**Country Study, Hungary**

Dmitri Maslitchenko dmitri@mailroom.com

**Introduction to Hungary’s political history**

Hungary has had a long and volatile history of political and economic change. Hungary as a organized society dates back before 1000 AD and has been ruled by different monarchies and foreign regimes every since. This brief introduction will outline Hungary’s political and economic history starting with Hungary’s “Post-1945 World War II era”.

During WWII Hungary fell under German control until the end of the war. After Germany’s defeat in WWII, a commission was established among allied forces (American, Soviet, and British) in which had ultimate sovereignty over the country. However, since the leader of the commission was a member of Stalin’s inner circle, the Soviets exercised absolute control.(Wash. Post., 1) The Government that was provisionally instituted in Hungary after WWII was shortly dissolved and the Hungarian Communist Party replaced them in the 1945 elections.

The (HCP)Socialist government had instituted radical land ownership reforms and had made many utilities, banks and heavy industries state ran. Then in 1949 at the beginning of the Post-Cold war era the Soviet’s gained control of Hungary and in 1949 Hungary adopted a Soviet-style constitution and formed the Hungarian People’s Republic. Hungary’s economic state up until the mid 1950’s was a economy similar to that of a Soviet modeled Centrally Planned Economy. However, the economy in the mid 1950’s had begun a rapid deterioration which led to more political reforms for Hungary.(Wash. Post, 2)

In the mid 1950’s Hungary attempted to withdraw from the Soviet sponsored Warsaw Pact and announced their neutrality and sought backing from the UN. However, the United Nations failed to respond, as they were preoccupied in other areas of the world. As a result of lack of UN support, Soviet troops invaded Hungary and regained control, during the invasion many Hungarians fled to other countries. This new Soviet culture in Hungary had a more liberal culture and economic path as did the Soviet regimes of the past. This Soviet government had become relatively complacent for the next two decades until about the early 1980’s.

**Start of Transition**

By the 1980’s Hungary’s government had some lasting economic reforms and was responding to political pressure to encourage more trade with the west. This new plan to trade more with the west for economic stimuli led to huge foreign debt as a result of unprofitable industries. These new economic troubles as well as Hungary’s strong nationalism to control their own destiny were Hungary’s first steps to a Western style democracy. By the late 1980’s radicals with the party as well as intellectuals were calling for change. In 1988 civic activism had accelerated to an all time high and a Reform Socialist leader, Imre Pozsgay was elected. Along with a new leader, Hungary also adopted a, “democracy package”, which included: trade union pluralism, freedom of association, freedom of press, freedom of assembly, a new electoral law, and radical revisions to their constitution.(Wash. Post,4)

**Hungary’s steps to a market economy**

In the following year the Hungarian parliament adopted legislation providing for multiparty elections and direct presidential elections. Hungary now had a new vision of government, the government now was to focus on human and civil rights, and to ensure the separation of powers among the executive, legislative and judicial branches.

One major step for Hungary in asserting its move to a market economy was to restructure its national security. In doing this Hungary reduced it’s defense expenditure by 17% and reduced its armed forces by 30% between 1989 and 1992, thus dissolving their membership in the Warsaw Pact . Currently Hungary is trying to develop Western-style defense force to join NATO.(Wash. Post, 5)

**Current Political Structure**

The current political conditions in Hungary are a system of many checks and balances. The Prime Minister whom is elected selects the ministers in the cabinet. Each of the cabinet members presides before four parliamentary committees in open hearings. The legislative body in Hungary is a unicameral house and is the highest authority in the state.

**Current Political State**

The Hungarian Socialist Party was re-elected in1994 in a multiparty election after receiving 54% of the popular votes. Although the (HSP) had taken back control of the government in the 1994 elections, the party has announced its intentions to: “continue economic reform, privatization and to preserve political rights.”(Wash. Post, 6)

**Economic Structure in Hungary**

Hungary’s history of economic vitality has predominately been agriculture. In 1950 , over 50% of Hungary’s work force worked on the land. Hungary’s percentage of workforce working on the land in 1993 was 7%. Hungary’s agricultural decline is directly tied to lack of investment in the 1970’s and the 1980’s. Hungary’s decline is also a product of large amounts of foreign debt that were accumulated in the 1970’s and 1980’s.(6) The net foreign debt in 1972 was about 1 billion(U.S. dollars) and in 1993 Hungary’s net foreign debt was 15 billion(U.S. dollars). Although Hungary has the highest per-capita debt in central Europe their repayment record is stellar.(Wash. Post,7) One of the major functions to Hungary’s success to transition is their role in revenue policy.

**Hungarian Tax Reform**

Hungary's movement from a centrally planed economy to a market economy has lead to massive tax reforms in the former soviet satellite country. These taxes basically fall into three major categories: Value Added Tax, Personal Income Tax, and Corporate Income Tax. In this section of the paper I will first examine the attributes and disadvantages of the separate categories of the taxes and compare them to the former means of revenue collection. Next, I will demonstrate the success (or as the case may be, failure) of such taxes. Finally, I will write about what effects Hungary has experienced due to the tremendous changes in the tax system.

**Value Added Tax**

On January 1, 1988 Hungary introduced a Value Added Tax (VAT) as part of a ovement from a socialist centralized country to on with a market economy (Newbery 1). This tax is similar to the tax currently operating in the European Union member states. This tax is interesting because it is an inclusive tax. That is a tax in which the base is included in the invoiced amount of the good or service. In other words the tax is passed down to the end customer and in turn the seller is reimbursed the amount of taxes paid on that particular good or service.

The concept of a Value Added Tax (VAT) was something that was entirely different to managers that were used to output based goals (in the old system) as opposed to budgets and cost minimization as practiced by their western counterparts. The Value Added Tax (VAT) has become a vehicle to flush out businesses that are experiencing market failure that demonstrate no reasonable need to continue to operate (there are obvious exceptions to this such as utilities, etc....). It also cut down on over production of certain goods.

The Value Added Tax (VAT) is also a way that a country such as Hungary can use to encourage (or as the case may be discourage) certain types of businesses in their country. According to Deloitte & Touche the standard rate for the Value Added Tax (VAT) is currently 25%. However, many products and services such as basic food products, medical instruments, and utilities are charged 12% . In addition, various supplies qualify for complete exemption such as education, cultural services, sport events, health services, and services contributing to scientific research and development (D&T 8).

**Personal Income Tax**

Along with the Value Added Tax (VAT) the Personal Income Tax (PIT) was also introduced to Hungary in 1988. The Hungarian Personal Income Tax (PIT) is a progressive tax with a universal additional tax for investment. The tax is based on individual earnings from all forms of work, though interest income is not taxed if certain conditions are meet (D&TII, 1). As shown in figure 1.1 the progressive tax rates on income earned at work range from 0-44%.

fig. 1.1

|  |  |
| --- | --- |
| Personal Income Tax Rates |  |
| Level of Taxable Income HUF | Rate Applicable to Level (%) |
| Up to 110,000 | --- |
| 100,001 - 150,000 | 20 |
| 150,001 - 220,000 | 25 |
| 220,001 - 380,000 | 35 |
| 380,001 - 550,000 | 40 |
| Over 550,000 | 44 |

Source 1996 Deloitte & Touche LLP

The Hungarian Personal Income Tax (PIT) has several interesting features. The first feature that is unique is that all Hungarians are taxed separately. In other words, unlike the American Tax system where a family can jointly file the Hungarians prefer (for ideological reasons) to file individually. However, this system is not with out it's flaws. The problem that tax administers run into is when one spouse stays at home to look after the children. The reason for this difficulty is the one wage earner is subject to heavier taxation than two wage earners making the same total. Tax administrators however are reluctant to change the current system because of the administrative simplicity.

A second feature of the Hungarian Personal Income Tax (PIT) that draws attention to itself is the fact that any income earned through deposits and securities are tax free if the interest rates are lower than that of the National Bank of Hungary. According to D&T the National Bank of Hungary's interest rate in January was 25%. This means that all bank deposits that pay lower than 25% are tax free. However, If an individual were to make 28% on investment he/she would be subject to a 20% tax on the additional 3% (as shown in figure 1.2).

fig. 1.2

Initial Investment 100,000 HUF

Interest Paid on Investment

in Bank X (28%) 128,000 HUF

Interest Paid on Investment

National Bank (25%) 125,000 HUF

Taxable Interest Income 3,000 HUF

Taxes Due 600 HUF

This aspect of this tax allows for fair treatment to those who would otherwise lose their money putting it in accounts that could not stay up with the tremendous inflation that several countries in eastern Europe face due to their recent transition to a market economy (Newbery, 6).

As was true with the Value Added Taxes (VAT) the Personal Income Tax (PIT) also has exemptions. The following is a list of examples of items exempt from tax (Okno 2).

1. Social Security allowances
2. Gains of up to HUF 100,000 from the non commercial sale of moveable

property

1. Retirement gifts of up to HUF 10,000
2. Compensation of defined working clothes

In addition as of January 1995 tax credits against taxes owed were offered in several areas such as social security contributions by the employee, for individuals making under 500,000 HUF, for installments on loans for dwellings, charitable contributions, and for special savings accounts.

**Corporate Income Tax**

The corporate tax is levied on all businesses, no matter how large or small, the same way. As of January of 1995 the corporate income tax has been reduced from 36% to 18% on undistributed profits before tax. this is called either the additional tax or the calculated tax. After this tax has been levied the profits are then distributed among the shareholders and an additional 23% is taxed to the shareholders. To illustrate this tax figure 1.3 demonstrates how the tax is calculated.

fig 1.3

Calculation of Additional Tax

|  |  |
| --- | --- |
|  | HUF |
| Income before tax | 100.00 |
| Calculated at 18% | (18.00) |
| Income after tax to be distributed | 82.00 |
| Amount available for distribution after payment of additional tax (82/1.23) | 66.67 |
| Total Tax Paid | 33.33 |
| Effective Rate of the additional tax (% of income before tax | 15.33% |

Source Deloitte & Touche LLP

In addition to the corporate tax employers must also make Social Security contributions. Typically, employers must make a contribution at a rate of 44% of their gross salary. Employees are required to make a 10% contribution, however, it not unlikely to see individuals putting more than 10% away of retirement.

Another tax that employers are subject to is the Unemployment Fund Contribution. This is to continue to support the unemployed between work. Employers must pay 4.2% of their employees gross salary and wages to the Unemployment Fund. Employees are required to pay 1.5% of their salary. However, employees' contribution is tax deductible.

Training Fund Contributions is yet another tax that corporations are subject to. This tax is to provide for the cost of training employees. This contribution is currently paid by the employer at 1.5% of the total payroll. This tax is for corporate income tax purposes.

As with other Hungarian taxes exemptions are offered to certain kinds of business. Hungary grants exemptions on a case by case basis and either dose not grant an exemption or grants a 100%, or 60% exemption. The figure below shows how companies are allowed to use their exemptions.

fig. 1.4

Percentage of Taxes due under specific exemption

|  |  |  |
| --- | --- | --- |
|  | 18% subject to Corporations | 23% subject to Shareholders |
| 100% Exemption | 100% reduction | No Reduction |
| 60% Exemption | 20% reduction | No Reduction |

Businesses view this set of taxes as equitable and do not squabble over the fairness of the taxes. They seem to be more interested in how to receive tax exemptions and want reform in the exemption granting side of the tax system (Newbery, 8). This is good because of the infectious shadow economy in other former soviet countries. This means that businesses will be more willing to pay taxes that are due to the government.

**So What Does this mean for Hungary?**

Newbery argues that the Hungarian tax system is at least as egalitarian as any where else in the world as far as an equal distribution of taxes. Especially since the method of redistribution is so good at keeping poverty remarkably low. While the transition still will put a gap between the “haves and the have nots”, the government needs to keep its eye out for the most vulnerable such as the old and unskilled. Many argue that because of the rough transition people may become disillusioned with a market economy and never realize the gains that the countries leaders have fought so hard for. However with vigilance and a little bit of patience Hungary will reach its goal.

**Privatization**

In addition to using tax collection as a source of raising revenue, Hungary has turned to privatization to offset Hungary’s 31 billion USD national debt (Galai, 1). The sale of government controlled industries such as natural gas, oil, and electric powered utilities has earned the government over 1.4 billion USD in the past year.

Recently the Hungarian Government decided to sale shares in eight of the fourteen nationally owned electrical power and distribution companies. A German consortium agreed to pay 180 billion HUF for the shares and controlling interest in the former government controlled utilities.

In addition to the sale of the utilities Hungary has had discussions about selling the National Bank of Budapest to investors. However analyst point out the bank will have to spend the next year fixing up the bank before they can think about selling it. Government officials would expect a heavy return if the bank were to be sold.

While some analyst applaud the actions the government has taken others wonder who is really in control in Hungary. Is the government still calling the shots or is it the foreign investor with the most money invested in a majority of Hungary's' industry. Another key step to Hungary’s transition to a market style economy is expenditure policy.

**Expenditure Policy**

Along with changing revenue policy expenditure policy is a crucial role of any government and especially important policy questions for governments in transition. Hungary’s main policy stance on expenditures is to try to match in-kind efforts and expenditure policy to specifically earmarked funds.

**Defense spending**

As mentioned in the introduction when Hungary decided to withdraw their membership with the Warsaw Pact they decided to drastically reduce their military expenditure. Hungary’s reduction in defense spending was a key decrease in fiscal consolidation to help decrease their ever rising budget defict. The graph in Fig. 1.5 represents Hungary’s decrease in defense spending over the last ten years.

Fig. 1.5

Source: SIPRI Military Expenditure Database

**Social Welfare Reform**

Reforms to Hungary’s Social Welfare systems have been plentiful. Decreases in Welfare systems have mainly been reallocation of subsides on a stricter criteria basis. Hungary has made constant efforts to restructure social programs in which have proven to be ineffective. One example is the reform of the “Family Allowance System.” After a evaluation of the old program it was proven to be cost ineffective and replaced by a new “Family Support System”. This new “Family Support System” target families in need based more on income criteria and targeted people in the greatest need. Another key social expenditure reform was that of pension and health programs.(CCET, 2)

**Pension and Health Programs**

Hungary experience great abuse in the areas of health and pension programs, but have taken steps in the right direction to help correct the situation. One such of these decisions was that of increasing the number of days employers are liable for sick pay. This reform travels in the right direction because the policy had reduced the Social Insurance Fund and also created minimum incentives for abuse of the system. Much more needs to be done in the way of pension and health reform however this policy shows a step in the right direction..(CCET,2)

**Expenditure Summary**

The underlying tone of Hungary’s expenditure policy is that of reducing the budget deficit without creating economic turbulence. Hungary faces many obstacles in trying to reduce their budget deficit. Such obstacles are rising inflation and high rates of unemployment these problems lead to substantial social problems. Regardless, Hungary is still looking the right “social safety net” but not at the expense of its economic viability and without effecting production and output ion a negative way.

**Conclusion**

Hungary has come a long way since the initial transition from a centrally planed economy to a market economy in 1988. However, Hungary continues to strive to overcome the obstacles described in this paper. The transition has been difficult for the people of Hungary. People accustom to a centrally planned economy are not typically faced with subjects such as unemployment or cost budgeting. Therefore, many Hungarians have become disillusioned with the new market economy. However, most (including socialist) have insisted that economic progress continue. In order for Hungary’s economy to continue its success it must remain to be egalitarian in both the way it collects cash through taxes and the way it redistributes resources to the people of Hungary. Hungary must be sensitive to the vulnerable such as the unemployed and the unskilled, during the sometimes unforgiving transition to a market economy.

**Bibliography**

1. **CCET.** “The Center For Co-Operation With The Economies in Transition.” OECD-OCDE. Http://www.oecd.org/sge/ccet/hun\_fisc.htm.
2. **Sipri.** “Military Expenditure Database”.
3. **Washington Post.** “ Hungary: State Department Notes” Washington Post.Com. http://www.washingtonpost.com/wp-s…term/worldref/statedep/hungary.htm
4. **Deioitte and Touche LLp**, “Taxation in Eastern Europe”. Webmaster@dtomlinr.com.1996.
5. Galai, Andra’s. “Sale of Eight Electric Co.’s Jolts Privitization Back to Life.” Http://www.iqsoft.hu/economy/page95\_4/privat.html. 10/17/96.
6. Galai, Andra’s. “Gathering momentum.” Http://www.iqsoft.hu/economy/page95\_4/csaba.html. 10/17/96
7. Langyel, Laszlo. “Towards a new model.” Http://www.iqsoft.hu/economy/page95\_4/langyel.html. 10/17/96.
8. Newbery, David. “An Analysis of the Hungarian tax Reform.” Center for Economic policy Research. #558 May,1991.