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**Kovács Péter Tamás**

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**Principles and standards of taxation in Hungary  
– assessing the development of the national tax legislation**

**Kovács Péter Tamás**

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## Table of abbreviations

FLH – Fundamental Law of Hungary

EU – European Union

PIT – Personal Income Tax

HUF – Hungarian Forint

VAT – Value-added Tax

MPs – Members of Parliament

## **0. Introduction**

The Hungarian tax system has to ensure that taxpayers contribute to state expenses in a proportionate way for the sake of social integrity. Willingness to pay tax largely depends on whether the taxpayer treats tax liabilities as a righteous duty and not as an excessive confiscatory measure. Implementing the principles of taxation have been of prime necessity for modern, egalitarian tax systems, therefore for a rule of law state like Hungary, incorporating the provisions of principles is vital. Whether or not the national tax system is on a sound constitutional and principled base, may affect general propensity to invest or engage in an economic activity in Hungary. My project is to shed light on what the core principles are and how they are put into effect considering the recent period of intensive legislation in Hungary that resulted in the new Fundamental Law of Hungary (FLH). This paper also elaborates on how the development of the national tax system towards a global tax system amended the core principles of the tax system. In some cases the research question had to be turned around because domestic affairs, and their effects on the principles, were much more severe than binding regulations of treaties or the European Union (EU). Starting with fundamental principles, my aim is to circumvent the most important principled areas of the tax system and assess the efficiency of these principles in practice. My objective is to get an up-to-date and realistic picture of the Hungarian tax system, with a special focus on the evolvement of principles.

## **1. Research methods**

The primary sources for my research were the actual Acts and my own notes from my lectures on constitutional law and consumption taxes. As aforesaid, there has been a vast change in legislation over the course of the last two years starting from April 2010. One of the results of this intense juridical period is the new Fundamental Law of Hungary in effect from 1<sup>st</sup> January 2012. The FLH provides for new provisions on the field of taxation, which are currently under the scrutiny of academics, arguing whether or not it is better than the old provisions or not. Due to its novice, there is yet very few written literature on this topic hence, besides those, I chose to rely on my own notes and impressions of professionals talking about their opinion on the matter. Secondly I used the commentaries of relevant Acts and - in the FLH's case – critiques and overviews provided by domestic and foreign professionals. To

base the study on academic foundations and to get general ideas of how to move forward and improve the tax system I used the textbook Hungarian Tax Law by Gábor Földes, published by Osiris in 2004 and Tax by Design – The Mirrlees Review by multiple authors, published by Oxford University Press in 2011. To get the framework of my study I have used the questionnaire compiled by Professor Tulio Rosenbuj from the University of Barcelona, who will be my mentor at EUCOTAX-Wintercourse 2012, where this study paper will be further processed, comparing its findings with findings on the same research questions from other countries. The rest of my used sources consist of country descriptions of tax advisor companies and relevant articles.

## **2. Legitimacy of tax systems in Hungary**

The legitimacy of the Hungarian tax system can be derived from the legitimacy of the State – if the State is legitimate then the tax system of the state will also be deemed as legitimate. *“The current government was formed by a political party that obtained more than two-thirds of the parliamentary mandate as a result of the spring 2010 elections. Hence, new (tax) laws are backed by political legitimacy. There seems to be a consensus in Hungary, at the moment, that the government is authorized to take radical measures to defend the people as much as possible against the harmful consequences of the global financial crisis.”*<sup>1</sup> That being the prediction in 2010, Hungary has seen a lot of changes over the course of the last two years. Although legitimacy was not questioned in 2010, and the political climate expected “radical measures”; as of 2012 everybody seems to doubt whether the intense legislation that resulted in more than 300 new Acts and a new Constitution, the Fundamental Law of Hungary, was legitimate. In that sense, legitimacy of the Hungarian tax system has been infringed in the last years – even if only in its reputation of being also modified at hands of the current government. Surprisingly enough, Deák (2010) also mentions that, *“despite the political legitimacy surrounding the then formed government, the state itself is suffering from a crisis of legitimacy, as its institutions operate inefficiently and are on their way to losing their moral authority.”* So there was legitimacy at hand but parallel to that, state institutions were losing their reputations fast. In my opinion Deák (2010) hoped in 2010 that a newly came legitimacy received through a landslide democratic victory by the currently ruling party

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<sup>1</sup> Daniel, Deak. *Hungary introduces special taxes*. Amsterdam: European Taxation, IBFD, December 2010, p. 545.

would mean taking radical measures to offset the decline of institutional legitimacy. He was right about the new wave of legitimacy, but could of course not foresee the extent of the exploitation of that legitimacy which brought down longstanding institutions which were supposed to be the checks and balances for the exerciser of state powers.

Approaching legitimacy from a different direction, the tax system will not be less legitimate through engaging in international treaties and obeying EU regulations, contrariwise, it will gain an extensive legitimacy – a supreme lawfulness because of the involvement of international standards or EU regulations. Developing the Hungarian tax system towards a global tax system is definitely beneficial for Hungary with respect to legitimacy.

### **3. General principles and standards of taxation in Hungary**

According to Paragraph 2 Section 1 of Act XCII of 2003 on the Rules of Taxation, *taxpayers and the tax authority shall exercise their rights and fulfil their obligations in compliance with the provisions of this Act and other acts. If vested by law with discretionary powers, the tax authority shall exercise such rights as consistent with the purpose of authorization and within the framework of law.* Stemming from the above it can be regarded that the principles of the Hungarian tax system lay in multiple sources. As the Commentary of Act XCII of 2003 on the Rules of Taxation puts it<sup>2</sup>, taxpayers' rights are of a heterogenic nature because they consist not only of provisions in the above mentioned act, but embody provisions laid down in the Fundamental Law of Hungary (FLH)<sup>3</sup> - earlier known as the Constitution<sup>4</sup> -, and other acts as well. Decisions of the Constitutional Court may also be of importance when assessing tax system principles.

When grouping tax system principles there are three categories: 1, *general provisions*, which should be applied on a broader scale than taxation – these are derived from the FLH; and 2, *field-bound provisions* introduced in Hungarian tax law – most notably in Act XCII of 2003 on the Rules of Taxation. I will now elaborate on these principles following the above structure. It should be noted that provisions collide when applying a top-down method: field-

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<sup>2</sup> Chapter 9.2 of the Commentary of Act XCII of 2003 on the Rules of Taxation by Dr. Gábor Földes and Dr. László Hadi.

<sup>3</sup> Chapter 9.2.1 of the Commentary of Act XCII of 2003 on the Rules of Taxation by Dr. Gábor Földes and Dr. László Hadi.

<sup>4</sup> Act. XX of 1949 on the Constitution of the Republic of Hungary

bound provisions for instance are deemed to consist of and further detail provisions from the FLH, hence fulfilling the general principle of legal certainty, which means that every Act adopted by the Parliament can be originated from the Fundamental Law<sup>5</sup>.

### *3.1 Principles originating from the Fundamental Law of Hungary*

Both in the present times and in the history of legal education in Hungary, taxation principles were taught as a tripartite, consisting of *legality*, *ability to pay* and *equality*. It can be derived from the principles of *equality* and *ability to pay* that the aim of the tax system is to tax people with the similar level of wealth or economic contribution the same way, and thus allowing people with greater wealth or economic contribution to be taxed at a higher rate.

#### *3.1.1 Principle of Legality*

Paragraph 1 of Article XXX of the FLA states: ‘Every person shall contribute, *according to their capacity* or *to the extent of involvement in the economy*, to financing the needs of the community.’ In a different translation the same paragraph reads: ‘Every person shall contribute to satisfying community needs to the best of his or her *capabilities* and *in proportion* to his or her participation in the economy.’ Defining ‘person’ is perhaps easier if we regard what the previous Constitution stated in Article 70/I: ‘All natural persons, legal persons and unincorporated organizations have the obligation to contribute to public revenues on the basis of their income and wealth.’ It has been in the focus of economic debate whether or not the FLH should include a more specific characterization of who should contribute. In this regard, I share the view Erdős (2011)<sup>6</sup> that it is not the FLH’s duty to specify; the concrete list of taxable persons shall be determined by special Acts.

Paragraph 3 of Article I of the FLH stipulates that in Hungary regulations pertaining to fundamental rights or duties are determined by law<sup>7</sup>. Consequently, Article 40 of the FLH states that rules concerning taxation must take the form of acts of Parliament: ‘the basic rules

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<sup>5</sup> Own notes from the lecture held by Dr. Péter Szegvári, Visiting Professor of Constitutional Law, Eötvös Loránd University.

<sup>6</sup> Eva Erdős – A közteherviselés elvének kiterjesztő értelmezése, Miskolci Jogi Szemle, 6. évfolyam – különszám, 2011

<sup>7</sup> Paragraph 3 of Article I of the FLH: „The rules for fundamental rights and obligations shall be determined by special Acts. A fundamental right may be restricted to allow the exercise of another fundamental right or to defend any constitutional value to the extent absolutely necessary, in proportion to the desired goal and in respect of the essential content of such fundamental right.”

concerning the bearing of public burdens () ... () shall be laid down by an implementing act...’ The legality of the tax system is ensured through Articles XXX and 40 of the FLH, the former sets out basic principles<sup>8</sup> and the latter secures that any attempt to introduce or modify taxes must be in the form of Acts.

### 3.1.2 Principle of ability to pay

In Hungarian ‘ability to pay’ is translated as “arányos közteherviselés” which jointly means “ability to pay” and “equality/proportionality”. There exists, however, a Hungarian equivalent for this principle, “teljesítőképeség”, which means *ability to contribute, ability to pay*. The Constitution of Hungary, which is of no effect from 1<sup>st</sup> January 2012, stated in Article 70/I: ‘All natural persons, legal persons and unincorporated organizations have the obligation to contribute to public revenues on the basis of their income and wealth.’ However, in Article XXX the FLA states – as cited above – that, ‘every person shall contribute to satisfying community needs to the best of his or her *capabilities* and *in proportion to* his or her participation in the economy.’

According to one interpretation the most important change in the new wording of this principle is that there was a shift from a vague, unspecifiable “basis of their income and wealth” to a clearer, more measureable “best of his capabilities/according to their capacity and in proportion to his or her participation/extent of involvement in the economy”<sup>9</sup>. Detailing this provision should be laid down in a cardinal act<sup>10</sup>, however in vain of such, further clarification will be needed. It may nevertheless be stated that the FLH, unlike the Constitution, approaches the issue of public burdens from a ‘*public expenditure*’ and ‘*public needs*’ point of view, not from a ‘*public revenue*’ perspective.<sup>11</sup>

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<sup>8</sup> Interestingly the new FLA contains a second paragraph in Article XXX: ‘*For persons raising children, the extent of contribution to satisfying community needs shall be determined in consideration of the costs of raising children.*’ This reflects on the government’s efforts to encourage couples to give birth to children. Currently Section 29/A of Act CXVII of 1995 on Personal Income Tax contain the provisions of family tax allowance.

<sup>9</sup> Two different English translations of Article XXX of the FLH.

<sup>10</sup> Eva Erdős – A közteherviselés elvének kiterjesztő értelmezése, Miskoli Jogi Szemle 6. évfolyam - különszám, 2011 p.58.

<sup>11</sup> Eva Erdős – A közteherviselés elvének kiterjesztő értelmezése, Miskoli Jogi Szemle 6. évfolyam - különszám, 2011 p.57.

Furthermore, as a part of the historic interpretation, the *tax exemption of the minimum wage* is also derived from this principle. However the Decision of Constitutional Court of Hungary 85/B/1996, ruled against the general exemption of the minimum wage. The decision stated that the – currently of no effect - Constitution of Hungary does not have any theoretical or practical restraint on imposing a tax on the minimum wage. This decision was based on Article 70/E of the previous Constitution and did not take into consideration the question of human dignity or the principle of ability to pay.<sup>12</sup>

What should be the role of the principle of ability to pay? The tax system must ensure that taxpayers bear no more than what they are capable of contributing of the public burden. However straight-forward that may seem, it is not evident that the ruling administration sticks to this principle. *“There is not much room in Hungary to enforce distributive justice due to the widespread application of tax incentives. It is important, indeed to encourage the rich to save and punish those who consume. However the poor have no choice but to consume what they earn.”*<sup>13</sup> There is a 16% flat-tax rate in effect from 2011 onwards, which replaced the progressive rates. Although at the time of writing the study, Professor Daniel Deák in 2010 was before the flat tax came in effect, his prediction seems to pull through: *“This is (the flat-tax rate) a clear sign of renouncing distributive justice.”*

The ability of pay is ensured in Article XXX of the FLH, but there should be further legislation made to clarify what really are the rules and boundaries of “capacity” or “best of his capabilities”.

### 3.1.3 Principle of equality

‘*Arányosság* and *igazságosság*’, proportionality and equality are the equivalent terms in Hungarian for this principle. In the old Constitution, proportionality was declared in Article 70/I saying extent of contributions should be decided “on the basis of their income and wealth”. According to Simon (2011)<sup>14</sup> proportionality is expressed in the term “on the basis of”, whereas the FLH actually says “in proportion to the participation in the economy”. He

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<sup>12</sup> István, Simon. *A közpénzügyek szabályozása az alkotmányban – tervezet*. Budapest: Pázmány Law Working Papers, 2011. p.12.

<sup>13</sup> Daniel, Deak. *Hungary introduces special taxes*. Amsterdam: European Taxation, IBFD, December 2010, p. 546.

<sup>14</sup> István, Simon. *A közpénzügyek szabályozása az alkotmányban – tervezet*. Budapest: Pázmány Law Working Papers, 2011. p. 12.

argues that in both cases the proportionality requirement is fulfilled. The two approaches share the aim of preventing digressive tax burdens – in which case persons in the lower brackets bear a disproportionately substantial part of the tax burden in a digressive tax system.

Subsequently, Simon (2011) outlines the basic practical requirements of proportionality. These are the: (1) tax exemption of the minimum wage, (2) tax exemption of the cost of raising children, (3) proportionality of the overall tax burden.<sup>15</sup> Out of these requirements I have dealt with the tax exemption of the minimum wage, which principle is not in effect in Hungary. I have also mentioned the recently introduced family tax allowances. The question of proportionality of the overall tax burden is relevant in this case but also falls beyond the scope of this chapter. Digressiveness stems from *indirect taxes* in Hungary, and this digressiveness, especially in a country where there is a flat-tax rate in personal income taxation, can only be mitigated by decreasing the overall tax burden. The Constitutional Court of Hungary – albeit its competence on the field of taxation has been withdrawn – ruled in its Decision of 1531/B/1991, that „the Constitutional Court of Hungary does not investigate tax rates; tax rates only raise constitutional concerns when the rate is excessive to such an extent (*is of confiscating nature*) that results in the taxpayer becoming unfeasible”.

To conclude, the documentation and wording of the equality principle is deemed as effective. However when we analyse the basic practical criteria set out by Simon (2011), we can state that there is still ground to improve in implementing this principle.

### *3.2 Field-bound provisions – Act XCII of 2003 on the Rules of Taxation*<sup>16</sup>

Act XCII of 2003 on the Rules of Taxation entails multiple principles regarding taxation and the legal procedure of taxation. This Act in general – as authorized by Article 40 of the FLH – regulates the tax system. It does not shed light on all necessary clarifications identified in the FLH (most notably the need for clarification in Article XXX of the FLH), but lays down basic principles that are for the good of the taxpayer. The real content and scope of these principles

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<sup>15</sup> István, Simon. *A közpénzügyek szabályozása az alkotmányban – tervezet*. Budapest: Pázmány Law Working Papers, 2011. p. 16.

<sup>16</sup> Chapter 3.2 „Field-bound provisions – Act XCII of 2003 on the Rules of Taxation” is based on and translated –in its entirety- from: Gábor, Földes. *Adójog (Hungarian Tax Law) – 2. Edition*. Budapest: Osiris, 2004. p. 103-119.

materialize in judicial and civil service practices. Distinction should be made between normative and declarative principles; the latter does not need legal regulations as it has no regulative effect. The overviews of these field-bound principles have been written based on the “Hungarian Tax Law” textbook by Gábor Földes (2004).

### 3.2.1 Legality

Paragraph 2 of Article 1 of Act XCII of 2003 on the Rules of Taxation provides: *„Taxpayers and the tax authority may exercise their rights and fulfil their obligations in compliance with the provisions set forth in this Act and in other acts. If vested by law with discretionary jurisdiction, the tax authority shall exercise such right as consistent with the purpose of authorization and within the framework of law. „* The legality principle expects both the tax authority and the taxpayer to obey the law throughout the entire taxation procedure. This principle supposes that all procedural and substantive rules of taxation are squarely defined. From the tax authority’s point of view legality means complying with procedural and substantive prescriptions, regardless of the circumstances which may occur.<sup>17</sup> From the taxpayers’ perspective legality means (1) conducting activities lawfully and exercising law in accordance with the purpose of the law, (2) prohibition of abuse of law.

### 3.2.2 Joint ‘legality and success’ principle

Paragraph 1 of Article 1 of Act CXII of 2003 on the Rules of Taxation states that, *„the purpose of this Act is to govern taxation procedures in a uniform concept as consistent with the rights and obligations of taxpayers and the tax authorities in order to assure the legality and success of such procedures.”* The main concept of this provision is that throughout the procedure of taxation the tax authority should not cross the line of legality on the account of striving for efficiency. Legality in substantive law terms refers to the prohibition of over- or under taxation, in other words disproportionate taxation.

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1. <sup>17</sup> On the grounds of expedience, the tax authority may want to deter from the laid down rules, however, on the grounds of the principle of legality, such deterioration is prohibited. In: Gábor, Földes. *Adó jog (Hungarian Tax Law) – 2. Edition*. Budapest: Osiris, 2004. p.112.

### 3.2.3 Integrity of taxation

The above cited paragraph of the FLA contains another provision for law-making bodies. The goal of this principle is that these bodies should make sure *“they carry out taxation procedures in a uniform concept as consistent with the rights and obligations taxpayers and tax authorities”*. Furthermore special taxation procedure shall only apply in unavoidable cases, to ensure the integrity and consistency of the tax system.

### 3.2.4 Principle of deliberation

In the second sentence of paragraph 2 of Act XCII of 2003 on the Rules of Taxation there are two criteria outlined regarding deliberation. Firstly, deliberation of the tax authority must not deter from the case it was assigned for and secondly, deliberation must not overstep the boundaries of legality. In no cases shall deliberation be excluded from a taxation procedure. Ruling made by deliberation does not fulfil the legality criteria, if the tax authority infringes the legal criteria of deliberation or if facts under deliberation are unrealistic. The deliberation procedure is a specified case of the general anti-abuse provision. The power of deliberation gives more space to the tax authority to decide whether or not a case constitutes tax abuse.

### 3.2.5 Principle of a fair procedure

This principle is binding for the tax authority. Act XCII of 2003 on the Rules of Taxation allows the tax authority to apply a reasonable, even-handed procedure in special cases designated by this law. For example, paragraph 6 of Article 1 of Act XCII of 2003<sup>18</sup> on the Rules of Taxation sets out special instances when the tax authority can reduce the payable tax. Court judgements make a clear-cut distinction between the conditions of the principle of fair procedure and other provisions on fairness in this Act<sup>19</sup>. The fair procedure also supposes that the tax authority carries taxation procedures in a reasonable manner.

### 3.2.6 Prohibition of discrimination by the tax authority

Article 1 of Act XCII of 2003 states that, *“in all matters, the tax authority must be unbiased and shall act without discrimination in accordance with the law”*. Furthermore, *“unless*

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<sup>18</sup> Paragraph 6 of Article 1 of Act XCII of 2003 on the Rules of Taxation states, that *„the tax authority shall act equitably and reasonably, and if the conditions set forth in this and in other acts are fulfilled, it shall abate tax debts or authorize some form of payment allowance.”*

<sup>19</sup> Most notably Article 73 of Act XCII of 2003 on the Rules of Taxation.

*otherwise provided for by treaty or international convention, discrimination on the basis of citizenship is prohibited in the tax matters of private individual*". Tax authorities of Hungary should in all cases carry out taxation procedures without discrimination and with maximum legality. This anti-discrimination provision, however, only consists of procedural arrangements; there are no substantive law provisions. For the sake of the principle of equality, discrimination cannot be positive either. The borderline between positive discrimination and principles of deliberation and fair procedure is very narrow. Needy taxpayers may receive "positive discrimination" from the authority, but that will in effect count as a result of deliberation.

### 3.2.7 Principle of information-share and publicity of documents

It is the duty of the tax authority to provide necessary information on tax legislation for taxpayers to be able to comply with regulations. The share of information includes the share of both procedural and substantive law provisions. However, this information-share is limited to the essential information a taxpayer would need. Paragraph 5 of Article 1 of Act XCII of 2003 on the Rules of Taxation provides for, that *"the tax authority shall provide taxpayers with all of the information necessary to abide by the law; it shall inform taxpayers regarding tax declaration and tax payment regulations and advise them in respect of exercising their rights."*

### 3.2.8 General good faith and cooperation principle

*"Taxpayers shall exercise their rights in good faith and shall cooperate with the tax authority in the fulfilment of its duties."* This is the wording of the provision also written in paragraph 5 of Article 1 of Act XCII of 2003 on the Rules of Taxation. The 'bona fide' exercise of law and the cooperation criterion have long been fundamental requirements for taxpayers. According to the 'bona fide' provision, the taxpayer is connected to his or her previous statements, especially to previous tax declarations. If the taxpayer makes contradictory statements over time, the tax authority will examine which statement is real and whether the other statements were intentionally deceitful or made by an error. The principle of cooperation means that the taxpayer must help the tax authority in carrying out its duties.

### 3.2.9 Interpretation of contracts according to real content ("A szerződések tartalma szerinti minősítés elve")

Out of all the field-bound provisions, the ‘real content’ principle is of the biggest practical importance and is hence the subject of legal debates. This provision is one of the special cases of the general anti-abuse provision. According to the provision, contracts should not be judged solely on the basis of the formula, the content must also be analysed. When analysing the substance and the form of contracts it should be viewed whether the characteristics of a contract between two parties are in line with what the two parties indicated beforehand. Paragraph 7 of Article 1 of Act XCII of 2003 on the Rules of Taxation states, that “*contracts, transactions and other similar operations shall be judged in accordance with their true content. For the purposes of taxation, an invalid contract or any other legal transaction shall be applicable to the extent of the apparent economic results it carries.*” Feigned contracts therefore should always be interpreted according to the real content of the contract.

### 3.2.10 General anti-abuse provision

The general anti-abuse provision in developed western economies is the number one tool to offset tax evasion – so it is in Hungary. Taxpayers must exercise tax law according to the purpose of law. In the practice of tax law, contracts whose principle purpose is to circumvent regulations are not treated as a lawful. In these cases the tax authority determines tax liabilities taking into consideration what would be the tax payable under normal conditions. Another important principle is that the tax authority does not amend the content of the contract between the two parties; it changes the tax law implications deriving from the contract. The tax authority evaluates the contract solely from a tax law perspective; it does not have competence to examine the invalidity of contracts in a civil law sense. This makes it easier for the tax authority, instead of having to prove the invalidity of the entire contract; it merely has to point out that the contract does not have economic rationality.

## 4. Apportionment between direct and indirect taxes

Tax wedge for individuals in Hungary exceeds EU and world averages; however the average overall cost of one worker for employers was 31.9% of the EU15 average in 2009.<sup>20</sup> This

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<sup>20</sup> Éva, Palócz; Ágnes, Hárs; Zoltán, Matheika; Katalin, Nagy; Péter, Vakhal. *A bérek konvergenciája az Európai Unióban*. Budapest: Kopint-Tárki, February 2011.

implies that albeit income tax burdens (personal income taxes, social contributions, national insurance contributions etc.) are exceptionally high; life standard and general wage level is low in Hungary. To exacerbate this scenario, indirect tax rates are also sky-high with the general VAT rate at 27%, excise taxes between 28.4% and 52%<sup>21</sup>. In fact, planned state revenue according to the 2012 budget<sup>22</sup> from income taxes (PIT, other citizen taxes) is 50% lower (1800 Billion HUF ~ ca. 6.2 Billion €) than from indirect consumption taxes (VAT, excise, registration tax for vehicles) at 3640 Billion HUF ~ ca. 12.55 Billion €. <sup>23</sup>At this point we have to refer back to Simon (2011) who stated that one of the requirements to ensure the equality of the tax system is the proportionality of the overall tax burden. By this he meant, that especially in a country like Hungary where there is a flat PIT-rate in effect, the lowering of, or changing of direct tax policies will not result in a subdued overall tax burden. The regressive nature of the VAT means that the hike of the tax rate from 25% to 27% hits the poor so badly, that is cannot be offset with a general drop in the direct tax rate. Deák (2010) offers a similar opinion: *“In line with a consumption-oriented taxation policy, it would be logical to decrease the overall level of taxation. This is not, however the case in Hungary. The allocation function of taxation is overemphasized in Hungary, a country that has, over the years, centralized though state channels more than half the GDP.”* Tackling the digressiveness of the tax system should be approached from indirect taxes’ point of view. There should either be lower tax rates on consumption to ease those who spend most of their income on non-durable goods (food etc.) while operating a flat-tax rate, or progressivity should be re-introduced in the PIT-rates while applying high VAT rates;- these measures should offset disproportionate allocation of the tax burden.

## **5. Destination principle versus principle of origin in Hungarian tax legislation**

The question of on which party tax on goods and services should be levied in a transaction is an issue of administrative efficiency on both national and cross-border level. In Hungary consumption taxes are to be generally borne by the end-user, however between B2B companies the seller pays, the buyer reclaims VAT. However as part of the battle against tax fraud, there are cases when the principle of origin is replaced by the destination principle.

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<sup>21</sup> Jaslovsky. *Taxation in Hungary*. Budapest: Jaslovsky.com, 2011 p.3.

<sup>22</sup> Act CLXXXVIII of 2011 on the Central Budget of Hungary for the year 2012

<sup>23</sup> Exchange rate calculated at 290 HUF/€.

This hinders fictitious economic activity and safeguards buyers – as I will show it in the subsequent chapter. *“If the rule of the tax of the country of origin were adopted, there would be a danger of creating trade flows based artificially on the difference in the taxes rather than on the difference in comparative costs, but there would be pressure on the Member States to approximate the rates of their taxes, and fiscal frontiers could be removed, as imported goods would already have paid taxes at the rate of the country of origin. If, on the other hand, the system of the tax of the country of destination were applied, production could be concentrated where the comparative economic advantages were greatest rather than where taxation would be lower, as all products in competition on a market, whether of domestic origin or imported, would be uniformly subject to the tax on consumption in force on that market.”*<sup>24</sup>

### *5.1. Destination principle versus principle of origin in the context of Hungarian taxes on consumption*

#### *5.1.1 VAT*

Hungarian VAT legislation separates the cases when destination principle shall be applied from cases where principle of origin is decisive. There are a couple of cases where destination principle is used in transactions between Hungarian residents, but in general VAT is payable for the seller of the product and reclaimable for the purchaser. Article 142 of Act CXXVII of 2007 on Value Added Tax sets out these instances where reverse levy of VAT shall be applied which implements the destination principle meaning payable and reclaimable VAT are both to be borne by the end-user.<sup>25</sup>

Sales transactions between Hungary and other EU Member States are considered intra-community acquisitions or supplies. The destination principle emerges when in case of an intra-community supply the taxpayer may issue an invoice to its EU-based purchaser without charging VAT if it has proof that the goods left Hungary; the buyer would then settle VAT payment, so VAT is payable - and may be reclaimable - in the destination country. The proof that goods have left the country is essential otherwise the taxpayer will have to pay the VAT in the country of origin. EU-based taxpayers supplying goods in Hungary can request VAT registration, however – and it will be further elaborated on in the Representation chapter – non-EU taxpayers supplying goods in Hungary must use a *financial representative* for VAT

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<sup>24</sup> [http://europedia.moussis.eu/books/Book\\_2/5/14/01/01/index.tkl?all=1&pos=171](http://europedia.moussis.eu/books/Book_2/5/14/01/01/index.tkl?all=1&pos=171)

<sup>25</sup> Lecture by Dr. Borbala Kolozs, research fellow at the Institute of Law, Corvinus University of Budapest, on Consumption Taxes

transactions. Companies that are non-resident in Hungary may still reclaim Hungarian VAT if they are registered for VAT purposes in their country of residence. In case these non-resident companies are resident outside the EU, the criteria for reclaiming Hungarian VAT is laid down in bilateral tax treaties<sup>26</sup>.

#### *5.1.2 Excise taxes*

According to Article 3 of Act CXXVII of 2003 on Excise Taxes, the following products are levied an excise tax: hydrocarbon oil, products containing alcohol, beer, wine, champagne, tobacco. Excise tax varies between 28.4% and 52% and in some cases it is a fixed amount. This single phase tax is levied on the manufacturer, importer or wholesaler; however no tax is imposed in export sales. The principle of origin is used when levying excise tax except for exports, where the importer settles excise duties in the country of destination. Within the EU, revenue from excise duty accrues entirely to Member States.<sup>27</sup>

### **6. Principles of democracy in Hungary in the context of developing the national tax system towards global tax systems**

#### *6.1. Democracy and sovereignty in Hungary*

Hungary is an independent, democratic state governed by the rule of law<sup>28</sup>. The source of public power is the people, and these public powers are exercised through elected representatives (indirect democracy), and in exceptional cases, in a direct manner (direct democracy).<sup>29</sup> Hungary's sovereignty has an international legal aspect: as an independent state it is not subordinated under any authorities, its sovereignty cannot be externally limited, however the state – through the democratically elected, reigning administration – can *choose to limit* itself and join the EU or engage in international treaties. Whether or not Hungary should make any commitments that limit its sovereignty, is up to the Members of Parliament, who can authorise the recognition of the binding nature of an international agreement by two-

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<sup>26</sup> For example, the DTC with Switzerland („Regulation equivalent with an Act” 23 of 1982).

<sup>27</sup> [http://ec.europa.eu/taxation\\_customs/taxation/excise\\_duties/gen\\_overview/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/excise_duties/gen_overview/index_en.htm)

<sup>28</sup> Deloitte. *Taxation and Investment in Hungary 2011* – Reach, relevance and reliability. Deloitte Global Services Limited, 2011. p. 19.

<sup>29</sup> Paragraph 4 Article B of the FLH

third majority.<sup>30</sup> However, when joining the EU, both as a legal obligation and because of its severe effect on everybody in the country, there had to be a national referendum. Furthermore, Article Q of the FLH states that Hungary strives for cooperation with every country and nation in the world and also pledges to ensure harmony between international law and Hungarian law in order to fulfil its obligations under international law.<sup>31</sup>

## *6.2. Principle of democracy and the development of the Hungarian tax system*

There should be a clear distinction made between Hungary developing its tax system (1) to meet EU tax standards and regulations, or (2) by engaging in international tax treaties.

Hungary is a Member State of the European Union since 2004 which means that EU Directives automatically become a part of the national legal system through an implementing Act to the extent that individuals can refer to EU Regulations in front of national courts. Hungary entering the EU happened through a fully democratic procedure; therefore legally binding provisions from the EU do not infringe the principle of democracy. As a consequence of being a Member State, Hungary naturally obeys all EU Directives and Regulations on the field of indirect taxation. Hungary retains its sovereignty on the field of direct taxation but in theory accepts that it should be in line with EU law<sup>32</sup>. However Hungary does not show any signs of forfeiting its sovereignty on the field of direct taxation as taxes are crucial for the state to finance itself. Tax wedge in the country is way above regional and EU-level averages - it is the runner-up in world-wide comparison behind Belgium.<sup>33</sup>

As for tax treaties or other international treaties, the previously mentioned condition from paragraph 4 of Article E of the FLH is decisive. If the MPs are elected in a democratic way, then their decision to limit sovereignty in tax matters through treaties is deemed to be democratic as well.

In Hungary, there is still fierce debate regarding obligations that come from external sources. One side – with national feelings - is convinced that with special regard to the EU, Hungary should not support any federal ambitions. The other side, however, is ready to accept – in case

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<sup>30</sup> Paragraph 4 Article E of the FLH

<sup>31</sup> Paragraphs 1-3 Article Q of the FLH

<sup>32</sup> [http://europa.eu/legislation\\_summaries/taxation/index\\_en.htm](http://europa.eu/legislation_summaries/taxation/index_en.htm) Time of last access: 26.03.2012

<sup>33</sup> [http://www.nationmaster.com/graph/tax\\_tot\\_tax\\_wed\\_sin\\_wor-total-tax-wedge-single-worker](http://www.nationmaster.com/graph/tax_tot_tax_wed_sin_wor-total-tax-wedge-single-worker) Time of last access: 26.03.2012

of the EU – the Lisbon-treaty as a European constitution in effect.<sup>34</sup> Concerning international tax treaties that provide for a better harmonised national tax system, there is less public or even academic resistance, due to the specificity of the area.

To complement the overview, it must be mentioned that in its 4/1997 (I.22) decision, the Constitutional Court of Hungary ruled that the binding nature of an international treaty can in fact be subject to posterior norm control.<sup>35</sup>

To bring it all to a conclusion it can be held, that the principle of democracy is not infringed by tax system regulations imposed by external parties as long as (1) in case of the EU, there is a constitutional authority setting out the limits of these interventions and (2) in case of international treaties, the binding nature of its provisions is recognized by the qualified majority of democratically elected MPs.

## **7. Principle of neutrality**

The principle of neutrality (sometimes called “efficiency”) tells us that a tax system should stay out of the way of economic decisions.<sup>36</sup> Neither the Acts (tax codes), nor the effective tax rates are allowed to influence the economic decision of the consumer. The question of neutrality in tax systems arises concerning consumption taxes, such as the VAT, rather than income taxes. There are large volumes of change in the majority of tax codes every year, making it difficult for all persons to comply and also for authorities to use. About the Hungarian tax system it can be said that the consumption tax burdens are generally very high for everyone<sup>37</sup> and therefore all persons (legal and natural) tend to exploit any inconsistency in the tax system to mitigate their payable tax. As a result of this taxing climate, neutrality cannot be eliminated until consumption tax rates are evened out. Act CXXVII of 2007 on

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<sup>34</sup> Own notes from a lecture held by Dr. Marta Dezső, full-time professor of Constitutional Law, Eötvös Loránd University, Budapest

<sup>35</sup> [www2.juris.u-szeged.hu/eujog/tartalom//docs/tematikak/bj-nj.rtf](http://www2.juris.u-szeged.hu/eujog/tartalom//docs/tematikak/bj-nj.rtf)

<sup>36</sup> Own notes from a lecture held by Dr. Borbála Kolozs, research fellow at the Institute of Tax at Corvinus University of Budapest, on Consumption Taxes.

<sup>37</sup> „The Hungarian tax system is designed to tax income, sales and other specific transactions, rather than capital. Most often individuals are subjected to pay personal income tax, while businesses, irrespective of their legal form, pay corporate income tax. Domestic sales are typically subjected to a general sales tax (VAT), to which other taxes (e.g. excise) are occasionally added.” Even if capital is not taxed, social contributions payable both by employers and employees are very high.

Value Added Tax details the tax rates for the certain group of products, outlining a wide variety of exempted goods (both subjective and objective exemptions), and three different VAT rates (5%, 18% and a general 27% rate). Hungary filed a special request to the European Commission to be allowed to have a 27% VAT rate because 112/2006 EC Directive limits the maximum VAT rate to be 25%<sup>38</sup>. Products and services that fit into each category have been sorted there with purpose to subsidize and encourage certain activities and products, but in reality maintaining multiple VAT rates results in complex and convoluted administration while creating a hotbed for using tax loopholes. In Hungary *inter alia* postal and financial services, education, sport, lottery and dormitory accommodation are exempted by object, whereas Courts of Justice, government and municipal authorities, companies with revenue under 5 Million HUF and non-profit organizations among others are exempt subjectively. Aiding culture, education (e.g.: books, videos, sheet music) and biotechnological products for the disabled only have 5% VAT on them. 18% VAT applies for quite a few products or services including, dairy products, products made using flour, commercial hotels and district heating. The general VAT rate is 27%, a rate that is ranked number one in a worldwide comparison. Services and activities are all sorted into the different VAT categories (e.g.: driving school lessons and private lessons are exempted objectively) using “TEÁOR” classification codes. There are clear-cut infringements of the neutrality principle in Hungary. Legal practitioners, entrepreneurs are all into the practice of squeezing certain activities under specific TEÁOR codes, classifying products differently to gain a lower VAT rate. VAT evasion therefore remains a problem. *Rate differentiation and the use of exemptions create welfare-reducing distortions as well as adding to complexity.*<sup>39</sup> Furthermore, referring back to the principle of equality, the regressive nature of the VAT must be put under extra surveillance with such a high general VAT rate in effect.

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<sup>38</sup> 112/2006 Directive sets the normal VAT rate between 15-25% and the reduced rate at 5% minimum.

<sup>39</sup> Stuart, Adam; Timothy, Besley; Richard, Blundell; Stephen, Bond; Robert, Chote; Malcolm, Gammie; Paul, Johnson; Gareth, Myles and James, Poterba. *Tax by design – The Mirrlees Review. Institute for Fiscal Studies*. New York: Oxford University Press, 2011. Chapters 6 and 7.

## **8. Effect on representation by the development of national tax system**

Joining the EU and establishing DTCs with several countries made fulfilling tax liabilities easier in Hungary. As described in the chapter about VAT, for companies resident and registered for VAT purposes in other Member States can claim the Hungarian VAT. Companies resident in third states can claim the same in accordance with the provisions of the respective DTCs. Companies with legal entities (permanent establishments, subsidiary companies) in Hungary can interact with the tax authority themselves, since they are in the register. The question arises what happens if a company does not have a registered entity or permanent establishment in Hungary but still engages in economic activity. Paragraph 1 of Section 9 of Act XCII of 2003 on the Rules of Taxation states that, *“any foreign company that is engaged in economic activities in Hungary without being required to establish a resident business entity may satisfy its local tax liabilities through a financial representative.”* Although it is against EU law to oblige non-residents to appoint of a tax representative, provisions in Hungarian law detailing the exact task of a tax representative are lax, and requirements are within the pale of reason.<sup>40</sup> The financial representative is merely a contact person who liaises between the authority and taxpayer company, which is essential to fulfil tax liabilities in Hungary. Companies operating in Hungary or in any other country in the world would have to deal with taxation and to cope with that they would need to appoint a representative.

## **9. Rule of law affected by the development of national tax systems**

*“The relatively sound judicial framework that sustains the rule of law and provides consistent protection for property rights has contributed to Hungary’s stability and long-term competitiveness.”*<sup>41</sup> The above overview was written in 2012; however the situation is far more serious. First it is worth examining the same issue inversely, how has the rule of law been affected in Hungary and what implications it may have on the tax system? Many professionals argue that the new FLH blunts the system of checks and balances in Hungary<sup>42</sup> inter alia because the pillars of democracy have slowly been decomposed, to the extent that

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<sup>40</sup> Section 7 (Representation of Taxable Persons) of Act XCII of 2003 on the Rules of Taxation deal with the question of representation.

<sup>41</sup> <http://www.heritage.org/index/country/hungary> Time of last access: 14.03.2012

<sup>42</sup> Lecture held by Dr. Péter Szegvári, Visiting Professor of Constitutional Law, Eötvös Loránd University, Budapest

for almost a year Hungary was in the focus of media attention from all over the world. From taxation point of view the two biggest issues at hand are the Constitutional Court of Hungary and the changes in the ordinary judiciary. Citing Kim Lane Scheppele's study; *"the Constitutional Court, which once had the responsibility to review nearly all laws for constitutionality, has been killed off in three ways. First, the government expanded the number of judges on the bench and filled the new positions with their own political allies. Then, the government restricted the jurisdiction of the court so that it can no longer review any law that has an impact on the budget, like laws pertaining to taxes and austerity programs, unless the law infringes particular listed rights. Finally, the government changed the rules of access to the court so that it will no longer be easily able to review laws in the abstract for their compliance with the constitution. Moreover, individuals can no longer challenge the constitutionality of laws without first going through a lengthy process in the ordinary courts. The old Constitutional Court, which has served as the major check on governmental power in a unicameral parliamentary system, is now functionally dead."*<sup>43</sup> The most important implication is that there is no institutional check that would proofread tax laws and analyse whether or not its provisions are in line with the principles of the FLH. The other serious change glooming over taxation is the amendment of the judiciary. Democratic countries apply the separation of powers<sup>44</sup>, which is an essential element of a modern state installation – judicial power therefore has to be independent. The judiciary has been changed by lowering the retirement threshold from the age of 70 to 62 with immediate effect, forcing more than 200 sitting judges to retire. Also there is a new law requiring the Supreme Court president to have 5 years of Hungarian juridical experience, which disqualifies and ousts the current president.<sup>45</sup> There has been a National Judicial Office set up and led by a single appointed judge, and this council has the authority *"to replace the retiring judges and to name future judges. This person also has the power to move any sitting judge to a different court. A new constitutional amendment – to the new constitution! – will permit both the public prosecutor and the head of this new National Judicial Office to choose which judge will hear each case."* To top it all, both the person at helm at the National Judicial Office and also the

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<sup>43</sup> <http://krugman.blogs.nytimes.com/2011/12/19/hungarys-constitutional-revolution/#> Time of last access: 19:29 24.03.2012

<sup>44</sup> Lecture held by Dr. Péter Szegvári, Visiting Professor of Constitutional Law, Eötvös Loránd University, Budapest

<sup>45</sup> <http://www.businessweek.com/news/2011-12-13/hungary-elects-new-top-judges-ousting-supreme-court-chief.html> Time of last access: 20:41 23.03.2012

public prosecutor are assigned to 9 year terms, overarching more than two parliamentary cycles. *“The independence of the judiciary is over when a government puts its own judges onto the bench, moves them around at will, and then selects which ones get particular cases to decide.”*<sup>46</sup>

The conclusions of this inverse hypothesis is that legal guarantees for a fair tax system obeying principles of the FLH or a fair trial following principles in Act XCII on the Rules of Taxation are currently non-existent. It cannot be stated that Hungary will stop functioning as a rule of law state in practice, but regulatory changes seem to be pointing to a different direction. Neither the EU, nor the international community would allow Hungary to implement tax laws contrary to treaties or EU principles – and this is definitely not where the current administration is heading, but recent law amendments have – quite reasonably – rang the alarm. The rule of law, as a principle, has not been infringed in a sense that the current administration’s landslide victory was free and democratic, and so were the subsequent massive changing and creating of law.

Getting back to the original question of how rule of law changed or would change in response to the development of the Hungarian tax system towards a global tax system, Hungary declares in Article 1 of the FLH that it is a rule of law state. Similar to sovereignty, Hungary may decide independently whether or not it will obey international regulations as law or not.<sup>47</sup> Rule of law means that the state has a consistent system of rules and norms, all of which can be derived from the FLH and that the system is sound, reliable and predictable. Should Hungary accept other sources as law; that will mean an extra effort harmonizing and integrating new material into the existing legal system. EU or international tax provisions are generally meant to be acceptable and applicable for states to implement, therefore – in my opinion – rule of law is endangered domestically and not in a transnational sense.

## **10. Conclusion**

Regarding the constitutional principles (legality, equality, and ability to pay) it can be said that they are incorporated fairly well in the FLH both wording- and content-wise. Their implementation is, however, does not generally materialize in practice. The excessive rates of indirect taxes levied combined with the flat PIT-rate raises concerns for disproportionate

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<sup>46</sup> <http://krugman.blogs.nytimes.com/2011/12/19/hungarys-constitutional-revolution/#> Time of last access: 19:29 24.03.2012

<sup>47</sup> Paragraph 3 of Article E of the FLH

treatment. Furthermore, the tax exemption of the minimum wage should be included in the FLH or at least in Act XCII of 2003 on the Rules of Taxation, because it currently lays unincorporated and with the possibility to impose tax on it. The principle of neutrality is being infringed by rate differentiation and the use of exemptions on the field of consumption taxes. The Hungarian tax system is on a sound democratic base, given the political legitimacy the current government has. However, recent actions of the government are decreasing legitimacy at a fast pace. From taxation point of view the building of political influence in the judiciary and the axing of the Constitutional Court of Hungary's powers are of main importance. But there are also positive areas to mention: representation and field bound provisions set out by Act XCII of 2003 on the Rules of Taxation – which have of course bigger practical influence than constitutional principles – function well. For foreign companies who want to engage in economic activities in Hungary, the above two areas are essential – how they can fulfil their tax liabilities and how will the taxation procedure be carried out. On the surface, it seems as Hungary has a user-friendly tax system.

All in all, in my opinion the problems were never in the principles of the Hungarian taxation. There is a lengthy list of provisions I have outlined, all striving for a better tax system. Taking a quick look at these principles, one would not think there are major problems with it. But there are. Problems are rooted deep down in public policy; tax burdens are excessively high compared to the low life standard in the country, but the disastrous indebtedness keeps it all this way out of necessity. The icing on the cake is that the current government battered substantially the legitimacy of the state, exacerbating these conditions. There is a lot to do.

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