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Work Incentives and Recent Reforms of the Tax and Benefit System in Hungary

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WORK INCENTIVES AND RECENT REFORMS OF THE TAX AND BENEFIT SYSTEM IN HUNGARY

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ABSTRACT/RESUMÉ

Work incentives and recent reforms of the tax and benefit system in Hungary

Reducing the extent of inactivity and promoting labour supply is essential to foster labour market outcomes in Hungary in the medium term. Notwithstanding specific factors linked to education, the pension system or family and disability policies, financial disincentives play an important role in this regard. This paper describes the impact of recent reforms of the tax and benefit system in Hungary on some indicators of financial incentives to enter the labour market derived from OECD tax and benefit models. While personal income taxes were cut and the system of tax allowances for families became more generous other welfare benefits were reduced or phased out, which causes significant changes in the incentives for workers, inactive or unemployed people. Between 2010 and 2012, the average tax wedge dropped for high-income earners and/or families with two children, but increased mainly for individuals without children and income below the 80th percentile, which was partly mitigated by the implementation of compensation schemes. However, there is still a large gap in the average tax wedge with the OECD average and regional peers, notably driven by high social security contributions. The implicit tax on returning to work from unemployment remains relatively high and increased below the average wage for most family types. However, it was cut above that level. The absolute level of the implicit tax on returning to work from inactivity is significantly lower notably following across-the-board cuts for lone parents and one-earner married couples with two children, somewhat offset by increases below the average wage for families without children.

This Working Paper relates to the 2012 *OECD Economic Survey of Hungary* (www.oecd.org/eco/surveys/hungary)

JEL classification: J22, J38, J65, D63, H23, H24

Keywords: benefit system; tax wedge; implicit tax; effective tax rate; replacement rate; labour supply; Hungary.

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Les incitations au travail et les récentes réformes du système de prélèvements et de prestations en Hongrie

La réduction du taux d'inactivité et l'augmentation de l'offre de travail sont deux éléments essentiels pour promouvoir de meilleurs résultats en termes d'emploi à moyen terme en Hongrie. Outre des facteurs spécifiques liés à l'éducation, au système de retraite, ou aux politiques en faveur de la famille ou des handicapés, les contre-incitations financières jouent un rôle important à cet égard. Cet article décrit l'impact des réformes récentes du système de prélèvements et de prestations hongrois sur certains indicateurs d'incitations au retour à l'emploi issus de modèles de prélèvements et de prestations élaborés par l'OCDE. Parallèlement à la baisse de l'impôt sur le revenu des personnes physiques et à des allègements fiscaux plus généreux accordés aux familles, d'autres prestations sociales ont été réduites ou progressivement supprimées, modifiant dans une large mesure les incitations pour les travailleurs, les inactifs ou les chômeurs. Entre 2010 et 2012, le coin fiscal moyen a baissé pour hauts salaires et/ou les familles avec deux enfants, mais s'est accentué essentiellement pour les personnes sans enfants et les salaires inférieurs au 80e centile, ce qui a été atténué par la mise en œuvre d'un système d'indemnisation. Le coin fiscal moyen reste toutefois largement supérieur à la moyenne de l'OCDE et des pays de la région, notamment en raison du niveau élevé des contributions à la sécurité sociale. Le taux implicite d'imposition sur la reprise d'une activité professionnelle à l'issue d'une période de chômage reste relativement élevé et a augmenté pour les revenus inférieurs à la moyenne pour la plupart des catégories de ménages. Il a toutefois été réduit pour les salaires supérieurs à ce niveau. En valeur absolue, le taux implicite d'imposition sur le retour à l'emploi des inactifs est nettement inférieur, notamment à la suite des réductions globales en faveur des parents isolés et des ménages à revenu unique avec deux enfants, même s'il a augmenté pour les ménages à bas revenu sans enfants.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Hongrie, 2012 (www.oecd.org/eco/etudes/hongrie).

Classification JEL: J22, J38, J65, D63, H23, H24

Mots-clés: système de prestations; coin fiscal; taux implicite d'imposition; taux d'imposition effectif; taux de remplacement; offre de travail; Hongrie.

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WORK INCENTIVES AND RECENT REFORMS OF THE TAX AND BENEFIT SYSTEM IN HUNGARY

by Tímea Ladányi and Rafał Kierzenkowski[1]

Major tax and benefit reforms have been implemented in Hungary over the last years. Annex 1 provides technical details about those introduced between mid-2010 and early 2012. These included a restructuring of the personal income tax system with the adoption of a flat-rate tax at 16%, a cancellation of the employment tax credit, an expansion of tax reliefs for families with children and a hike in employees' social security contributions. At the same time, the generosity of unemployment allowances was reduced and eligibility conditions tightened for social assistance and other income replacement benefits. Finally, the amount of sickness benefits was reduced, but the availability of the housing benefit was broadened.

Review of selected indicators

The tax wedge helps to assess incentives for workers to supply labour when considering the difference between total labour compensation paid by the employer and the net take-home pay of employees. More precisely, the OECD indicator is defined as the sum of personal income tax, employee plus employer social security contributions less cash transfers (earned income tax credits and other forms of support for families with children) as a percentage of total labour costs. The average tax wedge can be used to analyse incentives for people to enter the formal labour market, while the marginal tax wedge is used to examine the incentives for workers to increase their hours of work. The comparison of tax wedges between different household types and/or income levels can also be used to examine the distributional effects of various instruments of tax policies.

Labour supply is determined not only by the tax wedge but, more broadly, the overall generosity of the tax/benefit system, which influences financial disincentives to move from unemployment to work (reflecting the size of the so-called unemployment trap) or inactivity to work (reflecting the size of the so-called inactivity trap). Such disincentives can be assessed by calculating the implicit tax on returning to work for individuals, who are either entitled to unemployment allowances or eligible to social assistance. More specifically, the average effective tax rate (AETR) when moving from unemployment or inactivity to employment measures the proportion of any increase in earnings that is lost through the combined operation of different tax increases and withdrawal of benefits. For instance, a higher AETR for social assistance recipients indicates an increased risk of being trapped in long-term benefit dependence.

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The computation of AETRs can be complemented by the calculation of indicators of net replacement rates (NRRs), which measure the proportion of expected income from work replaced by unemployment and related welfare benefits. NRRs depend on the specific personal and family characteristics of the unemployed, their previous history of work and unemployment, and the different structures and entitlements of unemployment insurance, unemployment assistance, social assistance and the ways in which these systems interact with the tax system.

Explicit tax on labour supply: the average tax wedge

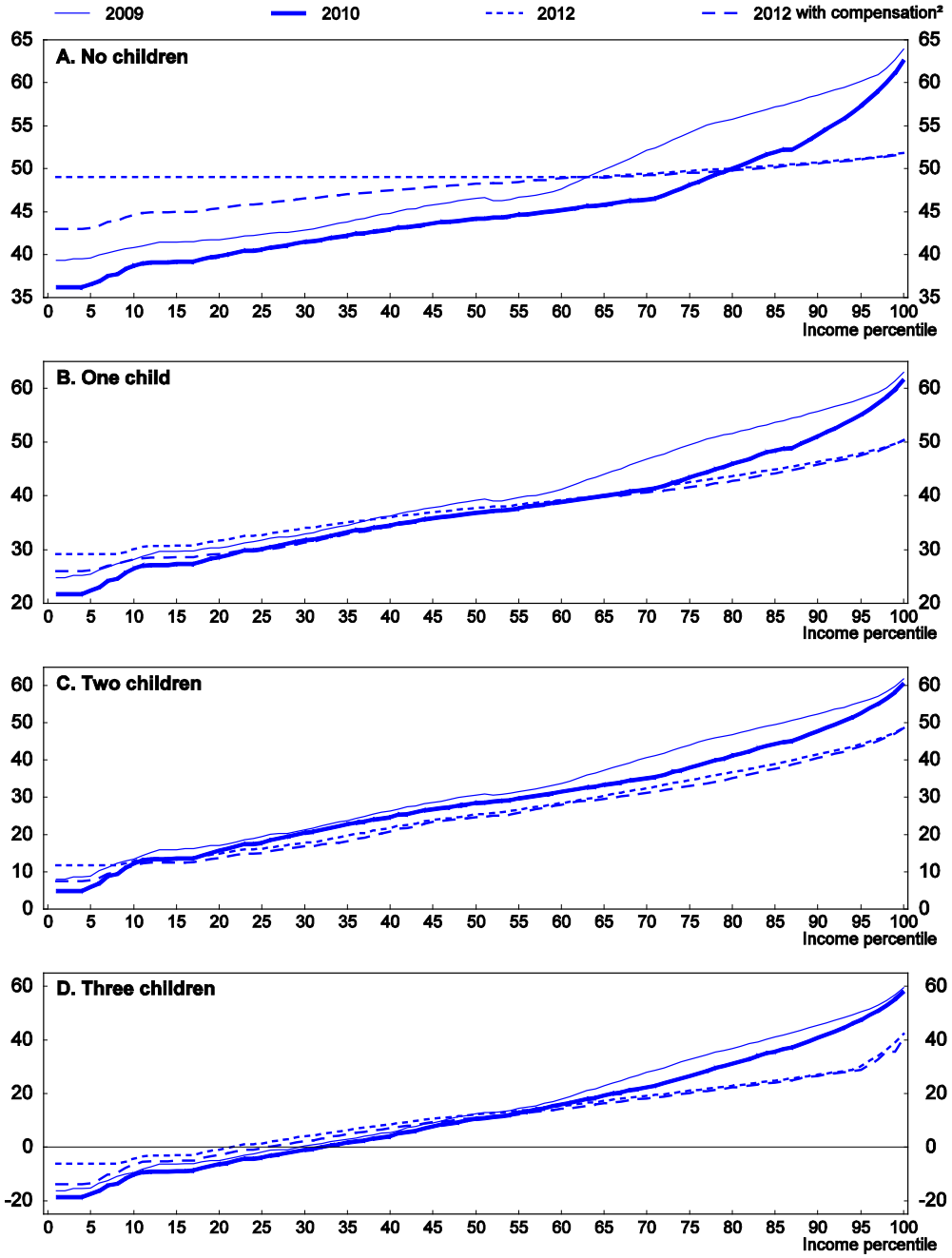
Figure 1 shows the average tax wedge for different income percentiles depending on the number of children in the household for 2009, 2010 and 2012. While the tax wedge declined across the board between 2009 and 2010, there has been an important heterogeneity in its evolution between 2010 and 2012. It increased significantly for individuals without children with income up to the 80th percentile and to a lesser extent for those with below-median earnings with one or three children. This has led the authorities to implement partial compensation schemes. However, the average tax wedge dropped for high-income earners irrespective of the family status and across almost the entire income distribution for households with two children.

Figure 2 illustrates changes in the average tax wedge between 2010 and 2012 for different income levels (expressed as a percentage of the average wage), with a breakdown by components depending on the number of children in the case of a single person. These changes have to be considered against a background of a wage distribution heavily skewed to the bottom (Figure 3). Reductions in personal income taxes and the introduction of tax allowances for families with children have cut the average tax wedge, while the removal of the employment tax credit and a hike in employees' social security contributions have operated in the opposite direction. The cancellation of the employment tax credit affected those earning less than 150% of the average wage in 2010. Increases in employees' social security contributions had a uniform impact on the entire wage distribution, irrespective of the family status. On the other hand, the decrease in personal income taxes was beneficial to all family types and income levels, with the strongest impact for high-income earners. Finally, the major drop in the average tax wage for above-average wage earners with three children has been mainly driven by the tax relief for children.

Table 1 summarises the recent evolution in the average tax wedge in Hungary in comparison with regional peers and the OECD average (assuming that other countries' tax and benefit systems did not change since 2010). Relative to other countries, the average tax wedge in Hungary is still systematically higher in 2012 for all income levels and family types. This is notably due to high social security contributions in Hungary. The gap is between 20 to 25 percentage points above the OECD average at very low earnings levels of 50% or 67% of the average wage for families with no children, but it shrinks to close to 15 percentage points for higher-income earners. However, the gap is less than 10 percentage points for families with two children across all income levels. The average gap *vis-à-vis* other Central and Eastern European countries is somewhat less pronounced for those at the bottom of the income distribution. However, as opposed to Hungary, the average tax wedge on lone parents and one-earner married couples with two children at 50% of the average is very low in other countries, except for Poland.

Figure 1. **Estimated average tax wedge for different income percentiles depending on the number of children in the household**

For a single person, per cent[1]

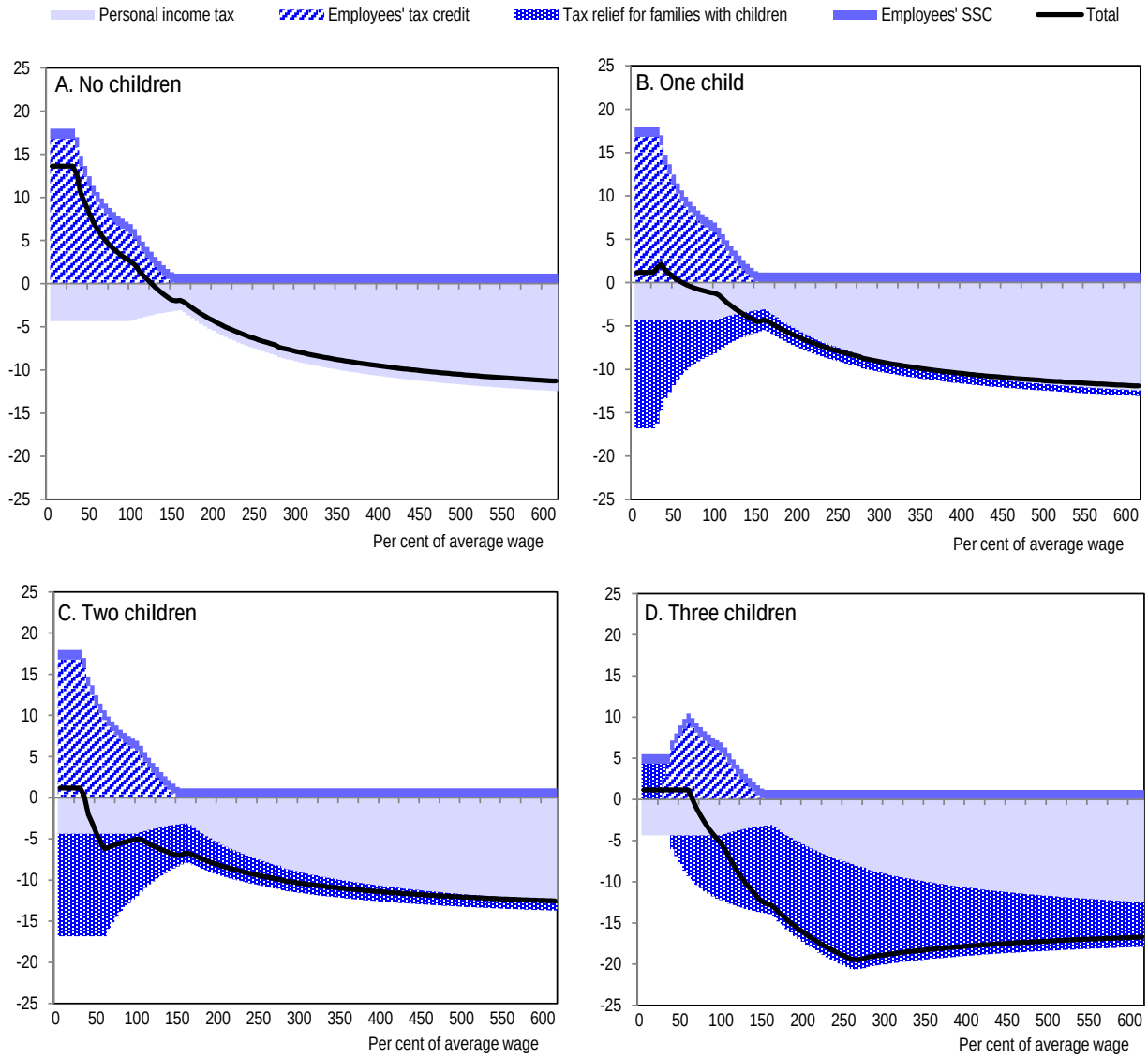


1. The definition of income percentiles is based on actual gross wage distribution in 2010 and projections of gross wages of the Ministry for National Economy for 2012. The income distribution does not correspond to the particular family types shown but is for the whole population, which may bias the estimates.
2. Any increase in private sector wages beyond 5% is refunded to firms through cuts in employers' social contribution tax (former social security contributions).

Source: Authors' calculations derived from OECD Tax/Benefit models and Ministry for National Economy data.

Figure 2. **Estimated changes in the average tax wedge and breakdown by components depending on the number of children in the household**[1]

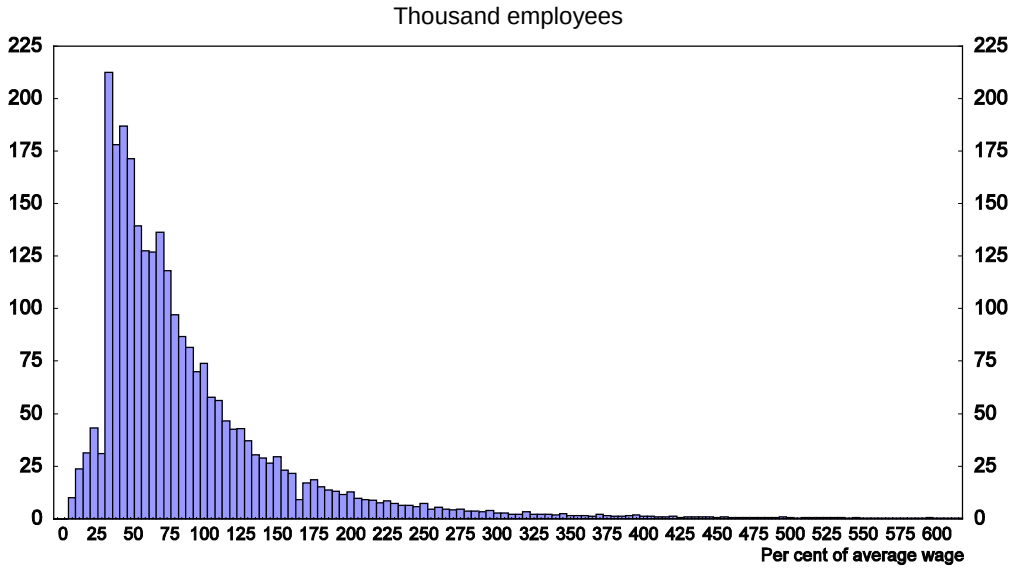
For a single person, percentage points, 2010-12



1. No compensation is assumed for low-income earners. The average wage corresponds to actual data for 2010 (HUF 202 503 in gross terms).

Source: Authors' calculations derived from OECD Tax/Benefit models and Ministry for National Economy data.

Figure 3. Wage distribution



Source: Authors' calculations based on Ministry for National Economy data.

Table 1. **Average tax wedge in international comparison**[1]

Income tax plus employee and employer contributions less cash family transfers (in per cent of labour costs)[2]

Family type	Wage level (% of average worker)	Hungary[3]			2010			
		2009	2010	2012	Czech Republic	Slovak Republic	Poland	OECD[4]
Single person	50	43	41	49	36	31	32	28
	67	46	44	49	39	35	33	31
	100	53	46	49	42	38	34	35
	150	58	52	50	44	40	35	39
	200	60	55	51	45	41	35	41
One-earner married couple	50	43	41	49	34	28	30	25
	67	46	44	49	34	31	31	28
	100	53	46	49	36	31	33	32
	150	58	52	50	40	36	34	36
	200	60	55	51	42	37	35	37
Lone parent with two children	50	21	18	15	4	8	28	6
	67	30	27	22	16	21	28	16
	100	43	35	31	29	29	28	26
	150	51	45	38	38	34	31	33
	200	54	49	42	42	36	32	37
One-earner married couple	50	23	20	17	2	-1	18	6
with two children	67	32	28	23	10	18	28	16
	100	44	36	32	21	23	28	25
	150	51	45	39	32	30	31	32
	200	55	50	42	37	33	32	36

1. No compensation is assumed for low-income earners in Hungary.
2. Labour costs are calculated as gross wage plus employers' social security contributions including payroll taxes.
3. Estimated average gross wage per month: HUF 211 340 (2012).
4. Unweighted average.

Source: OECD (2011), *Taxing Wages 2009-2010* and authors' estimates for Hungary 2012.

Implicit tax on returning to work from unemployment

Over the last three years, when considering a transition into full-time work for persons receiving unemployment benefits (Table 2), the AETRs in Hungary have diminished for those earning the average or above-average wage and increased for low-income earners, except for one-earner married couples without children (stability or across-the-board increase) and lone parents with two children (across-the-board reduction). Unemployment traps at above 80% are high at very low earnings levels of 50% or 67% of the average wage for all family types, with the exception of lone parents with two children for whom they are close to 70%. With AETRs between 50% and 60%, work disincentives are significantly lower at 150% of the average wage and above, except for one-earner married couples without children for whom they are higher. Assuming that other countries' tax and benefit systems did not change since 2010, unemployment traps have diminished below the OECD average for lone parents and one-earner married couples with two children at 67% of the average wage and above. For the latter income levels, they continue to be quite high for two-earner married couples with and without two children relatively to figures observed in Poland and the Slovak Republic for 2010.

Implicit tax on returning to work from inactivity

Between 2009 and 2012, there have been important changes in the level of AETRs for inactive persons returning to work according to different family types and wage levels (Table 3). A significant reduction in AETRs to below 50% has occurred for above-average wage earners (all family types) as well as for lone parents and one-earner married couples with children (all wage levels). However, inactivity traps have increased to above 50% for households without children (single person and one-earner married couple) at very low earnings levels of 50% or 67% of the average wage. Disincentives to work have also risen (admittedly, from very low levels) for working married couples with or without children and earning below the average wage.

In comparison with latest estimates for other countries available for 2010, the implicit tax on returning to work from inactivity has been cut to well below levels observed in the OECD and regional peers (except the Slovak Republic in some cases) for lone parents and one-earner married couples with two children. The AETRs have become comparable with the OECD average for single persons and two-earner married couples with two children. Yet the AETRs are higher for different family types without children than in Poland and the Slovak Republic, in particular for low-income earners at 50% of the average wage.

Table 2. **Unemployment traps in international comparison**[1]

Average effective tax rate for a transition into full-time work for persons receiving unemployment benefits at the initial level, for selected family types and earnings levels (same as in previous job)

Family type	Wage level (% of average worker)	Hungary			2010			
		2009	2010	2012	Czech Republic	Slovak Republic	Poland	OECD[2]
Single person	50	78	78	94	79	38	97	73
	67	81	82	88	80	43	82	71
	100	74	70	72	77	47	65	66
	150	68	64	61	65	49	53	61
	200	..	..	55	..	..	..	..
One-earner married couple	50	78	78	89	78	38	80	73
	67	82	84	84	78	38	83	73
	100	75	71	91	73	38	66	67
	150	69	65	74	60	44	54	60
	200	..	..	65	..	..	..	..
Two-earner married couple	50	78	78	89	79	44	75	69
	67	81	82	84	79	47	66	68
	100	74	70	68	78	49	54	64
	150	68	64	57	67	51	46	59
	200	..	..	51	..	..	..	..
Lone parent with two children	50	78	78	73	82	28	83	70
	67	82	85	72	82	35	97	73
	100	75	72	60	77	68	79	71
	150	69	65	55	63	63	62	64
	200	..	..	51	..	..	..	..
One-earner married couple	50	78	78	89	79	28	83	72
with two children	67	81	82	70	77	31	72	72
	100	75	70	60	71	33	65	70
	150	69	65	53	58	40	55	63
	200	..	..	51	..	..	..	..
Two-earner married couple	50	81	78	89	79	44	83	72
with two children	67	82	82	87	86	47	71	71
	100	75	70	75	83	49	58	67
	150	69	64	63	67	51	49	61
	200	..	..	57	..	..	..	..

1. Initial phase of unemployment but following any waiting period. No social assistance "top-ups" are assumed to be available in either the in-work or out-of-work situations. Any income taxes payable on unemployment benefits are determined in relation to annualised benefit values (*i.e.* monthly values multiplied by 12) even if the maximum benefit duration is shorter than 12 months. See Annex A of the OECD series *Benefits and Wages* for details. For married couples the percentage of average worker (AW) relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.
2. Unweighted average excluding Chile, Israel and Mexico.

Source: OECD (2012), Tax/Benefit models (see *www.oecd.org/els/social/workincentives*) and authors' estimates for Hungary 2012.

Table 3. **Inactivity traps in international comparison**[1]

Average effective tax rate when moving from social assistance into work for selected family types and wage levels

Family type	Wage level (% of average worker)	Hungary			2010			
		2009	2010	2012	Czech Republic	Slovak Republic	Poland	OECD[2]
Single person	50	49	49	64	66	28	59	61
	67	48	46	57	62	28	51	55
	100	50	44	49	55	29	44	49
	150	52	47	44	47	34	40	46
	200	..	..	42	..	..	..	..
One-earner married couple	50	75	51	62	83	48	51	70
	67	69	50	55	72	39	60	64
	100	64	46	52	57	31	50	55
	150	61	48	48	48	36	43	49
	200	..	..	45	..	..	..	..
Two-earner married couple	50	13	19	37	28	19	29	26
	67	21	24	36	29	22	29	28
	100	32	29	36	29	24	30	30
	150	40	37	35	30	26	30	33
	200	..	..	35	..	..	..	..
Lone parent with two children	50	47	46	41	73	-7	40	59
	67	47	47	38	69	3	63	57
	100	50	45	37	61	38	56	55
	150	53	47	40	51	40	47	51
	200	..	..	40	..	..	..	..
One-earner married couple	50	75	51	46	90	57	65	70
with two children	67	67	48	41	77	46	57	67
	100	64	46	40	63	35	55	61
	150	62	49	41	53	39	48	54
	200	..	..	44	..	..	..	..
Two-earner married couple	50	18	23	33	34	19	47	36
with two children	67	24	27	35	33	22	42	36
	100	35	31	40	33	24	38	36
	150	42	38	39	32	26	36	37
	200	..	..	39	..	..	..	..

1. Results relate to the situation of a person who is not entitled to unemployment benefits (*e.g.* because their entitlements have expired). Instead, social assistance and other means-tested benefits are assumed to be available subject to relevant income conditions. See Annex A of the OECD series *Benefits and Wages* for details. For married couples the percentage of average worker (AW) relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.
2. Unweighted average excluding Chile, Israel and Mexico.

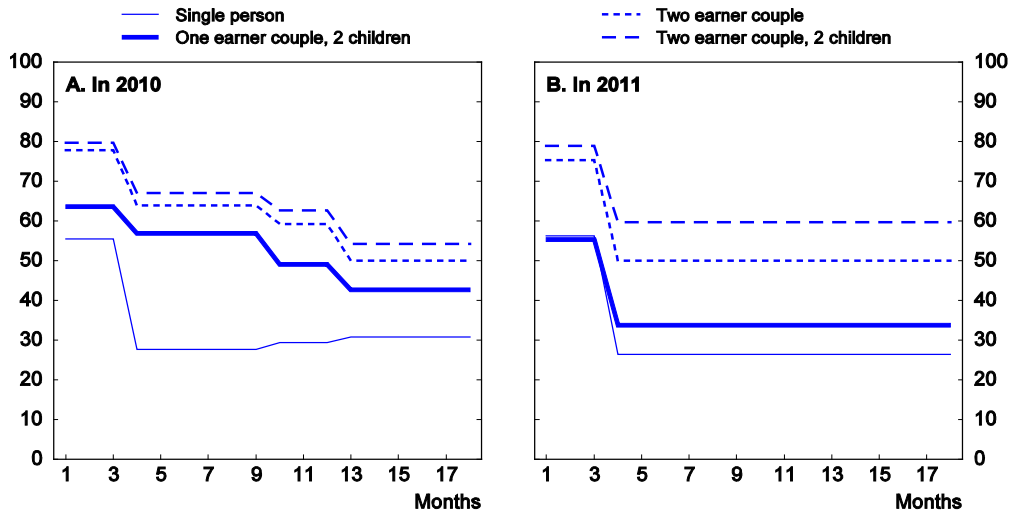
Source: OECD (2012), Tax/Benefit models (see *www.oecd.org/els/social/workincentives*) and authors' estimates for Hungary 2012.

Net income replacement for unemployed persons

Figure 4 illustrates changes in net replacement rates for unemployed persons that happened between 2010 and 2011. The overall generosity of NRRs was cut, but to a different extent depending on family type. Their level was left broadly unchanged for the first three months of unemployment, except for one-earner couples with two children for whom a significant reduction occurred. A permanent level of replacement rates is now reached right after that period, as opposed to a gradual reduction until the 13 months for all but single persons in 2010.

Figure 4. **Estimated net replacement rates for unemployed persons depending on family types**[1]

Previous wage of 100% of average worker earnings, per cent



1. Initial phase of unemployment but following any waiting period. No social assistance "top-ups" are assumed to be available in either the in-work or out-of-work situation. Any income taxes payable on unemployment benefits are determined in relation to annualised benefit values (*i.e.* monthly values multiplied by 12) even if the maximum benefit duration is shorter than 12 months. For married couples the second spouse is assumed to be "inactive" with no earnings in a one-earner couple and to have full-time earnings equal to 100% of average worker earnings in a two-earner couple. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.

Source: Authors' calculations derived from OECD Tax/Benefit models and Ministry for National Economy data.

ANNEX 1

Recent reforms in tax and benefit system in Hungary

Personal income tax

There have been important changes in personal income taxation in 2011 and 2012. In January 2011, a flat-rate personal income tax rate at 16% was adopted, cancelling the remaining two tax brackets at 17% (with no tax-free allowance and up to around two times the average wage or HUF 417 000 per month) and 32%. The 16% tax rate was extended to fringe benefits and separately taxable incomes (income of entrepreneurs, property income, in kind payments, etc.).

In 2011, the generosity of the employment tax credit was reduced in terms of maximum monthly amount (cut back by HUF 3 000 to HUF 12 100) and eligibility conditions. While in 2010 the tax credit was available up to a gross monthly wage (including the super-grossing system)[2] of HUF 266 000 (full amount) and HUF 392 000 (partial amount), the two wage thresholds were cut back in 2011 to HUF 230 000 and HUF 330 000, respectively. The employment tax credit was cancelled in 2012.

In 2011, the system of tax allowances for families with children was reorganised and expanded. A former family tax credit (only available for families with three or more children) was replaced by a wider and more generous tax relief for families with children, which is a deduction from the tax base that can be shared among spouses. The monthly reduction in the tax base is HUF 62 500 per child for one or two children, but goes up to HUF 206 250 per child for three or more children. As a result, are exempted from personal income tax persons with one, two or three children and gross monthly incomes up to approximately HUF 109 000, HUF 158 000 and HUF 487 000, respectively.

In 2012, employers' social security contributions that were included in the tax base were excluded from it for earnings below a gross monthly threshold of HUF 202 000, thus bringing the effective tax rate to 16%.

Social security contributions

In 2011, employees' pension contributions were hiked from 9.5% to 10%. In 2012, employees' health care and labour market contributions have been increased from 7.5% to 8.5%.

Unemployment allowances

The amount and the duration of unemployment allowances were reduced significantly. Before September 2011, the system of unemployment allowances consisted of two parts: the unemployment insurance and the unemployment assistance. The unemployment insurance had two stages. The maximum duration of the first stage was 91 days with a payment between 60% and 120% of the minimum wage. The second stage allowed for additional 179 days, during which the maximum amount of the allowance was 60% of the minimum wage. If the unemployed lost eligibility to unemployment insurance or did not fulfil

2. The tax base contains not only gross earnings, but also employers' social security contributions.

its conditions (for example, did not accumulate at least 365 days of contribution payments), but worked at least 200 days in the previous four years or only five years were missing to retirement, then s/he could benefit from unemployment assistance. This scheme amounted to 40% of the minimum wage and lasted for 90 days, but older persons above 50 could get an extension by another 90 days and those applicants who would have been retired within five years were entitled to this allowance until retirement.

From 1 September 2011, the unemployment insurance has only one stage which lasts for maximum 90 days and provides a payment between 60% and 100% of the minimum wage. The unemployment assistance was cancelled, except for older unemployed persons close to retirement who are entitled to it until retirement.

Social assistance and other income replacement benefits

For people not entitled to unemployment allowances, eligibility to social assistance and other income replacement benefits has been tightened significantly. Only selected groups are entitled to social assistance, which include health impaired people or those who are more than 55 years-old or bring up a child under 14 years-old whose daily care is not ensured in an institution providing daily care.

Other people of working age who are able and show willingness to work can benefit from a so-called "employment replacing benefit" (previously named a "wage supplementing benefit") provided they have cooperated with public employment services (PES) for at least one year (over the previous two years) and their family's income per consumption unit is lower than 90% of the minimum amount of the old-age pension (HUF 25 650 in 2011). Moreover, they have to fulfil additional conditions: *i*) be registered in a local PES; *ii*) irrespective of their qualification, must accept any job proposed by the PES; *iii*) must participate in every training programme offered by the PES; and *iv*) must take care of the surroundings of his/her home.

Sickness benefit

In April 2011, the maximum amount of sickness benefit was reduced from four times the minimum wage to a double that.

Housing benefit

The housing benefit was reorganised, notably by merging a former system of district and gas heating allowances, and came into force on 1 September 2011. Henceforth, the housing benefit can be used not only to cover housing costs (rent, common costs of the house, etc.), but also the heating costs irrespective of the type of heating. The availability of the benefit was broadened as well. A previous limit of 150% of the minimum amount of the old-age pension per consumption unit in the family was extended to 250% (HUF 71 250 in 2011). Another new element of the eligibility conditions is the introduction of means testing. However, the calculation of the benefit has been left unchanged: if the family's income per one consumption unit is less than 50% of the minimum amount of the old-age pension, then it is equal to 30% of the housing costs; if it is between 50% and 250% of the minimum amount of the old-age pension then it is calculated with a formula.[3] In the latter case, the value of the benefit should represent less than 30% of the housing costs but at least HUF 2 500 per month.

3. TM (measure of the support) = 0.3 – [{(income per one consumption unit – 50% of the minimum amount of the old-age pension)/minimum amount of the old-age pension}*0.15]

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