The redistributive impact of the Hungarian tax system

Non-technical summary

The study examines the functioning of the Hungarian tax system in terms of the redistribution between poorer and richer taxpayers and between childless and child-parenting taxpayers. We do not propose a desirable level of income inequality or an adjustment of the system: our aim is to document the distribution of the tax burden, the impact of the tax system on income inequality, and its changes over time.

In relation to their income, the poor pay more VAT and income tax than the rich

In Hungary, we estimate that the tax burden decreases with income: those in the top income decile pay roughly 6-8% less tax on their income overall than households in the bottom income decile. This is essentially due to the fact that higher incomes are subject to a similar level of income tax and a proportionately lower effective VAT rate than lower incomes.

In Hungary – similarly to other countries – richer people pay less VAT in relation to their income than lower earners, that is, the VAT is regressive. Lower earners spend a much higher proportion of their income on consumption and less on savings than those at the top of the income distribution, so a higher proportion of their income is subject to consumption tax. In addition, since the average VAT rate is high, VAT has a greater weight in the redistributive impact of the overall tax system than in other countries. The regressivity of the tax burden over the life cycle may be somewhat lower than the value calculated on the basis of current income, but given the low income-mobility, this is unlikely to change the picture significantly.

In most European countries, the regressivity of consumption taxes is offset by the progressivity of income taxes, but in Hungary, neither the income tax nor other taxes have such a balancing effect. The Hungarian income tax system is virtually devoid of progressivity: taxpayers without children are taxed at the same rate regardless of their income (i.e., the state deducts the same proportion of the income of low-earners as of high-earners). This is very rare in Europe: apart from Hungary, only Bulgaria and Romania have such a flat income tax system. Most flat tax systems introduced in post-socialist countries between 1994 and 2009 retained the tax credit option, and most have since reintroduced a higher rate(s) in the top income bracket, i.e. they have returned to a progressive system.

In Hungary, the overall tax burden on labour income around the minimum wage (tax wedge including both employee and employer contributions) is higher than in all other EU member states. This implies that it is expensive to employ unskilled labour, which in turn reduces job opportunities for the unskilled population. The high tax wedge is primarily due to the fact that the Hungarian income tax system does not include any credits or allowances to reduce the tax burden on low-income, childless taxpayers. In terms of the tax burden on high incomes, Hungary is in the mid-range of EU countries.

The redistribution effect of the income tax system has been eliminated in two steps: the flat tax rate was introduced in 2011, whereas the tax credit (which had reduced the tax burden on low incomes) was abolished in 2013. The second step was also important: while in 2011 the top decile of taxpayers paid almost half of the combined income tax, by 2020 the share paid by them was reduced to one-third. At the same time, the bottom half of taxpayers paid 10 percent of the overall tax on the combined tax base in 2011 and 20 percent in 2020.

The family tax credit does not significantly reduce the average tax burden for low-income taxpayers

Overall, the impact of the family tax credit system (including the family tax credit, the social contribution waver, and the income tax exemption for mothers with four children) on the distribution of the average tax burden has been limited, hence the tax system can still be considered “flat”. One reason for this is that only 23 percent of all taxpayers claim family tax credits, and the net value of all tax and social contribution credits for children accounts only for two percent of total taxable income.

The other reason is that – although due to a recent adjustment in the rules, the credit is now deductible from social security contributions as well, so that a larger share of the credit can be used by lower-income earners – the family tax credit system continues to distribute more to higher-income earners: in 2020, the top income decile of taxpayers received more than one-fifth (HUF 70 billion) of the overall amount of tax credits (HUF 336 billion, a net loss for the budget due to the tax reform). This is more than the total amount received by the bottom 40 percent of taxpayers (around HUF 60 billion). The top 30 percent of taxpayers received almost half of the credits (HUF 161 billion). Although the share of credits claimed relative to income is lower for the wealthier, the amount of credits increases with income deciles: those claiming family credits in the bottom decile of taxpayers receive on average 7,000 HUF per month, while those with children in the top decile receive on average almost 40,000 HUF per month.

The family tax credit system favours rich families with many children over single earners and poor families

The amount of the family tax credit depends on the number of children: the more children in a family, the higher the amount per child. The tax credit for taxpayers with one child has been HUF 10,000 per month since the time of its introduction (which has not offset the effect of the phasing out of the low-earners’ tax credit in 2011), so the tax burden for single earners on the minimum wage is about 9.5 percentage points higher in 2021 compared to 2010. However, the largest group of beneficiaries of the family tax credit is made up of parents with one child (half of the beneficiaries), while only one in six claimants qualify for the credit for three or more children.

In international comparison, the Hungarian family tax credit for three and more children is high relative to other European countries, while the one-child tax credit is rather low, and this disparity is not compensated by the universal family benefit (which is not conditional on income). The credit is not phased out, thus, in the top income bracket, taxpayers with three or more children can claim the full amount of the credit.

The biggest winners of the family tax credit system are therefore taxpayers in the top income decile with three or more children. These 22,000 taxpayers, constituting only two percent of all beneficiaries, receive 10 percent of the total family tax credit, and almost one-third of the credits claimed by taxpayers with three or more children, amounting to nearly HUF 34 billion in 2020.