Fidesz and the flat tax: seduced and abandoned

What was only a quickly reversed idea a couple of weeks ago is now a reality: the flat tax will be suspended for at least a year. While the higher rate will be applied already at income levels that ideally should have been subject to the lower rate, this policy reversal is a move in the right direction. In Hungary, the flat tax has failed to deliver the growth that some believe it has brought other countries in the region. Yet the problem is by no means only the flat tax. In international comparison, Hungary relies too much on consumption taxes and collects too little from taxing wealth. A complete overhaul would be necessary, but the problem is that Fidesz would have to do all the things it has vowed it'd never do. Then again: it has began doing just that with the introduction of two income tax rates.

Fidesz felt seduced by the simplicity of the flat tax. Now it is gradually abandoning it as the government is running into the limitation of this system in terms of both, engendering growth and collecting sufficient revenue to maintain the fiscal balance and debt-reducing course that the government has committed itself to ever since the EU made clear that it would not tolerate any digression from previously agreed on deficit figures.

The flat tax had made a fulminant entry in the region, taking most of the emerging markets here by storm. Of the EU's ten new Central and Eastern European members, only Poland and Slovenia have no flat tax. While the former is constantly toying with the idea, the Slovenian government apparently abandoned it precisely because it thought it would do little for growth and too much for inequality.

Following the madding crowd

The recalcitrant countries notwithstanding, Fidesz followed an enthusiastic and largely satisfied bunch, though it is unclear in how far the successes in the region were due to the flat tax. Nevertheless, a single rate of income tax (some define a flat tax more broadly to extend to corporate taxes and VAT, too, but we will stick with the income tax version) appears to be in many respects the ideal tax system for an emerging economy whose growth is in no insignificant part based on luring jobs away from the West. Moreover, it is simple and thus easy to administer and adhere to, and – that may be the most crucial point in its favour – if its level is not set too high than it may engender greater tax honesty.

Of course, in accepting this tax governments may have tied their hands in the long run – tax levels tend to be sticky and significant moves towards higher rates of direct taxation are tricky. The Hungarian government is finding that not only the flat tax, but even the promise is difficult to shy away from.

Goodbye, flat tax – at least for now

The government is moving towards a delay in the finalisation of its flat tax for pre-tax incomes of 202,000 HUF a month and higher. While the flat tax of 16% was until now only applied to pre-tax income without taking into account total gross (the so-called "szuperbruttó") salary including social security and other contributions, next year it will be applied to the total gross salary – except for those earning the abovementioned amount and above. The result will be two income tax rates, though they'll be far closer than the rates under the previous government.

While Fidesz is anxiously emphasising that this move is not inconsistent with its flat tax promise, no dazzling feat of communication will turn two tax rates into one. But of course Fidesz is right in saying that on the whole this is a move to save the flat tax: if revenue streams are not somehow stabilised then next year's runaway budget will bury fiscal stability and the government with it, thereby rendering improbable a timely reintroduction of the flat tax for the 2014 election.

This is costing the government crucial points on its already-battered credibility, not because the flat tax is so popular – most people have benefited little and many have been downright adversely affected – but because it has so steadfastly and aggressively claimed that the flat tax was sacred and irreversible, so much so that it was to be (and may well be) enshrined with a two-thirds majority so that future governments won't/wouldn't be able to pursue a different tax policy.

Fidesz is also running into credibility problems in other realms of tax policy.

In love with consumption taxes

In a country where income taxes are easily evaded, VAT is an attractive alternative. Governments of all stripes have relied on VAT revenues to keep them afloat. In fact, a crucial frailty of the Hungarian tax system lies in the over reliance on consumption taxes. Tax policy has been tending towards an increasing emphasis on consumption taxes in the entire region (and in fact increasingly in Western countries as well).

The reasons are simple. For one, these taxes appear more easily supervised and hence more difficult to evade. Though services from plumbing to medical appointments at private practitioners are often conducted without receipts and hence without VAT payment, on the whole VAT collection is considerably more successful than raising income taxes since declared incomes are often divorced from reality.

Second, with regard to individual citizens, consumption taxes appear as indirect taxes: they are collected and paid to the government by the retailers. In Hungary prices on display mostly do not contain the pre-VAT level price. Hence price increases will not necessarily be perceived by consumers as the result of an increased VAT, but probably as part of the general price increases that retailers want to implement from time to time. This might - this is an emphasised might - reduce the political price of the tax hike, as at least a portion of the electorate will blame corporations rather than the government.

Hungary: VAT recorder

The above reasons have already pushed the Hungarian VAT level into a tied first place in the European Union. Now she will have the distinction of moving ahead of the pack with her 27% VAT, which ranks near the top globally as well.

This may set the government up for a vicious circle, however. Even in international comparison, Hungary's reliance on the VAT has been extensive. Based on OECD data, former minister of finance Péter Oszkó shows that while in developed countries VAT contributes around 30% of total tax revenue on average, in Hungary this ratio was near 40% already in 2009 - that is when Oszkó himself was in office - and has since risen to well over 40% and continues to trend upwards.

Yet rising prices and the sluggish economy also have a depressing effect at least on some consumption, and at least in 2011 the government's plans for VAT intake (among other things) have been overoptimistic as well, leading to the new round of austerity measures imposed recently.

The roads foreclosed

The larger problem is that Fidesz' rhetoric over the past couple of years, specifically its relentless castigation of all previous attempts to raise revenue, will make any attempt to move the tax code into a sensible direction difficult. Specifically, we refer to the lack of a tax on real estate or other high value objects. Oszkó's abovementioned research shows that taxes of this kind constitute a conspicuously lower share of overall tax revenue than in other countries.

Nor is this a surprise in light of Fidesz' overall policies, which have consistently favoured the wealthy over the middle and lower classes. At the same time, with the budget in a volatile state and revenue calculations consistently overestimating real intake, it would be time to consider a progressive wealth tax on items that are difficult to conceal from the tax authorities, notably real estates.

While no tax is fair in a country where some people purchase their homes with hard-earned money left after taxes while others do so with income that they amassed without any type of social contributions, unlike income taxes property taxes have the benefit of at least extending to the latter group as well. While VAT has the same advantage, it is less social and arguably overused already.

Though it is not necessarily concerned about social considerations, Fidesz is probably aware that some kind of property tax is necessary. This is underlined by its argument for a luxury tax that is unlikely to materialise, as well as the pre-election confidential assessment of Fidesz founding member László Mádi, who was promptly exiled politically speaking for acknowledging that property tax is fundamentally sensible.

While the government has shown some willingness to break out of the trap it had set itself with its previous reckless rhetoric – cf. the temporary revision of the flat tax – it only remains to be hoped that it will take bolder steps towards a more well-rounded, fiscally predictable and also fairer tax system.

CORRECTION: In last week's issue (HPID 38) we erroneously claimed that the government limited the range of Swiss franc-based mortgages that may be repaid in advance with a favourable state-mandated exchange rate of 180 HUF/1 CHF to loans totalling 10 million forints or less. In fact, this was only one of the proposals that the government considered but ultimately chose not to adopt. We regret the error.