients, as well as the surface area, the number of population centres, etc. Each criterion is linked to an amount per unit. Altogether there are more than 60 criteria. The most important are as follows: 21% of the fund is distributed on the number of inhabitants, 9% on population density, 7.4% on youth population, 7.3% on social welfare recipients, 5.8% on households and 5.8% on households with low income, 3.7% on minority population, 3.7% on living spaces, 36% on living spaces per the soil factor, 2.2% on students in higher education and several other factors that capture municipal responsibilities and socio-economic and demographic changes. A municipality that has high costs, e.g. due to many low-income inhabitants, receives more from the fund than a municipality with fewer costs.

The equalisation system also considers the extent to which municipalities can generate income. The most important factor is the municipal property tax capacity, assessed on the basis of a predetermined tax rate for calculation purposes. A municipality that is capable of generating a relatively large income from the municipal property tax will receive less money from the municipalities fund – relatively speaking – than a municipality that is capable of generating only a small income.

Source - Congress of Local and Regional Authorities (2021): Monitoring of the application of the European Charter of Local Self-Government in the Netherlands. CG(2021)41-05_EN. Link: https://search.coe.int/congress?i=0900001680a42001

Increasing local discretion for task-based grants and the Local Business Tax (LBT)

Hungarian local governments are highly dependent on earmarked state grants, limiting their discretion and ability to plan and deliver local services effectively. To increase local autonomy and improve service delivery, the government could replace some task-based subsidies with sectoral block grants, providing more flexibility in spending within specific sectors.

Additionally, reducing restrictions on the use of Local Business Tax (LBT) revenues, particularly the limitations on using these funds for municipal office salaries, would enhance local governments' ability to tailor spending to local priorities and needs, fostering greater efficiency and effectiveness in public fund utilisation.

Box 18 – Bulgaria: Financing Framework for Local Governments

Since 2014, the overall budget framework and the structure of public finances are regulated in the Public Finance Act, including the fiscal relations between the central and the local governments and the Municipal Debt Act, which defines the borrowing framework.

Bulgarian municipalities are heavily dependent on transfers grants from the central government.
There are four main transfers grants that the central government provides to the municipalities annually:

- General Subsidy for Financing Activities Delegated by the State
- General Equalising Subsidy
- Earmarked Capital Expenditure Subsidy
- Transfer Grant for Winter Maintenance and Snow Removal of Municipal Roads

Their amounts and the mechanism for their distribution among municipalities are set in the state budget act for the respective year. Additionally, municipalities may receive also other earmarked funds and financial compensation by the state.

Source - NALAS & KDZ (2024): Fiscal Decentralisation in South-East Europe Report. 9th Edition. Edited by Stafa, E., Prorok, Th. & Elezi, Sh.; Link: https://nalas-observatory.eu/publications/23 and https://www.kdz.eu/en/knowledge/studies/fiscal-decentralization-indicators-south-east-europe

ANNEXES

Council of Europe standards and reports

ETS 122 European Charter of Local Self-Government https://rm.coe.int/european-charter-of-local-self-government-eng/1680a87cc3

CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=09000016805db09e

CM/Rec(2023)5 - Recommendation of the Committee of Ministers to member States on the principles of good democratic governance https://search.coe.int/cm/pages/result_details.aspx?objectid=0900001680abeb87

CG-FORUM(2021)01-03final - Congress of Local and Regional Authorities of the Council Europe: Monitoring of the European Charter of Local Self-Government in Hungary https://rm.coe.int/monitoring-of-the-european-charter-of-local-self-government-in-hungary/1680a129f6

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Mirska, A. (2021): Local Government in Poland. Responses to Urban-Rural Challenges. https://zenodo.org/records/5728281

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TÖOSZ (2023): Resolution from the May 2023 Membership meeting of the Hungarian National Association of Local Authorities (original in Hungarian)

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Databases

OECD/UCLG (2022): Country Profiles of the World Observatory on Subnational Government Finance and Investment, Link: https://www.sng-wofi.org/country-profiles/

OECD Fiscal Decentralisation Database (updated until 2022) https://www.oecd.org/tax/federalism/fiscal-decentralisation-database/

A.2. Policy Advice Consultation Agenda

Co-funded by the European Union — EUROPEAN UNION — COUNCIL OF EUROPE / CONSEIL DE L'EUROPE — Co-funded and implemented by the Council of Europe

22HU05 – Local Government Public Finance Development and Municipal Capacity Building in Hungary

Centre of Expertise for Good Governance, Council of Europe

Policy Advice

Consultation Agenda

23-25 April 2024, Budapest, Hungary

Time	*Topic*	*Participants*	*Location*
Tuesday, 23 April			
12:30	Lunch and briefing	**Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager	Paprika Vendéglő 1071 Budapest Dózsa György út 72.
14:00	Meeting with the Local Finance Working Group and Local Government Representatives	**Working Group Members** (MoPARD, MoF, TÖOSZ, State Audit, Treasury) **László Csőzik,** Hungarian Association of Local Governments (MÖSZ) and Mayor of Érd **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Conrad Zellmann**, Project Manager Nóra Radácsi & Gábor Répássy, Interpreters	TÖOSZ Offices 1071 Budapest Damjanich u. 44. III/1.
15:30	Meeting with TÖOSZ	**Dr. Ferenc Gyergyák,** General Secretary, TÖOSZ **Ms. Katalin Kolin-Sabján,** Secretary of Foreign Affairs, TÖOSZ **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager Nóra Radácsi & Gábor Répássy, Interpreters	TÖOSZ Offices 1071 Budapest Damjanich u. 44. III/1.
Wednesday, 24 April			
Postponed due to scheduling needs. The meeting took place online on 23 May 2024.	Consultation Ministry of Public Administration and Regional Development (MoPARD)	**Zoltán Kivés**, Deputy State Secretary **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager Nóra Radácsi & Gábor Répássy, Interpreters	Ministry of Public Administration and Regional Development (at MoI) H-1051 Budapest József A. u 2-4

14:00	Consultation Local Government Representatives	**Ferenc Zoltán Szabó**, Mayor of Szentes **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager Nóra Radácsi & Gábor Répássy, Interpreters	TÖOSZ Offices 1071 Budapest Damjanich u. 44. III/1.
Thursday, 25 April			
09:00-11:00	Consultation Local Government Representatives	**Tamás Wittinghoff**, Mayor of Budaörs **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager Nóra Radácsi, Zoltán Köröspataki, Interpreters	Municipality of the City of Budaörs H-2040 Budaörs, Szabadság út 134.
15:30	Consultation Ministry of Finance	**Dr. Ábel Berczik,** Deputy State Secretary for Public Finances, Human Resources and Local Government Budget **Ms. Éva Molnár,** Head of Department, Public Budget and Treasury Relations **Thomas Prorok**, KDZ/CoE Expert **Sofia Calzola**, KDZ **Dr. Gábor Péteri**, CoE Lead Project expert **Conrad Zellmann**, Project Manager Nóra Radácsi, Zoltán Köröspataki, Interpreters	Ministry of Finance 1051 Budapest József nádor tér 4

A.3. Background Document

BACKGROUND DOCUMENT

Policy Advice

22HU05(2024)7-updated 22042024

The Council of Europe is currently implementing the EU-CoE joint project 'Local Government Public Finance Development and Municipal Capacity Building in Hungary'. The project aims to strengthen the administrative and financial capacity of local authorities. The expected outcomes of the project are the following:

- The institutional framework related to the good democratic governance of municipalities has improved;
- Improved awareness, knowledge and skills of relevant authorities on the topics tackled by the capacity building activities.

The beneficiary of the project is the Hungarian National Association of Local Authorities (Települési Önkormányzatok Országos Szövetsége – TÖOSZ). The Hungarian Ministry of Public Administration and Regional Development (MoPARD) and the Hungarian Ministry of Finance (MoF) are involved throughout the project as members of the Project Advisory Group, as well as in the consultations for and as recipients of a Peer Review Report and a Policy Advice.

As per the detailed project document, *Output 3* foresees the development of a Policy Advice:

Output 3: Policy Advice to central and local authorities to improve the institutional and fiscal framework for local government in line with European standards

Elaborating on the Technical Report and the Peer Review Report, the CoE will draft a Policy Advice containing operational and public financial recommendations to improve the current institutional and fiscal framework for local government, in line with European standards and good practices. The Policy Advice will be transmitted to the Hungarian authorities in accordance with the Project timeline.

In order to produce the output, the CoE will perform the following activities:

Activity 3.1 Consultations and interviews with main stakeholders

The CoE will identify the relevant stakeholders (e.g. senior representatives of the MoI, MoF, Treasury, State Audit Office, TÖOSZ as well as elected representatives at local level) to conduct consultations and interviews.

Activity 3.2 Drafting, finalisation and presentation of the Policy Advice

The CoE will draft a Policy Advice which will present the main recommendations in order to improve the institutional and fiscal framework for local government, including multilevel coordination mechanisms. The Policy Advice will be officially presented to the Hungarian authorities during a dedicated meeting.

Focus of the Policy Advice
Building on the recommendations from the Peer Review conducted in the context of the project in September-November 2023, as well as consultations with the project's Advisory Group, the Policy Advice will focus on possible improvements concerning local finances and intergovernmental financial relations.

Specifically, the Policy Advice will focus on the following overarching questions:

1. In line with Article 9 of the European Charter of Local Self-Government,[15] what measures can be introduced to the Local Business Tax (LBT) to help develop this revenue source so as to enable local authorities to keep pace, as far as practically possible, with the real evolution of the cost of carrying out their tasks?

2. What changes can be introduced to the Solidarity Contribution that can help ensure a fair distribution of public resources in line with CM/Rec(2005)1[16] on the financial resources of local and regional authorities?

The project beneficiary TÖOSZ has further identified specific interests as expressed in the following guiding questions:
Regarding Question 1 on the Local Business Tax: How might local business taxation be further developed within the established system of local taxation? How can local business tax (LBT) revenue be made more equitable, either by modifying tax regulations or by regional sharing of tax revenue?
Regarding Question 2 on the Solidarity Contribution: What methods can be proposed to renew the system of Solidarity Contribution formation (withdrawal) and reallocation, ensuring incentives for municipal revenue mobilisation, transparency and predictability?

Audience of the Policy Advice
The recipients of the Policy Advice will be the Ministry of Finance and the Ministry of Public Administration and Regional Development. As the beneficiary, TÖOSZ will be closely involved in the process. As part of the consultation process for the Policy Advice, inputs will be sought from these key project stakeholders, the Local Finance Working Group and selected local government representatives.

Experts
Thomas Prorok, Managing Director, Centre for Public Administration Research (KDZ, Austria) has been appointed as lead international expert for the development of the Policy Advice. Mr. Prorok is a renowned local governance expert with significant experience on local finance issues. He has led contributions e.g. to the OECD-SIGMA work on local governance, as well as the implementation of the European Common Assessment Framework in various countries. Mr. Prorok has also been involved in the Peer Review activity in the context of this project, on which the Policy Advice will built. He will be supported by the project's lead national expert and the Council of Europe project manager during the development of the Policy Advice.

[15] ETS 122 https://rm.coe.int/european-charter-of-local-self-government-eng/1680a87cc3
[16] CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities (19 January 2005), https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=09000016805db09e