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TAX POLICY IN NEW EU MEMBERS: HUNGARY

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This paper is part of a wider research on Tax systems and Tax Policy in EU New Members, carried on at this Department, under the direction of L. Bernardi, M. Chandler and L. Gandullia, and the supervision of V. Tanzi.

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KEYWORDS: Taxation, Tax Reforms, EU New members, Hungary

TAX POLICY IN NEW EU MEMBERS: HUNGARY

by

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Abstract
This paper is a part of a wider research program on taxation in EU New members, directed by L Bernardi, M. Chandler and L. Gandullia under the supervision of V. Tanzi. Hungary is one of the fastest growing OECD economies, which outperformed most of the other countries during the 2001-2003 international slowdown. Total fiscal pressure, albeit a declining trend during the 1990s, is considered too high and harmful for potential growth; tax revenue continues to depend much more on indirect taxes and local taxation is still rather low (par. 2). The tax system seems relatively close to the EU ones, but further adjustments of rates and procedures are needed for accession. PIT is a progressive tax, however income from capital and capital gains are taxed separately; CIT is significantly lower than those applied in most of EU countries and a number of tax incentives is envisaged for large-scale investments or offshore companies; VAT rates and excise duties have been recently adjusted to get near to EU levels (par. 3). Labor, and to less extent consumption, are the main sources of tax revenue, while the tax burden on capital and business is very low (par. 4). As of the macroeconomic and budgetary outlook, growth is slightly accelerating, but fiscal policy is required to return to the announced consolidation path. A reorganization of public expenditure is needed and, on the revenue side, tax incentive regimes for firms should be abolished and excise duties further adjusted (par. 5).

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1. Introduction and executive summary

Hungary is a landlocked country in Central Europe, with a population of 10,1 million inhabitants and an area of 93,036 km^2. After the Second World War, Hungary experienced the communist regime until its collapse in 1989. In 1990, free, multi-party parliamentary elections were held for the first time in 43 years. In 1994, Hungary was the first country of the region to formally apply for EU membership and in 1998 the accession negotiations were finally launched. After joining NATO in 1999, Hungary will enter *de facto* into EU in 2004, as the Nice Treaty established it in 2001. Local currency is the forint (HUF=0.0039€[1]).

Growth in Hungary has averaged 4.5 per cent since 1997, and was well maintained at close to 4 per cent in 2001, when GDP was about 61 billion € (Per capita, PPP unweighted: about 6,150 €); in the same period unemployment fell below six per cent. The economy outperformed most of the other countries during the 2001-2003 international slowdown largely due to a strong fiscal impulse and to a consequent increase in private consumption. The highly expansionary fiscal policy caused a worsening of the general government deficit, which reached 5.2 per cent of GDP in 2001 and 9.2 per cent in 2002. Inflation was below five per cent in 2002.

Total fiscal pressure in Hungary, after a declining trend during the first half of the 1990s, reached 39 per cent in 1999 and is rather stable since then. This level is considered too high and harmful for potential growth. Furthermore, as in other New members, tax revenue continues to depend much more on indirect taxes while the shares of revenue generated by income taxes on capital and labor as well as property taxes remain relatively low. Social security contributions, making up one third of total revenue, are by law levied predominantly as the employers' share, thus generating a high tax burden on labor to the detriment of labor market participation and employment. As in any former communist country, the share of Local governments' revenues on GDP, generally used as an indicator of the size of Local governments, appears rather low if compared with the EU countries' levels. The revenue autonomy too is still very low, with only one third of Local government financing coming from own revenues, but major changes have been occurred since the beginning of the transition period[2].

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[1] This is the average exchange rate (ECB) in 2003.

[2] At the beginning of the transition, the rate of revenue autonomy was only one fifth. In 10 years it doubled, reaching 39.1 per cent in 2000. In 2000, for the first year, the rate of state grants (block grants

The time development of the tax structure since the beginning of the transition period in 1991 was dominated by the structural changes that have been achieved in order to bear up to the fiscal systems prevailing in the EU. In the earlier period from 1991 to 1996 one realizes the effects of the economic transition in marked changes of the level of total taxation, which was decisively lowered from 47 per cent of GDP to 41 per cent between 1991 and 1996 and has remained around 39 per cent since then. This trend is explained by a substantial reduction in the direct taxes to GDP ratio and also by a decrease in the social contributions to GDP ratio, whereas indirect taxes share on GDP lowered to a less extent.

The tax system in Hungary seems relatively close to the EU 15 ones, though some distinctive features are still present and further adjustments of rates and procedures are needed for accession to the EU. A progressive personal income tax with three brackets is applied on aggregate individual income, with the exclusion of income from capital and capital gains, which are taxed separately; a number of tax allowances in the form of tax credits are granted. The taxation of corporate profits is based on a partial integration system: corporate profits are taxed at a flat rate of 16 per cent[3] and dividends are taxed by way of a flat rate withholding tax of 20 per cent; beside the standard regime, a number of tax incentives is envisaged for large-scale investment or offshore companies.

The VAT system is very similar to that applied within the EU, although transitional measures regarding rate levels and exemptions have been required to the EU; the VAT standard rate is 25 per cent, the highest among the New members, but reduced rates of 15 per cent and 5 per cent are applied on some basic products and services[4]. As stated by the EU legislation, excise duties are levied on alcoholic beverages, tobacco and hydrocarbon fuels. Among local taxes, a major role is played by the local business tax, which accounts for some 85 per cent of all local governments tax revenues. Finally, relatively high social security contributions and payroll taxes must be paid by employers on gross wages, thus augmenting the direct cost of labor.

As to the distribution of fiscal burden according to economic function, the main source of tax revenues as percentage of GDP comes from employed labor and, to a

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and specific grants) within local budget (38.9 per cent) was less than the rate of own revenues. The total government transfers including shared taxes (15.0 per cent in 2000) are over 50 per cent of the total local revenues, whereas they were 70.9 per cent in 1992, thus resulting in a significant change in the revenue structure of Local governments.

[3] This rate has been reduced from 18 to 16 per cent since January 1, 2004 (law adopted by the Hungarian Parliament on November 10, 2003).

lower extent, from consumption. If compared with EU 15 countries, Hungarian factor taxation shows a higher role of taxes on consumption, while taxes on employed labor do not differ significantly from the EU average. Implicit tax rates confirm the overall picture.

Considering the macroeconomic and budgetary outlook for 2003 and 2004, growth is projected to slightly accelerate and new inflation targets have been established in accordance with the Central bank; fiscal policy is required to return to the announced consolidation path, with a stabilization of the deficit at around five per cent in 2003 and a further reduction to below four per cent in 2004.

Tax reforms in recent years appear to have been driven by the commitment to gradually harmonize with the EU and by the aim to further improve the environment for the business sector. The former objective has informed mainly the VAT and excise duties systems, whereas the latter has been translated into a favorable corporate tax regime and into a wide range of tax incentives, especially for offshore companies. At present, Hungary's taxation system is to a large extent aligned with the EU's requirements, although further harmonization efforts are needed notably as regard to rates of VAT and excise duties. Another recommended action concerns the progressive reduction of social security contributions, in order to reduce the tax burden on labor and hence stimulate employment. The corporate taxation regime should also be reconsidered in light of the risk of a harmful tax competition within the EU and a possible EU's action against specific incentives.

2. The structure of the system at the end of the 1990s and its development after the collapse of U.S.S.R.

2.1 A broad view at the current structure of taxes and social contributions

In 1999 the level of aggregate taxation in Hungary was 39 per cent of GDP, roughly 2 percentage points below the EU average. The distribution of fiscal revenues, which can be split into two third of taxes and one third of social contributions, shows some striking differences with the EU average. As in the other New members (with the only exception of the Czech Republic) indirect taxes play a larger role than in the EU being a

[4] Also these VAT reduced rates have been recently modified, being equal to 12 per cent and 0 per cent

43 per cent of total taxation; indeed the indirect taxes to GDP ratio of 17 per cent lies above the long term EU average of 14 per cent.

On the other hand, direct taxes represent a much smaller share of total taxation, that is 23.4 per cent against the ’96 EU average of 31.2, and make up only nine per cent of GDP, well below the ’96 EU average of 13 per cent. This fact can be explained through the relatively low level of tax payers’ average income and the very low level of the corporate tax rate (18 per cent[5]).

Social contributions share in total revenue of 33.6 per cent lies below the ’96 EU average of 36.3 per cent. Social contributions are by law levied predominantly on employers (fraction 0.82), whereas the employees’ share amounts to 0.16 of the total and self-employed persons contribute only a 0.02.

2.2 The development of the system from the early to the late 1990s

The time development of the tax structure since the beginning of the transition period in 1991 was dominated by the structural changes that have been achieved in order to bear up to the fiscal systems prevailing in the EU. In the earlier period from 1991 to 1996 one realizes the effects of the economic transition in marked changes both of the level of total taxation and of the relative weights of levies on the factors consumption, employed labor, capital and business, included self-employed labor (see par. 4.1).

The level of aggregate taxation was decisively lowered from 47 per cent of GDP to 41 per cent between 1991 and 1996 and has remained around 39 per cent later on. This reduction is explained by a substantial reduction in the direct taxes to GDP ratio, which passed from 12.9 to 9.0 per cent remaining roughly stable from then on, and also by a decrease in the social contributions to GDP ratio from 16.6 to 13.8 per cent in 1996 and 13.0 in 1999. Indirect taxes share on GDP lowered to a less extent (17.2 of GDP in 1991 and 16.6 in 1999), showing an increasing contribution of VAT (6 per cent of GDP in 1991 and 8.5 in 1999) in spite of the excise duties.

respectively until December 2003 (law adopted by the Hungarian Parliament on November 10, 2003).

[5] See footnote 3.

Table 1 Structure and development of fiscal revenue in Hungary, selected New members and EU average as % of GDP, 1992-1998

	1992			*1994*			*1996*			*1998*		
	Hungary	*New members*	*EU*	*Hungary*	*New members*	*EU*	*Hungary*	*New members*	*EU*	*Hungary*	*New members*	*EU*
Direct Taxes, of which	*10.1*	*10.1*	*13.5*	*9.4*	*10.0*	*12.9*	*9.0*	*9.6*	*13.4*	*8.7*	*9.2*	*13.7*
Personal income	7.5	6.4	9.6	7.4	7.0	9.3	7.1	7.1	9.3	6.5	6.7	9.3
Corporation income	2.2	3.6	2.3	1.9	2.9	2.4	1.8	2.5	2.7	2.2	2.5	3
Indirect taxes, of which	*17.9*	*15.6*	*13.4*	*17.9*	*16.5*	*13.7*	*17.8*	*16.9*	*13.7*	*16.3*	*15.5*	*13.9*
VAT	6.0	5.1	6.7	7.7	7.4	6.8	7.5	7.4	6.9	7.9	7.9	7.0
Excise duties	6.2	3.4	3.4	4.2	4.2	3.5	3.9	4.1	3.4	4.2	4.1	3.5
Others	5.8	9.3	3.3	6.0	5.0	3.4	6.4	4.9	3.4	4.2	3.6	3.5
TOTAL TAX REVENUE	28.0	25.7	26.9	27.3	26.4	26.6	26.8	26.5	27.1	25.0	24.7	27.6
Social contributions	*18.0*	*16.1*	*14.5*	*17.2*	*15.7*	*14.9*	*13.8*	*14.3*	*15.3*	*13.9*	*14.2*	*15.0*
Employers	14.0	10.0	8.1	13.5	9.0	7.9	11.4	8.0	8.3	11.6	7.9	8.2
Employees	3.3	5.3	4.8	3.1	5.1	5.2	2.1	4.8	5.1	2.1	4.8	5.0
Self employed	0.7	1.8	1.6	0.6	1.6	1.8	0.3	1.5	1.9	0.3	1.6	1.9
TOTAL FISCAL REVENUE	46.0	41.8	41.4	44.5	42.2	41.5	40.6	40.8	42.4	38.9	38.9	42.6
Administrative level												
Central government	24.9	25.9	22.8	24.8	25.8	22.4	23.8	25.4	22.4	21.5	23.9	22.9
Local government	3.1	3.0	3.0	2.4	3.5	3.2	3.0	3.4	4.0	3.5	3.7	4.0
Social Security	18.0	12.9	14.5	17.2	12.9	14.9	13.8	11.5	15.2	13.9	11.4	14.9

Sources: EU Commission (2000) for Hungary and selected New members (unweighted average); Eurostat (2000) for EU-15 (1997 unweighted average).
Notes: Czech data start in 1993 and Social security is only health.

2.3 The apportionment of revenues among Government layers

The splitting of the total revenue by receiving administrative levels as percentages of GDP shows that in 1999 the central government received a 22.4 per cent and the Local governments only a 3.2 per cent (the social contributions funds to GDP ratio was, as already said, 13 per cent). The share of central government in 1999 was 58 per cent of total revenue or 88 per cent of taxes without social contributions; non-central government received 8.3 per cent of total revenue or 12 per cent of taxes without social contribution, made up of 40 per cent of the personal income tax, of a local business tax, the taxes on land and buildings, one half of taxes on property transfer and more than one half of the motor vehicle taxes. The share of central government on total revenue did not change much during the 1990s, being 58.8 per cent in 1991, while there have been a slightly increase in the Local governments' share from 5.6 to 8.3 per cent of total revenue (EU Commission 2000a).

In 1999 the share of total Local governments' revenues on GDP, generally used as an indicator of the size of Local governments, was 11.1 per cent and the share in consolidated national government revenue amounted to 26.7 per cent. As to the composition of total Local governments' revenues, grants from the central budget accounted for 50 per cent, tax revenues for 33 per cent and non-tax revenues for the remaining 17 per cent. Notice that since the system of local taxes (not compulsory) was implemented in 1991[6], both the number of Local governments collecting local taxes and their revenues have been steadily increasing: in 1999 a 93 per cent of Local governments applied local taxes and these accounted for some 18 per cent of all current revenues, to be compared with the mere 3.5 per cent in 1990[7]. Among the local taxes, a major role is played by the local business tax, which accounts for some 85 per cent of all Local governments tax revenues.

Finally, looking at the revenue autonomy, Local governments financing can be split into a 33.3 per cent of own revenues, a 18.5 per cent of general grants and tax sharing arrangements and a 48.2 per cent of specific grants. In 1999 tax revenues were almost equally divided between own taxes and tax sharing with the central government (OECD 2002c).

[6] The Law No. C on Local Taxes was adopted by the Hungarian Parliament in 1990 and has gone into force since January 1, 1991. The first year (1991) of the new local tax system was a transitional year in which Local governments were able to choose to use the new system or keep the previous one.

[7] Local taxes accounted for 12.9 per cent of total current Local governments' revenues in 1999, and 13.4 per cent in 2001. In the first year of the new local tax system (1991), this ratio was 1.5 per cent.

2.4 A comparative view with other main New members and the average of EU[8]

In 1998 the level of aggregate taxation in Hungary (38.9 per cent) is exactly equal to the selected New members average and less than four percentage points below the EU 15 average (42.6 per cent). The difference in total fiscal pressure is therefore not very large; moreover, almost the same proportion between tax revenues and social contributions holds (two thirds and one third) in Hungary and in the EU. What changes is the distribution of tax revenues: as it is shown in table 1, if in the EU direct taxes account for a 13.7 per cent of GDP and indirect ones for a 13.9, in Hungary direct taxes account for only an 8.7 per cent of GDP against the 16.3 of indirect taxes. The same unbalance holds also in other New members, to a major extent in Estonia and Slovenia where the direct taxes to GDP ratio is only 7.8 per cent.

Looking at the levels of decentralized expenditure, Hungary's quota on GDP in 1999 is 10.4 per cent, the second higher level after the Polish one (12.1 per cent) among European and Baltic New members (average 7.2 per cent); however, compared with the EU countries average value of 16.2 per cent, this decentralization indicator appears rather low. The share of taxes on total Local government revenues (33 per cent) is lower than in all other New members (56 per cent on average), with the exception of Poland where tax revenues account for only 25 per cent, and is lower than in EU countries (43 per cent). On the opposite, the quota of local revenues financed by central government's grants is almost the highest (50 per cent) among the New members, a very high value also if compared with the EU average of 46 per cent. Finally notice that Hungary is characterized by the highest proportion of specific grants on total local financing (48.2 per cent of total local revenues) among the New members (OECD 2002c).

3. Some quantitative and institutional features of main taxes[9]

3.1 Personal income tax *(Személyi jövedelemadó)*

The personal income tax in Hungary, envisaged by the Law n.117 of 1995, is payable by resident individuals and the tax revenue accrues to both central and Local governments; the

[8] A detailed discussion may be found in Mitra and Stern, 2003.
[9] This paragraph owes much to EU Commission (2000a) and IBFD (2002a).

tax sharing arrangement is fixed by the annual budget law[10]: in 1999 the Local governments' share amounted to 40 per cent[11].

The tax base is the world-wide income of any kind, but different rules with respect to deductions and rates apply to different classes of income. The aggregate income (which includes mainly income from dependent and independent personal services and private pensions) is taxed at a progressive rate, but various credits are deductible from the tax liability. From 1 January 2002 pensions, provided on the basis of statutory provisions, are fully exempt from the income tax; payments received from a private pension fund are taxable, but a credit equal to 50 per cent of the tax calculated by applying the higher progressive rate, up to the actual tax due, is granted; pensions from a mutual insurance fund are exempt if the recipient has contributed to the pension fund for at least three years. The most important tax credits, deductible from the tax due, are granted for wage income, income from intellectual activities, social security contributions (both mandatory and voluntary)[12], life insurance premiums, education fees, housing mortgage loans, family allowances, donations.

The taxing unit is the individual. As of 2004, there are three classes of taxable income: the minimum tax rate of 18 per cent is due on the first 800,00 HUF (about 3,156 €); 26 per cent is levied on the excess up to 1,500,000 HUF (about 5,917 €) and the top rate of 38 per cent on the excess over 1,500,000 HUF[13].

Income from capital and capital gains are taxed separately at a flat rate, but different rules apply. Interest income is generally exempt (technically taxed at a rate of 0 per cent). Dividends are taxed by way of withholding at a rate of 20 per cent for ordinary and 35 per cent for "excess dividends"[14]. Rental income derived from immovable property is subject to tax at a rate of 20 per cent. Finally, capital gains from the disposal of property, whether movable or immovable, are taxed at a 20 per cent rate, with the exception of gains on non-quoted derivative instruments which are included in the aggregate income and taxed at a progressive rate.

[10] The Local governments' share of the personal income tax has been changed several times over the 1990s. In 1990 it was 100 per cent, but it has been reduced to 50 per cent since 1991 because of the waste differences in per capita personal income tax among Local governments. Since 1998 the share is 40 per cent.

[11] Taxes on private individuals' income from the rental of arable land are wholly payable to Local governments.

[12] The pension system is a three-pillar system consisting of a statutory state pension, a mandatory private pension and a supplementary private pension.

[13] Until 2003 the rates applied on individual income were 20, 30 and 40 per cent and also the income brackets were slightly different. Modifications have been adopted by the Hungarian Parliament on November 10, 2003.

[14] Excess dividends are defined as dividends paid in excess of a specified rate of return on equity, which is equal to double the prime discount rate of the National Bank of Hungary.

3.2 Corporate income tax *(Társasági adó és osztalékadó)*

Hungary has a partial integration system for the taxation of corporate profits. Corporate profits are subject to the corporate income tax, but dividends paid to natural persons are, as a general rule, taxed by way of the already mentioned flat rate withholding at 20 per cent known as “dividend tax”, introduced in 1997. Dividends paid to resident corporate shareholders are, however, normally exempt.

The taxable entities for corporate income tax, which accrues to the central government only, are joint-stock companies, limited liabilities companies, cooperatives, state-owned companies, foundations, associations, public service companies, social organizations, churches, risk capital funds.

Resident companies are taxed on their worldwide income; the taxable base is computed from the accounting profits (including also financial profits), that is gross revenue minus all deductible expenses. From 1997 to 2003 the corporate income tax rate has been 18 per cent, but a special rate of 3 per cent applied to the taxable profits of offshore companies[15]. Since January 2004 these two rates have been changed to 16 per cent and 4 per cent respectively.

3.3 Value Added Tax *(Átalános forgalmiadó)*

Hungary applies a VAT system under which tax is levied at all levels of the supply of goods and services. The beneficiary of the VAT revenue is the central government. VAT applies to all natural persons and legal entities supplying or importing goods or services on a regular basis for profits; business with an annual turnover below 2 million HUF (about 7,890 €) may opt to be exempt from accounting for VAT.

The taxable amount is given by the value of goods and services supplied or imported (excluding VAT but including customs duties). Important exemptions include transactions relating to financial services, health care services, lease of dwellings, insurance and education. Under reciprocity agreements, non-residents doing business in Hungary may reclaim the VAT paid on Hungarian supplies of goods and services including the importation of goods.

The standard rate is 25 per cent. A reduced rate of 15 per cent applies to certain basic foodstuffs, medicines, medical supplies, certain textile materials, coal and electrical energy. A 5 per cent rate (joint with the deduction of the tax paid on inputs) applies to export as well as

[15] In the early 1990s, the rate of the corporate income tax was 36 per cent.

to text books and specified medicines and medical equipment. The five per cent rate also applies to the development of gas and electricity infrastructures and to construction works[16].

3.4 Excise duties *(Jövedéki adó[17])*

Main items subject to excise duties in Hungary are:

a) *alcoholic products*. The beneficiary is the central government and the taxpayer is the person producing or importing the excise good. Rates are increasing going from sparkling wine to intermediate products, beer and spirits. As from 1 August 2000, the system of consumption taxes and excise duties has been amended; the major change concerned wine that, within the framework of EU harmonization, became excise product (the tax rate on grape wine initially set was HUF 5 per liter - about 0.02 € - against the previously applied consumption tax rate of 11 per cent; since January 1, 2004 the rate became HUF 8 per liter - about 0.03 €);

b) *tobacco products*. Again the excise duty's revenue accrues to the central government. The tax base is the retail price (including tax and value added tax) and thousand units. As of 2004, for cigarettes tax rates are HUF 6,450 (about 25 €) per thousand units and 23 per cent of the retail price;

c) *fuels*. The beneficiary is the central government and the tax is levied on any mineral oils produced or imported. Tax rates increase from diesel (HUF 85 per liter - about 0.33 €), to unleaded petrol (HUF 103.50 per liter - about 0.41 €), to leaded petrol.

3.5 Consumption taxes *(Fogyasztási adók)*

Consumption taxes accrue to the central government. The most important are levied on:

a) *coffee*. The applicable tax rate is 12 per cent;

b) *passenger cars*. The tax rates vary from 10 per cent applied to a car up to 1,600 cc equipped with catalytic converters to 32 per cent applied to a car over 1,600 cc without catalytic converter;

c) *products made of precious metals (other than silver)*. The relevant tax rate is 35 per cent.

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[16] See footnote 4.

[17] Before the date of accession (May 1, 2004), the Hungarian Parliament will adopt a new law on excise duties.

3.6 Local taxes

In Hungary Local governments benefit of tax revenues coming from both tax sharing arrangements with the central government and own taxes. The main taxes shared with the central government are the personal income tax (40 per cent sharing), the tax on onerous property transfer (50 per cent sharing), the taxes on inheritance and gift (50 per cent sharing), and the motor vehicle tax (the share of Local governments has increased to 100 per cent since 2003).

There exist also a number of taxes that Local governments can impose autonomously. The most important of them are:

a) *local business tax (helyi iparűzési adó).* Since 1991 municipal authorities are authorized to levy local business tax on corporate taxpayer who have their seat or who are registered within their jurisdiction. Some municipalities do not charge such tax (but the number of these municipalities is decreasing over time) and a number of municipalities grant tax incentives. The tax base for commercial activities is the net sales revenues of product sold or service provided less the purchasing costs of goods and subcontractors' fees. Manufactures may fully deduct the costs of materials. The maximum rate for local business tax was 1.7 per cent in 1999 and two per cent from then on[18];

b) *land parcel tax (telekadó).* Introduced in 1991, this tax is levied annually on the owner of a parcel; the tax base can be or the actual area in square meters or the adjusted market value of the parcel;

c) *building tax (építményadó).* As before, the tax, which is due by the owner of a building, is calculated on the floor space in square meters or on the adjusted market value of the building;

d) *communal tax (kommunális adója).* This tax can be levied on private individuals or on entrepreneurs. If on individuals, the occupants of a household dwelling pay HUF 12,000 (about 47 €) per dwelling as maximum annual rate, regardless of the number of inhabitants. This tax is suited to localities that have many government-owned social flats and cannot rely on property taxes for revenue. If levied on entrepreneurs, the enterprise pays a maximum annual rate of HUF 2,000 (about 8 €) per employee.

[18] The maximum rate for local business tax was 0.3 in 1991. By several modifications – 0.8 per cent in 1993; 1.2 per cent in 1996; 1.4 per cent in 1998; 1.7 per cent in 1999 – it became two per cent since 2000. Beside the change occurred in 1996, all increases of the maximum rate are related to the increasing possibilities for deduction of costs from the tax base.

3.7 Social security contributions *(társadalombiztosítási járulékok)*

Hungary reformed its pension system in 1997, introducing a multi-pillar system combining a PAYG state pension pillar and a fully-funded mandatory second pillar consisting of privately-operated pension funds. A voluntary third pillar of supplementary private pension was also introduced. Employees may either participate in the first and second pillars or remain covered by the state pension system only.

Social contributions are levied at a rate of 29 per cent as the employers' share[19] (pension security contribution at a rate of 18 per cent and health security contribution at a rate of 11 per cent) plus 11.5 per cent as the employees' share (pension contribution at a rate of 8.5 per cent, reduced to 1.5 per cent for members of private pension funds[20], and health insurance contribution at a rate of three per cent[21]).

In addition to the social security contributions, employers are obliged to pay a fixed health care contribution, which amounts to HUF 3,450 (about 14 €) per employee per month since 2003[22], and a sick-leave benefit contribution equal to 33 per cent of the overall employee's sickness benefits.

Finally, contributions must be paid to the unemployment fund, being the employees' applicable rate equal to one per cent and the employers' contribution equal to three per cent (*payroll tax*).

3.8 Other minor taxes

Beside the personal income tax, the motor vehicle tax is a shared tax. This tax was introduced in 1992. Motor vehicles - except those owned by public institutions or non-profit organizations and used for public transportation or communal services - are taxed according to their weight. Local governments are the taxing authorities, but the central government can set up the minimum and maximum rates. The minimum rate is HUF 400 (about 1.58 €) per

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[19] Some changes have been carried out over the 1990s. In the first period of the decade the employers' rate was 44 per cent. Between 1998 and 2002 the rate was changed four times: in 1998 it was 39 per cent (24 per cent pension plus 15 per cent health care); in 1999, 33 per cent (22 per cent pension plus 11 per cent health care); in 2001, 31 per cent (20 per cent pension plus 11 per cent health care); finally, a further reduction to 29 per cent was implemented in 2002 (18 per cent pension plus 11 per cent health care).

[20] The contributions to the second pillar were initially levied at a rate of 6 per cent of gross income, which would have to be increased to 8 per cent since 2000. The planned increased contribution to the second pillar however has been postponed. The new government has reduced the rate from 2.0 to 1.5 per cent for the first pillar and has increased to 7.0 per cent the second pillar's one since 2003.

[21] Since 2004 the rate for health insurance contribution is four per cent.

[22] The present government is however planning to reject this form of social security contribution before the end of the government period (2006).

100 kg and the maximum rate is HUF 800 (about 3.15 €) per 100 kg. Since 2003, as already noted, all motor vehicle tax revenues contribute to the local budgets.

Among the taxes accruing to the central government, in 1998 a tourism contribution (*Turisztikai hozzájárulás*) has been introduced: this tax is levied on enterprises involved in tourism, like hotels, car rentals, casinos, travel agencies etc., at a rate of one or two per cent, depending on the type of activities carried out, of the net sale revenues. Another tax introduced in the 1990s to the benefit of the central government only is the gambling tax (*Játékadó*), payable by gambling organizers on draws, totalizer-type bets, gambling machines, bets based on casinos.

Finally, Hungarian taxation system envisages a number of "environmental" taxes to the benefit of both central and Local governments: the environmental protection fee, the air pollution levy, the water pollution levy, the toxic waste levy, the noise abatement levy.

4. The fiscal burden

4.1 The distribution of tax charge: taxation by economic function and implicit tax rates

The assignment of total revenue according to the economic function of the tax base allows the subsequent calculation of the relative tax load on different production factors and on consumption, which is part of the relative factor prices and hence has an impact on factor allocation. The implicit tax rate is calculated to serve as a macroeconomic indicator for the factor tax loads.

Table 2 shows the structure of Hungarian taxation according to economic functions as percentage of GDP (EU Commission 2000a). In 1998 the main source of tax revenues was the employed labor, which accounted for 19.0 per cent of GDP. The second higher contribution to the tax revenues came from consumption, whose taxation amounted to 13.8 per cent of GDP. On the contrary, the shares of self-employed labor and of capital and business were significantly lower, being respectively of 1.2 and five per cent. The main component of capital and business taxation were profits (2.7 per cent of GDP), whereas taxation on financial activities was very low (0.3 per cent of GDP). Finally, in 1998 environmental taxation accounted for 3.3 per cent, of which a two per cent was covered by taxes on energy.

Looking at the evolution of the functional structure of taxation from 1991 to 1999, the decrease in the aggregate taxation from 46.7 to 38.6 per cent of GDP can be explained mainly by the reduction in the levies on employed labor (-4.7 per cent), through a lowering of social contributions, and the reduction of taxation in capital and business (-2.7 per cent). Taxation of consumption has been kept relatively constant in the '91 to '96 period and then has been slightly reduced to 14 per cent since 1997. Taxation of energy was and is relatively high in Hungary: it was reduced from four to two per cent of GDP from 1991 to 1996, and increased again to nearly three per cent in 1999.

Considering the factor taxation expressed as a fraction of total taxation (including social contributions), the fraction on consumption, after an increase in the first half of the 1990s, remained around 36 per cent since 1997. The fraction on employed labor, which reached 51 per cent in 1993 and 1994, decreased to 46.5 per cent in 1999. Finally, the fraction jointly assignable to capital and business and self-employed labor was 17 per cent in 1999, more than two points below the value at the beginning of the decade.

The implicit tax rates, shown in Table 2, confirm the overall picture: relatively high on consumption and not so high on employed labor. In 1998 the implicit tax rate on consumption was nearly 19 per cent, whereas the implicit tax rate on employed labor more than 40 per cent[23]. The evolution in the 1990s of the implicit tax rates for both consumption and employed labor shows an increasing trend in the first half of the decade, as a consequence of the economic transition, whereas since 1996 both figures have started to decrease. Indeed, the implicit tax rate on consumption decreased from 21.1 in 1995 to around 19 per cent through the years 1997 to 1999 and the implicit tax rate on employed labor was reduced from 43 per cent in 1997 to 40 per cent in 1999.

[23] Due to a lack of confirmed data on the net operating surplus an implicit tax rate for capital and business (incl. self-employed labor) could not be computed and thus is not available.

Table 2 Structure and development of taxation by function and by implicit rates in Hungary, selected New members and EU 15, 1992-98

	1992			*1994*			*1996*			*1998*		
	Hungary	*New members*	*EU*	*Hungary*	*New members*	*EU*	*Hungary*	*New members*	*EU*	*Hungary*	*New members*	*EU*
Economic functions												
Consumption	15.9	13.6	10.9	15.6	14.5	11.2	15.3	14.7	11.3	13.8	13.5	11.4
Labor Employed	23.4	19.7	20.6	22.6	19.4	20.7	19.3	19.0	21.4	19.0	17.9	21.2
Labor self-employed	1.8	2.9	2..4	1.7	2.8	2.4	1.4	2.6	2.4	1.2	2.6	2.3
Capital & Business	4.9	4.3	7.2	4.5	5.0	6.8	4.6	4.3	7.1	5.0	4.5	7.5
Implicit tax rates												
Consumption	18.8	16.3	16.2	18.5	17.4	16.5	20.6	17.8	16.7	18.9	16.6	16.8
Labor employed	42.9	37.1	39.0	44.6	38.3	40.2	42.3	37.4	42.0	41.9	38.0	41.9
Capital & Business	-	-	32.2	-	-	30.3	-	-	30.5	-	-	31.1

Sources: EU Commission (2000) for Hungary and New members (unweighted average); Eurostat (2000) for EU 15 (1997 unweighted average).
Notes: Taxation according to economic function is as per cent of GDP. Total may stay over Total fiscal revenue in Tab. 1 because of some double counting. Estonia's 1992 implicit rates and all Czech rates refer to 1993. Implicit rates for capital and business are not available for all New members, except Estonia.

4.3 The ability to attract foreign direct investments

Hungary attracted considerable inflows of foreign direct investment over the last decade, resulting in the creation of a competitive and dynamic economy. During the period from 1992 to 1995 Hungary has been the main recipient of FDI flowing to the Central and Eastern European Countries, both in absolute term and as a percentage of GDP (Mitra and Stern 2003). Out of a total of nearly USD 21 billion in FDI received by the region, Hungarian share was 45 per cent; indeed, FDI reached 5.7 per cent of GDP in that period against an average value for the whole region of only 0.5 per cent. During the subsequent period from 1996 to 1999, when FDI to the Central and Eastern European countries were more than USD 50 billion, the relative position of Hungary changed, being Poland and the Czech Republic the major recipients. Nevertheless Hungary continued to perform well, with a share of FDI in GDP of 3.8 per cent compared with an average of 3.3 per cent.

In the early 1990s a skilled labor force available at internationally-competitive wages combined with numerous tax incentives in the form of tax credits and tax allowances has been a major factor attracting foreign investments to Hungary. These tax incentives were phased out at the end of 1993, but foreign investors still continue to benefit from other incentive schemes: the offshore incentive regime, which entails a corporate income tax to be levied at a rate of four per cent[24], and a tax deferral for dividends in case of reinvestment. However, in order to comply with the EU's requirements, new tax incentive regimes will replace the existing ones from the date of Hungary's accession to the European Union. In addition, other more general reforms need to be introduced for Hungary to prosecute in its economic growth and continue to attract investments (OECD 2002b), such as intensifying up-skilling efforts, reducing disincentives to labor force participation arising from the early retirement's system and disability benefits, and reducing the high burden of social security contributions.

4.3 A comparative view with other New members and EU 15 countries[25]

The structure of taxation according to economic function in Hungary shows some striking differences with both other New members and EU 15 countries. Hungarian taxes on consumption have a much higher role than in the EU average and a higher role than in other New members, with the exception of Slovenia: considering the factor taxation expressed as a fraction of total taxation, in 1999 the fraction on consumption was still higher than 36 per

[24] The rate, as already noted, was three per cent until December 2003.

cent, in marked contrast with the ’96 EU average of 27 per cent. On the contrary, as in most of the New members, the share of taxation on employed labor displays minor differences with respect to EU 15 countries (46.5 per cent against a ’96 EU average of 51 per cent). Finally, the fraction jointly assignable to capital and business and self-employed labor, equal to 17 per cent, was still well below the long term EU average of 21 per cent and also below the correspondent figures of Estonia, Poland and the Czech Republic. The implicit tax rate confirms the overall picture: in 1999 the implicit tax rate on consumption was 19 per cent, against a ’96 EU average of 14 per cent, whereas the implicit tax rate on employed labor of 40 per cent was slightly below the ’96 EU average of 43 per cent.

5. Tax reforms and further steps to get closer to the EU

5.1 Macroeconomic and budget outlook

Hungary is one of the fastest growing OECD economies. Growth has averaged 4.5 per cent in the late 1990s and the unemployment rate fell from 8.9 per cent in 1997 to 5.8 per cent in 2001. Despite rapid output growth, the pace of consumer inflation decelerated over the same time period from 19 to seven per cent and the current account deficit was reduced from almost seven per cent to below six per cent of GDP. To a large extent, this macroeconomic performance reflects radical liberalization and microeconomic reforms achieved through the transition, substantial fiscal stabilization and the supportive exchange rate regime which helped preserve the international competitiveness of the economy while contributing to gradual disinflation. From the second half of 2001 on, the economy faced its first endogenous slowdown of the post-transition period, while a new exchange rate regime tightened monetary conditions in order to attain a more ambitious disinflation objective. Despite slowing, economic growth proved more resilient in 2001 than in many other OECD countries, with GDP being maintained at close to four per cent: public infrastructure investment and private consumption offset the strong decline in exports and private business investment. Whereas during the late 1990s the government achieved significant progress in fiscal consolidation, reducing the general government deficit in 2000 to 3 per cent of GDP, in 2001 a significant loosening of the fiscal stance of up to 2.5 per cent of GDP took place. Fiscal policy was highly expansionary also in 2002: the estimated deficit of the general government reached

[25] A detailed discussion may be found in Mitra and Stern, 2003.

approximately 9.2 per cent of GDP, due to both one-off expenditures and significant permanent expenditure increases, notably on wages and pensions as well as health-related spending (EU Commission 2003).

After the 2001-2002 slowdown, economic expansion was slightly accelerating, with GDP rising by a (first) estimated 3.7 per cent in 2003 and by a forecast 4.1 per cent in 2004. As in 2002, growth throughout 2003 has been primarily driven by domestic demand. New inflation targets were agreed between the Central bank and the government, at a maximum of 4.5 per cent average in 2003 and 4 per cent in 2004. Given the targets proposed in the government's medium-term pre-accession program to the European Union, a sharp fiscal tightening is required in the period 2003-2004. The 2003 budget is based on optimistic growth assumptions on the revenue side and planned spending cuts across the entire public sector. Overall, a stabilization of the deficit at around five per cent of GDP on an ESA basis is a preliminary estimate for 2003 and a further reduction to below four per cent is expected in 2004.

5.2 Last years' and planned tax reforms

Hungarian tax reforms in recent years appear to have been driven by the commitment to gradually harmonize with the EU and by the desire to further improve the environment for doing business. In contrast to the EU15, however, tax revenues continue to depend much more on indirect taxes while the shares of revenue generated by income taxes on capital and labor as well as property taxes remain relatively low.

The EU targets harmonization has informed the VAT regime and the 2000 excise duties reform, even if transitional arrangements have been requested to the EU. The VAT system applied is very close to that within the EU and the standard rate of 25 per cent is the higher among the New members; however, the reduced rates of 15 per cent and 5 per cent continue to be used as social policy instruments. As stated by the EU legislation, excise duties are levied on alcoholic beverages, tobacco and hydrocarbon fuels, but rates on alcohol and especially on tobacco are to be again adjusted to the higher EU levels.

Looking at social security contributions, the major change has been that the government has tried to compensate employers for massive increases in minimum wages and strong wage inflation by cutting the social security contributions, which fell between 2000 and 2002 from 33 to 29 per cent of gross wages.

The Hungarian tax regime provides an advantageous environment for the business sector. The corporate income tax, at 16 per cent, is significantly lower than those applied in most of

EU countries (EU average rate is 29.3 per cent) and generous incentives assure that large corporations can achieve tax breaks by investing above minimum thresholds. In addition, offshore firms are subjected to a corporate tax of only four per cent[26]. Finally, the dividend tax regime introduced in 1997 provides a dividend reinvestment incentive for foreign investors in the form of a tax deferral. In 2001, the government also helped reduce the tax burden on SMEs (i.e. medium-sized and small enterprises) by eliminating a special turnover tax on tourism transactions, speeding up the pace of VAT refunds and by providing an income tax credit.

5.3 The need for further steps

The tax system in Hungary seems relatively close to the EU 15 ones, so no major or structural changes in taxation have been decided for the near future (except perhaps for the elimination of the foreign companies tax regime), but gradual adjustments regarding rates and procedures.

On the grounds of efficiency considerations, it would be desirable to continue the process of reduction of social-security contributions (pension and health contributions) in order to reduce the tax burden on labor and further stimulate employment, especially for the low-skilled, and growth. This is particularly important for the small firms, which were hit hard by the increase of the minimum wage mentioned above: a timely first step would be abolishing the flat-rate health charge, financing the measure by cutting other subsidy programs (OECD 2002b). Furthermore, to enhance the nation's growth prospects, the authorities ought to reduce the use of multiple rates of VAT as social policy instruments[27] and, similarly, ought to gradually adjust excise duties on alcohol and tobacco products to higher EU levels. In addition, in the new context of relatively low inflation, it would be advisable to widen the tax base for personal income by including interest income: the extra revenues generated could be used to finance off-setting cuts in taxation of wages, further improving the incentive to employment. Looking at corporate taxation, as already noted, relatively high social-security contributions and payroll taxes coexist with a low taxation of profits and a wide range of tax incentives for firms: in view of the EU accession, the current incentive regime, especially for offshore companies, should be abolished in order to prevent a dangerous tax competition between EU members to attract FDI (Mitra and Stern 2003).

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[26] This offshore regime is contrary to the EU Code of Conduct for business taxation and has been listed as "potentially harmful" by the OECD.

[27] The main difference with the EU15 is the existence of three rates, which should be reduced to two with the lower rate set closer to 10 per cent than the actual five per cent and 15 per cent.

Further recommended actions regard the pension system. After the 1997 reform, which introduced a system combining a PAYG pillar and a fully-funded mandatory second pillar of privately-operated pension funds, planned adjustments have been postponed and key parameters modified: the mandatory nature of the second pillar has been abolished and the contribution rates to such accounts have not been increased from six to eight per cent, as originally planned, but only to seven per cent. At the same time, the government has announced that it intends to modernize the existing PAYG system, making it more attractive for all workers. These measures trade off a short run cash flow gain against long-term liabilities. Given the importance of the long run sustainability of the public pension system, these moves ought to be reconsidered by the authorities.

In general, the fulfillment of the short and medium-term fiscal objectives, as well as longer-term tax and expenditure reduction policies, requires a thorough reform of public spending. Longer-term spending reduction is important in order to reduce the high tax pressure (39 per cent of GDP in 2001), but it presents a real challenge: substantial new spending on infrastructure, public health, education and environment protection is implied by national priorities and EU accession rules, so that the room for such items has to be provided by curtailing spending in other parts of the budget (EU Commission 2000b; OECD 2002b).

Beside the cut back of government budget directed to reduce the high tax pressure, further reduction of central taxes is required to give place and higher potential for the development of local taxation. Although important steps have been achieved during the 1990s, the share of Local governments' revenues in GDP and the revenue autonomy are still too low. In the last years two main development lines have been mentioned by Hungarian and foreign experts: first, to move towards the Scandinavian system giving the potential for local personal income tax or surcharge on the national personal income tax; second, to improve the present local building tax by moving towards an Anglo-Saxon type value base property taxation.

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