A QUIET TAX REVOLUTION IN HUNGARY?

Author(s): György Matolcsy and Tamás Pesuth

Source: *Society and Economy*, Vol. 37, Supplement (November 2015), pp. 3-10
Published by: Akadémiai Kiadó
Stable URL: https://www.jstor.org/stable/43773861

Society and Economy 37 (2015) Suppl, pp. 3–10
DOI: 10.1556/204.2015.37.S.2

A QUIET TAX REVOLUTION IN HUNGARY?

Interview with Dr. György Matolcsy, Governor of the Central Bank

– After 2010, the Government implemented a substantial restructuring in the Hungarian tax system. What do you believe are the major results of the implemented measures?

– It is certainly an important accomplishment that we managed to stabilize and consolidate the budget in such a manner that during the process the total tax burden decreased by 1 per cent of GDP according to the data of Eurostat, or by 2 per cent of GDP, if we also consider the mandatory private pension fund membership fees compared to the period before 2010 *(Figure 1)*. This should be highlighted, because we had to start the transformation of the tax system after a period during which the budget deficit was 6.7 per cent on average and approached 10 per cent several times. That way, we simultaneously had to launch reforms improving economic growth and to stabilize the debt increasing in an unsustainable manner by adjusting the budget.

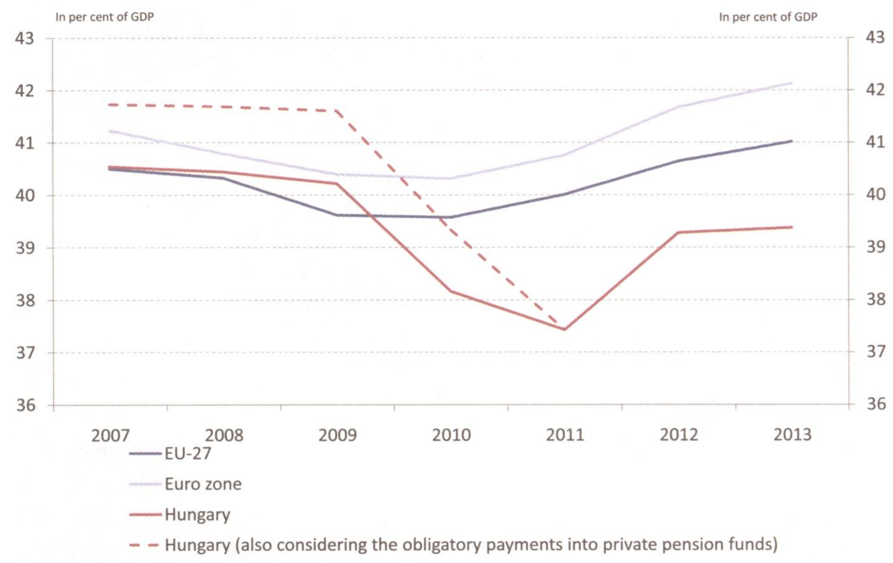

Figure 1. Tax centralization in Hungary and in the European Union

Source: Eurostat, MNB

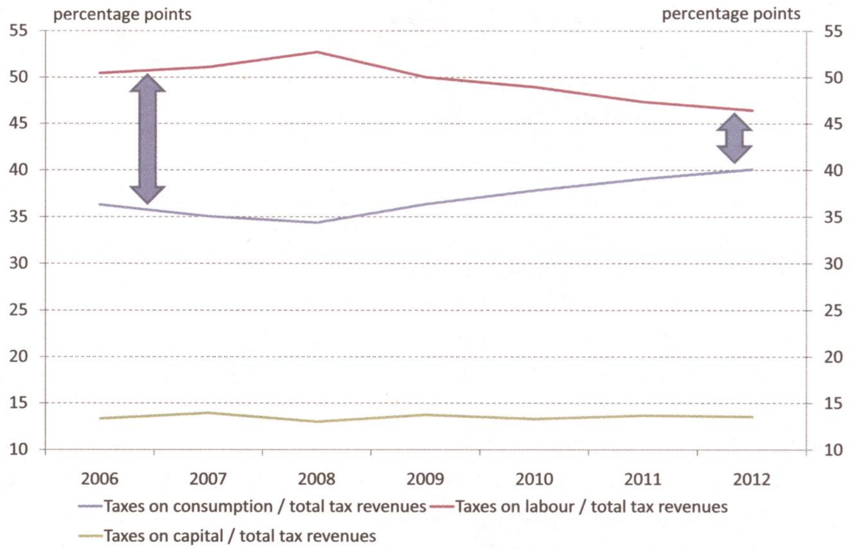

Figure 2. The change of the tax structure in Hungary

Source: Eurostat, MNB

It is an especially important outcome of the transformation that we managed to shift the center of gravity meaningfully from taxes on labour towards taxes on consumption, turnover and negative externalities: the ratio of taxes on labour compared to the GDP decreased by 2.6 percentage points, while the ratio compared to the total tax revenue went down by 3.5 percentage points between 2009 and 2012 *(Figure 2).* In respect of taxes on labour, the Hungarian taxation prior to 2010 had been by far the tax system that imposed the highest burdens and exhibited the strongest progressivity in the region, coupled by an unjustifiably loose welfare system for inactive persons, which led to a labour force participation rate in Hungary that was one of the lowest in the European Union. The marginal tax wedge, which shows the increase in taxes and social contributions triggered by wage growth as the ratio of the full costs of employers, reached 64% even with average wage, which was higher than the regional average by over 20 percentage points. This outstandingly high tax burden on labour penalized incomes received for additional work disproportionately, encouraged tax evasion and reduced the return on investment into human capital significantly, which decreased the attraction of the country for enterprises that create jobs with high value added.

By the introduction of the flat-rate tax system we managed to reduce the marginal tax rates to the level of the rest of the countries of the region, which increases work intensity and reduces the concealment of income in groups with a stronger attachment to the labour market and characterized by a higher labour market participation rate. The reform of the personal income tax increased the net income of employees by 450 billion forints between 2011 and 2013. Its effect is already registered in the macroeconomic statistics, which show an increase in both consumption and household savings.

It can also be considered a great accomplishment that, owing to the family tax allowance, the Hungarian tax system now takes into account not only individual income, but also the number of dependant family members. In my opinion this enhances the fairness of the tax regime and, in addition to its encouraging effect in demographics, also improves the employment incentives. By incorporating this transfer with a social policy aim into the tax system, the tax system is capable of taking into account that having children incurs additional costs at the individual level, at the same time, creates a significant benefit for the public. On the other hand, it reduces the tax burden on the affected employees and thus increases the labour supply for the primary wage earners, but also encourages in the families the return of second wage earners to the labour market.

Provision of support to the employment of low income earners was a special priority for the Government, since this is a large but vulnerable employment group, which is highly exposed to the economic cycles, and they are known to be affected by structural unemployment, plus recession also hit them strongly. Earlier the tax credit had been supposed to reduce the effective tax wedge in that group compared to the general rules of personal income tax; however, according to the experiences the regime of tax credit was not efficient. In 2010 over 75 per cent of the taxpayers took advantage of the tax credit and according to the Household Budget Survey, beneficiaries of the tax credit had been typically members of households with higher equivalent incomes. Therefore, the tax credit affected a community that had been too broad and did not support households with really low income.

In order to support in a focused manner the employment of groups of lower income earners, characterized by high elasticity at the extensive margin and in a worse situation in the labour market, and to reduce unreported employment, the Government introduced targeted benefits as part of the Job Protection Action Plan. The benefits are focused on five target groups: employees under the age of 25, those over the age of 55, unskilled labour force, persistently unemployed persons and those who return from maternity benefits to the labour market. That way, as opposed to the tax credit, the targeted benefits can reach those groups that are really in need and where the labour force participation rate is really low. Furthermore, the targeted benefits are not phased out even for persons with a higher income, that way, as opposed to the tax credit, they do not increase the marginal tax burdens and do not encourage wage concealment, either.

It demonstrates the success of the implemented measures that labour force participation rate, which was 55 per cent in 2010, has shown a rising trend over the recent years and in the first quarter of 2014 almost reached 59 per cent in the 14–74 demographic.

– **How do the changes that occurred in Hungary fit into the international trends?**

– During the crisis the issue of growth-friendly budgetary consolidation received special attention in the world, and within that, one of the priorities was the possibilities of transforming the tax systems to make them more economy-stimulating. In the recent period, studies dealing with such a transformation of the tax system have been receiving increasing attention both in the theoretical and empirical literature, and also among the analyses prepared by the OECD, the IMF and the European Commission. Naturally, there is not one single optimal solution for every country, but it is safe to say that it was a common feature of the theoretical literature and the policy proposals made by the institutions mentioned above that within the tax system they consider it necessary to reduce those taxes on labour and capital, which have the most adverse effect on economic growth, and which they consider capable of being financed, in order to maintain the balance of the budget, by increasing the less harmful consumption, environmental and property taxes. The most recent Eurostat data also demonstrate that in the transformation of the tax structure countries of the European Union and the region reduced the ratio of taxes on labour, while they increased the ratio of taxes on consumption over the recent years. In addition, owing to the narrower latitude of the budget, targeted benefits have been introduced in several Western European countries in order to increase employment, which were focused, similarly to Hungary, on groups in an adverse position in the labour market and responding more sensitively to the financial incentives. That way, over the recent years targeted benefits have been introduced in Belgium, Portugal and Sweden for senior citizens, in Belgium for employees with lower qualifications, in Belgium and Italy for younger employees and in Italy for women and people living in less developed regions. In the other countries the benefits typically reduced the burdens of employees but, for example, in Belgium they were incorporated into the social contributions payable by the employer, while in France or in Italy the employer is allowed to reduce its corporation tax by the benefits on its employees. Therefore, concerning the transformation of the tax structure in Hungary, in total it is safe to say that it is in harmony with the international trends and recommendations.

– **How did the transformation of the tax system affect the business sector?**

– The taxation of businesses is an especially sensitive area, since in addition to the revenue needs of the budget, it must also take into account the interests of businesses, it being understood that fundamentally their activities shape the economy of the country. In order to increase capital investments and employment persistently, we need both competitive large corporations establishing operations in Hungary and the sector of small and medium enterprises, which implement almost half of all capital investments and employ approximately two-thirds of all workers. Accordingly, in the last 20 years several benefits have been offered to both the SME sector and large corporations within the regime of the corporate income tax. At the same time, it was a problem that the regime of the benefits was not transparent or efficient, and typically only certain large corporations could take advantage of them. For that reason, while maintaining the development tax benefits supporting the continued growth of the economy and employment, the Government significantly reduced the tax burden of the SME sector. Such measures were employed for this purpose as the reduction of the corporation income tax to 10 per cent, the implementation of new tax types designed for small enterprises (itemized tax of small taxpayers, tax of small enterprises) and the alleviation of the administrative burdens. The new tax types implemented in 2013 were designed to remedy two major problems of the SME sector.

On the one hand, it is safe to say about the SME sector that they are characterized by more labour intensive production than large corporations; therefore they are more affected by the higher tax burdens on labour. For that reason the tax of small enterprises (KIVA) was designed in such a manner that it replaces not only the corporation income tax payable on profit, but also the tax burdens of the employer payable on wages (social contribution tax, contribution to vocational training). That way it offers an expressly favourable solution for enterprises with a high ratio of wages intending to develop, expand. The other problem was the relatively high administrative burdens on the smallest enterprises, which clearly caused them a competitive disadvantage compared to larger enterprises. Even the reporting of KIVA is substantially simpler than corporation income tax, but for enterprises of an even smaller size the itemized tax of small taxpayers (KATA) offers a more targeted solution for self-employed persons, since in this scheme the payment of an itemized tax of HUF 50 thousand (25 thousand for entrepreneurs not working full time) practically replaces all other taxes and thereby releases persons intending to start their own business from a significant administrative burden.

Parallel with that, in an effort to maintain the balance of the budget and to ensure more equitable public burdens, the tax burden of certain sectors surviving the financial-economic crisis in the healthiest state and typically dominated by large corporations, providing services to the domestic market, was raised. At the same time, the Government saw to it that the tax burdens of sectors manufacturing export goods did not increase. The reduction of taxes on labour and the increase of consumption taxes also contributed to the improvement of the competitiveness of medium and large enterprises manufacturing export goods. The increase of VAT does not affect export, therefore its increase does not impose any additional burden on companies typically manufacturing export goods, on the other hand, the reduction of taxes on labour reduces their wage costs as well.

– At the same time, it is raised as a criticism concerning the surtaxes whether these will prevent economic growth and employment creation by making the economic environment unpredictable. Do you see this kind of taxes as successful, and in your opinion should they be sustained in the long term?

– We should not make generalizations in the case of the surtaxes, either, and we should make a distinction among them according to what kind of tax base they are levied on from the point of view of economics. These tax types are also called sectoral taxes, some of them are in reality turnover, consumption taxes (telecommunications tax, financial transactions duty, insurance tax), others are property type taxes (public utility tax) and a smaller part can be considered taxes on capital (bank tax, income tax of energy providers). Therefore, from the point of view of economics most of the solidarity taxes belong to the category of less distortionary tax types. We must not forget, either, that the surtaxes were implemented in a crisis environment when it was necessary to reduce the budget deficit quickly without significantly straining the long-term capacities or creating conditions under which enterprises cannot operate. That way, the sector-specific surtaxes were essential tools for the fulfillment of one of the most important aims of the government, i.e. keeping the deficit of the government budget under 3 per cent.

In addition, the surtaxes were also instrumental in making the sharing of public burdens more equitable. Based on the experiences of the last 20 years, the Hungarian tax system was not able to handle the structural differences between companies and branches, which led to a situation of no fair sharing of burdens. The effective tax burden, i.e. the ratio of corporate income tax to profits before tax was lower in certain branches generating significant profits (in 2009 this value was only about 5–6 per cent in the energy, telecommunications and retail sectors) than the average of the national economy, in which one of the factors was that typically larger enterprises could take advantage of the tax benefits more efficiently, and presumably they also had better access to tax optimization tools applying international transactions in this scope. In the long term these disparities can also be resolved by the appropriate regulation of the corporate income tax and other relevant tax types, but in the crisis environment at that time the need to stabilize the government budget required a fast reaction. Therefore, whether the adjustment of the tax system was performed by amendments within the existing tax types or by the imposition of new public burdens is not the point here, the point is whether they made the sharing of public burdens fairer. In addition, some of the surtaxes (such as the financial transaction duty or the telecommunications tax) have the important virtue of loading wide tax bases, that way they result in a significant revenue even if the tax rates are extremely low, furthermore, their collection incurs low administrative costs. As to the future, I can say that maintaining a fair sharing of burdens built on wide tax bases continues to be necessary in order to ensure a balanced budget, but the form and exact rules of this could change depending on the circumstances.

– In the post-crisis period the reduction of tax evasion and acting against tax fraud was assigned more weight. There is a global effort in this area as well, to which Hungary is connected. What progress do you anticipate in this field in Hungary and globally?

– Tax evasion is a significant problem in Hungary, but it is not our unique problem, rather one that affects every country in the world to a different extent. Based on international surveys, in the case of Hungary the black economy, estimated at 22–25 per cent of GDP, is higher than the value of 12–16 per cent prevailing in Western Europe, but is lower than the 24–28 per cent typically registered in East-Central Europe. Tax evasion or the black economy has an adverse impact on several segments of the economy. It causes a competitive disadvantage for legally operating enterprises, reduces the revenues of the government budget, which results in a situation in which the tax burdens are more strongly concentrated on enterprises performing reported activities, distorts economic statistics and as a result, decision-making also becomes more difficult. There are several reasons for tax evasion: the size of the tax burdens on the economy, the probability of being caught and the size of the fines, i.e. the effectiveness of audits by the tax authority, the perception of the quality of services provided by state institutions, the social norms of the microenvironment, but it is also affected by the perceived penetration of the hidden economy.

Without any doubt, countering tax evasion has been one of the most important economic policy objectives of recent years in countries of the developed world. In accordance with that, the Hungarian Government also considers this area as a priority. Several measures have been introduced in an effort to increase the formal sector of the economy, which attempted to reduce the informal economy through various channels. The measures aimed at improving the efficiency of audits by the tax authority, such as the implementation of online cash registers, focused on the prevention of concealment of enterprise revenues, since by this we can reduce several other forms of tax evasion, for example, cash in hand payment of wages or payment in semi-legal ways.

The reduction and transformation of taxes on labour was a very important element in the fight against the hidden economy. The personal income tax regime applied prior to 2010, which strongly motivated both the employer and the employee to conceal their additional incomes, significantly contributed to the consolidation of the "culture" of tax evasion. In addition to increasing work intensity, the reduction of the marginal tax rates to the regional level also contributed to the reduction of concealment of income. Besides the above, the implemented flat-rate tax regime also meant large-scale simplification, which reduced the collateral costs of tax payment (reporting, interpretation of rules) and thereby also weakened encouragement for tax evasion. The tax type of KATA, which was introduced for self-employed persons, contributed to the decrease of the unreported activities of micro enterprises through the significant reduction of the tax burden and administrative obligations.

In addition, Hungary also joined to the multilateral agreement of the OECD, regulating international cooperation on tax matters, and initiated the conclusion of agreements on exchange of information with several states, which means obtaining new tools in the combat against tax fraud applying international transactions. Although it is difficult to measure to what extent the ratio of formal economy increased, we can infer from the most recent retail turnover figures and the audit statistics of the National Labour Office that the implemented measures were effective. This notion is also confirmed by the VAT revenues, which significantly exceeded in the first months of the year 2014 the corresponding figures registered one year earlier, despite low inflation, having increased to an extent even higher than the growth of retail sales or household consumption. Completing the connection of online cash registers means that in the future we can expect the increase of the formal sector of the Hungarian economy to continue.

Tamás Pesuth