

**Effects of the New Income Tax Regime on the SME sector**

The joint research efforts of SME Panorama, the Monitor, the Economic and Enterprise Research Institute (GVI) and the Volksbank have set a target of making available, on a quarterly basis, corporate empirical surveys based on the study and analysis of Hungarian small and medium enterprises (SMEs) -- their financial position, prospects and the factors affecting their businesses. A government proposal to the Hungarian National Assembly in 2011 substantially changed personal taxation in several important ways. The expectation was that no one would be worse off with the introduction of the new system; however, several studies pointed out that not everyone will be positively affected by this change. The aim of the MKIK GVI study is to illustrate the proportion of SME workers adversely affected by the introduction of a flat personal income tax in 2011, as well as show which employees were most affected by the law. A third aspect will be an examination of how the companies responded to the changes in personal income, that is, what adjustments were observable until April 2011, when the survey was completed.

The results show that the gross wages of employees at 35 percent of the companies surveyed has not changed in 2011, and declined for 1 percent of SMEs. A majority of businesses in turn raised wages: 27 percent of companies raised wages by less than 5 percent while 36 percent raised wages over 5 percent. The wage rate together with a company's business situation and outlook for the future are significantly related: a favorable business outlook means that a higher wage increase will be more likely. The results found that 82 percent of SMEs have workers whose real incomes fell as a result of the tax system changes introduced in 2011. For those businesses that are entirely Hungarian owned an average of 53% of workers are adversely affected by the new income tax law, while at entirely foreign-owned companies it's only about 36%.

The changes in personal income tax rules may lead to the beginning of different adaptation strategies by companies. 52 percent of companies claim to fully compensate workers for lost wages, while another 19 percent claim to only partially offset lost wages. The remaining 29 percent, however, are unable to compensate their workers at all for the loss of income. Thus, companies in a favorable business position are able to wholly or partially offset the loss of wages, while those in an unfavorable financial situation are typically unable to compensate their workers for a loss of income.

**SME Outlook and motivation**

The joint research activities of SME Panorama, the Monitor, the Economic and Business Research Institute (GVI) and Volksbank have set a target of making, on a quarterly basis, a corporate empirical survey based on the study and analysis of Hungarian small and medium enterprises; their financial position, prospects and factors affecting a company's business situation. Aside from the economic condition of enterprises in conjunction with current issues, problems and reactions of individual companies are also examined which, in turn, may play an important role in determining the adaptability of companies within this group as a whole, their financial status and development. In the survey conducted on April 26, 2011, the effects of changes in personal income tax regulations were examined.

As a result of a government proposal last year, the Hungarian National Assembly fundamentally changed the personal taxation system in 2011 in several important ways,

including the introduction of a flat tax rate of 16%. The initial expectation was that no one would be adversely affected by the new system; however several studies had showed that these changes would result in a non-negligible decrease in the net income of a disproportional number of employees.

The purpose of the MKIK GVI (<http://www.gvi.hu/>) analysis is to illustrate the proportion of workers at SMEs adversely affected by the 2011 introduction of a flat tax, and which SME employees have been most affected by this law. A third issue to examine was that of how businesses are responding to these changes in personal income, in addition to government policy and corporate adaptation as observed in April 2011, when the survey was completed.

### Wage increase levels

The results of the survey show that gross wages in 35 percent of SMEs did not change while 1 percent saw a decrease in 2011, with the majority of businesses actually increasing wages. Wages were raised by less than 5 percent by 27 percent of enterprises; 36 percent raised wages over 5 percent.

These wage increases largely depend on a company's business position. Employees have a chance for a wage increase of over 5 per cent at those enterprises which have a favorable business outlook for the future. Among those companies in a good business position, almost half (49%) increased wages by more than 5 percent, while only 16 percent of those in a poor economic condition were able to increase wages of a similar magnitude.

Workers within the retail and manufacturing sectors are more likely to receive a wage increase of over 5 percent.

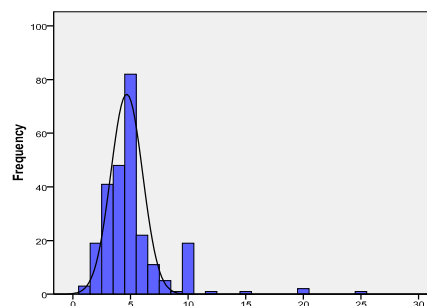
### Adversely affected employees

According to our results we find that 82 percent of small and medium sized businesses have workers whose real incomes fell with the introduction of the new tax system in 2011. An average of 48 employees per company was adversely affected by the new income tax law.

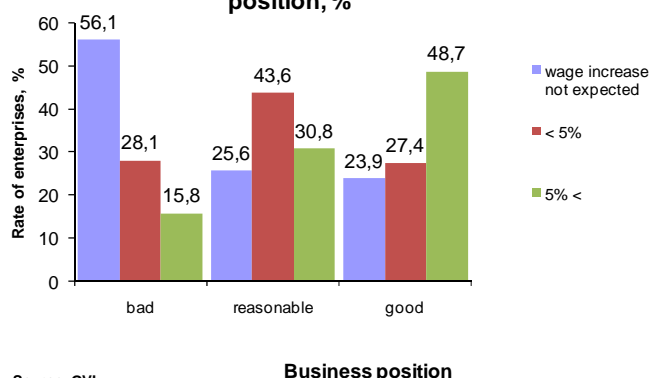
If we compare the number of workers adversely affected to the number of employees in a company, then a significant difference in this variable can be observed. For instance, those businesses that are entirely Hungarian owned have an average of 53% of workers adversely affected by the new income tax law, while for entirely foreign-owned companies it is only about 36%. This also means that Hungarian-owned

### Gross wage increase levels among SMEs

Gross wage increase levels in 2011 within the SME sector

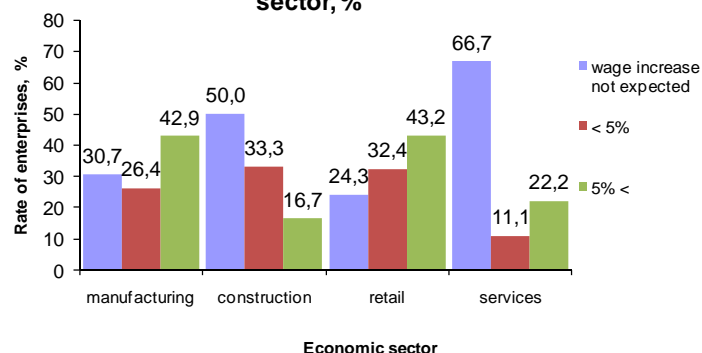


### Wage increases according to business position, %



Source: GVI

### Wage increases according to economic sector, %



Source: GVI

firms may be in a comparatively difficult situation, because they are relatively more affected by the tax law and yet are forced to somehow adapt. As the business situation and prospects for Hungarian-owned enterprises are less favorable than those of foreign-owned companies, the former are less able to compensate for the loss of net income due to the new income tax law, and therefore are less able to offer competitive wages as opposed to foreign-based companies which are already in a better position. This, in turn, hinders them in the race for more productive (skilled) workers, and thus in the long-term this group could ultimately collapse.

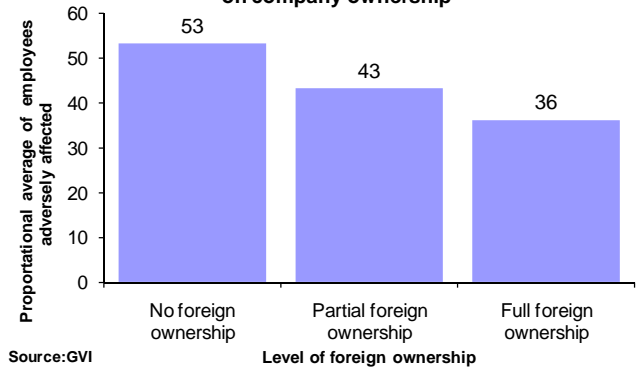
### Company Adjustment

The personal income tax rules changes which were introduced in 2011 can lead to different adaptation strategies among companies. In all, 52 percent of companies claim to totally offset the wages lost by their workers, while an additional 19 percent claim to only partially do so. The remaining 29 percent, however, are unable to compensate their affected workers at all. The results show that a company's favorable business situation will lead them to fully or partially compensate for lost wages. Workers at enterprises with a favorable business situation are three times more likely to receive partial compensation or have 4 times the chance of full compensation as opposed to those employed at a company with an unfavorable business situation.

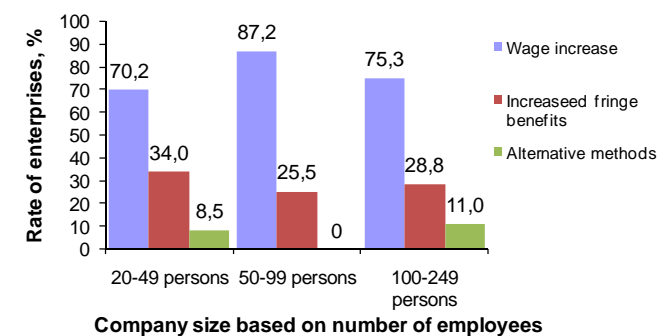
It has been observed that 77 percent of companies compensate their workers for the loss of net wages through a pay increase, 29 percent use increased fringe benefits, while 7 percent find another way to solve this problem. What lies behind the latter are gray-market wages (under-the-table cash payments or account transfers, payments made offshore) and the application of different forms of tax avoidance.

Irrespective of the size of a company, wage adjustments is the most common method used. This method of compensation is used by 70 percent of companies with less than 50 employees, 87 percent of companies employing between 50 to 99 people, and 75 percent of businesses with over 100 employees. The use of increased fringe benefits as a means of compensation is highest (at 34%) among enterprises with less than 50 employees. Other forms of compensation are more common among companies with 100 or more employees (11%), yet those with less than 50 employees is also significant at 9 percent. Companies with between 50-100 employees don't typically resort to the use of gray-market wages or tax evasion. This result suggests that the new law will more likely push small firms towards the "gray economy" as they try and adapt to the new regulations.

**Proportional average of employees adversely affected by the new personal income tax regime, based on company ownership**

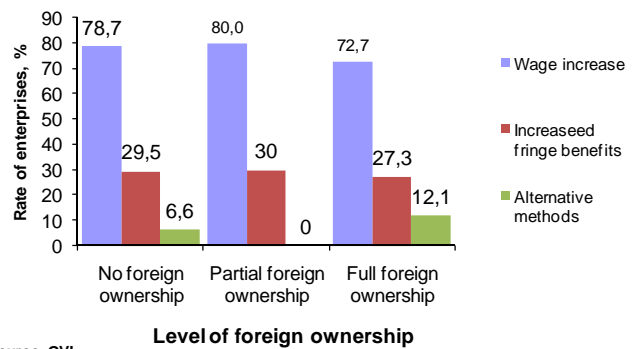


**Type of compensation based on company size, %**



In terms of ownership, wage increases are also by far the most common form of compensation, and can be found highest among partly foreign-owned firms (80%) and entirely domestic-owned firms (79%) as opposed to entirely foreign-owned firms (73 percent). In all three groups the proportion of firms paying increased fringe benefits is at about 30 percent. The use of other forms of compensation is a feature specifically related to companies that are either entirely foreign-owned or entirely Hungarian-owned (at 12% and 7% respectively).

**Type of compensation based on company ownership, %**



Source: GVI

## Macroeconomic trends: Consumption growth as the engine of the Hungarian economy in 2011?

The stagnation of retail trade in the first quarter doesn't yet appear to justify the expectation that the tax changes associated with those layers of the economy that drive increased consumption can become the engine of growth in 2011. The lack of recovery in domestic demand may call into question the government's ability to meet its 3.1 percent GDP growth forecasts.

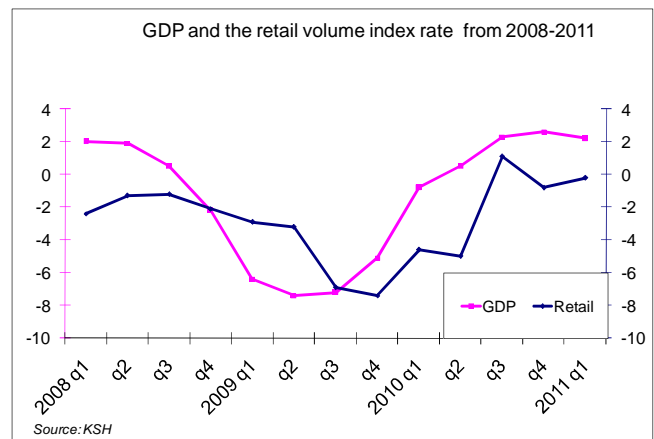
This stagnation in consumption can be attributed to various causes: households with uncertain income prospects have turned to "more cautious" patterns of consumption; the high installments on foreign currency based loans have shrunk the disposable income of many; and, finally, what is also perhaps an obstacle to consumption are the tax changes themselves for higher income earners with more money in their pockets have shown that they are more likely to save this extra amount rather than spend it.

### Stagnant retailing in the first quarter of 2011

According to a recent study by the Central Bureau of Statistics (KSH) in 2011, the volume of first quarter retail sales has essentially stagnated over the same period a year ago. According to the KSH, consumer spending has fallen for food, transport, cultural activities and other services, but had slightly increased for health care products and the amount spent on telecommunications.

Since early 2007, with the exception of the third quarter of 2010, the volume index of retail trade has shown no growth at quarterly intervals. The negative figures don't seem to justify those expectations at the beginning of the year that tax changes associated with increased consumption among the prosperous sectors of society can become an engine of growth in conjunction with exports.

If domestic demand fails to pick up in the second half, this "engine" will no doubt force a change to the government's 3.1 percent GDP growth forecast. The European Commission also feels that growth will most likely be less than the above-mentioned target, its economic forecasts in May sees a growth rate of 2.7 percent for the Hungarian economy in 2011.



GDP data = seasonally and calendar adjusted volume indices, corresponding to the period of the previous year = 100.0

Retail data = calendar adjusted data for the same period of the previous year = 100.0

### Tax changes and consumption

The reason for the stagnation in household consumption consists of several different reasons. While tax cuts are more favorable for higher income groups as opposed to lower income groups, the latter is characterized by a higher propensity to consume; thus, the overall effect of the tax cuts is that it has less of an impact on consumption, but promotes the growth of savings instead.

### **Repayments and rising insecurity**

The uncertain outlook for many household incomes is also not conducive to a lively domestic consumption rate as this income is "more cautiously" spent. This uncertainty is further reinforced by a reduction in the duration of unemployment benefits to only three months starting in 2012.

In addition this, the rise in the installments on foreign currency based loans has limited the rise in consumption by reducing the amount of household disposable income available.

*Source: fn.hu, origo.hu, portfolio.hu, ksh.hu, mnb.hu*

## International business trends

According to the Ifo Business Climate for German industry and trade, an indicator produced by the Institute for Economic Research in Munich which measures business confidence among leading German industrial and commercial entities, there was no significant change in the index for the month of June as compared to May, which means that the strong improvement that had been apparent over the past two years has come to an end. By comparison, German business executives in the current business climate expected further improvements in June, the highest level reached since 1991. A turning point of business expectations, however, could be detected: according to the June survey, German business expectations declined further in June. The Ifo forecasts that in the second half of this year the German economy will slow down in comparison to previous periods, however the economy as a whole will still remain positive. Meanwhile, according to the French statistical office (INSEE), its June survey results show that French industrial activity has slightly improved. The business confidence index, based on the outlook of French business leaders, rose three points and thus remained above the long-term average. The economic turning point indicator points to a favorable convergence. The representative index of the business climate in general shows a slight improvement.

### Short-terms perspectives of the German economy

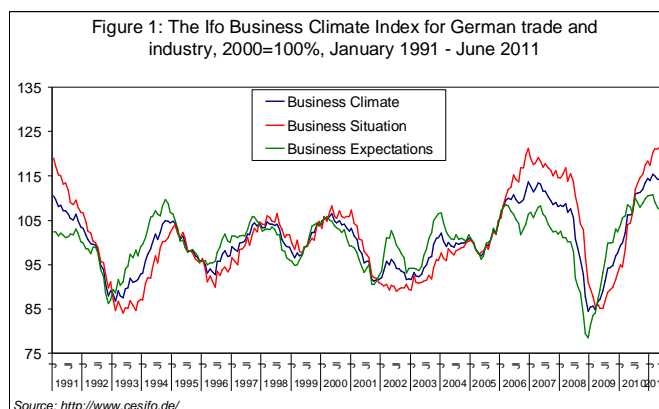
The Ifo Business Climate for German industry and trade, an indicator of the Institute for Economic Research in Munich, increased slightly in June 2011 compared to May, that is, the negative trend over the past three months has come to an end (see Figure 1). However, the current business climate indicator continued to rise since and has reached its highest level since 1991 at 123.3 percent (Table 1). By contrast, expectations for the second half of this year continue to decline in line with a trend observed since March as Germans are becoming less optimistic about the near future. This fits in with an overall slow down, something which can be observed over the past two years (Fig. 2).

This also means that the business confidence index is more uncertain than ever before: expectations for a worsening business climate are coupled together with a positive outlook. This can be shown in measuring the gap between the business climate and expected developments, as well as the rising value of the asynchrony index as calculated by IEER (Figure 3). In addition to this, the Ifo forecast for the German economy indicates a slow down in comparison to previous periods, yet the overall trend for the economy as a whole remains positive.

Expectations are that the economy will continue to be driven by exports, although not as much as in May. A record number of German companies were also in receivership.

For the industrial sector, the business confidence index remains high, which is an improvement in June; however, taken together with business expectations it had worsened, as it had in May.

A good portion of retail firms have a positive outlook of their financial situation, but expectations have deteriorated significantly in June, which resulted in an overall decrease in



	Business Climate	Business Situation	Business Expectations
Jan 2011	113,9	117,4	110,6
Feb	115,4	120,2	110,7
Mar	115,0	121,1	109,2
Apr	114,2	121,0	107,7
May	114,2	121,5	107,4
Jun	114,5	123,3	106,3

source: cesifo

the business confidence index for the retail sector. Improvements were still noticeable for wholesalers, on the other hand.

Business confidence has improved significantly for the construction industry compared to May, in which both the current business climate and the business outlook indicators are deemed to be realistic.

Source: Ifo (<http://www.cesifo-group.de/>)

### Short-term perspectives of French economy

The French statistical office (INSEE) survey in June shows a strengthening of French industrial activity: a three percentage point increase in the business confidence index (109%) which is above the long-term average (Fig. 4).

The turning point indicator increased again which suggests the likelihood of an improvement in the future outlook of businesses (Fig. 5).

According to the managers of manufacturing companies production increased in the last quarter. The volume of finished product inventories rose slightly. The executives surveyed noted an increase in their order books; in particular, their export order books appeared strong and steady.

French economic growth is expected to strengthen in the coming months: the forecast of individual business leaders (which sums up the business outlook for the coming months) improved in June and is above-average for the long-term. The general outlook of the representative index -- which reflects the overall opinion of respondents concerning industrial activity -- continued to decline slightly, but is still in positive territory (+13%).

Source: INSEE (<http://www.insee.fr/>)

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