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Estimates and Flat Tax Predictions using the  
Hungarian Tax Changes in 2005**

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## **Abstract**

Many Central and Eastern European countries are adopting flat tax schemes in order to boost their economies and tax revenues. Though there are signs that some countries do manage to improve on both fronts, it is in general hard to distinguish the behavioral response to tax changes from the effect of increased tax enforcement. This paper addresses this gap by estimating the elasticity of taxable income in Hungary, one of the outliers in terms of not having a flat tax scheme. We analyze taxpayer behavior using a medium-scale tax reform episode in 2005, which changed marginal and average tax rates but kept enforcement constant. We employ a Tax and Financial Control Office (APEH) panel dataset between 2004 and 2005 with roughly 215,000 taxpayers. Our results suggest a relatively small but highly significant tax price elasticity of about 0.06 for the population earning above the minimum wage (around 70% of all taxpayers). This number increases to around 0.3 when we focus on the upper 20% of the income distribution, with some income groups exhibiting even higher elasticities (0.45). We first demonstrate that such an elasticity substantially modifies the response of government revenues to the 2004-2005 tax changes, and then quantify the impact of a hypothetical flat income tax scheme. Our calculations indicate that though there is room for a parallel improvement of budget revenues and after-tax income, those gains are modest (2% and 1.4%, respectively). Moreover, such a reform involves important adverse changes in income inequality, and its burden falls mostly on lower-middle income taxpayers.

**Keywords:** elasticity of taxable income, tax reform, behavioral response, revenue estimation, flat tax

**JEL codes:** H24, H31



## 1. Introduction\*

Motivated by their simplicity, easy administration and effective monitoring, “flat tax” experiments have become practically the rule in Central and Eastern European (CEE) countries. Although involving a large cut in personal income taxes and thus often having adverse implications for income inequality, such reforms tend to boost budget revenues. It is not immediate, however, that this is evidence for some kind of a Laffer curve, since the introduction of a flat tax always comes together with additional changes in tax rates (like an increase in capital income tax rates). More importantly, there is often an increase in enforcement as well.<sup>1</sup>

One cannot easily distinguish the influence of these factors from each other, though it would be essential for the design of tax reforms in any of these countries.<sup>2</sup> If there is indeed a substantial labor supply (more precisely: taxable income) response, that is indicative of huge welfare gains from an overall shift away from labor income taxation, regardless whether it is a flat tax or not. If, on the other hand, there is little labor supply response, then the effect must be mostly due to increased enforcement, hence new reformers should concentrate their efforts on enhancing tax discipline, and use tax cuts mostly to compensate taxpayers for harsher enforcement; again, regardless whether all this takes a form of a flat tax or not. Alternatively, a tax cut can serve as a focus point in switching to a ‘high tax morale’ equilibrium.<sup>3</sup>

This paper aims at quantifying the response of taxable income to changes in tax schedules in Hungary, one of the outliers in the CEE region without a flat tax. Though there are some studies aimed at describing the structure of the Hungarian tax system (Bakos et al, 2008), or redistributive aspects of flat tax schemes (Benedek and Lelkes, 2006), we are not aware of any study analyzing the elasticity of taxable income.<sup>4</sup> Using a medium-scale tax reform episode of 2005 and a large panel of personal income tax files, we obtain an estimate for the behavioral response of taxable income to the marginal and average tax rate, *keeping tax enforcement unchanged*.

In particular, we use a Tax and Financial Control Office (APEH) panel data for the years 2004 and 2005, with roughly 480,000 raw observations. This allows us to compare taxpayer behavior before and after the 2005 tax changes. This reform episode reduced the number of personal income tax brackets from three to two, increased the employee tax credit, raised the maximum annual amount of pension contribution and introduced a gradual, income-dependent phase-out of certain tax allowances (also raising marginal tax rates for some). Together with the “bracket creep” of not adjusting tax brackets to inflation, these led to various changes in marginal and average tax rates, without any major change in tax enforcement.<sup>5</sup>

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\* We are grateful for Gabor Kezdi, Laszlo Matyas, Ágota Scharle and participants of the Annual Meeting of the Hungarian Society of Economics (MKE), a seminar at MNB and the 2008 Annual Meeting of the European Economic Society for comments, and the Hungarian Ministry of Finance (PM) and the Tax and Financial Control Office (APEH) for providing the data. Part of the work was done while Benczúr was a Jean Monnet fellow at the Robert Schuman Center for Advanced Studies, Florence. The views expressed herein are ours and have not been endorsed by PM, APEH or MNB.

1 See for example: Ivanova et al (2005) on Russia, and Moore (2005) on Slovakia.

2 Gorodnichenko *et al* (2008) is an empirical attempt to measure the response of tax evasion to the Russian tax reform, using a household panel survey.

3 This point is further elaborated in Papp and Takats (2008).

4 There is some empirical literature on the behavioral effects of taxation in Hungary. Examples include: Semjén and Tóth (2004), and Vidor (2005).

5 Hungary has recently strengthened its employment legislation in order to reduce tax evasion. This campaign, however, started only in 2006 (see for example Eppich and Lőrincz, 2007).

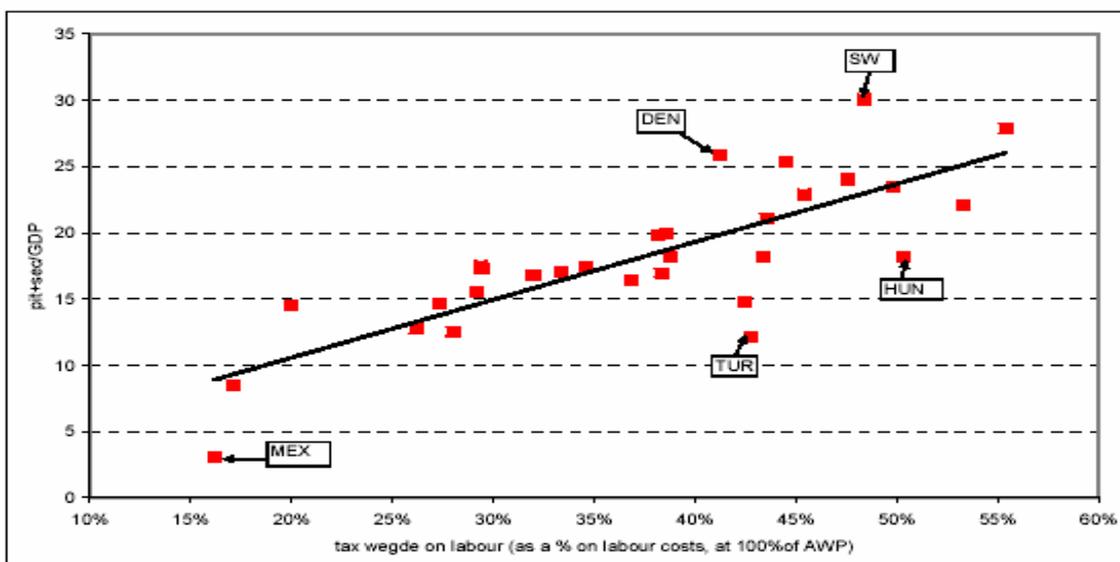
The feature that marginal tax rates are heavily influenced by the deduction status of the taxpayer makes it even more important to use actual tax data, as opposed to household surveys: without detailed information on tax deductions, one cannot calculate the marginal tax rates correctly.

Our focus on taxable income as opposed to labor supply itself is motivated by a long research line in public economics (Feldstein, 2002). The early research focusing on the effect of taxation on labor supply—as reviewed by Heckman (1993)—suggested that the labor supply of primary earners is rather insensitive to tax rates. Following the seminal paper of Feldstein (1995), a new literature has emerged which has been analyzing a broader context of labor supply. This approach is based on the observation that taxable income can vary not only with labor supply, but also with work effort, household investment, tax-deductible activities, the form of compensation, or with a change in tax compliance. Moreover, all these components are crucial both for assessing the deadweight loss of taxation and for revenue predictions of tax reforms. As summarized and surveyed by Gruber and Saez (2002), there is ample evidence that taxable income is quite sensitive to taxation.

Taxable income can adjust through three main channels: (i) taxpayers indeed work more, better or more intensively, and thus produce higher income, (ii) taxpayers declare a bigger portion of their total earnings, i.e., there is a decrease in tax deductions and avoidance, and finally, (iii) there is a shift between wage income and fringe benefits. Though one cannot separate these three elements based on tax file data, any other data source would lead to a much less precise estimate of the total effect.

Besides data availability and the important feature of the analyzed episode that there were changes in tax rates *without changes in enforcement*, the relationship of taxable income and labor tax rates in Hungary is an issue interesting on its own right. In an OECD comparison, Hungary has the third highest overall labor tax wedge; while its labor income tax revenue per GDP ratio is around the OECD median (see Figure 1).

**Figure 1. Labor tax wedges and labor income tax revenue per GDP ratios in OECD countries**



Source: Krekó and P. Kiss (2007), OECD 2004, 2005.

This aggregate cross-section evidence suggests an important elasticity of taxable income to taxation in Hungary. Maybe surprisingly, our Hungarian estimates indicate that the elasticity of taxable income to marginal tax rates is quite low for the upper 70% of wage earners (those earning at least the minimum wage)—in contrast to the canonical US findings of around 0.4 (Gruber and Saez, 2002), it is around 0.06. This means that wage income taxation leads to little welfare losses, but for a large enough

change in marginal tax rates, even these low elasticities imply a substantial change in taxable income. Moreover, the elasticity is much higher for the upper 20% of the income distribution (0.34), and for some groups, it is as high as 0.45, meaning that high marginal tax rates do lead to substantial distortions in certain income ranges.

The population average coefficient of *average tax rates* (the income effect) is zero for the upper 70% of the income distribution, but, unlike Gruber and Saez (2002), we find a very significant and substantial income effect for the upper 20% (-0.27). It means that the *uncompensated* taxable income elasticity is around 0.06 in both income subsamples—an increase in average tax rates makes taxpayers poorer and induces them to generate more income (“work more”), almost matching the reduction due to higher marginal tax rates. Consequently, an uncompensated tax increase (when marginal rates are raised but tax brackets are not adjusted to compensate taxpayers for losses) is very likely to increase revenues.

Now consider a flat tax experiment which is designed to be revenue neutral without any behavioral response. This means that there is some increase in marginal and average tax rates for low and middle income taxpayers; while for high income taxpayers, there is some decrease in average tax rates and a substantial decrease in marginal tax rates. Taking into account the heterogeneity of compensated elasticities and income effects over the income distribution, one can expect a non-negligible increase in total income and also in income inequality. Indeed, our hypothetical flat income tax<sup>6</sup> simulation shows a parallel improvement in budget revenues and after-tax income (2% and 1.4%, respectively). Though positive, these improvements are rather modest. Moreover, there are important changes in the income distribution, and the overall burden falls heavily on taxpayers in income deciles 5-7.

Comparing our results to those of the US literature, we get quite comparable elasticities for high income taxpayers, and much smaller elasticities for the entire sample. In our view the difference between the two overall elasticity results can be traced to differences in tax schemes. In the US, most deductions are applied to taxable income, and as Gruber and Saez (2002) highlight, the taxable income sensitivity is to a large degree due to such itemized deductions. In Hungary most of the deductions in the personal income scheme are subtracted directly from the tax itself, which does not affect taxable income. Self-employed individuals (entrepreneurs), on the other hand, are able to deduct various expenses from their tax base and there is indirect evidence that they do so excessively (Krekó and P. Kiss, 2007). However, the majority of entrepreneurial income is taxed separately in Hungary. It is less surprising to find a low elasticity for taxable income (which only contains income falling under the personal income tax scheme). In fact, the surprising finding is that high income individuals do exhibit substantial elasticities even without having access to deductions from the tax base.

The paper is organized as follows. Section 2 reviews the most relevant empirical literature in some details. The next section explains our empirical approach, section 4 presents and discusses our main results. Section 5 performs three revenue prediction exercises, while section 6 concludes. Finally, the Appendix contains some skipped details.

## 2. Related Literature

The key parameter of interest is the elasticity of taxable income with respect to the change in the *tax price* (net-of-tax income per marginal pretax dollar, i.e., one minus the marginal tax rate). The elasticity estimates are diverse, ranging from Feldstein’s (1995) result at the high end to close to zero at the low end. This variety reflects the different approaches applied in these papers such as the different definition of income, sample and source of identification. Below we give a brief overview of

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6 Our hypothetical flat tax system is a bit different from a “textbook flat tax”: it provides tax exemption up to the minimum wage, but levies a uniform social security contribution on all income. Actual flat tax schemes are often similar (for example in Slovakia and Russia).

the evolution of the consensus US estimates for taxable income (see Gruber and Saez, 2002, for details), and comment on some international results.

The applied empirical strategy is very similar in all these papers. They estimate the effect of the tax price on the taxpayers' income (in logs):

$$y_{it} = c_i + \gamma_t + \alpha_i x_i + \beta \log(1 - MTR_{it}) + u_{it}, \quad (1)$$

where  $y_{it}$  is taxable income,  $MTR_{it}$  is the marginal tax rate,  $c_i$  is the fixed effect for individual  $i$  and  $\gamma_t$  is a time-specific effect. The variables in  $x_i$  are individual characteristics that do not vary over time, but may have a time-varying effect on  $y_{it}$  (like wealth, entrepreneurial skills, regional dummies). Finally,  $\beta$  is the elasticity of taxable income, the key parameter of interest. Equation (1) is estimated in first differences.

Lindsey (1987) analyses the U.S. personal tax cuts from 1982 to 1984, measures the response of taxpayers to changes in income tax rates and then uses the results to predict the revenue maximizing rate of personal income taxation. The paper finds large tax elasticities: the results of the constant elasticity specification are always above one. Because of data limitations, he does not use panel data, instead, he compares taxpayers in similar income percentiles for different time periods. The main limitation of this approach is that it assumes a static income distribution over the investigated period.

To overcome this problem Feldstein (1995) uses a US Treasury Department panel of more than 4000 individual's tax returns before and after the 1986 tax reform. The analysis compares tax returns for 1985 and 1988, and finds an elasticity of at least one.

Auten and Carroll (1999) also analyze the effect of the 1986 tax reform using a larger panel of tax returns of 14,425 taxpayers. They report a significantly lower (0.6) tax-price elasticity. Besides data issues, the major reason for the difference is the inclusion of additional controls ("nontax factors"), past income in particular. This highlights the need of controlling for individual income profiles (mean reversion).

Gruber and Saez (2002) use a long panel of tax returns over the 1979-1990 period with roughly 46,000 observations. They relate changes in income between pairs of years to the change in marginal rates between the same pairs of years with a time length of three years. Their empirical strategy distinguishes the income and substitution effect of tax changes.

To identify these effects separately, they need variations in the average tax rate<sup>7</sup> that are orthogonal to variations in the marginal tax rate. This is supplied by the fact that the same change in the marginal tax rate implies a different change in the average tax rate for individuals with different incomes within the same tax bracket. In case of a single tax episode, however, that variation can be highly correlated with initial income controls, which are crucial to account for mean reversion and, as the authors argue, changes in the overall income distribution. Using a long panel dataset covering many tax reforms, they overcome all these difficulties and find that the overall elasticity of taxable income is approximately 0.4, which is primarily due to a very elastic response of taxable income for taxpayers who have incomes above \$100,000 per year and for itemizer taxpayers. They also find an insignificant income effect.

Using a methodology similar to Auten and Carrol (1999) and an exceptionally large dataset (nearly 500,000 prime age taxpayers) covering the 1988 Canadian tax reform, Sillamaa and Veall (2001) find that the responsiveness of income to changes in taxes is substantially smaller in Canada (0.25) than in

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7 Gruber and Saez (2002) work with virtual income instead of the average tax rate. Virtual income is the intercept of the budget line using the current tangent (one minus the marginal tax rate) as its slope. Non-labor income differs from virtual income as long as the marginal tax rate is not constant. The Appendix shows that virtual income and the average tax rate lead to the same specification.

the Auten and Carroll (1999) study for the US. They also report much higher responses for seniors and high income individuals.

Aarbu and Thoresen (2001) find even lower elasticity measures for Norway analyzing the 1992 Norwegian tax reform. They employ a panel dataset of more than 2000 individuals, and find that estimates for the elasticity of taxable income range between -0.6 and 0.21. Focusing on regressions which contain a measure for mean reversion in income, their baseline estimates are between 0 and 0.21.

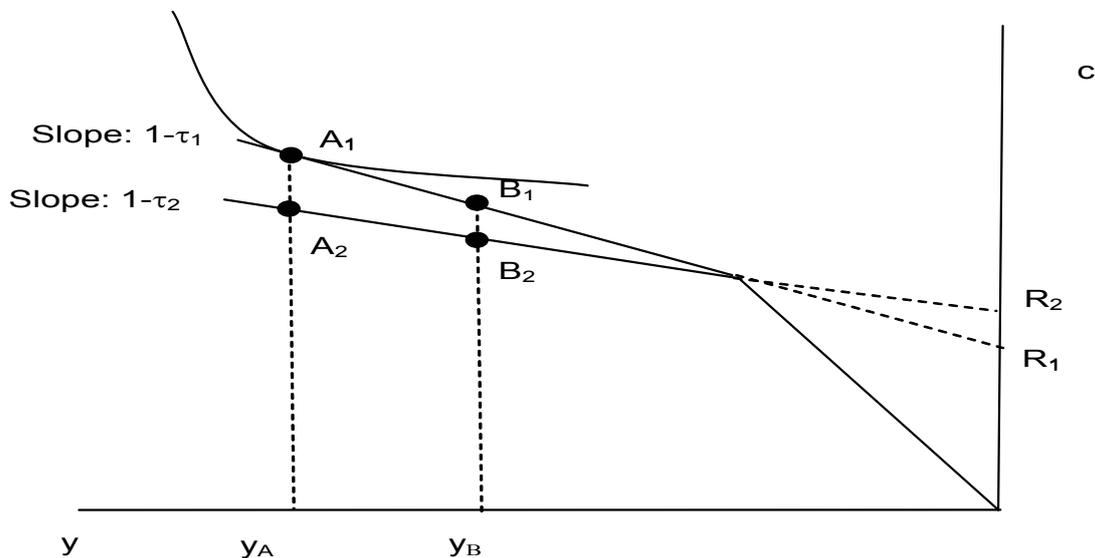
In contrast, Ljunge and Ragan (2005) obtain comparable compensated elasticities to Gruber and Saez (2002), of around 0.35, for the Swedish tax reform in 1991 (“the tax reform of the century”), using a six-year panel of 109,000 individuals. However, they also find a sizable and significant income effect, implying a much lower uncompensated elasticity.

### 3. The Empirical Framework

#### Methodology

We estimate the effect of the change in the marginal tax rate on the taxpayers’ reported taxable income following a slightly modified version of Gruber and Saez (2002). Taxpayers derive utility from consumption  $c$  and disutility from income generation efforts (‘labor’)  $y$ , and face a budget set which is locally linear:  $c = y(1 - \tau) + R$ . Here  $\tau$  is the marginal tax rate (one minus the local slope of the budget line) and  $R$  is the intercept of the local budget line (virtual income). Utility maximization yields an income supply function  $y(\tau, R)$ —see point  $A_1$  in Figure 2. Notice that a tax change in general affects both the marginal tax rate and the intercept of the budget line (or alternatively, the average tax rate, ATR)—see point  $A_2$  in Figure 2.

Figure 2. The nonlinear budget set



Consequently, the response of income to a tax change ( $d\tau, dR$ ) can be written as:

$$dy = -\frac{\partial y}{\partial (1 - \tau)} d\tau + \frac{\partial y}{\partial R} dR.$$

Introducing the uncompensated tax price elasticity parameter  $\beta^u = (1-\tau)/y(\partial y/\partial(1-\tau))$ , the income effect parameter  $\phi = (1-\tau)\partial y/\partial R$  and the compensated tax price elasticity  $\beta = \beta^u - \phi$  (from the Slutsky equation), we obtain

$$\frac{dy}{y} = -\beta \frac{d\tau}{1-\tau} + \phi \frac{dR - yd\tau}{y(1-\tau)}.$$

For non-infinitesimal tax changes, it is more appropriate to discretize this equation in a log-log specification. Replacing  $dy/y$  by  $\Delta \log y$ ,  $d\tau/(1-\tau)$  by  $\Delta \log(1-MTR)$  and  $(dR-yd\tau)/(y(1-\tau))$  by  $\Delta \log(1-ATR)$ ,<sup>8</sup> we get

$$\Delta \log y_i = \beta \Delta \log(1 - MTR_i) + \phi \Delta \log(1 - ATR_i). \quad (2)$$

Looking back to Figure 2, one can see now the key intuition beneath the empirical separation of the substitution effect ( $\beta$ ) and the income effect ( $\phi$ ). Without a behavioral response, taxpayer A moves from point  $A_1$  to  $A_2$ , while B moves from  $B_1$  to  $B_2$ . This implies the same change in the marginal tax rate for both, but a different change in their average tax rate, as the increased marginal tax rate applies to a different fraction of their income.

In addition to the terms in equation (2), income may change from year to year due to nontax factors as well. As Auten and Carroll (1999) and Gruber and Saez (2002) point out, one needs to control for additional covariates  $x_i$  that do not vary over time but may have a time-varying effect on income (such as wealth or entrepreneurial skills), and initial income  $y_0$  (to control for mean reversion in income and changes in the overall income distribution). This gives our full specification:

$$\Delta \log(y_i) = \gamma \log(y_{0i}) + x_i' \Delta \alpha + \beta \Delta \log(1 - MTR_i) + \phi \Delta \log(1 - ATR_i) + u_i. \quad (3)$$

Notice that this also coincides (apart from the presence of the average tax rate) with the first difference of equation (1).

The endogeneity of actual tax rates is a major problem in estimating equation (3). The Appendix contains a formal discussion of the identification procedure; here we only outline its main ingredients. On the one hand, the MTR can change both because of the change in legislation (exogenous variation) and because of an unexplained shift of taxable income (endogenous variation). This latter is characteristic of progressive tax systems: a negative income shock can cause—holding other factors fixed—a decrease in the MTR.

This means that  $\text{cov}(\Delta \log(1 - MTR_i), u_i) \neq 0$ , hence all parameter estimates are inconsistent. To overcome this problem, the usual procedure<sup>9</sup> is to instrument the log change in the true tax price by the log difference of the *synthetic* tax price in 2005 and the actual tax price in 2004. We calculate this synthetic MTR (SMTR) by applying the 2005 rules to inflated 2004 income and tax allowances. The synthetic MTR is the marginal tax rate that would have been applicable in 2005 had the taxpayer's real income not changed.

There is an identical endogeneity problem with the average tax rate as well, which can be treated by instrumenting the second period 1-ATR by the synthetic 1-ATR. We calculate this synthetic ATR (SATR) similarly to SMTR.

To use the synthetic tax rates as instruments, they need to be exogenous in equation (3) and correlated with the appropriate realized tax rate once the other explanatory variables have been netted out. If the error term  $u_i$  is uncorrelated with all the right hand side variables, then the exogeneity of the

8 This term is a straightforward reinterpretation of virtual income in the specification of Gruber and Saez (2002). See the Appendix for more details.

9 For example, Auten and Carroll (1999), Gruber and Saez (2002) follow this approach.

instruments is satisfied by construction, because they are calculated using the 2004 income inflated to 2005. We check the second condition using first stage diagnostic tests (partial F statistics). We also report a test for the exogeneity of realized tax rates (the C-statistics), and the Kleibergen-Paap rk statistics for the rank condition.<sup>10</sup>

It is important to take a closer look at the role of initial income. Some taxpayers who have unusually high or low incomes in 2004 may experience large offsetting changes. This mean-reversion effect can bias the tax price elasticity estimates: a negative correlation between the income innovation  $u_i$  and initial income  $y_{0i}$  of equation 3 makes the error term correlated with *initial and synthetic tax rates, too*.

The exclusion of low income taxpayers from the sample can limit this bias, but in order to further control for the mean reversion effect, we include *initial income* in the model as Moffitt and Wilhelm (2000) suggest, and also allow an income-dependent intercept and initial income coefficient (following Gruber and Saez, 2002). This should lead to an error term  $u_i$  that is uncorrelated with initial income. This way we also treat the problem of changes in the income distribution: a widening of the income distribution, for example, would induce a positive correlation between  $u$  and  $y_{0i}$ .

### ***Marginal tax rate (MTR)***

The variable of interest is the difference of the logarithm of the tax price<sup>11</sup> for a taxpayer in 2005 and 2004. The tax reform episode reduced the number of tax brackets from three to two, increased the employee tax credit, raised the annual maximum of pension contributions and introduced a gradual, income-dependent phase-out of certain tax allowances (also raising marginal tax rates for some). These led to various changes in marginal and average tax rates.<sup>12</sup> The Appendix contains a detailed description of the episode.

In general, it is hard to describe these tax changes as a function of taxable income itself. For example, if a tax deduction is phased out gradually above certain income levels, that leads to an increase in the marginal tax rate, depending on both income and deduction status. Moreover, all deductions and the employee tax credit are limited by broad income and not taxable income.<sup>13</sup>

The distribution of average and marginal tax rates in 2004 (which include social security contributions as well), and the full impact of all changes (including the “bracket creep” of not adjusting tax brackets to inflation) is summarized by Figure 3. For better visibility, we drop individuals above an annual income of 10,000,000<sup>14</sup> and use a 5% random sample.

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10 This exogeneity test estimates the equation assuming that all right hand side variables are exogenous, using the instruments as additional orthogonality conditions, and then tests the exogeneity of the realized tax rates with the C-statistics. The Kleibergen-Paap rk statistics test for the full rank of the instruments (rank condition), in a heteroskedasticity-robust way. See Baum *et al*, 2007 for details.

11 The expression ‘tax price’ refers to the fact that for unchanged wages, a change in the tax rate coincides with the change in the relative price of leisure.

12 Elements of the social benefit system also have incentive effects and affect the marginal *effective* tax rate. Scharle (2005) argues that the marginal effective tax rate can be exceptionally high on low income levels, despite the fact that the tax system is designed to be progressive.

It is important to note that in our analysis we only take into account the effects of the tax schedule, tax credit and social security contribution modifications and not the changes in the social benefit system. However we limit our sample to individuals above the minimum wage, therefore most taxpayers who are eligible for any social benefit are left out anyway.

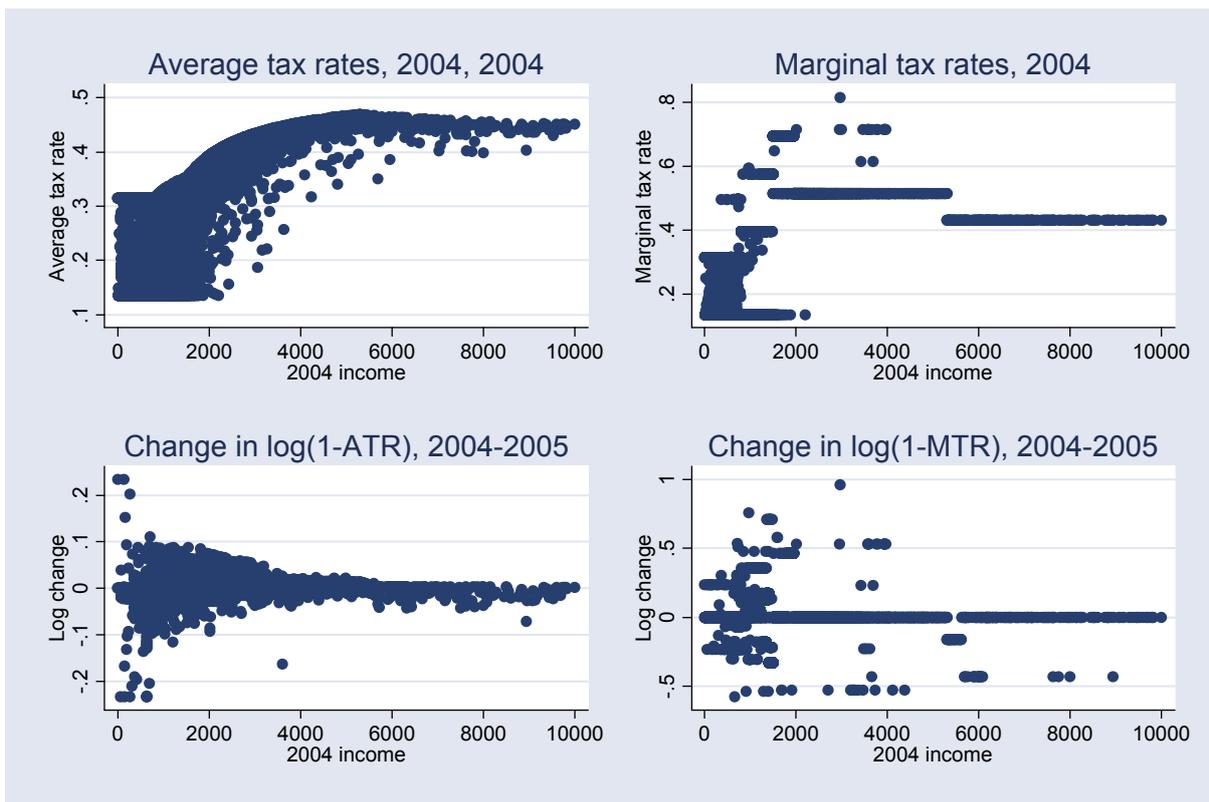
13 Broad income consists of wage income, non-wage labor income (the sum of these two is our taxable income measure), and other, mostly capital incomes (taxed separately).

14 The exchange rate is around 250 HUF per euro. An annual income of 10,000,000 corresponds to the top 0.5 percentile of the income distribution.

The top left panel indicates that the average tax rate broadly increases with taxable income, though it starts decreasing at very high income levels (due to the annual maximum of pension contributions). Various tax deductions, however, lead to large individual differences. The top right panel plots marginal tax rates, and we see that the highest marginal rates are faced by two groups of taxpayers: those who just lose their eligibility for the employee tax credit (income range 1,000,000-2,000,000), and those who lose their eligibility for various tax deductions.<sup>15</sup>

The bottom two panels describe the change in the log of one minus the average and marginal tax rates (a *decrease* thus means a *rise* in tax obligations). There is a general decline in the average tax rate for low and medium income taxpayers, though not universally (exceptions are largely due to the bracket creep). The most important variation in the marginal tax rate corresponds to the 636,000-4,000,000 income range (30 to 95 percentile of the income distribution). This is partly due to the employee tax credit—the legislative change points towards a decrease, but the bracket creep again leads to an increase for some. Another major source is the unchanged income limit of various tax deductions, leading to both increases and decreases. For high income taxpayers, there is some effect of the 6,000,000 overall tax deduction income limit, the increase in the annual pension contribution limit, and the introduction of an income limit to the family tax allowance. Overall, there is a substantial and non-obvious variation in average and marginal tax rates.

**Figure 3. Tax rates in 2004, and the 2004-2005 change in the log of synthetic tax prices in our sample**



15 One such example is the tax deduction for certain computer purchases ('SULINET' program). There is full deduction below an income level of 3,400,000, no deduction above 4,000,000, and a gradual phase-out in between. This leads to an extra 10% marginal tax rates for those with some deductions in the income range 3,400,000-4,000,000.

## Data

The source of data for our analysis is a Hungarian Tax and Financial Control Office (APEH) panel of individual tax returns for the years 2004 and 2005. This dataset was prepared for the Hungarian Ministry of Finance and it contains data from the personal income tax forms 0453 and 0553 (unaudited). The random sampling was done by the tax authority choosing 250,000 anonymous individuals for the year 2004, and matching their tax returns for the year 2005. It is natural that some individuals fall out from the sample between years, thus the panel for the second year contains 8,9% less observations. It is still an exceptionally large panel including more than 227,000 individuals, about 5% of all taxpayers.

We limit our sample by leaving out individuals with extreme rates of income changes (over 500 or below 1/500–16 observations). We also drop observations with nonzero foreign income (1336 observations), as it would be hard to compute their true marginal and average tax rates. Besides, those individuals are likely to differ from the rest of the population. We further drop a small number of additional observations (a total of 202) where certain data cells violate the tax code in a way that affects the tax obligation of the taxpayer. Regional indicators are missing from 583 observations. Then we limit the sample to taxpayers who filed in both years, which leads to a sample of 215,315. From this population, we limit our attention to those who had taxable income above the compulsory annual minimum wage in 2004 (636,000), a sample of 150,141. Finally, we exclude observations where reported and calculated employee tax credit numbers differ significantly (5423 observations, of which 3465 is above the minimum wage) in either tax year.<sup>16</sup> We certainly do a robustness check whether this last deletion has an effect on our estimates (and it does not). Our full income sample has 209,892 observations; of which 146,676 are above the 2004 minimum wage.

Following the literature and Auten and Carroll (1999) in particular, we include a set of individual characteristics in the regression that are likely to be correlated with income changes. *Taxpayer's wealth* is likely to be correlated with the ability to alter portfolios and labor arrangements as taxes change, thus we include a dummy for declaring any capital income in 2004 or 2005. *Entrepreneurial status* may reflect the ability of income shifting between different tax categories and the propensity of risk taking, therefore a dummy is included for income from any kind of self-employment income in 2004 or 2005. The *life cycle and family status of the individual* can have an effect on income changes, thus we include the age of the taxpayer in 2004, its square and a dummy for family based on claiming the family allowance.<sup>17</sup> We apply *urban dummies* to control for the difference in income growth in urban and rural areas (Aarbu and Thoresen 2001): we use a dummy for the capital (*Budapest*), another for the 19 county capitals; and also a regional dummy to control for regional differences. There might be different opportunities for income growth based on *gender* differences. Although *occupation* may have a significant effect (Auten and Carroll, 1999), the dataset does not allow us to control for that.

One also needs to control for the mean-reversion of income, and potential changes in the income distribution. We include *initial income* in the model as Moffitt and Wilhelm (2000) suggest, and also allow an income-dependent intercept and initial income coefficient (following Gruber and Saez, 2002).

The synthetic change in the marginal (average) tax rate is the difference in the logarithm of one minus the synthetic and the actual 2004 marginal (average) tax rate. It is calculated as follows. The 2004 income, deductions and most allowances<sup>18</sup> are inflated to 2005 using the official statistics office

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16 In these cases, the difference is between 2.1 and 12.25. This difference is negligible for the *average* tax rate, but it might be influential for the *marginal* tax rate of some. See footnote 22 for details.

17 There is no reliable information on family status in Hungarian tax reports. People claiming the family tax allowance certainly have children, but others who are not claiming it may also have children.

18 Some allowances correspond to delayed claims, which means that eligibility comes from a period prior to 2005, but the deduction itself has not been utilized for some reason. We assume that there were no behavioral responses in such cases, thus the inflated allowance was set equal to the realized allowance.

annual average inflation for 2004 (6.8%). The synthetic tax rates are then equal to the appropriate tax rates of the inflated income using the 2005 tax rules. The detailed program codes are available from the authors upon request.

The dependent variable in the model is the difference in the logarithm of income in the years 2005 and 2004. Income is defined as the total income that is covered by the personal income tax schedule.

Table 1 presents the descriptive statistics of the variables in our total working sample and in the subsample of individuals with income above the 2004 minimum wage.

**Table 1. Means and standard deviations of variables**

Variable	Total working sample		Income above 636th	
	Mean	Std. Dev.	Mean	Std. Dev.
$\Delta \log$ taxable income	0.10	0.57	0.03	0.39
$\Delta \log$ (1 - marginal tax rate)	0.02	0.23	0.04	0.26
$\Delta \log$ (1–exogenous marginal tax rate)	0.03	0.13	0.03	0.15
$\log$ 2004 gross income	6.88	0.96	7.33	0.61
$\Delta \log$ (1 - average tax rate)	0.01	0.07	0.01	0.07
$\Delta \log$ (1–exogenous average tax rate)	0.00	0.02	0.01	0.02
Wealth dummy	0.29	0.45	0.36	0.48
Age in 2004	39.86	11.82	40.71	11.10
Age in 2004 squared	1728.38	989.79	1780.54	930.85
Entrepreneurship dummy	0.17	0.37	0.16	0.36
Family dummy	0.28	0.45	0.34	0.47
Gender dummy	0.53	0.50	0.53	0.50
Budapest dummy	0.18	0.39	0.19	0.39
Regional capital dummy	0.41	0.49	0.42	0.49
Observations	209,892		146,676	

#### 4. Estimation Results

Table 2 presents our basic results for those who earned at least the annual minimum wage in 2004 (the upper 70% of the income distribution). Model 1 includes only one regressor, the tax price. Models 2-4 gradually add further controls: first initial income, then the income effect (the change in the average tax rate), and the full set of individual characteristics (the coefficients of the regional dummies are not reported). Finally, Model 5 allows the initial income coefficient and the constant to differ across income deciles (coefficients not reported). In all cases, the exogeneity of the realized tax rates is strongly rejected, while all first stage diagnostic statistics and rank tests are perfect for the instruments.

**Table 2. Main results, 2004 income above 636,000**

<i>Δlog taxable income</i>	Model 1	Model 2	Model 3	Model 4	Model 5
<b><i>Δlog (1 - marginal tax rate)</i></b>	<b>0.0743**</b>	<b>0.0528**</b>	<b>0.0501**</b>	<b>0.0494**</b>	<b>0.0648**</b>
	(0.011)	(0.011)	(0.011)	(0.011)	(0.016)
<i>Δlog (1 - average tax rate)</i>			0.145*	0.340**	-0.0673
			(0.064)	(0.067)	(0.065)
<i>Log 2004 gross income</i>		-0.0231**	-0.0252**	-0.0311**	
		(0.0022)	(0.0025)	(0.0028)	
<i>Wealth</i>				0.0294**	0.0265**
				(0.0024)	(0.0023)
<i>Age</i>				0.0143**	0.0135**
				(0.00094)	(0.00091)
<i>Age squared</i>				-0.000208**	-0.000197**
				(0.000012)	(0.000011)
<i>Entrepreneurship</i>				0.0196**	0.0139**
				(0.0034)	(0.0034)
<i>Family</i>				-0.0039	-0.00653**
				(0.0022)	(0.0021)
<i>Gender</i>				0.00746**	0.00712**
				(0.0022)	(0.0021)
<i>Budapest</i>				0.00226	0.00361
				(0.0051)	(0.0048)
<i>Regional capital</i>				0.00012	-0.000853
				(0.0028)	(0.0027)
<i>Constant</i>	0.0288**	0.199**	0.213**		
	(0.0011)	(0.016)	(0.018)		
<i>p-value of the Kleibergen-Paap rk statistics (full rank of the instruments)</i>	0	0	0	0	0
<i>p-value of the C statistics (exogeneity of marginal and average tax rates)</i>	0	0	0	0	0
<i>First stage partial F</i>					
<i>For the marginal tax rate</i>	10978.05	10840.36	5665.87	5709.65	2928.02
<i>For the average tax rate</i>			3549.76	3318.36	2577.54
<b><i>Observations</i></b>	<b>146,676</b>	<b>146,676</b>	<b>146,676</b>	<b>146,676</b>	<b>146,676</b>

*Robust standard errors in parentheses. \* significant at 5%; \*\* significant at 1% level*

*Model 5 includes separate initial income and constant terms for the ten income deciles of the sample.*

The estimates for the tax price are significant in all specifications and vary between 0.0494-0.0743, depending on the controls included. This range is lower than most tax elasticity estimates for other countries (for example Auten and Carroll, 1999: 0.6; Gruber and Saez, 2002: 0.4 for the US; Sillamaa and Veall, 2001: 0.14 for Canada; or Aarbu and Thoresen, 2001: 0.21, for Norway; Ljunge and Ragan, 2005: 0.35 for Sweden). The difference between these elasticities can be a natural consequence of the characteristics of the different tax systems, even if individuals in different countries exhibit identical behavioral responses (Slemrod, 1998).

Initial income is highly significant and its inclusion decreases the key elasticity by one third, while the further inclusion of the income effect and additional controls has a limited impact on the tax price

elasticity. Though the income effect appears to have the wrong sign in Models 3 and 4,<sup>19</sup> it becomes insignificant once we allow for our most flexible control for changes in the income distribution (Model 5).

Most of the control variables behave the way we expected. For example, wealth has a positive effect on the income change, family, as a proxy for having children, decreases the possibility to adjust income to tax rate changes.

The results change substantially if we concentrate on a middle income sample (2004 income above 2,000,000, top 20%).<sup>20</sup> As Table 3 shows, the coefficient for our key regressor is now around 0.3. Initial income is still significant and it decreases the tax price elasticity estimate by 20%. The income effect has the right sign, it is quite significant and it decreases the tax price elasticity further. Additional covariates (particularly the flexible controls for initial income) then reverse this decline.

Given that Model 5 has the richest set of covariates, that the income-dependent coefficients do influence certain parameters (particularly the income effect) and the finding of Gruber and Saez (2002) that mean-reversion and the change in the income distribution are more complicated than a pure control for the log of initial income, we treat Model 5 as our benchmark. Under that choice, we get a compensated elasticity of 0.337 and an uncompensated elasticity of 0.07 in the top 20% sample; and an elasticity of 0.065 in the top 70% sample, both compensated and uncompensated.

### ***Robustness***

First we explore whether the age composition of our sample matters. Table 4 compares results for three age groups, adding a restricted sample (18-60) and prime age (23-55) for both income samples we used so far. All regressions contain the full set of controls (Model 5), with income deciles corresponding to the sample at hand. For the sample above 636,000, the tax price elasticity tends to decrease as we restrict the age composition; while for the sample above 2,000,000, the tax price elasticity increases, and the income effect coefficient becomes smaller. These changes, however, are quite modest in size.

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19 If  $\log(1-ATR)$  increases, that corresponds to a decrease in the average tax burden, implying an increase in net disposable income. If leisure is a normal good, its consumption should go up, hence the generation of income ('labor supply') should go down ( $\phi < 0$ ).

20 This is the range where employee tax credit is already completely phased out under the 2005 tax code; thus the variation in synthetic tax prices is not due to changes in the employee tax credit scheme.

**Table 3. Main results, 2004 income above 2,000,000**

<i>Δlog taxable income</i>	Model 1	Model 2	Model 3	Model 4	Model 5
<b><i>Δlog (1 - marginal tax rate)</i></b>	<b>0.402**</b>	<b>0.325**</b>	<b>0.268**</b>	<b>0.290**</b>	<b>0.337**</b>
	(0.052)	(0.051)	(0.047)	(0.050)	(0.059)
<i>Δlog (1 - average tax rate)</i>			-0.654**	-0.384**	-0.267*
			(0.11)	(0.12)	(0.12)
<i>Log 2004 gross income</i>		-0.0763**	-0.0849**	-0.0788**	
		(0.0064)	(0.0065)	(0.0069)	
<i>Wealth</i>				0.0168**	0.0169**
				(0.0041)	(0.0043)
<i>Age</i>				0.0209**	0.0216**
				(0.0022)	(0.0022)
<i>Age squared</i>				-0.000281**	-0.000289**
				(0.000027)	(0.000027)
<i>Entrepreneurship</i>				0.0196**	0.0203**
				(0.0053)	(0.0054)
<i>Family</i>				-0.0120**	-0.0113*
				(0.0044)	(0.0045)
<i>Gender</i>				0.0016	0.00167
				(0.0044)	(0.0045)
<i>Budapest</i>				-0.0014	-0.00144
				(0.0089)	(0.0091)
<i>Regional capital</i>				0.000727	0.000391
				(0.0056)	(0.0057)
<i>Constant</i>	0.0171**	0.634**	0.721**		
	(0.0022)	(0.051)	(0.053)		
<i>p-value of the Kleibergen-Paap rk statistics (full rank of the instruments)</i>	0	0	0	0	0
<i>p-value of the C statistics (exogeneity of marginal and average tax rates)</i>	0	0	0	0	0
<i>First stage partial F</i>					
<i>For the marginal tax rate</i>	722.23	711.97	360.72	361.98	317.52
<i>For the average tax rate</i>			867.33	762.01	745.33
<b><i>Observations</i></b>	<b>41,819</b>	<b>41,819</b>	<b>41,819</b>	<b>41,819</b>	<b>41,819</b>

Robust standard errors in parentheses. \* significant at 5%; \*\* significant at 1% level

Model 5 includes separate initial income and constant terms for the ten income deciles of the sample.

**Table 4. 2SLS regression results for different age groups**

<i>Δlog taxable income</i>	Income above 636,000			Income above 2,000,000		
	All ages	18-60	23-55	All ages	18-60	23-55
<i>Δlog (1 - marginal tax rate)</i>	<b>0.0648**</b>	<b>0.0592**</b>	<b>0.0576**</b>	<b>0.337**</b>	<b>0.353**</b>	<b>0.357**</b>
	(0.016)	(0.016)	(0.014)	(0.059)	(0.060)	(0.060)
<i>Δlog (1 - average tax rate)</i>	-0.0673	-0.0524	-0.0306	-0.267*	-0.234	-0.155
	(0.065)	(0.064)	(0.063)	(0.12)	(0.12)	(0.12)
<i>First stage partial F</i>						
<i>For the marginal tax rate</i>	2928.02	2857.76	2982.12	317.52	308.22	298.13
<i>For the average tax rate</i>	2577.54	2521.08	2353.07	745.33	736.46	696.73
<i>Observations</i>	146,676	143,185	129,961	41,819	40,451	36,238

*Robust standard errors in parentheses. \* significant at 5%; \*\* significant at 1%*

*The p-values for the Kleibergen-Paap rk statistics and the C-statistics are zero in all columns.*

Next we run our benchmark regression on various income groups separately. The subgroups are mostly defined in line with the tax code: 636,000-2,000,000 is roughly the range where the employee tax credit still applies; 2,000,000-4,000,000 is a range where most deductions are still active or are just being phased out; while 6,000,000 is the cutoff for the new deduction phase-out introduced in 2005.

**Table 5. 2SLS regression results for different income groups**

<i>Δlog taxable income</i>	636,000 to	636,000 to	2,000,000	2,000,000	2,000,000	
	top	2,000,000	to top	to	to	4,000,000
<i>Δlog (1 - marginal tax rate)</i>	<b>0.0648**</b>	<b>0.0292</b>	<b>0.337**</b>	<b>0.451**</b>	<b>0.379**</b>	<b>-0.0517</b>
	(0.016)	(0.015)	(0.059)	(0.060)	(0.060)	(0.31)
<i>Δlog (1 - average tax rate)</i>	-0.0673	0.0443	-0.267*	-0.0502	-0.0402	-0.918*
	(0.065)	(0.077)	(0.12)	(0.13)	(0.13)	(0.46)
<i>First stage partial F</i>						
<i>For the marginal tax rate</i>	2928.02	3032.96	317.52	288.83	313.83	25.34
<i>For the average tax rate</i>	2577.54	1818.28	745.33	664.52	675.83	101.88
<i>Observations</i>	146,676	104,857	41,819	31,494	37,609	10,325

*Robust standard errors in parentheses. \* significant at 5%; \*\* significant at 1%*

*The p-values for the Kleibergen-Paap rk statistics and the C-statistics are zero in all columns.*

The numbers in Table 5 suggest that the 0.0648 overall tax price elasticity is a mix of an even lower elasticity (0.0292) in the range of 636,000-2,000,000 and a much higher elasticity above 2,000,000. This higher elasticity, on the other hand, comes mostly from the income range 2,000,000-4,000,000. Above 4,000,000 the estimate becomes very noisy: it gets much smaller and its standard error increases. Our interpretation is that the exogenous variation in tax rates in this income range is insufficient for estimating the tax price elasticity (as indicated by the little variation in the synthetic

marginal tax rate in Figure 3).<sup>21</sup> The income effect, on the other hand, comes mostly from high earners. This apparent backward bending labor supply may in fact reflect their bargaining power, allowing them to bargain about their *after-tax* wage. At longer time horizons, we are likely to see this income effect decreasing as bargaining should matter less.

Finally, we check whether the elimination of those taxpayers who had potential problems with their reported employee tax credit numbers matter for the income and substitution effect parameters.<sup>22</sup> As Table 6 suggests, the estimates change very little.

**Table 6. The inclusion of taxpayers with problems in their reported employee tax credit**

$\Delta \log$ taxable income	636,000 -		636,000-2,000,000		2,000,000-	
	without	with	without	with	without	With
$\Delta \log (1 - \text{marginal tax rate})$	<b>0.0648**</b>	<b>0.0562**</b>	<b>0.0292</b>	<b>0.0335*</b>	<b>0.337**</b>	<b>0.336**</b>
	(0.016)	(0.014)	(0.015)	(0.015)	(0.059)	(0.060)
$\Delta \log (1 - \text{average tax rate})$	-0.0673	-0.0157	0.0443	0.104	-0.267*	-0.244
	(0.065)	(0.066)	(0.077)	(0.078)	(0.12)	(0.13)
<i>First stage partial F</i>						
For the marginal tax rate	2928.02	3558.43	3032.96	3261.54	317.52	317.34
For the average tax rate	2577.54	2616.30	1818.28	1879.84	745.33	726.78
<b>Observations</b>	<b>146,676</b>	<b>150,141</b>	<b>104,857</b>	<b>108,247</b>	<b>41,819</b>	<b>41,894</b>

Robust standard errors in parentheses. \* significant at 5%; \*\* significant at 1%

The *p*-values for the Anderson canonical and the *C*-statistics are zero in all columns.

Summing up, we find lower elasticities for our larger sample than other empirical studies. Concentrating on a medium-high income sample, on the other hand, leads to an elasticity of around 0.3, already in the high range of the international evidence. As Gruber and Saez (2002) indicate, high tax price elasticities for the U.S. are likely to be driven by itemizing, which is a cost reduction status that can be chosen by all taxpayers. Employees are also entitled to some cost deductions in Hungary, but their coverage and impact is very limited.<sup>23</sup> This is likely to reduce tax price elasticity, as a major margin of adjustment is missing. Combining this observation with the fact that we had only a one year difference between our pre- and post-reform observations, our elasticity results are rather high.

21 Another factor contributing to the insignificant tax price elasticity for the high income group is that a large part of the change in their MTR reflects an increase in pension contributions, which are much better linked to direct future benefits to the same taxpayer than overall taxes.

22 Employee tax credit is calculated based on *wage income* capped by the monthly minimum wage times the number of eligible months, and then it is phased out according to *broad income*. The ‘number of eligible months’ variable is missing from our original dataset. We recovered this variable by allowing its value to go from 0 to 12 and selecting the one with which we get back the reported tax credit (with a rounding error of 2.1, which allows for multiple rounding errors before summing up). For around 5500 taxpayers, none of the values 0-12 were able to replicate their reported tax credit. We attribute this to the fact that tax credit rules are quite complicated and our data contains *unaudited* tax files. The difference never exceeds 12.25, which means that this problem is negligible for the average tax rate. The phase-out of the employee tax credit, however, creates complicated patterns for the marginal tax rate, which might be sensitive to such miscalculations.

23 In our sample, roughly 10% of all taxpayers report some cost deductions. The average deduction, however, is 163, compared to the average income of 3041 in this group. Running separate regressions for this group reveals no significant difference in their tax price elasticity.

## 5. Revenue Predictions

To illustrate the quantitative importance of our results, we simulate the effect of actual and hypothetical changes in the Hungarian tax system on taxable income and the government budget.<sup>24</sup> We would stress upfront that our calculations do not take all potential behavioral effects into account: adjustment of labor demand is missing, and the extensive margin of labor supply (the participation decision) is only partially captured.<sup>25</sup>

Two particular cases are presented first—a low and a high income range where the marginal tax rate changed. In these scenarios we use 2004 incomes and abstract from inflation, meaning that we apply the behavioral response to non-inflated 2004 income. Then we simulate the full population taxable income and budget revenue implications of a hypothetical flat income tax proposal in 2005.

**Table 7. Effect of the marginal tax rate change in the 720,000-756,000 income range**

<b>2004 - Before reform</b>			
Average income in 2004	734		
Personal income tax	20		
Social security contributions (employee)	65		
Social security contributions (employer)	235		
Total tax in 2004	320		
<i>Tax price elasticity</i>	<i>0</i>	<i>0.0292</i>	<i>0.0648</i>
<b>2005 - After reform</b>			
$\Delta$ in taxable income*	<b>0.00%</b>	<b>1.04%</b>	<b>2.31%</b>
Average income in 2005	734	742	751
Personal income tax	9	10	12
Social security contributions (employee)	65	66	67
Social security contributions (employer)	235	237	240
Total tax in 2005	309	314	319
$\Delta$ paid tax	-11	-7	-1
Number of taxpayers in this income range	95,601	95,601	95,601
$\Delta$ in the budget (in thousand HUF)	-1,057,352	-627,179	-102,722

Source: own calculations and Tax and Financial Control Office

Notes. All numbers are in thousand HUF. The calculations assume only wage income and employee tax credit but no deductions or any tax allowance. \*The tax price increased by 35.64 percent from 50.5% to 68.5%. This increase has to be multiplied by the calculated elasticity to get the change of taxable income (e.g.  $0.3564 \cdot 0.0292 = 0.0104$ ).

24 We include both personal income tax and social security receipts in the budget revenue figures. We first show the revenue from employee contributions, and then the sum of employee and employer contributions. Employer contributions are calculated as 32% of the total pretax income. In reality, the tax base is slightly smaller, but the difference is negligible. We also take into account that for a large number of taxpayers, a certain part of social security contributions (8% of income up to the annual limit) is channeled towards private pension funds and not to the central budget (although the Maastricht criteria allows for a temporary deduction from the budget deficit due to private pension fund payments). We approximate this fraction as the ratio of private pension fund members in 2005 (2,509,000, according to official data the website of the Hungarian Financial Supervisory Authority) to the number of individuals filing a tax return in 2005 (4,374,000, according to the website of APEH).

25 Another caveat is that the aggregate response may differ from the sum of individual responses, due to labor demand constraints. In our case, however, it is probably less of an issue, since the labor market of high earners (who exhibit a substantial tax price elasticity) is dominantly supply-driven.

Table 7 shows the effect in the 720,000–756,000 income range where the marginal tax rate changed from 49.5% to 31.5% (due to changes in the phase-out of employee tax credit). The number of taxpayers in 2004 who have taxable income within this range was 95,601<sup>26</sup> and their average income was 733,867. The second part of the table presents the post-reform situation with three different tax price elasticities (and no income effect). If there is no behavioral response (first column) the post-reform income is the same as the before reform, and the tax cut increases the burden of the budget by around 1,057 million. However if we apply the estimated tax price elasticity of 0.0292 (second column), the average taxable income increases as the marginal tax decreases, and thus the total amount of tax in 2005 is higher than without any response. This means that with a 0.0292 tax price elasticity (taken from column 2 of Table 5) the burden of the budget increases not by 1,057 million but only 627 million. The third column shows what would happen in the case of a higher elasticity, 0.0648 (column 1 of Table 5). In this case the tax cut would result in a decrease of the budget's revenue by around 103 million.

Table 8 shows the effect of the change of the marginal tax rate from 43% to 51.5% in the 5,307,000–6,000,600 income range.<sup>27</sup> The table is split into two parts, one with the part of the income below 5,307,000 and one with the part above. The first column of the table shows that without any behavioral response (no income and substitution effect) the raise in marginal tax rate increases the budget's revenue by approximately 322 million.

Adding the income effect (but no substitution effect) increases this number to 598 million (column 2). Adding a bigger and bigger substitution effect (0.0648, the entire population elasticity estimate, then 0.337, the estimate above 2,000,000 and finally 0.451, the estimate in the range 2,000,000–4,000,000) this revenue change gradually becomes more and more negative, turning to a dismal decrease by around 6.85 billion in column 5!<sup>28</sup> Notice that even social security contributions decline in the last two columns.

The full impact of this increase in the annual pension contribution limit, however, is much larger, as there is a revenue gain from taxpayers with income above 6,000,600 (who face unchanged marginal tax rates). Moreover, as their ATR increases, the income effect implies a positive response of their income. Using that there are 77,073 taxpayers in this range with an average income of 10,034,850, they increase their total tax contribution by 2,091 billion (3,747 billion with the income effect).

Table 9 displays the full impact of the tax change. Estimates for the change in the government budget range from 4,345 million (only income effect) to -3,101 million (income effect, highest substitution effect). Using our benchmark elasticity estimate, the impact is a decline of -1,219 million, which is substantially lower than the no behavioral response prediction (2,412 million). There is also a notable redistribution from the tax budget to the social security budget in columns 4 and 5.

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26 Though APEH publishes some statistics about the distribution of income, it does not contain the income range at hand. For this reason, we first calculate the number of taxpayers with income between 720 and 756 in our sample (5232), and then multiply by the ratio of the entire taxpayer population in the income range 700–750 (127761) to the number of taxpayers with income between 700 and 750 in our sample (6992). This latter ratio is 18.272.

27 Our calculations quantify the impact of this single change in the tax code. It thus neglects tax deductions, the changes in average and marginal tax rates they may imply, and also the elimination of the middle tax bracket.

28 This huge difference is partly due to the fact that the average income in this range is quite close to the bottom of the income bracket. If that is the case, an increase in the marginal tax rate has a disproportionately huge impact on that part of income which falls into this tax bracket.

**Table 8. Effect of the marginal tax rate increase in the 5,307,000-6,000,600 income range**

<b>2004 - Before reform</b>					
Average income in 2004	5,637				
Part of income below 5,307 <sup>th</sup> HUF					
Personal income tax	1,773				
Social security contributions (employee)	473				
Social security contributions (employer)	1698				
Sum	3,944				
Part of income above 5,307 <sup>th</sup> HUF	330				
Personal income tax	126				
Social security contributions (employee)	17				
Social security contributions (employer)	106				
Sum	248				
Total tax in 2004	4,192				
<i>Tax price elasticity</i>	0	0	0.0648	<b>0.337</b>	0.451
Income effect coefficient	0	-0.267	-0.267	<b>-0.267</b>	-0.267
<b>2005 - After reform</b>					
Δ in taxable income*	<b>0.00%</b>	<b>0.25%</b>	<b>-0.72%</b>	<b>-4.78%</b>	<b>-6.48%</b>
Average income in 2005	5,637	5,651	5,597	<b>5,368</b>	5,272
Income range 0 - 5,307					
Personal income tax	1,773	1,773	1,773	<b>1,773</b>	1,759
Social security contributions (employee)	473	473	473	<b>473</b>	470
Social security contributions (employer)	1698	1698	1698	<b>1698</b>	1687
Sum	3,944	3,944	3,944	<b>3,944</b>	3,916
Income above 5,307-	330	344	290	<b>61</b>	0
Personal income tax	126	131	110	<b>23</b>	0
Social security contributions (employee)	29	31	26	<b>5</b>	0
Social security contributions (employer)	106	110	93	<b>20</b>	0
Sum	261	272	229	<b>48</b>	0
Total tax in 2005	4,205	4,216	4,173	<b>3,992</b>	3,916
Δ paid tax (total)	13	24	-19	<b>-200</b>	-275
Number of taxpayers in this range	24,887	24,887	24,887	<b>24,887</b>	24,887
Δ in the budget (total)	321,592	597,736	-472,078	<b>-4,965,957</b>	-6,848,037

Source: own calculations and Tax and Financial Control Office

Notes. All numbers are in thousand HUF. \*The tax price decreased by 14.91% from 57% to 48.5%. This decrease has to be multiplied by the calculated elasticity to get the change of taxable income (e.g.  $-0.1491 \cdot 0.336 = -0.0501$ ). The average tax rate (on the average income 5637.4) has increased from 0.467 to around 0.472, a 0.93% decrease in 1-ATR. This subtracts 0.25% from the overall income decline ( $-0,0503 + 0,0025 = -0,0478$ ). The calculation neglects any tax allowances and assumes that the only tax change was the increase in MTR, thus it neglects the decline in the ATR brought about by the elimination of the middle tax bracket. Taking that into account would have changed the contribution of the income effect from -0.25% to 0.25%.

**Table 9. Total revenue impact of the social security contribution increase (in millions of Ft)**

Tax price elasticity	0	0	0.0648	<b>0.337</b>	0.451
Income effect coefficient	0	-0.267	-0.267	<b>-0.267</b>	-0.267
Change in ssc revenue, 5307 - 6000,6	322	465	-90	<b>-2,420</b>	-3,042
Change in tax revenue, 5307 - 6000,6	0	133	-382	<b>-2,546</b>	-3,453
Change in total revenue, 5307 - 6000,6	322	598	-472	<b>-4,966</b>	-6,848
Change in ssc revenue, above 6000,6	2,091	2,908	2,908	<b>2,908</b>	2,908
Change in tax revenue, above 6000,6	0	839	839	<b>839</b>	839
Change in total revenue, above 6000,6	2,091	3,747	3,747	<b>3,747</b>	3,747
Change in full ssc revenue	2,412	3,373	2,818	<b>488</b>	-134
Change in full tax revenue	0	972	457	<b>-1,707</b>	-2,613
Change in total revenue	2,412	4,345	3,275	<b>-1,219</b>	-3,101

Finally, we quantify the implications of a hypothetical flat income tax proposal of a tax rate of 30,3% above the 2005 minimum wage (684,000) and a 13,5% social security contribution rate. These rates are applied to all components of taxable income. This means that tax deductions are eliminated; and all incomes that used to be part of the tax base but were previously untaxed (like scholarships) are now taxed the same way as any other personal income items.

The single tax rate is chosen such that the proposal is revenue neutral in case of no behavioral response. Eliminating the tax exempt status of the minimum wage would imply a combined rate of 32%. This is close to CEE flat tax rates, but those flat tax schemes also involve a tax-exempt income range. Consequently, our 13.5+30.3% rate is high compared to other flat tax rates in the CEE region.<sup>29</sup>

Let us stress that this reform does not change the overall tax rate below the minimum wage. Our reasons are twofold: on the one hand, we do not have reliable estimates for taxpayer behavior below the minimum wage; and on the other hand, a raise in the marginal and the average tax rate for this income group is likely to involve substantial social tensions.<sup>30</sup>

We apply this tax scheme to 2005 income data under three scenarios. Scenario 1 assumes no behavioral effect at all. Scenario 2 assumes no income effects and the appropriate substitution effect (an elasticity of 0.0291 for incomes in 684,000-2,000,000 and 0.336 above 2,000,000). Scenario 3 works with the same substitution effect and adds the income effect (a parameter of -0.271) above 2,000,000. Though such a large tax change may induce larger behavioral responses, the literature does not point to a particularly important nonlinearity.

As this tax scheme still makes the marginal and average tax rate endogenous, we predict income changes the following way. First we calculate the 'no behavioral response' case by inserting original 2005 incomes into the new tax scheme. Then we calculate the change in income implied by the realized marginal and average tax rates corresponding to scenario one. This new income leads to

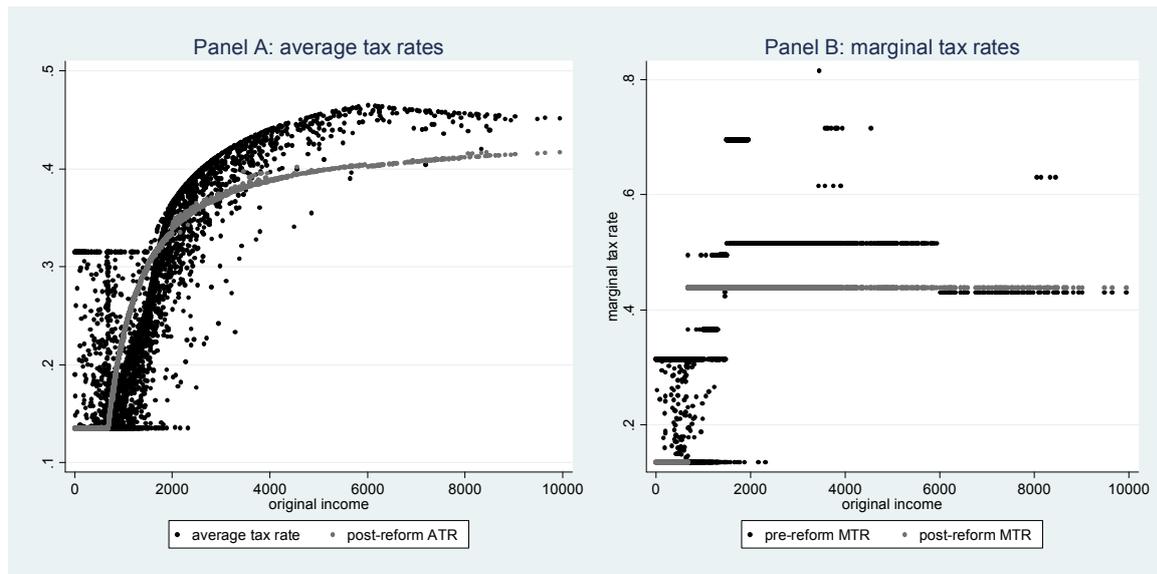
29 Ivanova *et al* (2005) gives an international comparison: flat tax personal income tax rates range from 12% to 19%. Based on more recent and more comprehensive comparisons (Keen *et al*, 2006 and [www.worldwide-tax.com](http://www.worldwide-tax.com)), this range is between 10% and 25%. Ivanova *et al* (2005) also report that there was an additional social security contribution rate and a tax-exempt 'zero bracket' in Russia, while Moore (2005) indicates the same for Slovakia.

30 Actual flat tax schemes are often similar. For example, the flat tax scheme in Slovakia involves a single rate above some tax-exempt threshold, and social security contributions are kept separately.

different realized tax rates, with which we update our income estimate. This iterative process leads to a solution where our predicted post-reform incomes are consistent with the appropriate realized tax rates.<sup>31</sup>

Figure 4 depicts the change in the average and marginal tax rates (the former is calculated under Scenario 3) as a function of pre-reform 2005 income (in a 2% random sample for better visibility). It is immediate to see that there is a substantial increase in the average tax rate between the minimum wage and 2,000,000; and most of the fall in the marginal tax rate concentrates in the range 2,000,000-6,000,000. We will return to the former property in the incidence analysis; while the latter is quite desirable, since taxable income is quite sensitive to the tax price in that income range.

**Figure 4. Average and marginal tax rates: before and after the flat income tax scheme**



There is also a decline in marginal tax rates below the minimum wage. This is due to the fact that our hypothetical tax scheme determines tax obligations based solely on taxable income, while the original 2005 tax scheme often used *broad income* to determine the tax payment on *taxable income*. As a matter of fact, most taxpayers earning below the 2005 minimum wage would experience no change in their marginal tax rate (34,436 out of 49,647).

Table 10 summarizes the main implications of our flat income tax. Without a behavioral response, there is no change in budget revenues and taxable income. Adding the substitution effect leads to a 2.77% increase in revenues, together with a 1.88% increase in after-tax income. These numbers become somewhat smaller as we add the income effect: a 2.06% increase in revenues and a 1.39% increase in after-tax income. If one gives up the revenue gain, the 30.3% tax rate can be reduced to 27.9%. That would imply a 2.1% increase in pre-tax income and a 3.9% increase in after-tax income. These effects are substantial—total pretax income is approximately one third of total GDP in Hungary,

31 In practice, this procedure is much simpler. Without an income effect, there is only one necessary adjustment: those who start above 684,000 but would go below as a response to higher marginal tax rates bunch at exactly 684,000. Anyone who remains above the minimum wage will be subject to a marginal tax rate of 43.8%.

For the income effect, we first use the ‘no behavioral response’ ATR (calculated in Scenario 1). This leads to some income change, which then implies a slightly different realized ATR. In the next step, we modify our predicted income change by the log difference of these two (one minus) ATRs, multiplied by the income effect coefficient. Then we calculate the corresponding ATR again and repeat the previous step till convergence. After the second step, the change becomes negligible.

which is the base of the 32% employer contributions, and the approximately 32% income tax and employee contribution<sup>32</sup> --, but we do not see such a “miracle” as flat tax proponents would like.

**Table 10. Implications of a flat income tax scheme**

	Behavioral effects considered		
	none	only subst.	subst. and income
Percentage change in total			
Budget revenue (employee part only)	0.04	3.31	2.45
Budget revenue (employee and employer)	0.02	2.77	2.06
pretax income	0	2.30	1.71
after-tax income	-0.02	1.88	1.39
Pretax income, % change in			
p90/p10	0	5.08	4.18
p90/p50	0	5.64	4.74
p10/p50	0	0.56	0.56
p75/p25	0	2.16	2.16
p75/p50	0	2.17	2.17
p25/p50	0	0.00	0.00
Gini (pre reform: 0.46023)	0.46023	0.46038	0.4655
After-tax income, % change in			
p90/p10	0.07	4.62	3.81
p90/p50	11.48	17.03	16.10
p10/p50	11.23	11.78	11.78
p75/p25	-2.40	-0.54	-0.54
p75/p50	5.90	7.73	7.73
p25/p50	8.55	8.25	8.25
Gini (pre reform: 0.38529)	0.39582	0.403536	0.40116

*For a full description of the three scenarios, see the main text. Variables like p90/p10 refer to the ratio of the 90 and 10 percentile of the income distribution.*

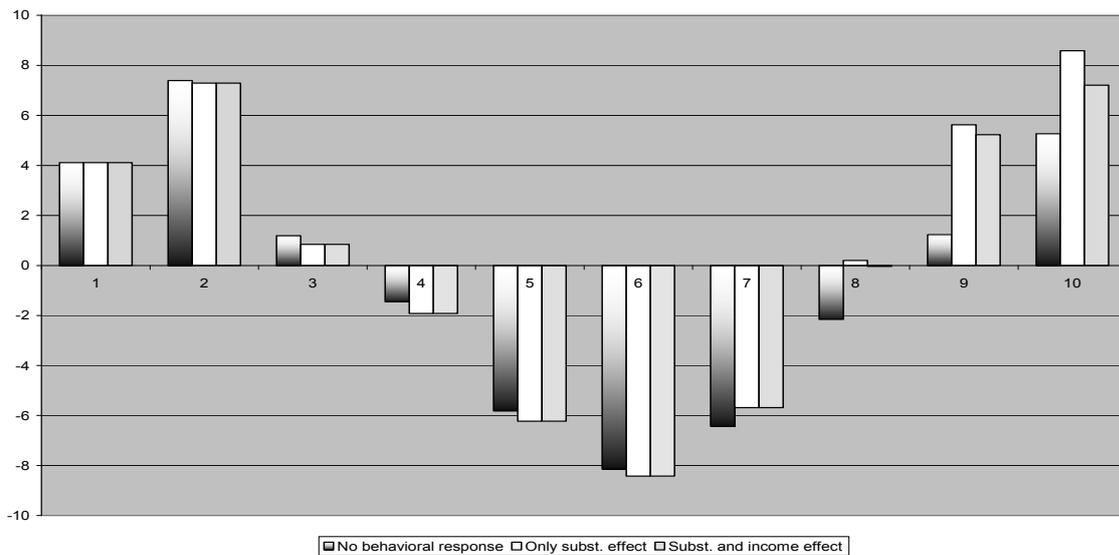
There are, however, notable changes in the income distribution (due to the nature of our data, we are talking about the distribution of taxpayer individual and not household income). In pretax income, the most substantial change is in the 90-10 percentile (p90-p10) and the p90-p50 ratio, an increase of 4-5.5%. In after-tax income, there are similar changes in the p90-p10 ratio, but all ratios involving the median are much higher. This is in line with our observation that there is a substantial increase in the average tax rate between the minimum wage and 2,000,000 (see Figure 4). The Gini coefficient of pretax income increases from 0.46023 to 0.4655; while for after-tax income, it increases from 0.38529 to 0.40116.<sup>33</sup> This increase is partly driven by the change in tax rates, and partly by the behavioral response: without the latter, the after-tax Gini would be 0.39582.

32 It means that a truly flat income tax system would need a 32% key to be revenue neutral (in the case of no behavioral responses).

33 These changes in the Gini coefficient are roughly similar to typical annual changes in the Gini coefficients of per household member income, individual income and individual labor income. Most percentile ratios, on the other hand (like p90/p10) change much more during our hypothetical reform than in a typical year (Kapitány and Molnár, 2005). Note that our calculations cannot take into account individuals without taxable income and redistribution within

To illustrate the detailed incidence of the tax reform<sup>34</sup> and the impact of behavioral responses, Figure 5 plots the percentage change in the average after-tax income for pre-reform after-tax income deciles, for Scenarios 1, 2 and 3. There is a substantial increase in the average income level in the first two deciles and some increase in the third decile, which are unaffected by the presence of behavioral responses. There is a small decline in decile 4, and a very sizable fall in deciles 5-7. In deciles 4-6, the behavioral response works against taxpayers as they experience a small increase in their marginal tax rates as well. In decile 7, the behavioral response mollifies the impact of higher average tax rates; while in decile 8, it turns an income loss into an income gain. Finally, deciles 9 and 10 experience a sizable increase in their income. The behavioral response is most notable in decile 9, increasing the gain from 1.23% to 5.25%.

**Figure 5. The percentage change in after-tax income by 2005 after-tax income deciles**



In summary, these three cases illustrate the importance of the elasticity of taxable income to changes in the marginal tax rate. Even the internationally small elasticity estimate (0.0648) has a remarkable effect on the government's budget, while the 0.337 elasticity is very influential for tax revenue developments. Based on our flat tax results, there is room for a parallel improvement of budget revenues and taxable income. Such a reform, however, involves important changes in income inequality, and its burden falls mostly on lower-middle income taxpayers.

Let us also stress the importance of the income effect. Tables 9, 10 and Figure 5 show that its presence has very important quantitative effects on income and revenue predictions. In particular, a reduction in the average tax rate of top earners leads to a substantial decrease in their income gain brought about by lower marginal tax rates (see income decile 10 on Figure 5).

## 6. Conclusion

In evaluating tax policies and forecasting the effects of future tax changes it is essential to distinguish the influence of changing tax rates and changing law enforcement. In case of extensive tax reforms usually it is not possible. Hungary introduced a medium-scale reform in 2004/2005 without any

(Contd.) \_\_\_\_\_

households. Consequently, these Gini numbers cannot be directly compared to typical measures of income inequality across households. Still, as Benedek and Lelkes (2006) suggests, the distribution of household income and individual income are quite similar.

34 Benedek and Lelkes (2006) discusses the redistributive aspects of a flat tax reform at depth.

changes in tax audit rules and practices. We used this occasion to analyze the behavioral response of taxable income to marginal and average tax rates.

Our empirical analysis suggests an overall tax price elasticity of about 0.06 in Hungary. Though this number is significantly lower than elasticities found in other countries, even this low elasticity can have some effect on the government's budget. Moreover, the upper 20% of the population exhibits a much higher elasticity, exceeding 0.3, and even as high as 0.45 for some income groups. This is already at the high end of the international evidence. We demonstrated that such elasticities have important impacts on the income generation process and budget revenues.

These results are mixed news for flat tax proponents: the low overall elasticity indicates that cutting marginal tax rates might not lead to such an economic stimulus as many would expect. For the upper 20% of the population, on the other hand, a decrease in marginal tax rates may indeed lead to a substantial increase in income generation, but that would also exacerbate the adverse redistributive aspects of such a reform.

Our detailed flat income tax simulation confirmed these general points. In particular, we calculated the impact of a reform that keeps the existing 13.5% combined income tax and social security contribution rate below the annual minimum wage, and its single rate above the minimum wage is selected such that there is no effect on budget revenues in case of no behavioral responses. This revenue neutral flat tax rate (30.3% income tax plus 13.5% social security) is high compared to other flat tax rates in the CEE region.

We predict a roughly 2% improvement of budget revenues and a 1.4% increase in taxable income, which is significant but rather modest. On the other hand, there are important changes in the income distribution, and the overall burden falls mostly on lower-middle income taxpayers (income deciles 5-7).

Besides the flat tax predictions, our results have a number of additional, potentially important policy implications. One is that the conclusions of Gruber and Saez (2002) for the US also apply to Hungary—both in terms of the desirability of low marginal taxes on a broad income basis, and in terms of the potentially low distortion caused by the high marginal tax rates of phasing out employee tax credits.

The first statement is supported by our highly positive tax price elasticity estimate. As compared to the US, where much of the elasticity is likely to be due to itemized deductions, Hungarian wage earners cannot deduct much from their tax base, meaning that the elasticity we find may be much closer to a true “generalized” labor supply elasticity than the US findings. It also means that the tax base of wage earners' is already quite broad, a property which does not hold for entrepreneurs.

The second claim is based on the finding that the same elasticity is much lower in the income range 636,000-2,000,000 where employee tax credits are phased out. On the other hand, the marginal tax rates implied by phasing out other tax allowances are likely to cause substantial losses, as those extra 10-20% marginal rates apply to taxpayers with substantial tax price elasticity and high preexisting marginal tax rates.

A possible extension of this analysis could be to control for other characteristics of taxpayers, such as the level of education or occupation. Using a different dataset, such as survey data, would allow for these controls, but data reliability and size of the dataset would probably be lower and a detailed simulation of tax allowances would not be possible. The use of a longer panel may also improve the results because (1) the tax changes in the beginning of 2005 might have long effects on the taxable income and (2) it allows to investigate other changes in the tax system (e.g. the change in the top rate from 2006 to 2007) and to apply a richer set of controls for initial income. This will be resolved by time. Finally, a further step can be to investigate the effect and nature of tax optimization more directly. A particular avenue we are pursuing is to analyze the role of deductions in determining taxpayer behavior.

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## Appendix

### A. Changes in the Hungarian Tax System, 2004-2005

The four key elements of the 2004-2005 tax reform were the following (Income Tax Act 1995; OECD, 2004 and 2005).

1. Reduction of the number of tax brackets from three to two. Taxpayers with taxable income between 800,000 and 1,500,000 experienced an 8 percentage point decrease in their marginal tax rate. The tax schedule in Table A1.a changed to the schedule in Table A1.b.

**Table A1.a Tax schedule in 2004**

		Number of tax filers
0–800 000	18 %	1 815 111
800 001–1 500 000	26 %	1 138 156
1 500 001 -	38 %	1 196 610

Source: <http://www.apoh.hu/adotablak> and Tax and Financial Control Office

**Table A1.b Tax schedule in 2005**

		Number of tax filers
0–1 500 000	18 %	2 806 935
1 500 001 -	38 %	1 342 948

Source: <http://www.apoh.hu/adotablak> and Tax and Financial Control Office

2. The maximum amount of the supplementary employee tax credit was increased from 540 per month to 1260 per month. The phase out interval for the supplementary tax credit was changed from 720,000-756,000 to 1,000,000-1,302,000, which also means the changing of the phase out rate from 18% to 5%.<sup>35</sup>
3. An income limit was introduced both for the family tax allowance and for the sum of other tax allowances. Parents are eligible for the total amount of the family tax allowance if their broad income is below 8,000,000, above this limit the allowance is phased out by a rate of 20%.<sup>36</sup> Broad income consists of wage income, non-wage labor income (the sum of these two is our taxable income measure), and other, mostly capital incomes (taxed separately). For the sum of other tax allowances the maximum amount of the allowance is 100,000 and the eligibility broad income limit is 6,000,000, above which it is gradually withdrawn (also at a rate of 20%).
4. The maximum of annual pension contribution was increased from 451,095 to 510,051. This implies that the maximum income for pension contribution was changed from 5,307,000 to 6,000,600.

There were no changes in the rate of the social security contributions, namely in the pension, sickness and the unemployment scheme, their level remained 8.5, 4 and 1 percent respectively.

<sup>35</sup> In Hungary the employee (earned income) tax credit has two parts, the main 'tax credit' and the 'supplementary tax credit'. Both are applicable after earned wage income, therefore entrepreneurs are excluded from these allowances. The two together guaranteed the tax exempt status of the minimum wage until 2006. Both have a gradual phase out, although the two intervals differ.

<sup>36</sup> Family tax allowances, just like other elements of the income tax system, work on an individual basis, i.e. parents can decide which of them requests the tax allowance, and they also have the option to split the amount.

## B. The Identification Scheme

Following Gruber and Saez (2002), we write the change in income as a sum of the substitution and the income effect:

$$\frac{dy}{y} = -\beta \frac{d\tau}{1-\tau} + \phi \frac{dR - yd\tau}{y(1-\tau)} + u_1. \quad (4)$$

Here the first regressor is the realized change in  $\ln(1-mtr)$ , while the second is the realized change in  $\ln(1-atr)$ . For this latter step, one needs an extra assumption:  $y(1-\tau) \approx y - y\tau + R$ . This is also adopted by Gruber and Saez (2002). This is then how the approximation works:

$$\begin{aligned} d \log \left( \frac{y - T(y)}{1 - ATR} \right) &= d \left( \frac{R + y - y\tau}{y} \right) = \frac{dR + dy - dy\tau - yd\tau}{R + y - y\tau} - \frac{dy}{y} \\ &\approx \frac{dR + dy - dy\tau - yd\tau}{y(1-\tau)} - \frac{dy}{y} = \frac{dR - yd\tau}{y(1-\tau)}. \end{aligned}$$

Notice that Gruber and Saez (2002) do not deduct the  $dy/y$  term. That distorts the parameters—their estimates need to be divided by  $1-\phi$ , which is essentially one for them, finding no income effects. For us it does matter as our  $\phi$  is often nonzero.

Equation (4) cannot be estimated via OLS because the realized tax rate changed for two reasons: tax reform (exogenous variation) and income dependence of the tax scheme (endogenous variation). The proposed solution is to instrument each tax rate variable by its “synthetic” version, which is the change in the appropriate tax rate implied by the change in legislation, applied to *unchanged real income*.

Formally, this is how identification works. Assume that

$$\tau = \tau(y, \lambda) \quad \text{and} \quad R = R(y, \lambda),$$

where  $\lambda$  is a parameter indexing the tax reform. Using a first order approximation:

$$\begin{aligned} \frac{d\tau}{1-\tau} &= \tau_1 \frac{dy}{y} + \tau_2 d\lambda \\ \frac{dR - yd\tau}{y(1-\tau)} &= R_1 \frac{dy}{y} + R_2 d\lambda. \end{aligned}$$

Here in principle the second term is nothing but the change in the synthetic tax rate: the change in  $\ln(1-mtr)$  implied by reform  $\lambda$ , for an unchanged income level. As any practical reform is a discrete change, the first order approximation is surely not precise—meaning that there is a separate error term corresponding to this equation, moreover, the coefficient of the synthetic tax rate change can differ from one.<sup>37</sup> Thus we write the equations for the realized tax rate changes as follows:

<sup>37</sup> Running exploratory regressions confirms this: regressing the realized MTR change on all controls plus the change in income and the synthetic MTR change, with income change instrumented by the synthetic change in ATR yields a synthetic MTR coefficient around 0.3. The same argument applies to the ATR equation: here we get a coefficient of 0.9, still differing from one at the 5% level.

$$\frac{d\tau}{1-\tau} = \tau_1 \frac{dy}{y} + \tau_2 ms + u_2$$

$$\frac{dR - yd\tau}{y(1-\tau)} = R_1 \frac{dy}{y} + R_2 as + u_3.$$

Here the variable  $ms$  is the shorthand for the change in the synthetic (unchanged real income) log one minus marginal tax rate, and  $as$  is the same for the average tax rate.

Based on this, it is straightforward to see that the original regression (4) is misspecified—both of the right hand side terms contain the error term  $u_i$  in general (unless there is no endogeneity problem in the sense that the tax rate—be it the marginal or the average—does not change with income levels).

Equation (4) can still be estimated by single equation IV. We run (4) by using  $ms$  and  $as$  as instruments—they are uncorrelated with the error terms and (by the reduced form) are correlated with the realized tax rate changes. This identifies  $\beta$  and  $\phi$ .

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