

THE INFLUENCE OF TAX ALLOWANCES ON TAX LIABILITY

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ABSTRACT

Though the tax system has changed significantly in our modern age, we have certain abiding expectations of it. Namely, that it be clear, simple, and fair. One way to simplify taxation would be to introduce the flat tax system. This concept stimulates domestic and foreign experts, provoking strong opinions both in favor of it and against it. In practice the flat tax system has shown varied solutions and results. Although the amount of the tax rate has an important role in the development of tax liability, we must not neglect the diminishing influence of the tax allowance. For governments struggling with socio-political problems, it is not an easy job to create a fair tax-system. Governments support savings, child rearing, and other important causes according to economic and social considerations through taxation systems. There can be big differences between tax burdens for the various income levels, especially if a certain part of the benefits is fixed to an income limit. Taxable persons are entitled to several allowances. Tax allowance advantage or disadvantage could be a problem between them. All these factors can affect the transparency of the tax system significantly. Cutting these possibilities radically would simplify the tax system significantly even if the system in question is a progressive tax-system. The range of tax benefits has become significantly smaller in Hungary. The version for 2011 introducing the flat tax-model ensures a great tax reduction for parents with children. In European countries, a trend of reduction in personal income tax has been prevailing. The arrangements in Hungary follow the regional trend.

Keywords: tax system, fair, transparency, flat tax model

INTRODUCTION

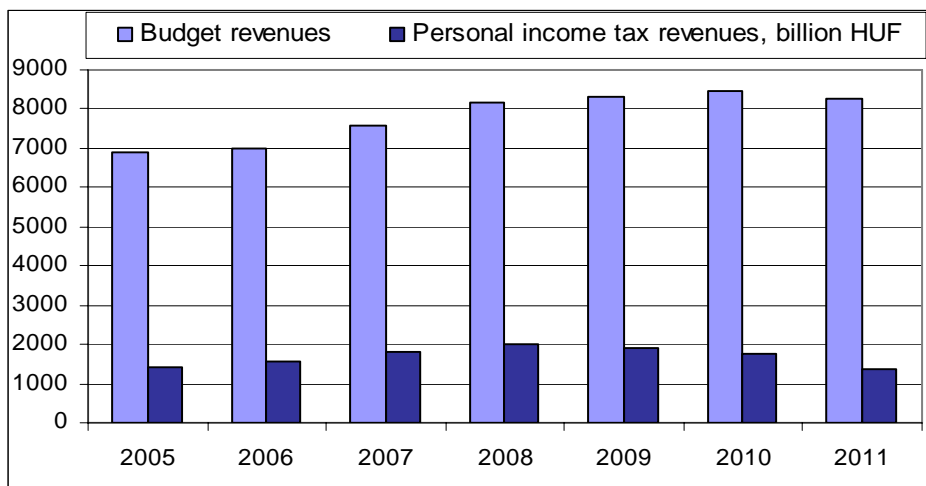
The role of the three classic economic functions, i.e. allocation, redistribution, stabilisation is different according to historical periods and governments; conformity between them is shaped by taking the current objectives into consideration. In addition to the allocation of revenues, functionality can be maintained by the regulation (Burján *et al.*, 2007). The following factors play a significant role in setting objectives on the tax policy: Determining the adequate size and structure of the tax income, supporting the economic political ambitions and achieving the socio-political aims. There are several methods for the redistribution of incomes through the tax system, ranging from determining the extent of progression through the correction items of the tax base to the conditions of tax allowances. In practice, some proportional combination of the above-mentioned methods is implemented; the more of them are applied, the more complicated the tax system is made. When modifying the system, simplification is an important aspect; however, the question is to what extent the tax system is able to meet the requirements of the modern times and the actual tax political priorities.

The tendency of revenues from personal income tax

Among budgetary revenues taxes collected by the Hungarian Tax Authorities (APEH) play a significant role (*Figure 1*). The total proportion of personal income tax, social security contributions and general turnover tax payments has amounted to approx. 80% for years. In spite of the slightly decreasing tendency tax centralisation is high. The structure of collection has changed favourably: mainly due to an increase in the general turnover tax rate, the proportion of turnover taxes has risen, while the proportion of income and contribution burdens has decreased. As a result of the flat-rate income tax and the proposed legal amendments (phasing out the increased gross tax base) this trend is expected to continue in the future.

Figure 1

**Personal income tax revenues in budget revenues,
between 2005 and 2011, billion HUF**



Source: homepage of Hungarian Central Statistical Office, Budget revenues

Changes in declared incomes

Revenues from personal income tax are crucially influenced by declared incomes. Due to the financial crisis, the rise in revenues belonging to the aggregate tax base stopped in 2009, the changes in the amount and structure of the separately taxed incomes may be traced back to amendments in legal provisions (*Table 1*). The average tax burden on the separately taxed incomes was determined by the proportion of the taxable incomes and the tax rate belonging to the individual incomes (tax on property sales, tax on dividend, tax exemption).

Among the revenues belonging to the aggregate tax base, the proportion of taxes from employment made up around 90% until 2006, but it has exceeded 80% since 2007. The change was due to the amendment of law, namely from this year on no tax was imposed on pensions, which led to about 50% increase in the fiscal

year. Payments without tax constituted a special income bracket¹ which were exempt from taxes (they were not subject to declaration), as long as private individuals had no other income. If this condition was not fulfilled, these sums had to be recorded in the tax return as a part of the aggregate tax base but the tax imposed on such payment decreased the tax liability.

Table 1

Declared incomes (billion HUF) and the average tax burden (%)

	2004	2005	2006	2007	2008	2009
Incomes in consolidated tax base	5853	6391	7001	8048	8670	8301
Tax of consolidated incomes	1127	1207	1332	1503	1636	1503
Tax burden %	19.3%	18.9%	19.0%	18.7%	18.9%	18.1%
Incomes taxing separately	582	644	753	945	580	574
Tax of incomes taxing separately	104	126	155	186	154	139
Tax burden %	17.9%	19.6%	20.6%	19.6%	26.5%	24.3%

Source: Based on NAV²

The distribution of incomes according to tax rates meant a restructuring to the advantage of higher income categories. While in 2004 37% of incomes did not reach 1 500 000 Ft, in 2009 less than 25% belonged to this category. In 2005 the number of tax rates decreased to two rates (below 1 500 000 Ft 18% tax rate was imposed on incomes, over this sum it was 36%). During the examined period by increasing the tax brackets the number of incomes with the lower tax rate did not fall significantly.

The tendency of tax burdens according to incomes

By examining the tax return in recent years, the average burden on the aggregate tax base declared by individuals is below 20% (*Figure 2*), which shows a significant spread according to income levels. The tax burden on minimum wages in 2009 did not reach 3%, whereas in case of incomes over 6 million Ft 30% tax was imposed.

In shaping the tax burden the measure of tax rate is one of the most important factors, although the computed tax may be reduced by different items. In addition to the tax allowances – dealt with in the following chapters - tax credits related to wages and salaries, as well as, payments which are exempt from taxes should be highlighted. Tax credits are bound to income limits, therefore the tax imposed on lower incomes falls, and the „decreasing” tax credits modify the progression. A major part of tax allowances may only be enforced up to a definite income level. Due to the stricter conditions, since 2007 none of the restricted allowances may be enforced over 3 400 000 Ft (in a decreasing amount up to 3 900 000 Ft), from which only tax allowance for families was exempt with a higher limit. As a result of the measures the

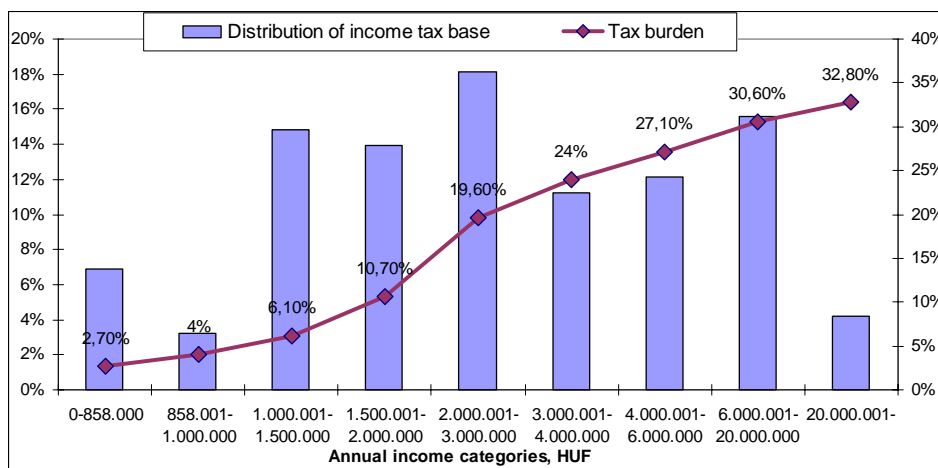
¹ With the introduction of a flat tax rate since 2011 these incomes – except for incomes from student work have been exempt from taxation.

² <http://www.apoh.hu/>; „Személyi jövedelemadók – adóstatistikák 2004-2009.”, 2010.10.07.

number of taxpayers entitled for allowances has shrunk, for example after the annual life assurance premiums and pension scheme payments the number of those claiming allowance fell by 12%. The correction of the tax brackets in case of tax credits provided lower taxes for a growing number of individuals, thus more than 80% of taxpayers could reduce their tax liability by some allowance.

Figure 2

The distribution of income tax base and the development of tax burden in income categories in 2009



Source: Based on NAV³

Allowances of calculated tax

Besides income limit, due to the changes in both the range of allowances and the conditions of certain allowance types the proportion of tax allowances to the amount of calculated tax has changed, too. *Figure 3* shows (right hand scale) the lowest value in 2006; in that year the share of tax allowances decreased to less than 23 per cent.

From year 2006, child allowances have been available for families with at least three children; and at the same time it shrunk from 10 thousand forint to 4 thousand per beneficiary dependent. The total amount of allowance could only be claimed if the annual personal income did not exceed 6 million forints. Looking at the composition of tax allowances (*Figure 4*) it is found that a major part of the amount coming from the shrinking child allowances has been reallocated to tax credits of wages by having changed the income limits for allowance. A quite popular type of allowance can be emphasised at the beginning of the period. The so called “sulinet” allowance⁴ significantly contributed to the improvement of the number and age of computers (and digital cameras till 8 March 2004) used by households; with an annual

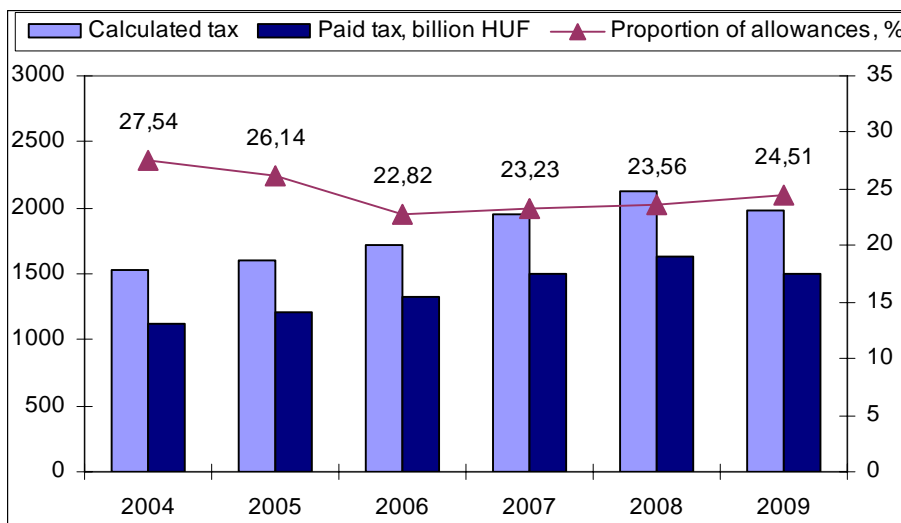
³ <http://www.apeh.hu/>: Sajtótájékoztató háttéranyag, Budapest, 2010.09.14.

⁴ Private individual may have decreased their tax by 50% of the price of a new computer or maximum 60 thousand forints.

15 billion forint of tax credit. Following the shaping out of this type of allowance adult education became an allowance of tuition fees from 2007, but even the sum of these two allowances could not reach 1 per cent of the allowances.

Figure 3

Calculated tax of composite tax base and the paid tax reduced with tax allowances between 2004 and 2009, billion HUF



Source: Based on NAV⁵

The increase of tax allowances in 2004 was obviously due to that pension had moved among non-taxable revenues. Therefore the structure of items of tax allowance modified (*Figure 4*). However, many lost their tax allowances due to the pension, thus their tax burden increased. In 2009 the amount of pension decreased within the aggregate tax base, thus the relating allowance decreased as well.

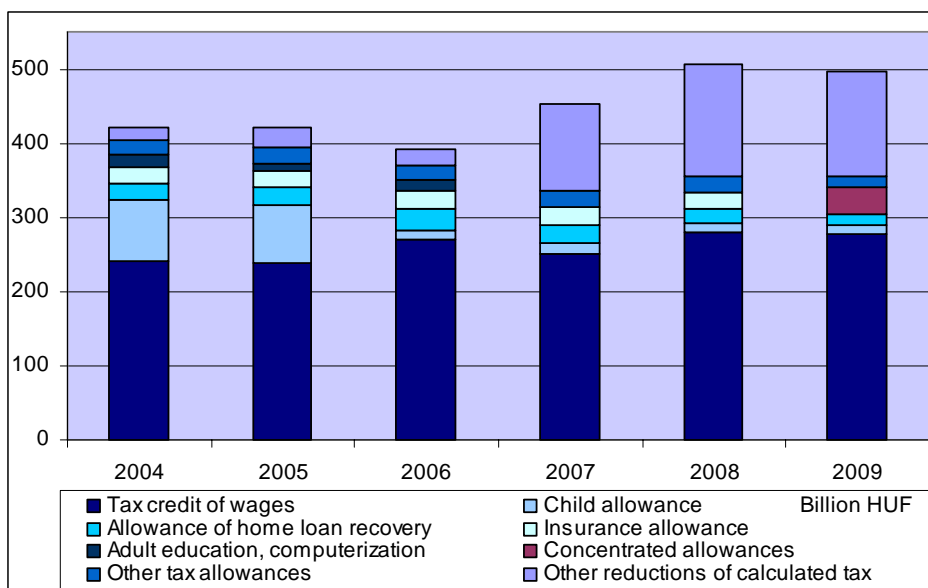
In 2004 allowances of home loan recovery significantly decreased. From 2007 it has been even phased out as new opportunity. From that year this allowance can only be claimed – with the conditions of 2006 – if the paying back of loan started before 01.01.2007; thus its share and amount has been decreasing year by year.

Insurance allowances were the highest in 2006 (some 25 billion forint). Besides a lower income limit the allowances available for individuals was further cut by that this allowance become subject to the so called 100 thousand forint limit, thus even in case of several different allowances, more than 100 thousand forint was not claimable. In 2009 – in terms of simplification - the law imposed similar conditions on the majority of tax allowances - introducing the new “household allowance” at the same time. The aggregate tax credit is 30% and maximum 100 thousand forint.

⁵ <http://www.apch.hu/>: „Személyi jövedelemadók – adóstatistikák 2004-2009.”, 2010.10.07.

Figure 4

Items⁶ of tax allowance on aggregate tax base, 2004-2009, billion HUF



Source: Based on NAV⁷

Allowance of life assurance premiums and of pension scheme payments can be claimed with no income limits, but it does not reduce the payable tax, the amount of the allowance has been transferred to the personal account by the authority on the basis of person's declaration, since 2009.

Effect of law modifications on tax burden

The earlier two-tier taxing has been replaced by a flat rate personal income tax scheme from 2011 (*Figure 5*). The eventual effects of this linear 16% tax rate are still to wait for. The increased gross tax base introduced in 2010 leads to that tax burden in the tax brackets where tax allowance cannot be claimed is 20.32 per cent, while below it – right due to the allowance itself it is not linear.

As consequence from the above mentioned, the average tax burden decreases at the beginning of the decade, but for those with lower incomes favouring change will be brought if the increased gross tax base is phased out – obviously presuming that the conditions of tax allowances remain. The law in force will decrease the tax base amendment from 2012 to 13.5 per cent and it will be phased out from 2013. The

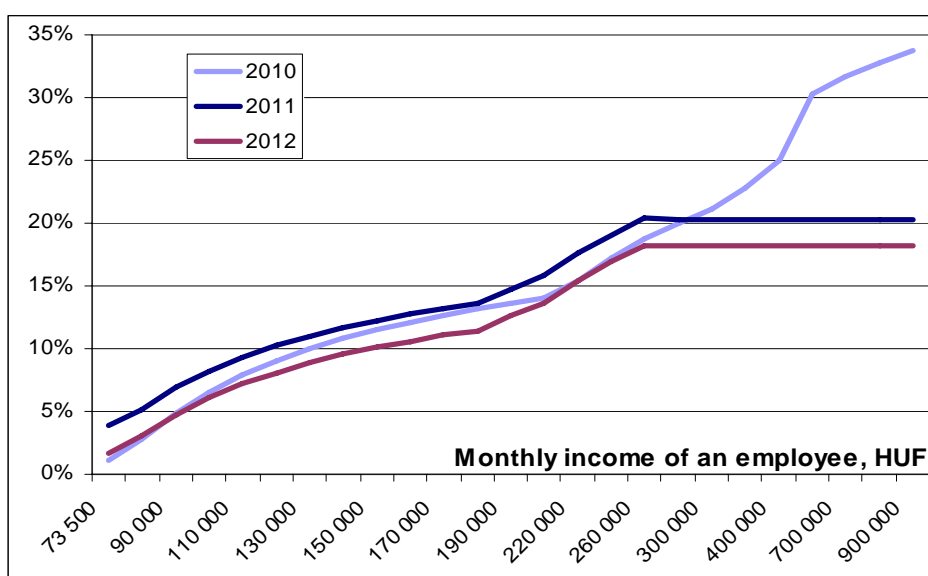
⁶ Among the allowances belonging to other allowances, only the amount of allowances on volunteer mutual self-help payments exceeded 10 billion forints at the beginning of the period, giving 3 per cent of the total beneficiaries; after that both its amount and share gradually decreased. During the period, none of the other allowances reached even 1 per cent.

⁷ <http://www.apeh.hu/>: Sajtótájékoztató háttéranyagok, Budapest, 2006-2010.

income limit increased in 2010 and it declined in 2011, but still is better than in 2009. In 2009 more than 3 million people claimed for tax allowance, this number is not anticipated to change. Since 2010 only the child allowance, personal tax allowance and allowances of agricultural production and of long term self-care can be claimed. It is interesting that life insurance allowances are not any more available even despite the 10 year duration in the conditions. Allowances on pension scheme payments gradually decreased. Although the amount of the credit could contribute to personal savings, for those suffering from daily liquidity problems this is not an option any more.

Figure 5

Tax burden of rentals between 2010 and 2012



Source: Based on the modified law 1995. CXVII

Family taxation, child allowance

Family taxing may be mutually a means for imposing tax according to marital status and a progressive tool. There are several ways to imply family taxing. One frequent and simple method is to bind the tax base to the marital status or to the number of children. “The effect of these two methods is different; while the family taxing defining the tax base modifies the limit of tax-freedom, the decrease in tax burden due to tax allowances decreases the effective tax rate” (Balogh et al., 2010)

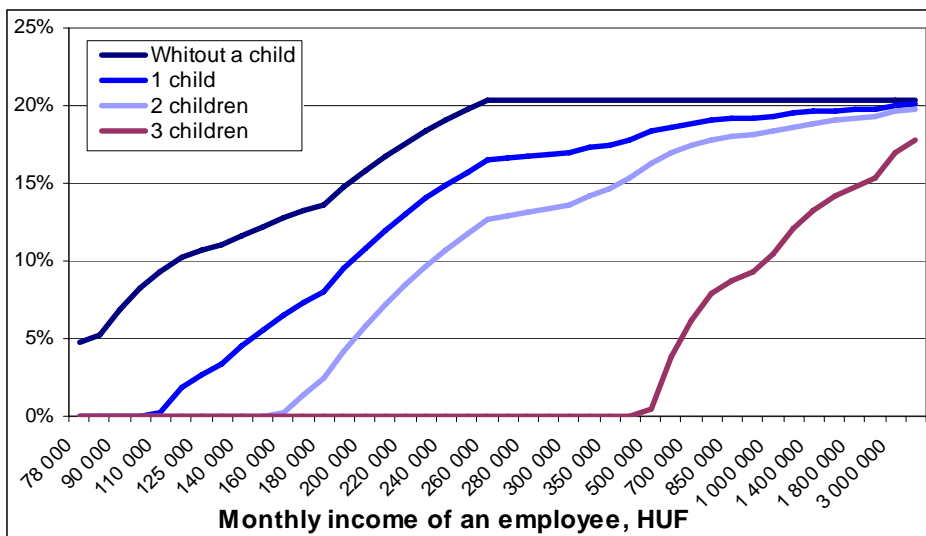
A more complicated method is splitting used in Germany and France, where the total income of spouses or even of all people living in the family is the tax base.

As a consequence of the changes of Hungarian law one of the most significant allowances was the child allowance in 2010, because more than 100 thousand parents claimed an average allowance of 110 thousand forint. The importance of this allowance increased in 2011. Those children with no or one sibling become

subject to the allowance again, thus the number of those entitled for allowances multiplies. As new element, this allowance is a tax base corrector. *Figure 6* shows that up to 500 thousand forint of monthly income parents with three children do not pay tax (*Figure 6*).

Figure 6

Tax burden of rentals with family allowance taking into account in 2011



Source: Based on the modified law 1995. CXVII

Opinions of neither private people nor professionals are uniform. The question is whether the tax system needs to ensure the principle of fair or even reallocation. After the decrease in family allowance and as a result of higher child benefit it was found that the tax allowance is claimed by richer families in similar extent to most needy ones (*Handa, 2007*). We must not forget about that the base of contribution to be paid by people with higher income is also higher, thus in spite of higher allowances their burden is higher, as well. Many people see child allowance as “tax” for people with no children; the problems of pension system up-value the role of self-care over generations (*Ambrus, 2010*).

International practice: linear tax rate with allowances

Flat rate taxing put in force in 2011 fits into the international and primarily to the CEE trends. The main reason for its introductions was a requirement for one of the most important tax system: the simplification. Of course, simplification should imply for the definition of tax base, which come true due to neither the increased gross base nor the previously mentioned child allowance. Another question arising from tax theoretical aspect is that in case of a linear system, what is the reason for applying such aspects (child allowance) that even decrease progressivity?

Pros of flat tax rate emphasise the simplification of the system - besides fair tax burden. Considering the personal income tax although, the single flat rate is rarely used. In those countries, where this tax system is chosen the rate is so low that no further allowances are necessary (e.g. Bulgaria, 10%). Various correcting items may lead to a less transparent system. In few countries (Russia, 13%) tax credit is not bound to income limit, thus a progressive tax system is applied despite the flat rate. In most complicated options, those with the highest income are excluded from tax allowances. Due to the decreasing tax allowance the marginal tax rate is higher, and above the income limit linear taxing is implied (see *Figure 5*). Similar to the Hungarian system is used for instance in Romania (16%).

CONCLUSIONS

The analysis of the period shows that the average tax burden on incomes decreased. According to our calculations tax burden are crucially influenced by tax allowances between 2004 and 2009. The results show the paid tax was 22-28% lower than calculated tax. The new proportional taxing scheme been introduced and its peculiar rules represent a positive change for those with income living in families with children. In Europe there are some examples of addition fair allowances to linear tax system. In Hungary the mid-class is small. The measure favouring for families with moderate income and children will likely cause the smallest loss of revenue for the government. For lower income categories, the tax credit system still in use resulted in lower tax burden, but with shrinking tax allowances the phasing out of tax credit brings increasing tax burden. Allowances on pension scheme payments and volunteer mutual insurance payments remained, despite that phasing out the allowances on life insurance payments, the encouragement for long term savings was significantly hurt. The personal income tax system might be simpler cutting allowances. The simplification is recommended by EU, too. The transparency of the tax-system means an indisputable competitive advantage, especially if the tax-rate is moderate. The possibility of tricks to minimize taxpaying can decrease and the collection of taxes becomes more efficient helping the tax revenues increase.

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