MINISTRY
FOR NATIONAL ECONOMY

TAX POLICY OF A REFORMED HUNGARY

Steps towards a transformed tax system

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Table of contents

Overview – background, objectives, achievements

In the focal point of tax policy: reducing the proportion of income taxes and , increasing the role of consumption and turnover taxes

Since taking office, the Hungarian Government has been consistently pursuing the implementation of the tax policy that it had predefined: it has submitted only such measures to the Parliament that **gradually shift the emphasis of income taxes towards levies on consumption and turnover, or on negative externalities (environmental or health-related taxes).** The reduction of incomes taxes has already been completed, and the work of implementing taxes on consumption and on negative externalities is also getting to an end – thus the reform of the Hungarian tax system will be complete in the near future.

A proportionate income tax system stimulating performance, boosting employment and supporting families

The Hungarian income tax system is proportionate, stimulates performance, boosts employment and supports families. It is proportionate as it puts equal burden on every income: tax liabilities double as income doubles instead of a three- or four-fold burden. It stimulates performance and has an inciting effect on gross wages, since additional work is not discouraged by disproportionate tax liabilities it boosts employment, as it encourages the hiring of disadvantaged job seekers – such as career-starters, young people, long-time unemployed, young mothers, elderly people and unskilled workforce – by an unprecedented tax cut. Last but not least, the system supports families by leaving a significant amount of money at them to cover the costs of raising children.

To sum up, it can be concluded that the measures of the Government are based on the principle of **reducing levies on labour**, which is to be financed by the increased taxes on consumption as well as higher revenues due to a more efficient tax collection system and strengthened tax compliance.

Turnover taxes are to play a greater role

There are other arguments why the Government attributes higher importance to **increasing the role of turnover taxes**. These types of levy are **less distorting** and, due to a more solid tax base, they comprise **a more robust revenue source** than income taxes.

Concerning the taxes on negative externalities, the objectives of the Government go far beyond the tax system. Such a new type of tax is, for example, the **public health product fee** (levied on unhealthy food and beverages) which is not just another tax- policy instrument, but one that aims to achieve some more profound **healthcare policy objectives**. So it means if the producer of a certain food or beverage changes the recipe –providing a more healthy option– it is exempt from paying tax.

Facilitating the development of small and medium-sized enterprises

Small and medium-sized enterprises constitute the growth engine of a country's economy and they also play a crucial role in employment. Therefore, among its very first measures the Government initiated the reduction of the high tax and administrative burdens. **Corporate tax rate was cut to 10 percent and 10 small taxes have been abolished**, including the municipal tax for enterprises. The new Labour Code and the announced Job Creation Action Plan **increased labour market flexibility** and **reduced the burden on labour** for enterprises. In addition, the Government introduced **two new types of tax specifically created for small companies,** which will result in outstanding tax liability reduction for them.

Significance of a diversified economy

In recent years, the instability of global economy has proved that the current economic status quo lacks firm fundamentals, and **every country has to be prepared for sudden, unexpected and significant crisis situations.** Hungary, being a small and open economy, has been especially affected by the crisis. It has been highlighted that **only an adequately diversified economic structure can ensure stable economic growth for the medium and the long term.** Therefore Hungary needed an economic transformation underpinned by and active economic policy.

Having learnt from the euro-zone crisis, the Government has established a new economic structure which, in addition to foreign investors, focused on other growth-stimulating factors, such as Hungarian human and knowledge capital, innovation capacities, entrepreneurial spirit, regulatory environment and administration.

Securing financial stability, the sine qua non for economic growth

The events of recent years proved it beyond doubt **that long-term economic growth and stability must go hand-in-hand with financial stability**. To this end, the Government **consolidated the budget** and defined the **substantial reduction of general government debt** as a main objective.

In exchange for establishing financial stability, the Government has requested greater contribution from the **banking and other highly profitable sectors.**

By its recent measures the Hungarian government managed to set the Hungarian economy on a right track. The first time Hungary's budget deficit stayed under 3 percent was in 2011 since our accession to the European Union and the government will insist on this in the following years. Considering the 2012 prognosis it is an outstanding achievement that the EU is expecting a 2.5 percent deficit, and forecasting it under 3 percent for 2013.

Connection between economic growth and the taxation system

When aiming for economic growth, with regard to taxation, it matters how a country levies taxes, and how stable and predictable its taxation system is. The factors through which the taxation system primarily impacts **economic growth** are as follows:

- total tax burden (ratio of tax revenues as percentage of GDP);
- composition of tax revenues (proportion of taxes on turnover, income taxes);
- tax allowances;
- efficiency of tax authority;
- complexity of tax regulations;
- administrative costs;
- stability and predictability

In the past two years the Government achieved ground-breaking results regarding most of the aforementioned factors. The Government made clear steps in improving business environment, reducing administrative costs of individuals and, in addition, measures aimed at increasing the efficiency of the tax authority have begun to deliver results as well.

Analysis of changes in tax revenues as percentage of GDP and the structure of taxation

Tax measures always have to be analyzed within a coherent framework, along with other changes made. **In 2010, the Government embarked on consolidating a budget with an extremely high annual deficit, which managed to maneuver Hungary away from the crisis zone of the European Union.**

After the consolidation process the **Government decided on reforming the tax system,** which has been carried out in several steps while constantly **observing fiscal discipline.**

Changes in tax revenues as percentage of GDP

According to ESA-95 methodology, tax revenues as percentage of GDP have changed in recent years as shown below (Fig.1). The methodology used by the EU omits private pension fund contributions, but since they originate from compulsory levies on wages, such data is also worth to be observed up to 2010 including private pension fund payments.

In the period of 2005-2007, the ratio of tax revenues as percentage of GDP increased significantly in Hungary, which put considerable burden on taxpayers until 2009. However, in light of the data, we can conclude that in 2010 and 2011 this ratio decreased markedly, regarding both unadjusted and adjusted data for private pension fund payments.

The data showed on the chart may slightly differ from statistics published by the EU, as they include EU own funds in a different way, but this mismatch in methodology does not alter the underlying trend for the observed period. Data for 2012 is equal to fiscal appropriations for 2012.

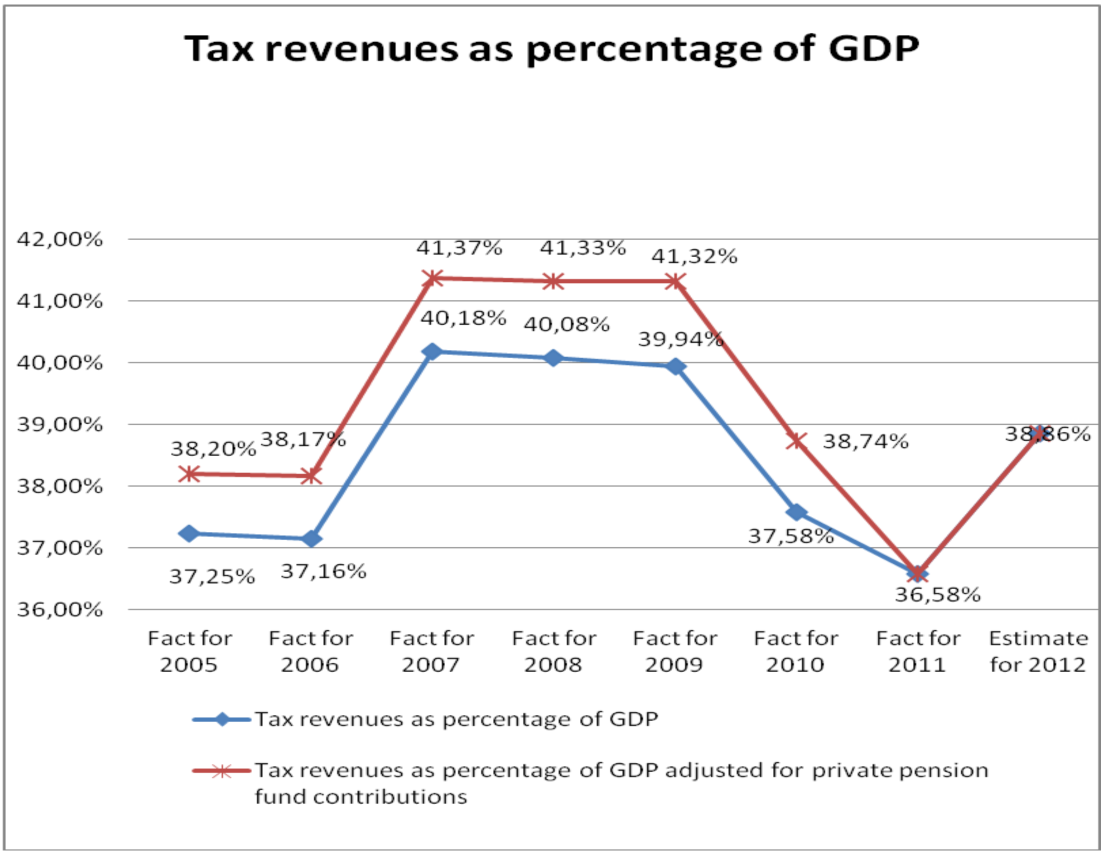

Fig.1. Change in the ratio of tax revenues as percentage of GDP in Hungary (2005-2012)

Change in taxation structure

Up to 2008 the share of taxes and contributions on income had increased continuously (Fig. 2). In 2009 there was a shift toward higher levies on consumption, and it continued after 2010. By 2012 the share of levies on income declined to 54.9 percent and taxes and contributions on wages moderated to 47.6 percent compared to the total amount of tax revenues.

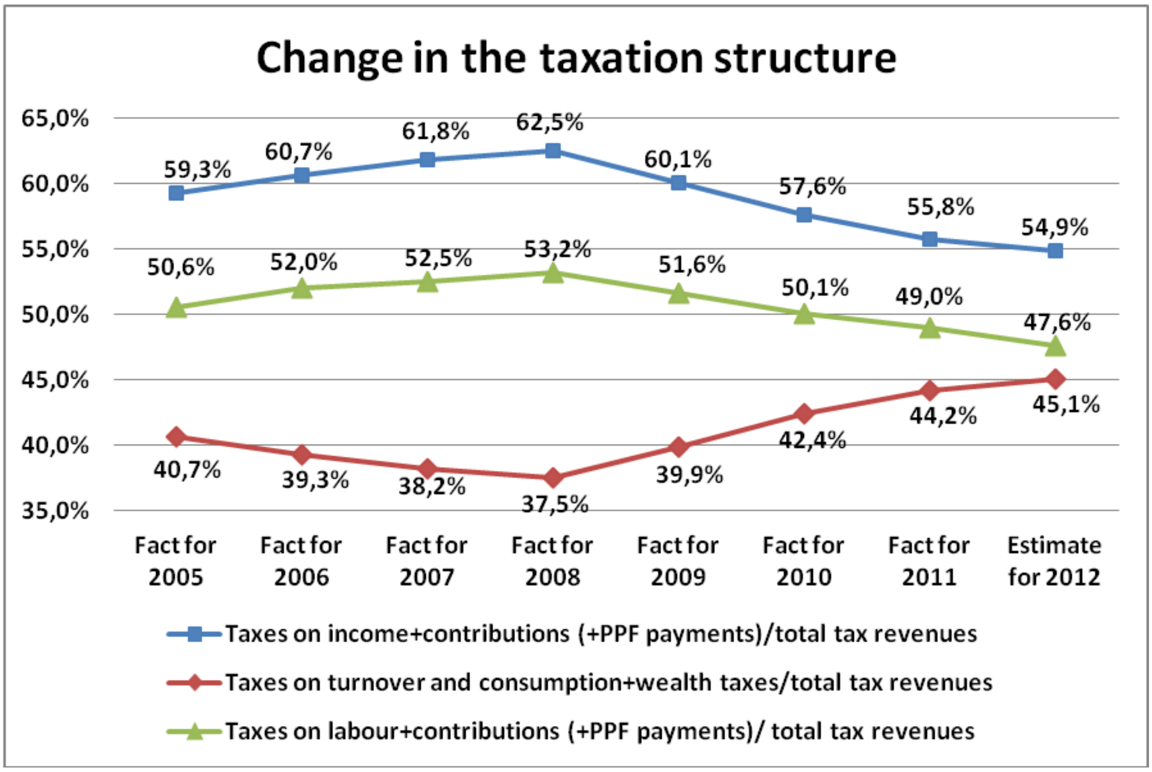

Fig.2. Change in tax burden (2005-2012)

The key tax policy measures of the Government in detail

The Government has been committed to gradually decrease taxes on income. Besides that – while concentrating on the deficit target – the Government has begun shifting towards a greater weight of taxes on consumption and broadening burden sharing. In addition, aspects of environmental protection and healthcare gets a greater attention in the tax system.

Appendix 1 and 2 of this analysis contain in details tax measures already implemented or planned to be introduced in the future.

The aforementioned measures as a whole help the country get prepared that by the time Europe will recover from current economic turbulences Hungary will already be on the fast track leading to the position of the most competitive economy of Central Europe.

Ministry for National Economy

Appendices:

Appendix 1: Measures implemented

Appendix 2: Planned tax policy measures for 2013

Appendix 1

Implemented tax policy measures

Change in the tax burden on income; acknowledging labour to a greater extent

- As of 1 January 2011, the **flat-rate personal income tax system with a tax rate of 16 percent** came into effect, and as a result taxes on labour decreased significantly.
- The greatest beneficiaries of the **new system which supports families** are employees who raise children. For them the introduction of family taxation offers significant support. The **family tax allowance** provides with 62,500 HUF per beneficiary per month after one or two dependants, and with 206,250 HUF after the third and every further dependant.
- In order to strengthen the proportionate flat-rate personal income tax system, as of 2012 **tax-base supplement (so called super-grossing) was abolished** for incomes below 202, 000HUF a month or 2, 424, 000 thousand a year, while for incomes above that level the 27 percent tax-base supplement was temporarily maintained. As of 2013, super-grossing as an instrument will be entirely phased out of the personal income tax system.
- In 2011, **tax credits** were cut from 15,100 HUF to 12,100 HUF per month and as of 1 January 2012 tax credits, which turned out to be wasteful as they lacked focus and facilitated tax evasion, **were entirely abolished.**
- In order to counterbalance the negative impact resulting from the phasing out of tax credits and preserve the net wages, the Government introduced a **wage compensation scheme** to help maintain the wage level of low-income employees. To stimulating hiring people marginalized by the labour market, the Government plans to introduce further well-targeted allowances in the longer term.
- As of 2012, **social contribution tax (27 percent)** has been introduced by fusing the former healthcare contributions, labour market contributions and pension benefit contributions payed by the employer. The act on social contribution tax strengthens the principle of solidarity, and the merge of various levies has simplified the taxation system.

- In 2012, the tax rate of **personal healthcare contributions** increased by 1 percentage point.
- In 2010, a **preferential corporate tax rate of 10 percent** was introduced on revenues of up to 500 million HUF which has significantly eased the burden of enterprises. As of 2011, a **sport tax relief** related to corporate tax was introduced. In 2012, **tax allowance on intangible goods** in connection with the corporate tax was also adopted which contributed to creating a competitive taxation system.

Taxes on consumption and turnover; aspects of environmental protection and healthcare

- In order to make up for the temporary fiscal revenue shortfall resulting from the flat-rate personal income tax, in 2012 **the rate of value added tax was increased by 2 percentage points**. The measure was also aimed at securing the financing of the Country Protection Fund.
- **Aspects of environmental protection** have been taken into account as **car registration tax components** were significantly reduced and regulation regarding **company car tax** was modified (total company car tax burden as a whole increased).
- With regard to **excise taxes**, those on alcohol and cigarettes have been increased in several steps while special attention was paid to aspects of healthcare protection. The tax rate on diesel was increased in order to reduce the tax differential compared to that of petrol, which measure was introduced parallel to increasing the amount of excise tax rebate which transport enterprises are eligible to.
- In order to incorporate aspects of a healthier lifestyle in the taxation system, in the year of 2011 the **public health product fee** was introduced. After levying tax on pre-packaged sugared or salted products, sugar-sweetened beverages and energy drinks, the number of taxable products was increased in 2012.
- In order to promote more careful car driving, in 2012 the Government introduced the **accident tax** levied on the compulsory third-party vehicle liability insurance corresponding to 30 percent of the above (maximum 83 HUF per day).
- In order to adhere to the deficit target, as of July 2012 a **telecommunications tax** of 2 HUF (0.67EUR) per minute, or per SMS/MMS was introduced.

- As of 1 January 2012, a **national cultural contribution** was also adopted. The objective of introducing the tax was to bring under tax regulations a well-defined category of products and services with pornographic content.
- The **food-chain supervision levy** introduced in 2012 helped to establish balanced and proportionate burden-sharing across the entire system of food chain supervision.
- **Certain other rates of duties** were also increased.
- **Environmental product fee** increased three-fold on average as of 2012.

Measures aimed at increasing the number of taxpayers, broadening tax base and increasing greater transparency in the economy

- In order to **combat large scale agricultural VAT fraud**, as of 1 July 2012 **reverse charge VAT was introduced to the trade of grain-, oilseed- and protein crops.**
- As of 2012, fringe benefits are subject to a **healthcare contribution** of 10 percent.
- **Contribution base** of self-employed individuals working full-time was broadened in 2012.
- As of November 2012, **gambling tax** was increased and levied also on on-line gambling.
- The carry-forward of losses in **corporate taxation** was limited from 2012.
- Contribution base of **innovation and vocational training contributions** was broadened in 2012 by the abolition of various tax deduction possibilities.

Other taxation policy measures

- In 2010, in order to aid recovery from the crisis, **surtaxes on financial institutions and certain other sectors** were introduced, with the aim of increasing the share of these sectors in burden-sharing.
- As of 2011, **local building tax** ceiling increased from 900HUF/sqm to 1100HUF/sqm.
- The upper limit of payable tax and the tax rate for **simplified entrepreneurial tax** were increased (to 30 million HUF and 37 percent).
- As of 2012, the upper limit of **communal tax payable by private persons** was increased from 12,000 HUF to 17,000 HUF per each taxable property.

- One of the key taxation policy objectives of the Government has been to combat **black economy** which constitutes a severe burden on economy. In order to establish a competent institutional background for the fight against the black economy as of 1 January 2011 from the merger of the former Tax and Financial Control Administration (APEH) and the Hungarian Customs and Finance Guard (VPOP) the **National Tax and Customs Administration (NAV)** was founded. The new regulations which came into force on 1 January 2011 **added several new instruments to the control toolbar of the NAV** (i.e.: assessing the genuineness of certain economic activities), and introduced **new measures aimed at boosting efficiency,** such as tax registration enabling the detection of enterprises which pose significant taxation risks, faster suspension of tax permit of fictitious enterprises or closer monitoring of taxpayers considered to be less transparent from the aspect of taxation. Legal retributions have also become considerably stricter, which can therefore reduce the risk of tax evasion and have a greater preventive impact than before.

In order **to cut administrative costs**, several **small taxes** have been abolished, and measures aimed at simplifying taxation have been introduced. The first phase of reducing the number of taxes took place in 2010, among the very first measures of the newly-formed government, which abolished compliance requirements for ten small taxes. Most of these measures entered into force already in the year of 2010.

Appendix 2

Planned tax policy measures for 2013

The Government continues the transformation of the tax system in 2013. Taxes on labour will decrease further and the weight of indirect taxes will increase. The Government aims to improve the job prospects, preserve existing jobs of the most disadvantaged groups of people and to develop the situation of small and medium-sized enterprises via the Job Protection Action Plan. However, companies holding large market share and operating in highly profitable sectors will have to continue to share burdens, –but these liabilities will be gradually diminished parallel to the improving of economic prospects. Combating the black economy by tax policy measures will also be more intensive in 2013. In order to achieve its objectives the Government has decided on the measures as follows:

Change in the tax burden on incomes

- Within the framework of the Job Protection Action Plan:
  - As a complementary measure of the reform of the personal income tax system, in order to increase labour market demand and **stimulate job creation**, as of 2013 certain **well-targeted tax allowances** can be utilized **by employers.** These allowances are introduced in order to improve the job prospects of and safeguarde existing jobs of career-starters, young mothers, elderly jobseekers, the long-time unemployed and low-skilled workers. These specific allowances are expected to be more effective than former general tax credits for employers which used to be often abused.
  - Compliance with tax regulations has been a constant challenge for the smallest **micro enterprises** from both administrative and financial aspects. For solving these two issues the Government provides as of 2013 a very simple, optional taxation scheme, the **lump-sum micro enterprise tax**. The monthly amount of payable lump-sum tax – up to a turnover of 6 million HUF – is 50 000HUF for a registered full-time self-employed person irrespective of the actual amount of turnover, while for a micro tax payer who is not a full-time entrepreneur this amount is 25 000HUF per month.

- **Small and medium-sized enterprises** have been the engine of hiring and economic growth, therefore the Hungarian Government considers the issue of assisting small and medium-sized enterprises a priority. It has been obvious that financial and economic recovery cannot take place without this sector and burdens weighing on their activities shall be eased. The small enterprise tax provides the opportunity for paying tax on a cash-flow basis and thus it points to a new concept regarding income taxation. The taxpayer subject to the 16 percent **small enterprise tax** will be exempt from declaring and paying corporate income tax, social security tax and training contribution.
- In line with establishing a linear taxation system regarding levies on labour, the **pension contribution ceiling of employees** will be abolished.
- In 2013 **extra taxes for certain sectors will be phased out.**

Changes in taxes on consumption

- In accordance with the Job Protection Action Plan, the introduction of **cash-flow VAT** (in line with the EU directive on VAT) will enable enterprises opting for this tax scheme to pay VAT only after having paid their invoices (thus the payment of the invoice will also carry the right of deduction). By improving the liquidity of small and medium-sized enterprises this measure contributes to safeguarding jobs.
- The ceiling for tax exemption for taxpayers liable to **VAT** will increase from 5 million HUF to 6 million HUF (thus matching the tax base threshold of the lump-sum micro enterprise tax).
- In order to combat fraud and irregularities in the **swine and forage sector**, as of **2013 reverse charge VAT** will also be introduced regarding trade in live swine and swine halves furthermore some products serving also as forage, which measure depends on the approval of required EU derogation request.
- In 2013, certain amendments concerning the **public health product fee** regulation will be introduced due to recipe modifications by producers of energy drinks with extreme health risks. In addition, **excise tax** on tobacco products, alcohol and liquefied petroleum gas (LPG) will also increase.

- In order to sustain fiscal balance, as of 1 January 2013 a **financial transaction levy** will be introduced. The new levy is a kind of duty on transactions applicable to a large number of taxpayers, has a rate of 0.2 percent and is capped at 6000 HUF. The levy is applicable to retail bank transactions, cash withdrawals, postal paper-based payments, foreign currency exchanges and transactions of the Hungarian State Treasury stipulated by law. In order to reduce paper-based payments, parallel to the introduction of the levy certain **incentives stimulating electronic payment** will also be put in place. With the aim of preventing a shift to more frequent cash payments and of reducing cash transfers which strengthen grey economy the tax rate levied on cash withdrawals will be 0.3 percent.
- An **insurance tax replacing two current levies on insurance companies** (surtax of financial institutions, fire protection contribution) will also be introduced. Taxes on the insurance sector utilized in other European countries have been taken into consideration in the elaboration of the new scheme. Life insurances will be exempted because the Government aims to stimulate self-provision and long-term savings. The rate of tax for property and accident insurance policies will be 10 percent, while that of casco insurance will be 15 percent.

Measures aimed at broadening the tax base and increasing economic transparency

- **Approximating the taxation of preferentially taxed fringe benefits and certain other benefits** has been a measure aimed at neutralizing the taxation system. As a result of the measure, a health contribution tax of 14 percent will be levied on fringe benefits instead of the current 10%.
- In order to broaden the tax base of **local business tax**, the amount deductable as acquisition cost of goods sold or services mediated will be determined progressively depending on the amount of revenue.
- In order to combat VAT fraud, **cash registers will be electronically connected to the tax authority.**
- As of 2013, **certain other legislative changes assisting the fight against black economy** will be introduced: as of 1 January 2013 issuing and declaring domestic VAT

will be mandatory (for invoices above 2 million forints both the issuer of the invoice and the taxable person exercising the right of deduction based on that invoice shall make a detailed report in its VAT return on the data contained in the invoice); e-invoicing will become simpler and in the same calendar month based on the same business transaction between the same parties only 1.5 million HUF can be paid in cash.

Other tax policy measures

- As an extension of the **local buildings tax**, a tax of 100 HUF per meter will be possible to be levied on wires (electricity, phone, television, internet) and pipelines (gas, water, conduit) owned by the providers of utilities.
- As of 2013, three other small taxes will be abolished.