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# **The Public Effects of Tax-Base Reductions and Tax Allowances in Hungary**

**Anita POTOCSKÁNÉ KÖRÖSI, Tünde BOKORNÉ KITANICS**

**Kaposvár University, Kaposvár, Hungary**

**Abstract.** *Amongst the many roles of the taxation, it's most important function is to provide sufficient cover for budget expenditures, although, a well-developed, all-out tax system could be used to affect the attitudes of each market operators. Manipulation, through allowances and exemptions, is an essential element of tax policies, but in many cases, it is non-public or confidential. Therefore taxation and tax policies are always result from specific professional and political compromises. After the Financial Crisis of 2008, especially after the 2010's National Elections, the Hungarian Tax System had been substantially reformed. The changing economic environment induced changes in economic policy as well. The Government had decided to follow new, unorthodox, economic policies, and among others, carried out a radical reform of the Personal Income Tax (PIT) System. Instead of the former progressive taxation, they have introduced a flat PIT system, generating changes in the field of tax allowances too. Our recent study focuses on the public effects of tax-base reductions and tax allowances, related to the PIT system. The conclusions made, are based on our online questionnaire. The goal of the survey was not only to get a clearer picture of the public awareness regarding the tax allowances, but to ascertain the common opinion on the long-term demographic effects of these preferences. Considering this, we established our questionnaire placing more emphasis on questions concerning the Family Allowance and the First Marriage Tax Allowance.*

## **Introduction**

Demographic changes in the Hungarian society tend towards a declining, aging population, thereby threatening the sustainability of the current pension system. To reverse these negative changes, the government, in addition to social policy measures, uses fiscal instruments as well. Decision makers intend to increase the willingness to get married and have children, among other social policy measures, by the Family Tax Allowance and the First Marriage Tax Allowance. If birth rates and the number of marriages increase, that could mean a way out of the spiralling demographic decline. Considering, that to apply tax- and tax base allowances, taxable income is required, these benefits and social policy

measures differ substantially from each other, but they are directly linked to employment. In our study, we examined the public awareness on these allowances and placed special focus on the question, that in the respondents' opinion, whether these allowances have direct effect on birth rates. We felt it particularly important to examine this in detail, because having children is a long-term commitment for families thereby it is strictly necessary that these tax allowances remain applicable with predictable conditions, at least for 18-20 years, and no government can responsibly guarantee this. One can state this, also because economic policy decisions and tax regulations are always made by the current federal government. Therefore, parents could be deeply affected by a change of government, especially those, who make their family decisions based on tax allowances and other benefits.

### *Material and methods*

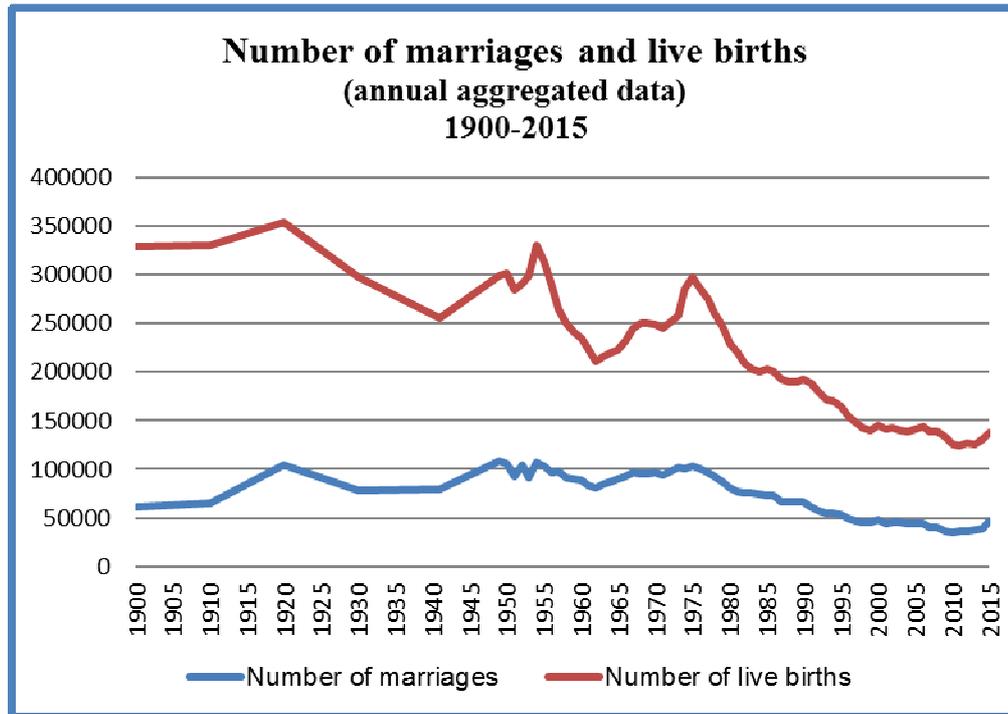
In our research, we used online questionnaire, and to confirm the accuracy of the data, in some questions we used Central Statistical Office databases. We have chosen to make an online questionnaire so there would be no geographical obstacles to participating in this study. We divided the questions into separate topics, and this study includes the evaluation of two subjects. The questionnaire was completed by 268 respondents – 198 females and 70 males. The average age of the participants is 45.3 years.

### *"The wedding gift" of the legislature, the First Marriage Tax Allowance*

In Hungary, after the regime change, not only the economic policy conditions, but social structures have also changed radically. These changes have become more and more evident in demographic and sociological surveys as well, showing from year-to-year, a declining birth rate, ageing population and – consequently – a declining population. In formulating economic policies, decision makers had to take into consideration the fact, that without sufficient government measures, this process could endanger social structures, and will lead to serious budget deficit; and unfortunately, this is not only a long-term threat any more.

During the period, following the regime change, numerous economic policy measures had been taken to stop and reverse these indicated processes. Some of the actions only had temporary effects, while other, more drastic measures, were meant to have prolonged but deep and immediate effect on demographic changes. In 2011, the Hungarian Parliament adopted a new Fundamental Law that has included a separate article to protect the institution of marriage and the union of the family. Among all forms of unions, marriage has the highest potential to improve

birth rate, but in the last century, the institution of marriage has lost its former popularity, and more and more people chose to live in civil partnership. This social process causes negative demographic trends, because couples, living in marriage, are more likely to have children. Consequently, the rise of marriage rate, positively affects birth figures as well. The diagram below demonstrates statistical data, to back up our statement.



Source: KSH Statat 1.1. Population, population movement (self-edited)

Based on the long-term data, provided by the Central Statistics Office (KSH), it is obvious, that while in the 1950-s, there were 100 000 marriages per year in average and 200 000 children were born, by the year of the regime change, the number of marriages has decreased to 66 949, and only 123 304 children were born in this year. After the 2008 Financial Crisis, the yearly number of marriages were only 40 000, and from these years, the annual number of live births, fell under 150 000. Statistical evidence indicates that the falling of the number of marriages has a ripple effect towards a decreased willingness to have children and a drastic delay in starting a family.

To increase the number of marriages, the Government had introduced a new Personal Income Tax (PIT) base reduction from 1<sup>st</sup> of January 2015. This tax benefit is the First Marriage Tax Allowance. The conditions, for receiving this benefit, are regulated by the Act CXVII of 1995 on Personal Income Tax, Article 29/C. After the introduction of the regulation on 31<sup>st</sup> of December 2014 this tax allowance can be utilised by a couple if at least one of the spouses is married for the first time. The allowance is applied to the income of one of the spouses. Since 1<sup>st</sup> of January 2016, the first

marriage tax benefit per couple is HUF 33 335 tax base allowance monthly, resulting in a decrease of HUF 5 000 per month in PIT liability.

The first month, when a couple becomes eligible for this benefit, is the first month after the marriage was formed. The allowance can be applied for maximum 24 months in the marriage union. During the 24 months of entitlement, the eligibility for the allowance ends, in case of the dissolution of marriage or if the individual becomes entitled to family tax allowance. This also means that if an individual was entitled to family tax allowance before getting married, then he/she can take the first marriage tax allowance as well, without any further restrictions. In this case, first marriage tax allowance is ahead of family tax allowance in the row of deductions.

Just over two years have passed since the introduction of this tax allowance. However, infra-annual statistics indicate a slight growth in the number of marriages. The number of marriages in 2014, was 38 780. In the next year, when the tax allowance has been introduced, there was 18.97 % growth, 46 137 marriages were formed. The data of the period from January to August 2016, is also available (36 026 marriages), which, compared to the data of the same period of the preceding year (32 991 marriages), shows a 9.2% growth.

In our study, we aimed at answering the following questions:

- Have the respondents heard of the First Marriage Tax Allowance?
- In their opinion, does this allowance affect the willingness to get married?

69% of the respondents (185 people) have heard of the opportunity of the First Marriage Tax Allowance. However, when we introduced specific regulatory details (the criteria of the first marriage of one of the spouses), and asked the question again, if they know this tax-base allowance only 48.3% of the participants answered yes.

The National Tax and Customs Administration (NTCA) published the main data of the 2015 Personal Income Tax Returns, on 19<sup>th</sup> of October 2016. In this report, the amount of tax credits applied is also presented, including First Marriage Tax Allowance as well:

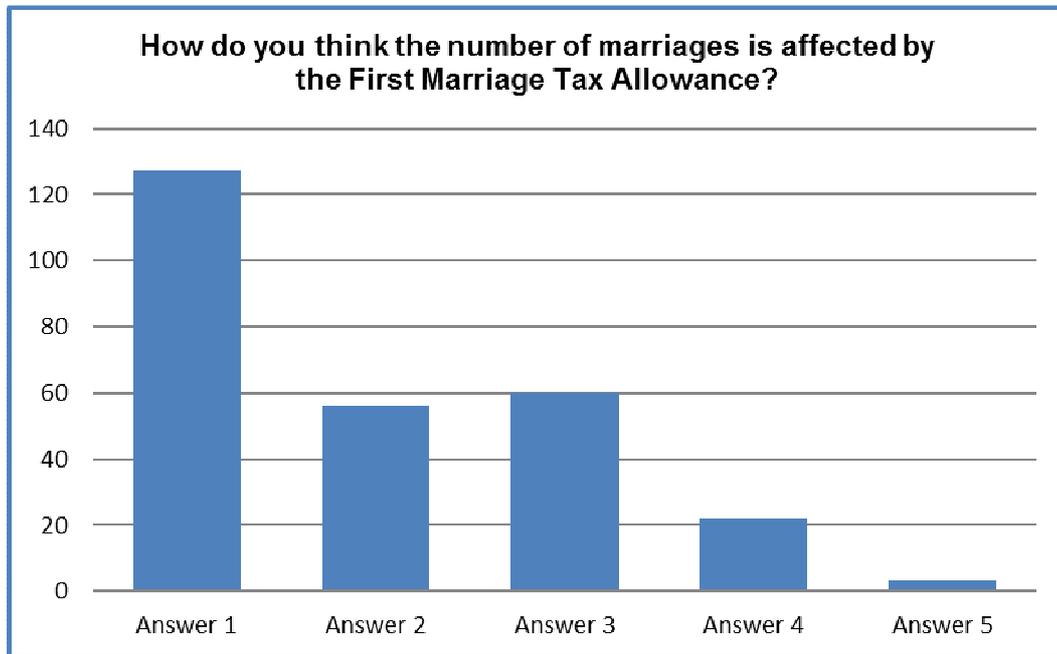
„Under the First Marriage Tax Allowance 22 thousand individuals have used 3.2 billion forint tax base deductions. This, using the 16% tax rate, equals 0.5 billion forints of tax credit.”

Considering the total percentage of the people who applied this benefit, the numbers equal the results of our study (47.8%), if we round up the number of marriages formed in 2015 to thousands (46 137 ~ 46 thousand marriages).

Based on the results above, we can conclude, that Hungarian households lack basic financial literacy, since to claim the First Marriage Tax Allowance, only a single statement is required. But because of the lack of financial awareness, almost half of the employees simply do not know about this benefit, and they do not apply for it.

The questionnaire examines the First Marriage Tax Allowance further, by asking the respondents opinions whether this tax allowance has

relevant effect on the willingness to get married. To answer this question, we used a 5-point scale, where "Answer 1" means, that the allowance does not affect the decision of getting married at all, whereas by choosing "Answer 5" the respondent states, that this benefit fully impacts the number of marriages.



Source: assessment, based on own research (self-edited)

The bar chart above represents the results of the study. Almost half of the 268 respondents (127 people) thinks that the First Marriage Tax Allowance has no effect on the number of marriages, and only 3 people answered, that it fully impacts the willingness to get married. Summarizing the data, the average value - given by the 268 respondents - is 1.94.

Almost the same number of women and men (32.3% - 35.7%) could not assess the influence of the allowance on the number of marriages. 58% of the males, who gave their opinions on this issue, thinks that the allowance affects the number of marriages, whereas 63% of the females stated that it has no significance in making the decision to get married.

Based on an age-based distribution it can be concluded, that with the increase of age, people tend to think that the tax allowance does not affect the number of marriages. 22 participants of the survey are running businesses, and filled in the questionnaire as employers. 68% of the employers knew, that the First Marriage Tax Allowance can be deducted from the income tax base. Managers assessed the impact of the benefit on the sum of marriages with an average value of 1.77 which, in comparison with the total average of the respondents, indicates 0.17 lower supposed effectiveness.

## *The effects of the introduction of Family Tax Allowance*

With establishing the Family Tax Allowance, decision makers not only intended to improve the financial situation of families, but to increase the willingness to have children, which is a key factor in dealing with the population decline. The population of Hungary has exceeded 10 million persistently between 1961 and 2010, and despite the fact, that the number of marriages has increased in the previous years, the population is still decreasing. Since the introduction of the family taxation, the conditions of applying for the tax allowance have changed several times. These changes have included the amount of the benefit applicable, and there were eras, when the regulatory environment has only favoured families with at least three children. In the second part of our study, we examine the impacts of Family Tax Allowance.

The Family Tax Allowance is regulated by the Act CXVII of 1995 on Personal Income Tax, Article 29/A. Individuals can decrease their consolidated tax base with the family allowance, depending on the number of beneficiary dependents the individual has, and the number of the months of eligibility. Beneficiary dependents, in general, are dependents on who's account the individual is eligible for family allowance, and the yet unborn baby, during the pregnancy. Families, with at least three children, receive the highest tax allowance. In tax year 2016, they can deduct 220 000 forints/ beneficiary dependents, from their taxable income base. When claiming the benefit, parents – no matter, if they are married or not – can share the amount of the allowance, and both can decrease their taxable income, or they can decide that only one of the spouses uses the tax allowance. From tax year 2014, Family Tax Allowance can be deducted from social security contributions as well, which was an important change because earlier, those with lower personal income than average, could not fully use the advantages, provided by this benefit. By means of this measure, the whole amount of savings through the Family Tax Allowance became a considerable and tangible support for families.

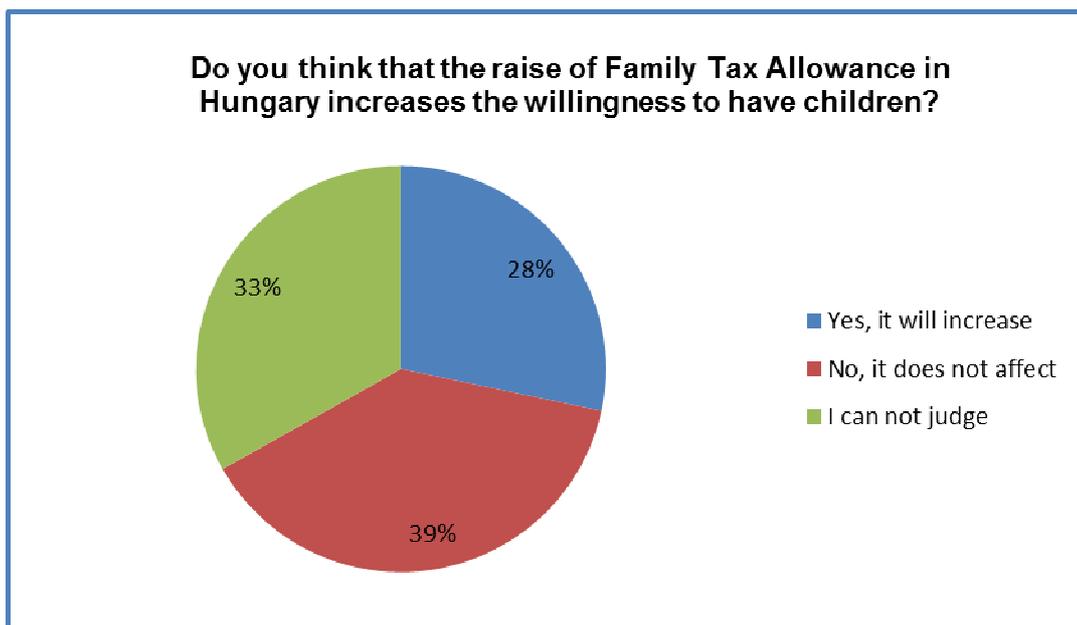
As reported by the National Tax and Customs Administration (NTCA), in the 2015 annual report, family tax allowance has been applied by nearly 1.1 million individuals (23.7% of those, who had submitted tax returns). The average allowance used, was 1 110 thousand Ft/person, while the sum of the Family Tax Allowance in the country, amounted to 1 218.6 billion forints. According to the statement, 49.4% of those who claimed the benefit have one, 32.5% has two, 15.4% has three, while 2.5% of the individuals have more than three beneficiary dependents in their households. However, this data does not include those, who submitted tax declarations.

46% of those, who completed our online questionnaire is not eligible for this benefit, while 26% of the respondents – almost the same proportion as the number indicated in the NTCA report - have claimed the family tax allowance themselves, or shared with their companions.

The most important change in the regulatory environment in the past years was in the number of beneficiary dependents, and the new opportunity of deducting the allowance from social security contributions, which is a convenience, but tax payers do not possess up-to-date knowledge on the issue. The survey has also confirmed this, as 15.5% of the respondents did not know, that family tax allowance can be applied even if they have only one child, and 44.9 % was not aware of the fact, that the allowance can be subtracted from social security contributions as well. The lack of financial and tax awareness affects socio-economic situation negatively, regardless of the age, education, or budgetary situation of the person, especially, when they do not know of an aid, that they would be basically eligible for.

In connection with the impacts of the Family Tax Allowance on the willingness to have children, we asked the question, whether the respondents consider the opportunity and the level of the Family Tax Allowance as an aspect of their family planning. 7.2% of the respondents (19 people) stated, that the allowance was an aspect taken into consideration in family planning, whereas, 44.9 % (119 people) did not count on it as an important factor. 37.7% of the people did not take into account the benefit, because there was no family tax allowance when they gave birth to their children. The study also examined the opinion on the issue, whether the Family Tax Allowance affects family planning in general. To assess this question, we have chosen a 5-point scale survey method. Summarizing the results, the average value, given by respondents, is 2.62, and therefore, this issue seems to be neutral.

From tax year 2016, the government has introduced a 3 staged, annual increase of the allowance, in case of two dependents. 58.9% of those, who have filled the questionnaire was not aware of the raise of the benefit, and this indicates, that also this tax issue would need more publicity and more effective communication.



*Source: assessment, based on own research (self-edited)*

The diagram above shows the view of respondents, on the effectiveness of the increase of Family Tax Allowance, on the willingness to have children. 75 people (49 females and 26 males) have stated that the raise of the allowance generally increases the willingness to have children.

## *Summary*

Tax regulatory measures taken by the government, were crucial in dealing with the demographic decrease and they have started a positive tendency, as since the introduction of the First Marriage Tax Allowance, the number of marriages have been growing slightly, and according to statistics, this will increase birth rate as well. Extending Family Tax Allowance to families with one or two children meant a significant aid for households. The participants of our survey, in general, do not think that allowances will have considerable effect on the willingness to have children, but overall, they favour these changes of the tax regulations. To change public opinion appreciably, a stable regulatory environment is needed, because having children is a long-term commitment, and responsible families need a stable and clear vision of the future. Based on our research we can conclude that taxpayers have an incomplete knowledge of tax allowance conditions, so to improve their awareness, a more effective communication is essential.