TAX POLICY ISSUES - TAXATION OF HUNGARIAN AGRICULTURAL ACTIVITY

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SUMMARY

In modern market economies the majority of state revenues is derived from taxation. Since 1988 the Hungarian regulations on taxation follow the practices of developed countries. The system of burdening is focused/based more and more on consumption instead of production as a result of tax reforms. The different types of enterprises and their activities are subjected to various taxation rules. Unfavourable conditions in agriculture (higher risk, lower profitability) are controlled through the adjustments or reduced tax rates and application of various kinds of tax allowances. The study examines both the theoretical and practical elements of income taxation in the enlarged Europe, particularly the tax schemes employed in Hungary's agriculture in the period around the EU accession. These investigations are focused also on prospective changes and their consequences for the near future in this regard. In new member states lower income tax rates are applied, and agriculture is a distinguished sector in this regard of the economy.

INTRODUCTION

"Enlargement will extend the EU's stability and prosperity to a wider group of countries. Enlargement will present significant economic opportunities, the "new members" will reinforce their economic integration, common set of rules and benefit from increased trade, will affect greater efficiency and more competition and the "old members" can establish new economic connections." This could be read in the announced opinion of the Commission previous to the enlargement. Behind the common declarations - before of 1st of May 2004 - many hopes and fears had been formulated on both side, in the old member states and the new accessing countries alike.

As mentioned earlier, since 1988 Hungarian taxation regulations follow the practises of developed countries. Value added tax and income taxation were introduced for companies, private enterpreneurs and private persons. The 2003 Comission Report on taxation policy in Hungary declared that Hungary essentially meets her commitments and requirements arising from the accession negotiations. It is therefore expected to be in a position to implement the "acquis" in the area of taxation following accession. The new EU members are required to take over the whole body of EU law (the 'acquis') and to refrain - in the run-up period to membership - from introducing any measures, which would conflict with that law. After 1st of May 2004, new member states continue their work of adapting to EU law and guaranteeing that any new tax measures they introduce for business taxation are compatible with Community rules. The integration process, regarding taxation to the

European Union will only affect the areas, which are directly related to the development of the single market, principally the Value Added Tax.

An optimal tax structure should be defensible, effective and simple, both at the implementation and maintenance.

The role of taxation by economic functions can be described as:

- financing of public goods;
- income allocations, redistribution;
- investment orientation;
- influencing competitiveness;
- economic-policy coordination (indirect taxes);
- increasing employment;
- promote economic growth;
- achieve environmental goals;
- sufficient revenue to finance social welfare;
- affecting long-term structural changes;

EVALUATION OF THE EUROPEAN INCOME TAX SCHEMES

One of the greatest challenges the European Union has ever had is the accession of ten new member states. The historic opportunity for the new member states is both unique and challenging. The currently used taxation system in Hungary is generally inadequate if measured against optimal taxation criteria, with particular problems such as excessive redistribution due to high taxation rates on capital earnings. The excessive redistribution of incomes is a typical characteristics of young market economies. In most cases, the state revenues are expected to finance state debts and government deficits instead of supporting public utilities/goods at a higher level. The distribution of tax burden between consumers, labour and capital indicates the link between fiscal performance (determining with regards to taxation), economic growth and income redistribution.

Analysis of the fiscal systems in the European Union shows that the overall tax burden (taxes plus compulsory social contributions) in relatively high in relation to the GDP. This indicates a high level of income redistribution in the EU compared other economy centres such the USA or Japan (Fig. 1). The new member states of the EU have in general lowers taxation levels in relation to the GDP than the older members. On average the tax burden, as a ratio of the GDP of new members in 2002 was 6.6% lower than that of EU-15 countries. Of the new members in three countries (Slovenia, Poland and Hungary) taxation level is close to that of EU-15 and in the remaining states the level is substantially lower, by up to 12%. Of EU-15 states only Ireland has a lower taxation than the new members, but there is a marked variation in the taxation-GDP ratio among the EU-15 states. Sweden is on the top, Ireland is on the bottom and the difference between the two is 22%. The highest ratios are found in Sweden, Denmark, Belgium and Finland, while lowest ratios occur in Ireland, UK, Spain and Portugal.

The average value of taxation-GDP ratio of EU-15 increased between 1995 and 1999 despite tax reforms, but was substantially reduced in recent years (since the Millennium) among the majority of them. The effects of tax cuts did not show up immediately possibly because the economic upswing of the late 1990's may have lifted the measured overall tax burden, whereas the slowdown of recent years blocked this trend. The effects of tax reductions are noticeable in the years between 2001 and 2002. The taxation-GDP ratio remains relatively high in Nordic countries and in Belgium, whereas it is low in the United

Kingdom, Portugal, Spain and Ireland. The latter state stands out for having reduced tax burden by the largest amount. However, the taxation-GDP ratio in the European Union remains high in international comparison.

As for taxation structure direct taxes including social contributions represent a lower share of the total tax revenue in new member states than in EU-15 states (Fig. 2). Some Nordic countries (i.e. Sweden, Denmark and Finland) collect a relatively high percentage of the total tax revenue as direct taxes, whereas some southern countries (Portugal and Greece) prefer to gather the state revenue relatively more indirectly in comparison with EU average. Social contributions as a percentage of total tax revenue are relatively low in Denmark, the United Kingdom and Ireland and relatively high in Germany and to a lesser extent in France.

In 2002 the differences in levels of various taxes between EU-15 and new member states was on (arithmetic) average 10%. A reason for this was the lower rate of corporate and personal income taxation in new member states (Fig. 3, 4). In 2004 the average corporate tax rate in new member states was 10% lower and the top statutory personal income rate was about 11% lower than those in EU-15 states. From the beginning of 1990's, following western European practices, consumption and sales came into the focus of taxation, instead of corporations and production. As a consequence of these and some complementary reforms, Hungary has built a stable market economy in the region and became one of the most attractive destinations for direct foreign investments. This process was also supported to some extent by a well-functioning system of tax incentives and favourable labour costs.

Later lower direct taxes in the new member states were offset by a higher rate of the indirect taxes such as social contributions (social insurance rates) in the case of the Czech Republic, Poland, Slovakia and Hungary. As for local government taxation, these do not vary a great deal between new member and EU-15 states (they represent about 10% of total taxes).

The implicit tax rates on capital and business income depend considerably on the development of business processes and cycles. As a consequence of the so-called "symmetrical" influences caused by corporate losses of over the latest years, no clear effects on business cycles can be traced from the beginning. However, due to the relatively long-lasting expansionary period from 1995 to 2000, increases in tax rates were expected. This phenomenon arose from the progressive nature or character of personal income tax system and the fact that more and more companies became profitable with diminishing carried-over losses. In addition, structural changes in the financial situation of companies has also led to increased tax rates on capital gains and business incomes; this has commonly led to a shift in corporate financing and utilization of incomes toward dividend payments.

Between 1995 and 2004, the average top statutory corporate tax rate (including local taxes and surcharges) in EU-15 countries was reduced by 6.6 percentage points. The new members first reduced their rates at a similar pace but then accelerated this process in recent years. In fact, the competition in tax-abatement and the reduction of corporate tax rates is not merely a consequence of EU enlargement. The directions of changes in tax-policies are influenced by international capital movements as well as by the efforts focussed on equilibration and simplification. This new type of approach has also become predominant in

the case of Central and Eastern European (CEE) countries. The so-called "one key system" (considering VAT, Corporate Income Tax, and the Personal Income Tax schemes) has already been introduced in Slovakia and Romania. These tax categories have been established in the new system using relatively low rates (in Slovakia, for example, 19%) and on the basis of a year's experience the introduction of a similar system is considered in Hungary and in the Netherlands with respect to personal taxation. Although the introduction of the one-key taxation system can be very effective, it may damage the important principle of "Justice" in a tax scheme.

Simultaneously with tax rate reduction another process is taking place, notably the extension of the basis of assessment (through narrowing, for example, the span of allowances related to amortization) to counterbalance to some extent the effects of diminishing tax rates between 1995 and 2004. Comparing Hungary with other newly joined countries our rates in the Personal Income Tax System are still too high and this does not favour competitiveness. In any case it would be necessary to reduce these rates to minimise tax evasions. Although, the rates have been reduced lately, nevertheless the position has further deteriorated due to the heavy taxation of labour income through the very high level of employer's social security contributions. In addition, the growth of wages and salaries in recent years in Hungary exceeded that of the GDP while in neighbouring countries this growth remained under the expansion of GDP. This has lead to further deterioration in competitiveness.

Characteristically in modern market economies (also Hungary) the role of income taxes is moderate compared with that of indirect taxes (Fig. 5). Furthermore a relatively high taxation-GDP ratio is frequently coupled with high labour taxes and social contributions and vice versa.

The rates of various contributions to social insurance charged to labour costs/personal incomes have been increasing continuously from the seventies. Although in the period from 1988 to 2002 the rates have declined by 1,4%, their level may still be considered as high in international comparison. In the majority of EU states a parallel can be drawn between rates of personal income taxes and the importance of contribution related to wages, demostrating at the same time the level of finance for the social umbrella.

Many member countries of the EU introduced the so-called "Green Tax Reforms" including Denmark, Germany, Italy, the Netherlands, Austria, Sweden, Finland and the UK. The core concept of these reforms was to increase taxes on activities polluting the environment, while reducing taxes on labour incomes thus avoiding the collection of a higher level of total revenues from enterprises. In addition to reducing environmental damages another benefit is the higher rate of employment due to reduced labour costs. In 2002 revenues related to environmental protection amounted to 6,5% of total taxes including social contributions and about 2,7% of the GDP. Compared with 1980's, this represents a significant shift.

THE AGRICULTURAL TAXATION SYSTEM IN HUNGARY

Even though the value of Hungary's agriculture is a small fraction of GDP, it is favourably endowed and plays a determinant role in the economy and regional development.

The application of optimal taxation principles can be occasionally a serious problem and this is particularly the case in agriculture, where demand and supply does not always balance. This is the reason why fiscal policies frequently attribute special importance to agriculture and rural areas. The rules presently applied attempt to provide an unbiased environment to domestic and foreign entrepreneurs alike. The taxation system attempts to compensate the unfavourable characteristics of agriculture (high risks, law profitability) by reduced tax rates and the application of various allowances (Fig. 6).

Various legal formulae are available for pursuing agricultural activities in Hungary. Not only production structure can be characterised by a wide scale but also the profitability of these economic enterprises. According statute we differentiate the following forms of enterprises:

- companies; corporations
- co-operatives
- individual entrepreneurs;
- subsistence farms; small producers (primary producers)
- family enterprises.

Small-scale enterprises (individual entrepreneurs, subsitence farmers) are taxed under Personal Income Taxation, whereas companies and co-operatives come under Corporation rules. Co-operatives (6.9% of the total number of farms) or companies (32.7% of farms) cultivate 48% of agricultural land, whereas individual entrepreneurs 52%.

The "Aquis" includes several directives concerning the direct taxation of corporations and the movement of capital. In the case of corporation taxation it calls for attention to co-operation between national taxation authorities and offers assistance in removing barriers to cross-border activities. In Hungary the taxation rate is 16% for companies and co-operatives and this may be considered favourable as compared with Western European countries. Foreign corporations frequently select the location of their investment according to the level of corporation taxation.

Most co-operatives functioning at present in Hungary are successors to co-operatives before the change of political regime that together with state farms used to form the basis of agricultural production. Unlike their Western European counterparts they carry out their profit orientated activities on land, which does not belong to the co-operative. From the point of view of taxation they behave like corporations.

The basic taxation principles, cost and income calculation procedures are the same for corporations, individual entrepreneurs and subsistence farmers. The size of enterprise is irrelevant from the point of view of taxation when accounting itemized costs for personal income tax of entrepreneurs or in the case of corporations. Sales returns function as a limiting factor, however, when selecting the mode of taxation in the case of Simplified Entrepreneurial Tax (in Hungarian abbreviated as EVA) and/or flat rate taxation especially for subsistence farmers. Although the EVA system introduced in 2003 is very popular among entrepreneurs, agricultural producers do not take up this option. This type of taxation favours the entrepreneurs who possess few certified invoices for costs, do not have to charage VAT and their income is below certain limit.

According to the rules of taxation the tax on the consolidated assessable income of an individual entrepreneur is 16%, the same as that for business organisations such as co-operatives, companies. Unless individual entrepreneurs and primary producers choose to pay a flat rate tax, they can reduce their taxable income similarly to corporations. The system applies positive discrimination in

the case of small agricultural producers and family farms. The determining factor in calculating taxable income will be sales returns and character of activity (plant cultivation, animal husbandry, horticulture, forestry). If their income falls below certain level, they receive various allowances, for example, they can opt to pay flat rate tax or even enjoy tax-free status. Most family farmers tend to choose flat rate taxation or attempt to collect invoices of their costs for at least 20% of their sales return. Primary producers are allowed to sell only products produced by themselves on their own farms. Commercial activities are not allowed. If the sum of individual limits is not sufficient to stay below the income limit, all family members older than 16 years can be included in the calculations. Individual entrepreneurs and primary producers can register themselves as family farmers. This type of category was popular with producers when other allowances accompanied this legal form, for example higher income limit or pre-emption right in case of land tenancy.

According to an unrepresentative (not yet evaluated) government sponsored survey in the western part of Hungary by the authors, about 85% of registered agricultural producers are not subject to statutory taxation. About 58% of small agricultural producers do not reach the tax free limit of sales returns (600,000HUF) and 65% of the remaining producers possess invoices of costs for at least 20% of their income. The remaining farmers pay taxes either by itemized cost accounting or at flat rate. If sales returns exceed the tax-free limit, incomes are collected into the tax assessable base, which according to Hungarian taxation statistics are still not relevant (Table 1). The taxation characteristics of individual entrepreneurs are displayed in Table 2. In 2003 the number of profitable enterprises declined by 13%, enterprises making a loss increased by 1.2%, while the total number of enterprises declined by 6%. The proportion of profitable agricultural enterprises has deteriorated.

Table 1

Data on personal Income Tax between 1996-2002

	1996	1997	1998	1999	2000	2001	2002
Tax (head)	4 346 746	4 223 877	4 239 696	4 344 346	4 403 465	4 471 256	4 449 227
Declaretors of consolidated tax base (head)	4 200 966	4 168 755	4 192 476	4 245 206	4 308 708	4 350 314	4 205 854
Consolidated tax base (Mio HUF)	1 935 683	2 336 226	2 785 500	3 260 613	3 116 242	4 424 893	4 935 464
Income coming from separated activity (Mio HUF)	114 422	135 033	143 185	152 472	176 642	184 469	212 597
From which agricultural producer activity	0	480	3 377	2 160	2 501	2 358	3 254
From which smallholder activity	994	2 914	0	0	0		
Income coming from separated activity (Thous.HUF/head)	137	173	185	225	260	268	306
From which agricultural producer activity	0	213	233	248	260	253	274
From which smallholder activity	74	227	0	0	0	0	0

Source: Az APEH világa, 2001, 2002, 2003.

Table 2

Results of agricultural activity at agricultural individual entrepreneurs

	Profitable	Loss	Zero	Flat rate	Total	%
			2002			
Number of individual entrepreneurs	5 278	5 371	2 244	417	13 310	
Yearly result, Bio HUF						
*profit	4 536 574		0	145 803	4 682 377	42,08%
*loss		6 443 807	0	0	6 443 807	57,92%
			2003			
Number of individual entrepreneurs	4 595	5 437	2 169	328	12 529	
Yearly result, Bio HUF					0	
*profit	3 448 453			118 999	3 567 452	32,69%
*loss		7 344 675			7 344 675	67,31%

Source: APEH statistical database

There are of course regional variations within the country. The government acknowledges unfavourable conditions for preferred agricultural activities. In most cases, however, these preferences are available only for family farmers; not for companies or co-operatives. The problems arising in relation to the taxation of agricultural activities are frequently extremely complex. Although agriculture contributes minimally towards the common expenditures of society, numerous problems occur in relation to the taxation of incomes from agricultural activities, especially among family farmers. The source of many problems is the poor administration kept by the farmers, i.e. the deficiencies in ledgers. It often happens that required documents simply get lost.

The applied system of taxes is also rather complicated. Producers suffer frequently from lack of knowledge and information about taxes. The presently operated network of advisers cannot be regarded as an adequate system. Village consultants (falugazdász) do not deal in problems of taxation or they do not give taxation counsel, because this involves liabilities. Most producers turn to accountants or tax-advisory offices. And this is where the problems arise from the specialized nature of agricultural activities.

CONCLUSIONS

- The EU enlargement did not bring about revolutionary changes in the CEE countries because of pre-accession reforms and adoption of the “acquis communautaire”.
- Concurrently with this, not only the adoption of new administration procedures, management tools related to the operation of the system is required. Conditions of taxations will have to be re-examined to reduce costs and optimise the finances at enterprises level. Retraining of personnel will take much time and energy.
- The development of total taxation in the EU still indicates a relatively high level of income redistribution.
- Concerning the structural aspects of taxation in new member states, the role of direct taxes is to be diminished.
- Personal income tax rates and corporate taxes rates are lower in new member countries. No compulsion for the harmonization of income tax rates in the EU exists. Certain allowances in agriculture and special forms of taxation (such as EVA) can be kept.
- High income tax rates and social contributions may unfavourably influence international competitiveness.
- Similar changes are expected in future; personal income tax and corporate

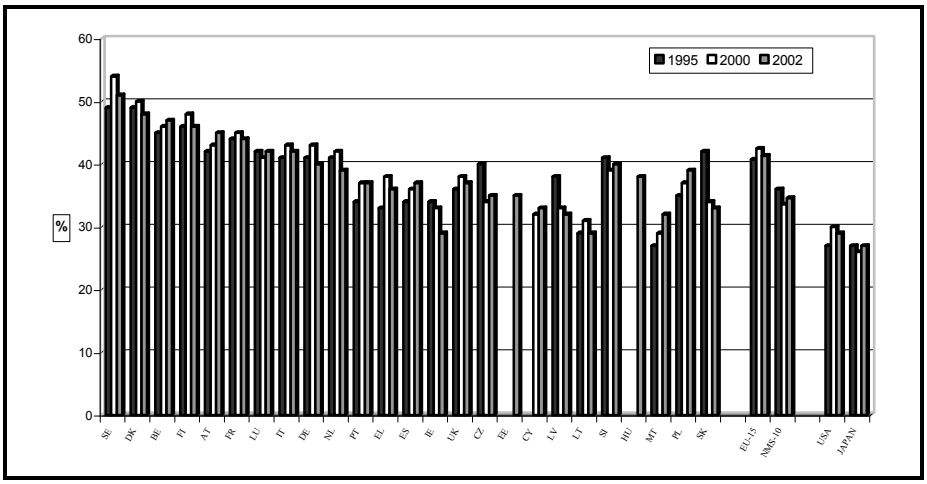
tax rates will be lowered but assessment bases will be widened on the long term.

- Allowances have an important role in agriculture, especially in the case of small farms.

The greatest challenge in the European Union is the simplification and restructuring of taxation system to make it internationally competitive.

Figure 1

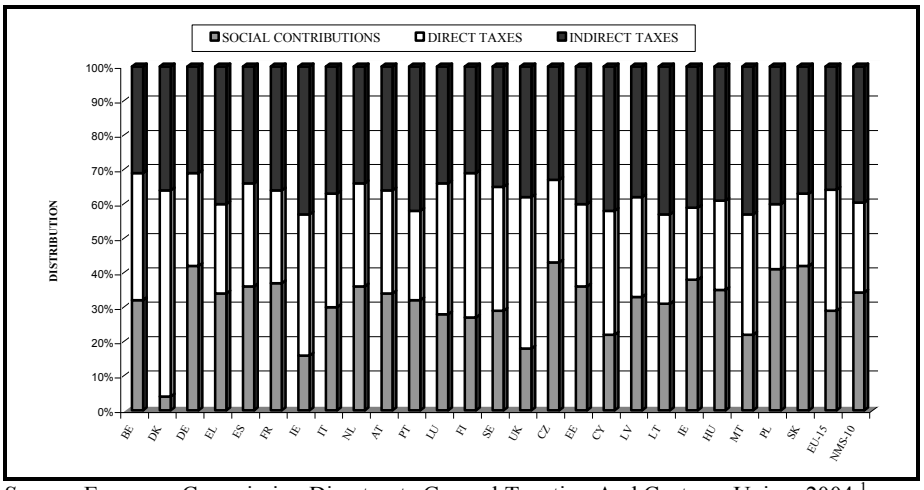
Tax to GDP ratio in EU countries and the US and Japan 1995; 2000 and 2002, in %



Source: European Commission Directorate General Taxation And Customs Union, 2004.

Figure 2

The structure of tax revenues by major type of taxes 2002, in % of total tax burdens

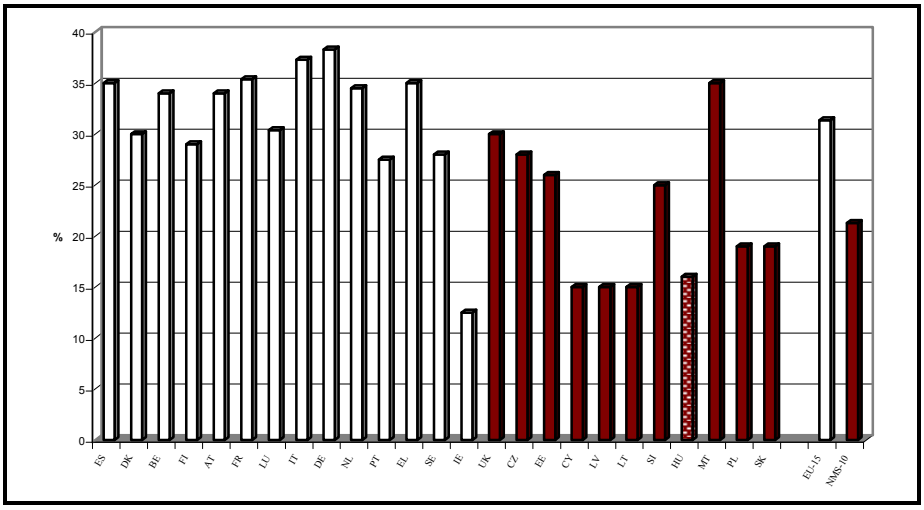


Source: European Commission Directorate General Taxation And Customs Union, 2004.[1]

[1] • Direct taxes: They are paid and borne by the taxpayer and include income tax, corporation tax, wealth tax and most local taxes.

Figure 3

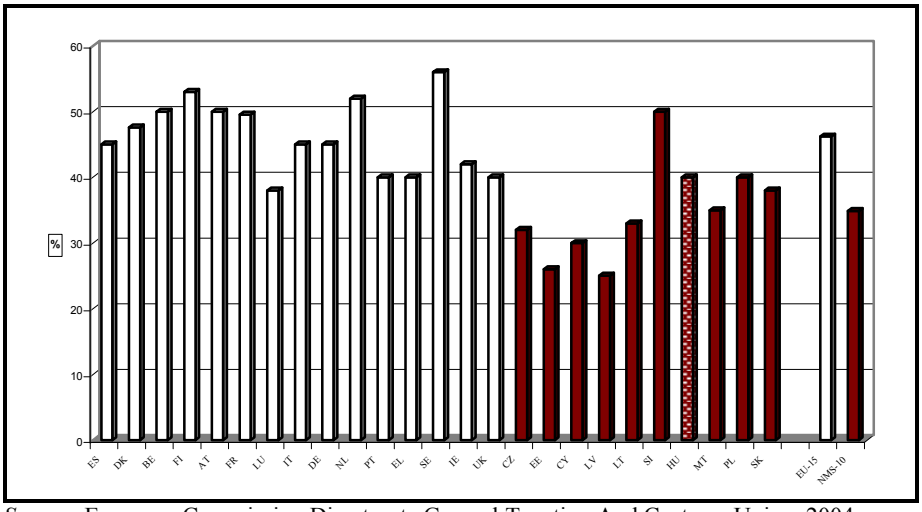
Effective top statutory tax rate on corporte income 2004 in %



Source: European Commission Directorate General Taxation And Customs Union, 2004.

Figure 4

Top statutory personal income tax rate, 2004 in %



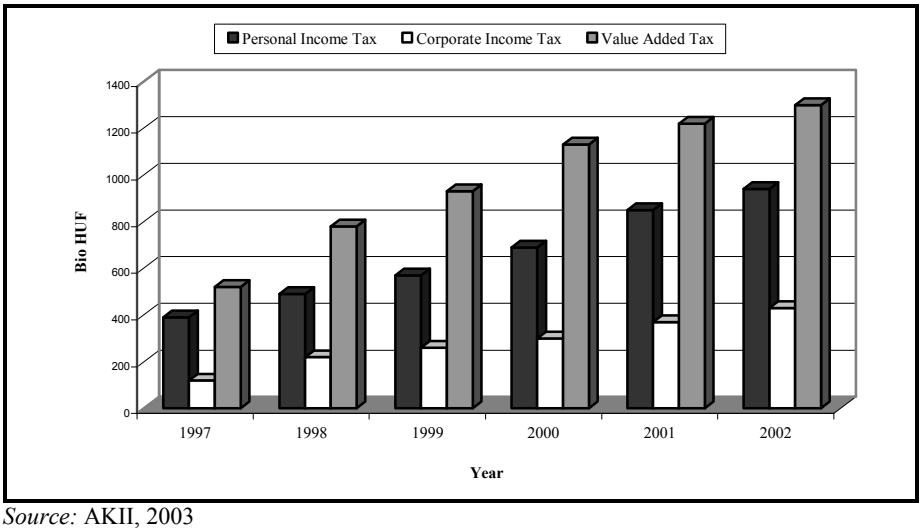
Source: European Commission Directorate General Taxation And Customs Union, 2004.

• Indirect taxes: These are levied on production and consumption and are not borne by the 'taxable persons' (traders or industry) who pay them, collecting the tax on behalf of the government and passing it on in the price to the final consumer on whom the burden falls (examples include VAT and excise duties).

• Social security contributions: These are compulsory charges levied by social security organisations to pay for sickness, disability or unemployment benefits, workers to maintain insured persons' income in the event of certain risks (sickness, compensation and old age pensions, etc.). Social security contributions are paid by people in work and employers.(Source: European Commission Directorate General Taxation And Customs Union, 2000.)

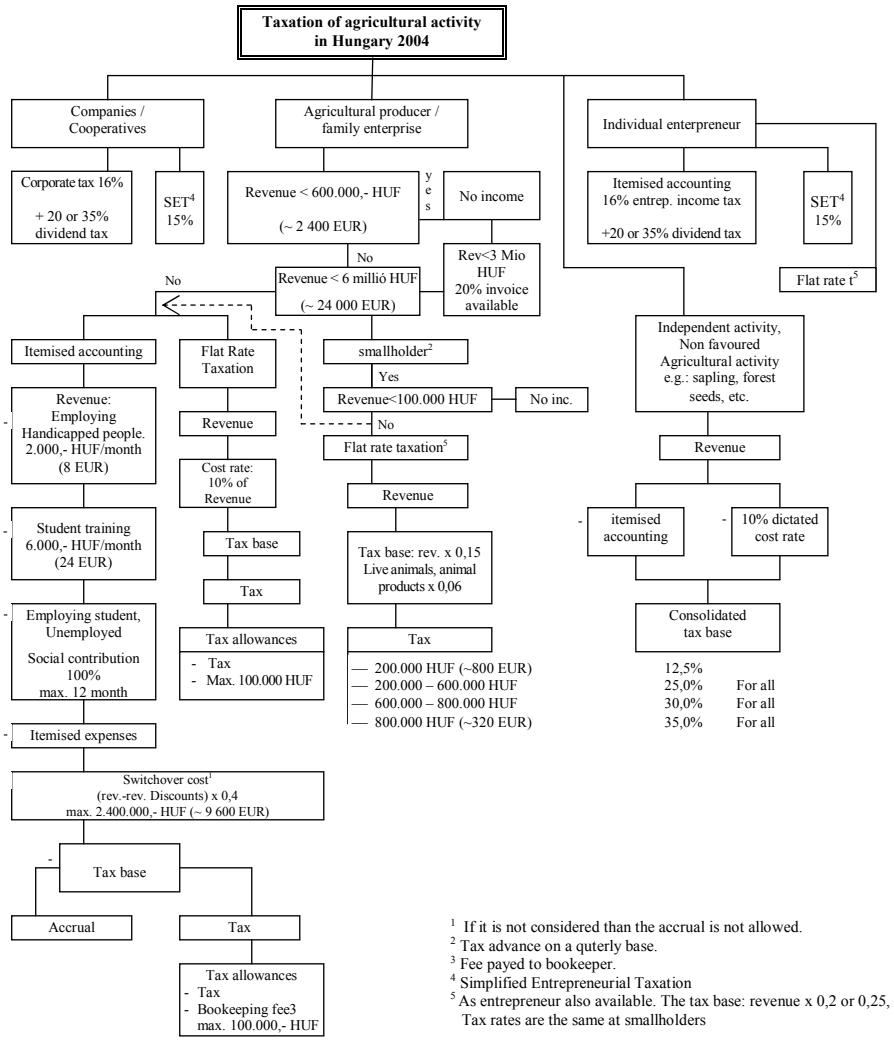
Figure 5

Development of distribution of tax types in Hungary



Source: AKII, 2003

Figure 6



Source: based on Herich György investigations

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