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The Evolution of the Hungarian Tax System

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Introduction

In the late 1980's and early 1990's, the Hungarian economic and political systems were in a state of transition. After the collapse of the Soviet Union, establishing a new tax system was a very important step for every country transitioning from the Soviet economic structure to a market economic structure. Government revenue is vitally important for the government of any country to be able to provide its citizens with services that they need and want, and tax collection is a primary source of government revenue. Tax revenue is especially important for countries working towards improving and growing their economies and for countries striving to reduce poverty rates among their citizens. However, many counties with low incomes struggle to take full advantage of their potential for tax revenue collection.[1] Such a trend is evident in Hungary's initial tax reforms following the end of Soviet rule. Tax collection operated very differently in a Soviet structured economy than it did in a market structured economy. It was much easier to collect taxes and enforce tax collection from government-owned corporations than it was from private corporations. Intelligent, effective tax reform was therefore especially important for Hungary and other post-Soviet countries in this time of transition.

The Hungarian tax reform during this transition period is interesting because Hungary was the first country in Central-Eastern Europe to attempt such a comprehensive fiscal reform.[2] This made the implementation of the reform more challenging. There were no other countries

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[1] Morrissey, O., Von Haldenwang, C., Von Schiller, A., Ivanyna, M., & Bordon, I. (2016). Tax revenue performance and vulnerability in developing countries. The Journal of Development Studies, 52(12), 1689-1703. doi: 10.1080/00220388.2016.1153071
[2] Koltay, J. (1993). Tax reform in Hungary. In *Hungary: An Economy in Transition*. Ed. by Szekely, I. P., and Newbery, D. M. Cambridge University Press: Glasgow.

from which Hungary could draw a relevant comparison, nor was there an appropriate baseline from which to set expectations for Hungary's reforms.[3] Even the most complicated and dramatic tax reforms in western countries were far less dramatic than this reform. This meant that the effects of changes in tax policy in western countries could not necessarily be assumed to have the same effects in Hungary.[4]

A second complication that makes the Hungarian tax reform interesting is that the Hungarian tax reform was initiated and implemented before other important structural changes in the Hungarian economic system were complete. For example, the first legislation that addressed the privatization of perviously state-owned enterprises was not passed until 1989 and did not come into effect until the middle of 1990.[5] This was well after the initial and most dramatic Hungarian tax reform of 1988 took place.[6] Similarly, legislation regulating relationships between businesses did not come into effect until mid-1990.[7] Nor was the Act on Accounting introduced until 1991.[8] Because the tax reform was implemented before many of the other economic transitions were completed or even initiated, the reformed tax system was initially incompatible with the Hungarian economic system as a whole.[9] This dissonance can help explain why Hungary experienced some difficulties in tax collection and enforcement immediately after the reform, but it can also point to ways in which the tax reform was able to facilitate further economic reforms.

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[3] *Id.*
[4] *Id.*
[5] Sarkozy, T. (1993). A legal framework for the Hungarian transition, 1989-91. In *Hungary: An Economy in Transition*. Ed. by Szekely, I. P., and Newbery, D. M. Cambridge University Press: Glasgow.
[6] Koltay, J. (1993). Tax reform in Hungary.
[7] Sarkozy, T. (1993). A legal framework for the Hungarian transition, 1989-91.
[8] Kardos, B. & Madarasi-Szirmai, A. (2013). European traditions in accounting: Accounting in Hungary. In European Accounting Association Newsletter, March 2013.
[9] Koltay, J. (1993). Tax reform in Hungary.

A final point of interest regarding the tax reform was its relationship with the tax policies adopted in Western Europe. An important goal, which permeated much of Hungary's transition strategy, was gaining membership in the European Union.[10] This goal led to the adoption of tax policies that were similar to those used by European Union members or required by the European Union. While this practice was necessary for facilitating the long-term goal of achieving European Union membership, it may have made Hungary's transition more difficult in the short-term.[11]. For example, value added taxes were common in Western Europe, but they are more difficult to enforce than taxes such as property and land taxes.[12] A further problem is that, while Hungary did adopt tax structures and policies similar to those found in Western Europe, the Hungarian policies lagged far behind the western policies on which they were based.[13]

The 1988 Reform of the Hungarian Tax System

Pre-Reform

Before the major overhaul of the Hungarian tax system in 1988, two thirds of Hungarian tax revenue came from taxes paid by state-owned enterprises.[14] This was very different from the tax systems of Western Europe where direct taxes on individual households constituted a larger percentage of tax revenue than those on businesses.[15] This sharp contrast pointed to just how dramatic of a transformation the Hungarian tax system would need in order to emulate its counterparts in Western Europe. Additionally, such a heavy reliance on taxes from state-owned enterprises would not be sustainable as privatization occurred. This emphasized the importance

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[10] Szekely, I. P. & Newbery, D. M. G. (1993). Introduction. In *Hungary: An Economy in Transition*. Ed. by Szekely, I. P., and Newbery, D. M. Cambridge University Press: Glasgow.

[11] Hussain, A. (1993). Discussion of part five. In *Hungary: An Economy in Transition*. Ed. by Szekely, I. P., and Newbery, D. M. Cambridge University Press: Glasgow.
[12] *Id.*
[13] Koltay, J. (1993). Tax reform in Hungary.
[14] *Id.*
[15] Hussain, A. (1993). Discussion of part five.

of tax reform not only for the rest of Hungary's economic transition, but also for the successful operation of Hungary's new government as a whole.

The Hungarian tax system pre-reform has been described as "confused and opaque."[16] There were many different rules, allowances, exemptions, subsidies, etc., and these rules and exceptions were continuously changing.[17] Not only would such a system become increasingly difficult to enforce as privatization occurred, but such a system could also serve to inhibit privatization. Such a system had little stability and little predictability and therefore was not good for encouraging investment. This would have been especially detrimental during Hungary's transition period because privatization required the attraction of direct and indirect foreign investments.[18]

Pre-1988, only one-sixth of Hungary's total government revenue came from indirect taxes.[19] This was again very different from Western Europe where about one-third of tax revenue came from indirect taxes.[20] Furthermore, pre-1988, Hungary had no general turnover tax, nor did they have a personal income tax.[21] This fact would make the introduction of the Hungarian value added tax and personal income tax in 1988 all the more dramatic.

The 1988 Reforms

Early on in its transition, the Hungarian legislature enacted Act No. V on Value Added Tax, Act No. VI on Income Tax, and Act No. IX on Corporate Profits Tax which all became effective on January 1, 1988.[22]

[16] Koltay, J. (1993). Tax reform in Hungary. At 251.
[17] Koltay, J. (1993). Tax reform in Hungary.
[18] Foty, A. G. (1995). COMMENT: Hungary: Securities on the Forefront of Revitalization. 8 Transnat'l Law. 415.
[19] Koltay, J. (1993). Tax reform in Hungary.
[20] Hussain, A. (1993). Discussion of part five.
[21] Koltay, J. (1993). Tax reform in Hungary.
[22] Sarkozy, T. (1993). A legal framework for the Hungarian transition, 1989-91.

The Hungarian value added tax was implemented based on the value added taxes found in European Union countries. Most goods and services were taxed at the standard rate of 25%, some services (including the transportation of goods, repairs, and tourism) were taxed at a middle tier of 15%, and basic consumer goods (including food, public transportation, and books) were not taxed.[23] Other exceptions to the tax included housing, health, education, culture, and sport which were not subject to the tax.[24] The introduction of the value added tax in Hungary required increased administration because Hungary did not previously have a general turnover tax.[25] The implementation of this tax despite the required administration was justified by a desire to eventually join the European Union.[26]

The personal income tax was the second new tax that was introduced by the 1988 reform. The revenues from the personal income tax were distributed to local governments primarily because the 1988 tax reform abandoned local taxes (including property taxes).[27] The Hungarian personal income tax taxed all income (no matter its source) from each individual (i.e. the tax was calculated on an individual basis rather than on a household basis) according to a standard, progressive tax table (see Table 1).[28]

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[23] Koltay, J. (1993). Tax reform in Hungary.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*

Table 1. *Changes in Personal Income Tax Rates, HUF per year, 1988-92*

1988

Tax base	Tax rate
0- 48,000	0
48,001- 70,000	20
70,001- 90,000	25
90,001- 120,000	30
120,001- 150,000	35
150,001- 180,000	39
180,001- 240,000	44
240,001- 360,000	48
360,001- 600,000	52
600,001- 800,000	56
800,001-	60

1989

Tax base	Tax rate
0- 55,000	0
55,001- 70,000	17
70,001- 100,000	23
100,001- 150,000	29
150,001- 240,000	35
240,001- 360,000	42
360,001- 600,000	49
600,001-	56

1990

Tax base	Tax rate
0- 55,000	0
55,001- 90,000	15
90,001- 300,000	30
300,001- 500,000	40
500,001-	50

1991

Tax base	Tax rate
0- 55,000	0
55,001- 90,000	12
90,001- 120,000	18
120,001- 150,000	30
150,001- 300,000	32
300,001- 500,000	40
500,001-	50

1992

Tax base	Tax rate
0- 100,000	0
100,001- 200,000	25
200,001- 500,000	35
500,001-	40

Source: Koltay, J. (1993). Tax reform in Hungary, p. 254.

Although the Hungarian personal income tax was modeled on personal income taxes found in countries in Western Europe, the tax was not as successful in Hungary as anticipated. This can largely be attributed to a failure of the Hungarian government to consider how tax policies might discourage work effort and thus reduce the tax base and reduce overall tax revenue.[29] The Hungarian tax had higher marginal tax rates, steeper progression, and narrower income brackets than its western counterparts.[30] In 1988, there were eleven different income brackets, and the highest tax rate was 60% (see Table 1). The combination of these factors resulted in the creation of too high a tax burden for many Hungarians.[31] Furthermore, the system hardly considered factors such as the number of dependents relying on an individual's income.[32] This policy further increased the tax burden on Hungarian families. These systematic flaws were attempted to be corrected by yearly changes in the income brackets and tax rates, but change was slow and the refusal to introduce tax reduction based on the number of dependents contributed to a reduction in the tax base.

The tax on corporate profits that was introduced in 1988 was designed to replace the tax on state-owned enterprises. In 1988, the tax was set at 50% of corporate profits, but this was lowered to 40% in 1990.[33] Like the personal income tax, there were several problems with the corporate profits tax when it was first implemented. The first problem was that, at the time this tax was enacted, there was no unified system of accounting in Hungary. Hungary's first Act on Accounting was not introduced until 1991.[34] Without a uniform system of accounting, there was no uniform way to measure corporate profits. This made the measurement and enforcement of the corporate profits tax extremely difficult.

A second problem with the corporate income tax was that this tax introduced a systematic discrimination against private businesses in favor of state-owned businesses.[35] As of 1988, privatization had not officially begun and there were still a significant number of state-owned

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[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] Kardos, B. & Madarasi-Szirmai, A. (2013). European traditions in accounting: Accounting in Hungary.
[35] Koltay, J. (1993). Tax reform in Hungary.

enterprises.[36] However, taxing a privately-owned business at the same rate as a state-owned business did not have an equal effect on each type of business. The privately-owned businesses were normally expected to pay out a portion of their after-tax profits to their owners, while the state-owned businesses had no such requirement.[37] Such a system impairs the progress of privatization because it allows the state-owned enterprises to remain in a more favorable financial position than similarly situated privately-owned businesses. This problem was addressed in 1990 by the introduction of an obligatory payment for state-owned enterprises.[38] This elimination of the initial discrimination against privately-owned businesses helped encourage the privatization of Hungarian businesses.[39]

A third problem with the corporate income tax was the persistence of the double taxation of corporate profit distributions. Corporate profits were taxed first at the corporate rate and then at the personal income tax rate after being distributed to owners as income.[40] This policy also impairs privatization because it makes it less attractive to privately own a business.

Evaluation of the 1988 Reform

A major takeaway from the Hungarian tax reform implemented in 1988 is that the reform implemented a tax system that was designed for a market economy, but the Hungarian economy was not yet a full market economy.[41] This led to some problems with measurement, enforcement, and collection of the taxes that were implemented. However, the tax reforms were also able to help perpetuate other aspects of Hungary's transition, such as the development of a uniform system of accounting. In turn, the development of a uniform system of accounting

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[36] Mihalyi, P. (1993). A unique approach to privatization, 1989-91. In *Hungary: An Economy in Transition*. Ed. by Szekely, I. P., and Newbery, D. M. Cambridge University Press: Glasgow.
[37] Koltay, J. (1993). Tax reform in Hungary.
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*

helped perpetuate further economic developments in Hungary such as the growth of the stock market in Budapest. Additionally, with the eventual goal of acceptance into the European Union, these tax reforms made sense in the long term even though they may have caused some problems in the short-term.

The Current State of the Hungarian Tax System

In the last three decades, although there have been many changes in tax rates, tax bases, tax credits, and tax exceptions, there have not been any reforms of the same magnitude or dramatic effect as the 1988 reform. This is in large part due to the fact that the 1988 reform instituted the foundations of a tax system similar to those used in market economies around the world. Because the 1988 reform set the appropriate stage for the growth of Hungary's market economy as well as Hungary's acceptance into the European Union, it has not been necessary for Hungary to undergo another dramatic tax reform. In 2017, Hungary had a tax-to-GDP ratio 37.7% which is comparable to the average across all countries in the Organization for Economic Cooperation and Development of 34.2%.[42] Excluding social security taxes, the majority of Hungarian tax revenue today is received from the value added tax, other taxes on goods and services, personal income taxes, and corporate income taxes.[43]

Personal Income Tax

Rather than having a tiered personal income tax structure, Hungary implemented a flat personal income tax of 16% in 2010 and lowered it to 15% in 2016.[44] The current personal income tax rate is still set at a flat rate of 15%.[45] An additional change is that a family tax

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[42] Bradbury, D. & Harding, M. (2018). Revenue statistics 2018 – Hungary. Center for Tax Policy and Administration. https://www.oecd.org/tax/revenue-statistics-hungary.pdf
[43] *Id.*
[44] 2017 Investment Climate Statements: Hungary. (2017). U.S. Department of State. https://www.state.gov/reports/2017-investment-climate-statements/hungary/
[45] 2019 Tax guideline – Hungary. (2019). Accace. https://accace.com/wp-content/uploads/2019/02/2019-02-Tax-Guideline-Hungary-EN-compressed.pdf

allowance may now be deducted based on the number of dependent children.[46] There is also an allowance for married couples, and deductions are allowed for business and school expenses, interest on housing loans, qualifying real estate sales, and charitable donations.[47]

Corporate Income Tax

The corporate income tax was lowered to 20% in 1995 and then lowered again to 9% in 2016.[48] The tax base for the corporate income tax was set by Act LXXXI of 1996 on corporate income tax and is calculated as business profits modified by items such as depreciation, dividends, royalties, penalties, etc.[49] Hungary also offers tax credits to businesses investing in energy efficient technologies, making capital investments, and performing research and development.[50] Further tax allowances are granted to businesses qualifying as small or medium enterprises.[51]

Hungary's corporate tax rate of 9% is the lowest corporate tax rate in the European Union.[52] Such a low rate was seen by many to be an attempt to attract foreign investment (especially from Western Europe) into Hungary.[53]

Value Added Tax

The current standard value added tax rate in Hungary is 27%, but some goods and services are taxed at reduced rates.[54] Items including dairy products, corn, starch, and

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[46] Hungary: Tax System (2019). Santander TradePortal. Export Enterprises, SA. https://en.portal.santandertrade.com/establish-overseas/hungary/tax-system
[47] *Id.*
[48] Hungary Corporate Tax Rate. (2019). Trading Economies. https://tradingeconomics.com/hungary/corporate-tax-rate
[49] 2019 Tax guideline – Hungary. (2019). Accace.
[50] Hungary: Tax System (2019). Santander TradePortal. Export Enterprises, SA.
[51] 2019 Tax guideline – Hungary. (2019). Accace.
[52] Byrne, A. (2017). Hungary to offer EU's lowest corporate tax rate. Financial Times. https://www.ft.com/content/302fa4b4-acda-11e6-9cb3-bb8207902122
[53] *Id.*
[54] 2019 Tax guideline – Hungary. (2019). Accace.

commercial accommodation services are taxed at the rate of 18%.[55] Additionally, items such as meat, fish, eggs, medicine, books, heating services, live music, restraunts, and internet are taxed at a 5% rate.[56] Value added taxes are filed and paid by businesses, but the cost is passed on to consumers through prices.[57] Therefore, the value added tax falls on the final consumer of the goods and services.[58]

Evaluation of Recent Tax Changes

Many people note that the more recent changes in the Hungarian tax system (introduction of a flat personal income tax, introduction of a flat corporate income tax, increase in the value added tax rate) helped Hungary avoid a debt-driven economic collapse such as the financial crisis experienced by Greece.[59] However, these same policies have also had disproportional effects on poor Hungarians. The introduction of a flat rate for personal income tax was disproportionately burdensome on poorer Hungarians who pay the same rate as those with the highest level of income. As a result of the tax changes, nearly a million poor Hungarians have had their share of income decline since 2010.[60] Furthermore, the European Commission noted that these policies have contributed to "one of the biggest rises in inequality across the EU since the financial crisis".[61]

An additional note of potential concern is that Hungary has offset the reduction in tax revenue caused by the reduction in personal and corporate income tax rates with a series of

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[55] *Id.*
[56] *Id.*
[57] Hungary: Tax System (2019). Santander TradePortal. Export Enterprises, SA.
[58] Koltay, J. (1993). Tax reform in Hungary.
[59] Megyesy, E. (2017). A look at Hungary's experience with tax reform. Washington Examiner. https://www.washingtonexaminer.com/a-look-at-hungarys-experience-with-tax-reform; Szakacs, G. (2018). As Hungary roars ahead, Orbanomics leaves some of the poorest behind. Reuters. https://www.reuters.com/article/hungary-election-economy/rpt-as-hungary-roars-ahead-orbanomics-leaves-some-of-the-poorest-behind-idUSL5N1RG265
[60] Szakacs, G. (2018). As Hungary roars ahead, Orbanomics leaves some of the poorest behind.
[61] *Id.*

"crisis taxes". These crisis taxes are large, temporary tax increases in specific industries.[62] While the crisis taxes have helped Hungary avoid large fiscal deficits, the unpredictable nature of these taxes may prove to disincentivize both foreign and domestic investment in Hungary in the long-run. Furthermore, these crisis taxes are alleged to be inconsistent with European Union regulations, and the European Union has already instructed Hungary to phase out sectoral taxes.[63]

Corruption

In addition to the problems of inequality (and perhaps further contributing to those problems), there is some evidence of corruption in the Hungarian tax system. The Hungary Corruption Report notes that irregular tax payments and bribes are common.[64] This, combined with the fact that over one half of Hungarian firms report being visited by tax officials could indicate that bribery in the tax system is widespread.[65] Furthermore, in 2017, there was a report from a former employee at the Hungarian National Tax and Customs Administration that the administration instructed employees to refrain from inspecting large companies who were suspected of committing and benefiting from tax fraud.[66] Given the importance of sustaining government revenue as well as the potential misuse of tax revenue by corrupt officials, any reports of tax fraud or corruption in the tax system are highly concerning.

There are further concerns regarding the National Tax and Customs Administration's relationship with businesses, especially foreign businesses. Some United States firms operating in Hungary have reported that they are often under audit.[67] These audits often result in

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[62] 2017 Investment Climate Statements: Hungary. (2017). U.S. Department of State.
[63] *Id.*
[64] Hungary Corruption Report. (2017). GAN Business Anti-Corruption Portal. GAN Integrity Inc. https://www.business-anti-corruption.com/country-profiles/hungary/
[65] *Id.*
[66] *Id.*
[67] 2017 Investment Climate Statements: Hungary. (2017). U.S. Department of State.

substantial costs, especially considering that auditors apply a system of strict liability for errors.[68] Even simple calculation errors or using the wrong form have reportedly resulted in fines of several hundred dollars per mistake.[69]

There have also been complaints about the frequency of changes to Hungarian taxes and about the fact that many tax changes are implemented without consulting the businesses that will be affected by the changes.[70] Although it is not legally necessary for a government to consult with businesses before implementing a new tax policy, it is often helpful to receive feedback from the affected businesses. The businesses will often have a better sense of what the actual effect of the change will be and may be able to propose additional modifications that would better achieve the government's policy objective (assuming that the objective is a legitimate one).

There have been further problems within the tax system of the Hungarian government enacting taxes that have not been approved by the European Union. There have been several taxes implemented that have the affect of benefiting Hungarian-owned firms at the expense of foreign-owned firms. Taxes levied on banks have resulted in foreign banks selling their operations to Hungarian investors or to the Hungarian government itself. This has resulted in foreign participation in the Hungarian banking sector decreasing by almost 30%.[71] Additionally, a 2014 Retail Tax seemed to be designed to specifically target large foreign firms such as Tesco and Spar.[72]

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68 *Id.*
69 *Id.*
70 *Id.*
71 *Id.*
72 *Id.*

Perhaps most concerning is a 2015 amendment to Hungary's Advertising Tax that was deemed discriminatory by the European Union.[73] This tax favored national and government-linked media corporations and appeared to specifically target a German-owned TV group that was known as the most prominent independent voice in Hungarian broadcast media.[74] Such an obvious attempt by the Hungarian government to target a foreign company is concerning in itself, but the targeting of an independent media company raises far more serious concerns about free speech and democracy in general.

Response to Corruption

Many of these apparent attempts to inhibit competition or favor domestic companies have not gone unnoticed by the relevant European Union authorities. As noted above, the European Union has instructed the Hungarian government to stop its use of industry-specific crisis taxes.[75] Additionally, the European Commission suspended the implementation of the 2014 Retail Tax which resulted in the Hungarian government restoring the tax to its previous non-discriminatory design.[76] Finally, the European Commission launched an in-depth investigation of Hungary's 2015 Advertisement Tax Amendment that resulted in a ruling that the amendment was discriminatory and in violation of European Union rules on competition.[77] The European Commission issued an injunction which the Hungarian government complied with.[78]

Although some areas of concerns of corruption in the tax system have not yet been addressed by the European Union (i.e. reports of bribes, tax fraud, and unfair audit procedures), the response so far from the European Union seems to indicate that it is committed to rooting out

[73] Vizer, J. (2017). Advertisement tax - change in legislation. RSM Hungary. https://www.rsm.hu/en/blog/2017/05/advertisement-tax-legislation-change
[74] 2017 Investment Climate Statements: Hungary. (2017). U.S. Department of State.
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*

corruption and anti-competitive behavior in its member countries' tax systems. Furthermore, the work of organizations including the U.S. State Department, Transparency International, and GAN Business Anti-Corruption Portal to identify areas of potential corruption and inform investors will help hold governments accountable for corruption and hopefully help eliminate it.

Conclusion

It has long been known that governmental tax policies have the power to affect and perpetuate a wide range of economic policies. From promoting equitable redistribution to incentivizing investment in environmentally friendly technologies, the benefits that can be bestowed by a well-structured, intelligent tax policy are far-reaching. Even a tax system with significant flaws has the power to promote positive development, as evidenced by the Hungarian Tax Reforms of 1988. Although the 1988 reforms were not perfect, they set Hungary up for membership in the European Union and several decades worth of positive tax policies. The 1988 Tax Reform also helped facilitate other necessary changes as Hungary transitioned from the Soviet-based economy to a market economy.

Although there is concern about the unequal distributional effects of the current personal income tax bracket and rate, it is important to note that the underlying structure of the Hungarian tax system has not been altered. That is, in the same was that the first personal income tax introduced in Hungary in 1988 might have had too many income brackets, the current tax might have too few. But in the same way that the 1988 design was altered many times, the current design can be altered because the underlying structure is still in place.

Similarly, although concerns about corruption entering the Hungarian tax system are not trivial, Hungary's foundation of a tax structure that has proven effective (i.e. value added taxes, personal income taxes, and corporate income taxes) will hopefully provide some resistance against this corruption. Additionally, Hungary's desire to remain a member of the European Union will likely curb the implementation of corrupt taxes, because the European Commission has proven that it will investigate and strike down such corrupt taxes.