

Incomes, Incentives and the Growth of Means Testing in Hungary

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AND THE GROWTH OF
MEANS TESTING IN
HUNGARY**

by Gerry Redmond

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INCOMES, INCENTIVES AND THE GROWTH OF MEANS TESTING IN HUNGARY

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Gerry Redmond was a Senior Research Officer at the Microsimulation Unit, Department of Applied Economics, University of Cambridge, when most of the research reported in this paper was carried out. He now works at the Social Policy Research Centre. The research reported in this paper was funded by the European Union under the ACE scheme (Contract No. P95-2081-R). Sincere thanks to Holly Sutherland, Cathal O'Donoghue, Tony Eardley and Hans Bækgaard for comments. All errors are the responsibility of the author.

Abstract

In this paper, a new microsimulation model for Hungary is used to simulate the full impact of the April 1996 reforms to child-related benefits. Thus, Family Allowance is means tested, and earnings-related maternity and child care pay are replaced with means-tested flat-rate payments. Because of increases in levels of flat rate maternity/child care payments, the overall effect of the reforms is found to be mildly progressive compared with the 1995 system. However, the targeting of child-related payments is still found to be spread throughout the income distribution, rather than focused on low-income households. An alternative scheme, modelled on the UK means-tested benefits system, achieves a much greater level of targeting, but has the side-effect of greatly increasing the effective marginal tax rates of low-income working households with children. In view of the poverty and employment traps that such marginal taxation has caused in the UK, the paper cautions against the over-extension of means testing in the Hungarian benefits system.

1 Introduction

After the collapse of the Communist system, Hungarian governments managing the economic transformation of their country came under pressure, both as a result of a fiscal crisis and because of advice from the World Bank and the OECD, to carry out fundamental reforms to their generous benefits system. One of the focal points of this pressure centred on universal family benefits, which began to assume increasing importance in the incomes of households with children as unemployment increased and real earnings declined in value.

After considerable debate, major reforms to family benefits were finally implemented in April 1996. The overall impact of these reforms was relatively mild and the least well-off families were mostly protected from benefit cuts. However, the reforms were important psychologically. Social security in the Communist welfare state consisted of employment and enterprise-related benefits, supplemented by centrally administered universal schemes, and backed up by a locally administered discretionary and residual means-tested scheme with very low coverage and take-up. The 1996 reform constituted a first definitive step away from welfare built up during the Communist era, and towards centralised and standardised means testing procedures for millions of families. Further reforms, introduced in 1997, extended centralised means testing further, suggesting that the Hungarian welfare state was becoming more like a Western European, or perhaps even Anglo-Saxon welfare regime.

The purpose of this paper is to examine the reform of family benefits and the growth of means testing in Hungary, focusing on the targeting of benefits, their distributional impacts and their effect on incentives to work. The paper also investigates the potential impacts of a more fully means-tested system of family benefits in Hungary by asking the following question: 'what would be the effect on targeting, household incomes and incentives of introducing a system of means-tested family benefits in Hungary, such as that which exists in the UK?' The paper argues that while undoubtedly helping to target benefits particularly at the poorest families, a UK-style family benefits regime would also create considerable incentive problems that have not so far existed in the Hungarian benefits system. Incentives are particularly important in the Hungarian context because, until recently, high levels of labour market

participation among Hungarian men and women, including those with child care responsibilities, have been a factor in the relatively low rates of poverty experienced by Hungarian families with children in the early transition years.

The targeting of welfare and the impact of welfare reforms on incentives to work are important areas of analysis in social policy, perhaps particularly in the transition economies of Central and Eastern Europe, where pressures for reform are considerable. There is a growing literature on welfare reform in Central and Eastern Europe, much of it produced by organisations such as the OECD and the World Bank (OECD, 1995; World Bank, 1995, 1996). Such research has argued against universalism and even against what Esping-Andersen (1990) describes as the continental European welfare state, characterised by employment-related social insurance, and in favour of greater means testing (Standing, 1996). Before the Hungarian reforms of April 1996, the Polish and Czech governments had already introduced means testing for previously universal family benefits. Coulter *et al* (1995) argued that the Czech reforms, while improving the targeting of benefits, also resulted in limited disincentive effects. They did not, however, examine the impact of a more fully means-tested system in terms of targeting and incentives. This is where some Central and Eastern European welfare states may be headed if the above advice is heeded, and it is in this area that the paper makes a contribution that has relevance not just for Hungary, but also for other economies in transition that are facing similar welfare policy dilemmas.

To perform the major part of this analysis, the author exploited a new microsimulation model of the Hungarian tax and benefit system built by a team from the Hungarian Central Statistical Office and the Microsimulation Unit at the University of Cambridge. This model is described briefly in Section 2. Section 3 discusses the development of family benefits in Hungary, the reforms of April 1996, and their impact on household incomes. In Section 4, the introduction of a more fully means-tested system of benefits, modelled on the UK system, is analysed. Section 5 summarises the main findings of the analysis and argues that the full effects of extended means testing should be carefully considered before further reform in that direction is implemented.

2 Method and Data

This paper is a report on an exercise in microsimulation. That is, a tax-benefit microsimulation model was used to simulate the distributional and incentives effects of the system of family benefits in Hungary before and after the April 1996 reforms, and under a hypothetical benefits regime based on the system of family benefits used in the UK. A tax-benefit microsimulation model is a computer program that runs on a survey microdataset and calculates liability to taxes and eligibility for benefits for sample observations, where the analyst varies policy proposals by altering policy parameters. A microsimulation model has two inputs: microdata and policy parameters (usually the current system and the proposed reform); and one output: a simulated population sample from which tables summarising the revenue, distributional and other impacts of a policy change can be produced. In using a microsimulation model, it is important to understand both its complexities and its limitations. In particular, any model can only be as good as the data that are available to it. The Hungarian microsimulation model runs on a sample of data from the Household Budget Survey (HBS), which is carried out annually by the Hungarian Central Statistical Office. At the time of carrying out this exercise, the latest available data were from 1995. The HBS is a large scale survey of household incomes and expenditures, with detailed information on the characteristics and incomes (as well as expenditures) of a sample of 27,534 individuals who live in 10,582 households. The sample is reweighted to represent more closely the demographic characteristics of the Hungarian population.

There are two tasks that must be performed if we are to model a tax or benefits system. First, the system must be described in a form that is possible to translate into a computer language - that is, in an algorithm, in as much detail as is necessary for the accurate modelling of the system. A discretionary system, where there are no hard and fast rules, is difficult to write as an algorithm. A bureaucratic system, where all contingencies are explicitly described and no exceptions are allowed for, is relatively easy to turn into an algorithm. In common with most tax and benefits systems, the Hungarian system falls somewhere between these two extremes. Secondly, the characteristics associated with the system we wish to model must be defined in terms of the microdata at our disposal. As part of the first task,

we must ask, for example: ‘what is the definition of income for income tax purposes?’ As part of the second task, our question becomes ‘how can we operationalise this definition of income for income tax purposes, given the survey data available to us?’ The less close we are able to get to the ‘ideal’ definition, the more we must be wary of how, or whether, we can model the tax or benefit in question. In any case, it is necessary always to be aware of how a departure from the ‘ideal’ definition is likely to influence simulation results. In practice, the HBS proved to be quite well suited to the task of calculating tax liabilities on incomes (although, as noted in Havasi and Rédei, 1997, representativity of some incomes was problematic) as well as entitlement to major benefits such as Family Allowance. However, problems were encountered in modelling entitlement to some benefits, such as Pregnancy Allowance (for expectant mothers), because the HBS did not include data on whether, or how long, a respondent was pregnant. In such cases it was necessary to impute pregnancy on the basis of other information in the data.

The Hungarian microsimulation model was programmed as a SAS application capable of running on a PC. It is described in greater detail in Papp and Jarabek (1997). It is the first durable microsimulation model to be built in Hungary for general policy analysis since the beginning of the 1990s. It is a static model: that is, it is most suitable for examining the immediate impacts of policy shocks, such as the distributional effect of means testing a universal benefit (essentially the function it performs in this analysis), rather than the life-cycle dimensions of policies, such as the lifetime distributional impacts of introducing a fully actuarial pension scheme or student loans system.

Most of this analysis concerns the study of decile groups of equivalised household income. Each decile group of household incomes contains the same number of weighted person-level observations. Household income includes (for each household member) earnings from employment and self-employment, other market earnings, private transfers, simulated and reported state benefits and imputed income from the consumption of home production, less simulated income tax and social insurance liabilities. Incomes are equivalised according to the OECD scale, which gives a weight of 1 to the first adult, 0.7 to subsequent adults, and 0.5 to all children aged under 14 in the household.

3 The Legacy of Communism and the Reform of Family Benefits in Post-Communist Hungary

Family Benefits in Communist Hungary

Family benefits have traditionally had an important place in Hungarian social policy, both in terms of their contribution to the incomes of families with children and the share of government expenditure devoted to them (Jarvis, 1995). The most important, and the oldest, benefit in Hungary for families with children was Family Allowance. Family Allowance was introduced in 1938 as a work-related benefit: receipt was conditional on a satisfactory employment record, as well as the number of children in the family. Under state Communism the Government provided a comprehensive range of employment-related benefits, including a generous Family Allowance regime, paid child care leave, free nursery places for the young children of working mothers and maternity benefits. This comprehensive state welfare regime was designed so as to encourage women to fulfil their roles as both waged workers and carers (Ferge, 1979). In addition to Family Allowance, earnings-related maternity and child care allowances were available for mothers with children under the age of three. These policies reflected Hungary's pro-natalist orientation, the need for more workers to increase production, and the ideological commitment to a high level of labour force participation for both men and women.

However, the system of maternity and family benefits in Communist Hungary did not just encourage women to remain attached to the labour force, it effectively compelled them to work. First, eligibility to maternity and family benefits was dependent on a qualifying formal employment record. Secondly, earnings were effectively designed to support an individual rather than a couple or a family. A couple in Communist Hungary would find it difficult to survive on one person's earnings from formal employment. A couple with children would have difficulty in managing without family benefits, even if both partners worked.

With the collapse of Communism, the quickening pace of economic transition and an emerging crisis in government finances, international agencies such as the World Bank (1995; 1996) and the OECD (1995)

argued that comprehensive reform of the Hungarian welfare system was imperative. The solutions proposed by these agencies focused on means testing, so that overall benefit expenditure could be reduced and benefits could be targeted at the very bottom of the income distribution. However, the generosity of the Hungarian family benefits system, its popularity, and the fact that parts of it pre-dated the Communist regime made its reform in transition Hungary problematic. This was compounded by two factors: first, in the dying months of the Communist regime, new benefits, such as Unemployment Benefit and Social Benefit (social assistance for unemployed people with no entitlement to Unemployment Benefit) were introduced, and Family Allowance was transformed into a universal benefit; second, the impact of transition itself, as both earnings and employment declined, meant that the relative importance of family benefits increased as a proportion of household incomes.

Therefore, in the first six years after the collapse of Communism, the new Hungarian governments did little to reform the welfare system. The 1995 regime of state support for families with children was more-or-less the system inherited from Communism. The value of most cash benefits was greatly eroded by inflation (as, indeed, was the value of earnings for most people) but the overall structure of the system was retained. In addition to Family Allowance, a Pregnancy Allowance was available (at the same rate as Family Allowance) for women who were three or more months pregnant. Women who had been employed for at least a year before the birth of their child were entitled to Child Care Fee (GYED), which was equal to 65-70 per cent of a woman's previous wages and was paid until the child's second birthday. Flat-rate Child Care Allowance (GYES) was payable to mothers with an employment record who remained out of the labour force until a child had reached the age of three. In 1993 a new means-tested benefit, Child Raising Allowance (GYET), was introduced. This was aimed at families with three or more children, the youngest of whom was aged between three and eight. However, its importance within the overall scheme of family benefits was small.

The Reform of Family Benefits in April 1996

In early transition Hungary, the availability of relatively generous universal family benefits, coupled with the absolute need for every active

Table 1: Economic Activity of Working-age Persons in Hungary, 1987 and 1995 (per cent)

	Employed	Unemployed	Child care leave	Student	Retired	Other inactive	Total
All working-age persons							
1987	84.0	0.3	4.0	1.2	5.0	5.5	100
1995	60.3	11.8	5.9	5.2	11.3	5.6	100
Working-age men							
1987	90.1	0.3	0	1.2	6.2	2.2	100
1995	64.3	14.0	0.1	5.2	13.0	3.4	100
Working-age women							
1987	78.0	0.3	7.9	1.3	3.8	8.7	100
1995	56.0	9.5	12.1	5.1	9.4	7.9	100

Source: Hungarian HBS, 1987 and 1995

age person to have an income in a system where individual earnings prevailed, continued to have the effect of encouraging many women to retain their attachment to the labour market through their child-bearing years (Jarvis and Redmond, 1997). Table 1 shows that up until 1995 women's participation in the labour force had fallen no faster than that of men. This was in spite of the considerable reduction in additional support provided for working women with young children: for example, the number of subsidised day and infant nursery places available to working women with young children fell by 45 per cent between 1988 and 1995 (HCSO, 1991; 1995)¹.

In April 1996, in response to the deepening fiscal crisis, and after a protracted political and constitutional debate, a series of reforms to child-related benefits was instituted. Pre- and post-April 1996 family benefit

¹ Evidence from the 1987 and 1995 HBS does suggest, however, that women's withdrawal from the labour market was more selective than that of men: women in unskilled, blue-collar occupations made up 39 per cent of female employees in 1987, but only 30 per cent in 1995. The comparable percentages for men were 26 per cent and 22 per cent in 1987 and 1995 respectively.

regimes are summarised in Table 2. The reforms instituted in April 1996 included:

- the means testing of Family Allowance for households with less than three children. The means test was set at a relatively high level, with entitlement only exhausted when per capita household income was about twice the minimum pension²;
- the abolition of Pregnancy Allowance, and its replacement with a Maternity Payment of HUF 14400, equal in value to about five months' Pregnancy Allowance for a woman expecting her first child, but equal to less than four months' Pregnancy Allowance for a women expecting her third;
- the abolition of earnings-related Child Care Fee (GYED) and its amalgamation into Child Care Allowance (GYES), which was awarded as a flat-rate benefit equal in value to the Minimum Pension (HUF 9 600 per month in 1996), an increase from HUF 7 500 per month awarded to GYES claimants prior to April 1996. Also from April 1996, GYES was only available to parents who had already been awarded means-tested Family Allowance.

The Full Impact of the April 1996 Reforms on Government Expenditures and Household Incomes

If we look beyond the initial impact and attempt to gauge the impact of the reforms after they matured, then the overall impact is still fairly small. In this analysis, we attempt to model the impact of the April 1996 policy reforms at their mature state by assuming that everybody experiences the full impact of the policy shock from the day it is implemented. From this perspective, we can examine more adequately the intended and unintended consequences of the policy reforms. Table 3 shows the simulated aggregate impact of these reforms. This resulted in an overall reduction in expenditure on these benefits of HUF 15.7 billion,

2 A more detailed description of the rates of Family Allowance before and after April 1996, and the means test instituted from April 1996, is provided in Redmond (1998a).

Table 2: Summary of Cash Benefits Available for Families with Children in Hungary

	1995	April 1996
Income tax	Individual taxation - no extra benefits for taxpayers with children	No change in family provisions
Universal children's allowances	<i>Family Allowance</i> , payable to either parent; extra for more children Pregnant women could claim a <i>Pregnancy Allowance</i> from 13th week of pregnancy	<i>Family Allowance</i> means-tested for households with less than 3 children <i>Pregnancy Allowance</i> abolished
Maternity benefits	Employment and earnings related <i>Maternity Allowance</i> and <i>Child Care Fee</i> (GYED) until child's 2nd birthday Fixed-rate <i>Child Care Allowance</i> (GYES) until child's 3rd birthday	<i>Child Care Fee</i> and <i>Child Care Allowance</i> amalgamated into a means-tested unified flat-rate benefit
Means-tested and safety net benefits	<i>Child Raising Allowance</i> (GYET) for non-working mothers with three or more young children (means-tested at a high level) Means-tested cash benefits <i>Social Assistance</i> , <i>Social Benefit</i> , <i>Housing Allowances</i> and <i>Temporary Crisis Allowances</i> (locally administered)	<i>Family Allowance</i> means-tested (see above) Eligibility to <i>Child Care Allowance</i> became contingent on eligibility to <i>Family Allowance</i> Other locally administered means-tested social assistance continued

offset to a small extent by a reduction in income tax revenues³. Means testing of Family Allowance has the greatest impact: the amount of this benefit paid to households decreases by more than HUF 10 billion, and

3 As an earnings-related benefit GYED was taxable, while as a means-tested benefit GYES is not taxable, although a six per cent social insurance contribution is deducted. Simulated income tax revenues decrease by HUF 1.5 billion as a result of this reform, so the final simulated reduction in expenditure is just over HUF 14 billion. It is worth noting that this estimate of savings in government expenditure as a result of the 1996 reforms is larger than that of Rédei, Lakatos and Éltető (1998). This is for two reasons: first, their estimate refers to the impact of the April 1996 reforms during 1996, before the reforms have matured; secondly, their estimate is affected by assumptions that they make about how people might under-report their incomes for means testing purposes. This has not been done in this paper, since there is as yet little hard information about how people in Hungary have reacted to the means testing of benefits such as Family Allowance.

Table 3: Simulated Aggregate Costs of Pre- and Post-April 1996 Hungarian Family Benefit Regimes and Numbers of Claimants

	1995 Regime		1996 Regime	
	Expenditure (HUF billion)	Number of claimants (000)	Expenditure (HUF billion)	Number of claimants (000)
Family and Pregnancy Allowance	103.3	1 443	92.9	1 259
Child Care Fee (GYED)	18.6	178	0	0
Child Care Allowance (GYES)	13.4	184	25.9	283
Maternity Payment	0	0	0.8	57
Social Assistance/Benefit	22.5	400	22.5	400
Total	157.8		142.1	

Source: Microsimulation model, using 1995 Hungarian HBS, updated to 1996.

184,000 households are judged ineligible as a result of the reform. The abolition of GYED results in a saving in public expenditure of HUF 18.6 billion, but of the 178,000 claimants who lose entitlement, at least 99,000 are judged as eligible for GYES. Expenditure on this benefit almost doubles, from 13.4 billion under the 1995 regime to 25.9 billion under the 1996 regime. About HUF 1 billion of the reduction of expenditure on Family Allowance is accounted for by the abolition of Pregnancy Allowance. Of this, HUF 0.8 billion is spent on the new Maternity Payment from April 1996.

These reforms, particularly the means testing of Family Allowance, were radical in the Hungarian context, even though they were formulated in such a way that only relatively well-off households would be affected. Moreover, the amalgamation of GYED into GYES, and its means testing, (although not the means testing of Family Allowance) were only instituted in respect of babies born after April 1996. Thus, as Rédei, Lakatos and Éltető (1998) show, the initial impact of these reforms was not severe.

Although the aggregate reduction in family-related benefits paid to Hungarian households is quite large, the distributional impact on household incomes is small, as Table 4 shows. On average, Hungarian

Table 4: Distributional Impact of April 1996 Reforms to Family Benefits

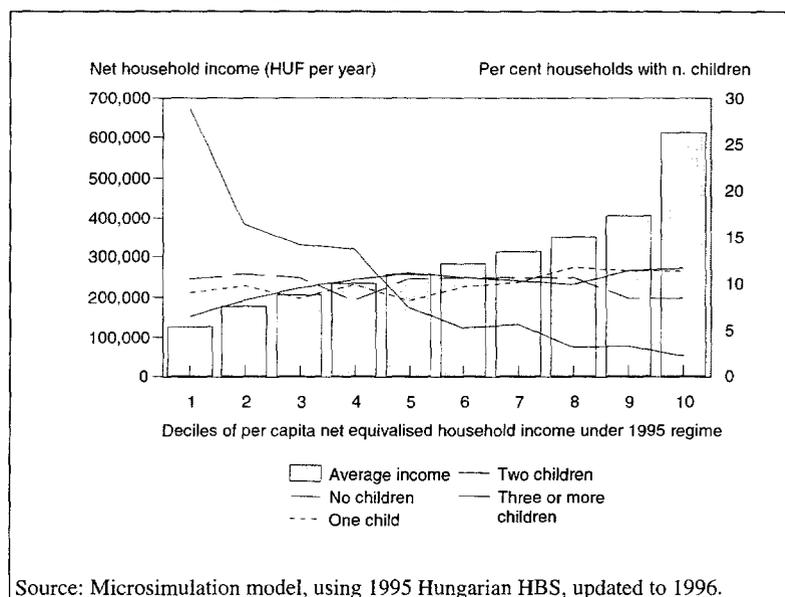
Decile groups of equivalised household income, 1995 regime											
	Low	2nd	3rd	4th	5th	6th	7th	8th	9th	High	Total
Average equivalised yearly income and per cent change in income											
HUF (000)	127	178	207	233	257	284	313	351	406	609	
Percentage Change	0.39	0.07	-0.16	-0.03	-0.14	-0.33	-0.31	-0.86	-1.38	-1.65	
Per cent winners and losers											
Losers	6	5	6	7	4	5	7	17	30	42	13
No change	80	86	85	88	89	92	91	81	68	57	82
Winners	14	9	8	5	7	3	2	2	2	0	5

Source: Microsimulation model, using 1995 Hungarian HBS, updated to 1996.

households lose 0.6 per cent of their pre-reform incomes as a result of the reforms. However, these losses are progressively distributed. Households in the bottom decile gain an average 0.4 per cent of their pre-reform incomes as a result of the reforms, while households in the top decile lose an average 1.65 per cent of their pre-reform incomes. There are both gainers and losers in nearly all decile groups. Six per cent of households in the bottom decile experience losses as a result of the reform, as do five per cent in the second decile. These losses are mostly caused by the abolition of Pregnancy Allowance and GYED. In the 9th and top deciles, 30 and 42 per cent of households respectively have reduced incomes after the April 1996 reforms, mainly the result of means-testing of Family Allowance and the abolition of GYED. The small number in the 7th and 8th deciles who gain as a result of the reforms have benefited from increases in the level of GYES.

While the overall impact of these reforms may appear benign, only households who receive family benefits, those with dependent children, are affected by them. People living in households with children comprise about 56 per cent of the Hungarian population. It is on this group that the remainder of this analysis will concentrate. Figure 1 shows average equivalised household incomes among households with children by decile group under the 1995 regime, and the distribution of households with different numbers of children across decile groups. The distribution of households with no children, or one or two children, is fairly even

Figure 1: Distribution of Income and Children Among Hungarian Households with Children: 1995 Family Benefit Regime

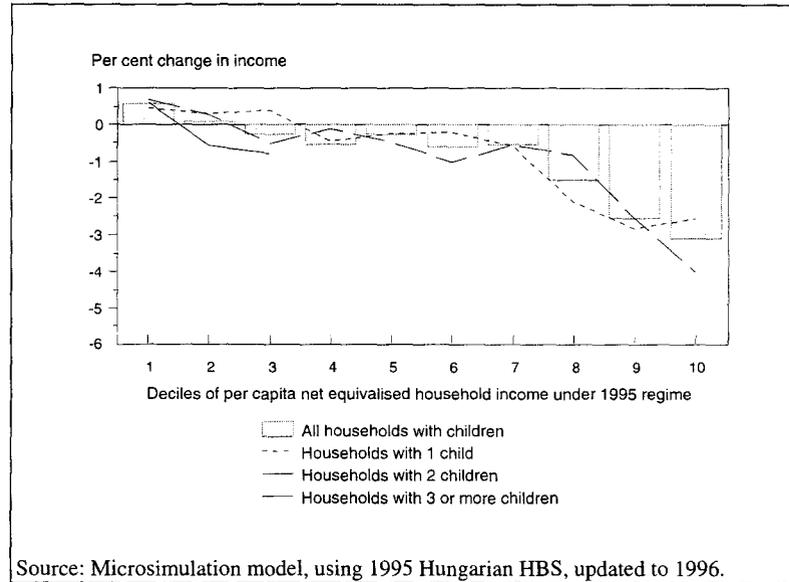


across decile groups, but this is not the case for households with three or more children. Twenty-nine per cent of all households containing three or more children are in the bottom decile of the income distribution, and 16 per cent are in the second decile.

Therefore, almost half (45 per cent) of people living in households with three or more children are in the poorest fifth of the Hungarian population⁴. It is here where the problem of poverty among households with children is concentrated, and it is here that many of the government initiatives aimed at alleviating poverty have been aimed. For example, as we saw from Table 1, Child Raising Allowance was exclusively aimed at

4 The choice of equivalence scale can obviously affect the proportions in this analysis. However, Collins and Redmond (1997) show that even with equivalence scales that weight children less heavily than the OECD scale used here, households with large numbers of children are still over-represented at the bottom of the income distribution.

Figure 2: Distributional Impact of April 1996 Reforms on Hungarian Households with Children



households with three or more children, and this group was exempted from the means testing of Family Allowance from April 1996.

Figure 2 shows how the April 1996 reforms affect the incomes of households with children. The bars indicate that among all households with children, people living in households in the bottom two deciles gain slightly on average, while people living in households in the remaining deciles lose. The losses are small but fluctuate in the middle of the distribution, and increase in the top three deciles, amounting to almost three per cent of pre-reform incomes among people living in households in the top decile. The increased losses experienced by people living in households in the top three deciles are caused by the means testing of Family Allowance. People living in households in the bottom seven deciles are largely unaffected by this.

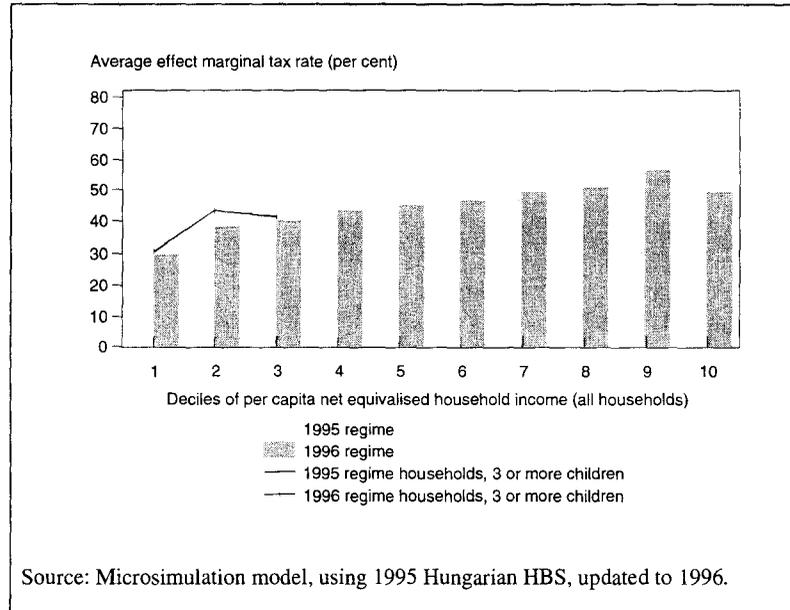
If we examine the impact of the reforms on households with different numbers of children, the results fluctuate rather more. These fluctuations

are mostly caused by the abolition of GYED and its replacement with increased GYES, and to a lesser extent by the abolition of Pregnancy Allowance and its replacement with Maternity Payment. Among households with one or two children in the second decile, the increase in GYES effectively compensates for the abolition of GYED, with the result that average incomes do not fall for these groups. Among households with three children in the second decile, however, GYED and GYES combined are about 10 per cent more generous under the 1995 regime than the reformed GYES is under the 1996 regime - hence the losses experienced by this group. In the third decile, people living in households with one child still record a slight gain in income. This is because the increase in GYES under the 1996 reforms more than compensates for the abolition of GYED. But this is not the case among people living in households with two or more children in the third decile: they lose out, on average, from the abolition of GYED.

As is evident from Figure 1, people living in households with three or more children are concentrated in the bottom deciles. Therefore, calculations of average gains and losses among households in this group above the third decile are based on small sample sizes and are unreliable. Thus they are not shown on Figure 2. However, Figure 2 does show that while the reforms sought to protect benefits for large families, particularly poorer ones, they were not universally successful in this regard.

Overall, families with three or more children saw their child care payments decrease by more than three per cent on average as a result of the reforms. The abolition of Pregnancy Allowance also adversely affects households with three children, since Pregnancy Allowance was higher for a woman expecting her third child than for a woman expecting her first or second child (see Redmond, 1998a), while the Maternity Payment which replaced it is a flat-rate lump sum which does not take numbers of children into account.

Figure 3: Average Effective Marginal Tax Rates Under 1995 and 1996 Hungarian Family Benefits Regimes: All Households with Earners and Children



The impact of benefits on incentives to work is often seen as a crucial criterion on which the efficacy of a reform package is judged (Danziger, Haveman and Plotnick, 1981). In the case of Hungary under the Communist regime, the impact of benefits on incentives to work was not seen as a problem. This was, first, because most benefits were employment related, second, because neither of the principal causes of disincentives in Western social security systems, means tests and income taxes, were significant, and third, because most active age adults were effectively compelled to work. With the exception of earnings-related unemployment benefit, which was introduced at quite generous rates just before the collapse of Communism (Micklewright and Nagy, 1997), this situation continued for most people into the 1990s. In the Hungarian context, it must further be remembered that in families with children, *both* parents were traditionally compelled to work, as were single parents. It is therefore arguable that any benefit reform which had the effect of discouraging either men or women to work might have a long-term detrimental impact on the incomes of households with children.

Incentives to work are often measured through effective marginal tax rates - the amount of taxes paid and benefits lost as a proportion of an extra unit of income earned. Figure 3 shows that the reforms of April 1996, even though they introduced means testing, do not appear to have had a large effect on the effective marginal tax rates paid by working Hungarian households. Except in the highest deciles, where the means testing of Family Allowance takes effect, effective marginal tax rates on an extra HUF 10,000 earned in a year remain very much the same under the 1995 and 1996 regimes, and also remain relatively low: under some Western social security systems, effective marginal tax rates of over 90 per cent for certain workers are not uncommon (see Evans, 1996; Redmond, 1998b).

4 The Continuing Growth of Means Testing in Hungary: Lessons from the UK

The Growth of Means Testing in Hungary

The reforms to family benefits described in Section 3 constituted an important psychological shift in the orientation of social policy in Hungary, away from universalist and contingent policies, and towards means testing. Even before these reforms had been instituted, however, means testing was already becoming more prevalent. We have already noted that Child Raising Allowance, introduced in 1993, was means tested, albeit with the aim of excluding very high-income families rather than targeting on low-income families. Other means-tested benefits, such as Social Assistance, had been introduced for families experiencing severe hardship during the Communist regime. Towards the end of the Communist era, Social Benefit was introduced as a benefit for claimants of earnings-related Unemployment Benefit who had exhausted their entitlement. These means-tested social benefits are administered in accordance with local conditions and criteria by local authorities and councils⁵. As Micklewright and Nagy (1997) point out, it cannot be

5 Bird, Wallich and Péteri (1996) note that there are over 3,000 local councils in Hungary, three-quarters of which cover populations of less than 2,000 people.

Table 5: Expenditure on Selected Social Security Benefits in the UK and Hungary (per cent of total social security expenditure)

UK	1993	Hungary	1993	1995
		Means-tested		
Family Credit	1.4	Child Care Assistance	0.1	0.4
Housing Benefit	10.1	Regular Social Assistance	2.6	4.0
Income Support	20.0	Non-Regular Social Assistance	1.1	1.2
		Other cash benefits	0.2	1.0
Total	31.6	Total	4.1	6.7
		Non-means-tested		
Child/One Parent Benefit	7.6	Family Allowance	15.5	11.3
Unemployment Benefit	1.9	Unemployment Benefit	8.0	7.0

Sources: UK - Annual Abstract of Statistics 1995, Table 3.5.
Hungary - Hungarian Statistical Yearbook 1994, Table 15.2; Hungarian Statistical Yearbook 1995, Table 5.3.

assumed in these circumstances that entitlement to social benefits is either claimed or accurately assessed. This makes it difficult to model entitlement using standard microsimulation techniques. However, aggregate data indicate the increasing importance of these benefits in post-Communist Hungary. Table 5 shows that while the significance of the biggest non-means-tested benefits, Family Allowance and Unemployment Benefit, declined markedly as a percentage of total social security expenditure between 1993 and 1995, spending on means-tested benefits almost doubled, from 4.1 per cent to 6.7 per cent of total expenditure. The reforms of April 1996 increased the prevalence of means testing considerably. Table 5 also shows, however, that compared with the UK, where almost one-third of total social security expenditure was in the form of means-tested benefits in 1993, expenditure on means-tested benefits in Hungary in 1995 was rather small.

Clearly, however, in accordance with advice from the World Bank (1995; 1996) and the OECD (1995), the importance of means testing is likely to continue to grow in Hungary. The introduction of a new means-tested

benefit, Permanent Child Protection Support, in November 1997 provides further evidence of this⁶. This benefit is targeted on families with very low incomes and children aged under 14, but as with Child-Raising Allowance, benefit amounts per child are relatively small. However, unlike Social Assistance schemes, this benefit is centrally administered. Its introduction at this time suggests that a central bureaucracy capable of large-scale means testing is being developed, and the shift towards means testing in Hungary appears set to continue.

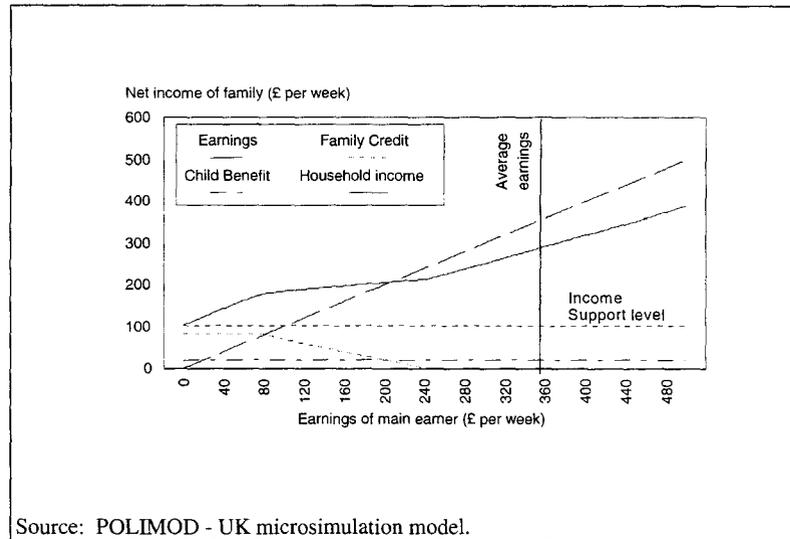
A Model for Hungary? Family Benefits, Means Tests and Participation in the UK

McLaughlin (1994), in her analysis of the development of the modern British welfare state, argues that in the formative period of its establishment, the relatively greater political power of working class men compared to women, the partial overlap of the interests of employers and employees as family men, and the interest of the nation state in women as reproducers and carers, conjoined to make the male breadwinner the key institutional basis of the British welfare state. Men had a strong interest in their own decommmodification as workers, which they campaigned to achieve through employment legislation and cash social security provision, but showed less interest in the state provision of facilities which supported women in their dual roles as workers and carers.

One consequence of the 'breadwinner' ethos was that family benefits in the UK never assumed the importance that they did in Hungary. Until the 1970s, apart from a basic social assistance programme, help for families with children was confined to a minimal (but universal) Family Allowance, some income tax allowances, and some additions to social insurance benefits. In 1971 a new in-work benefit, Family Income Supplement (later to be called Family Credit) was introduced to provide means-tested support for families with children with a parent in full-time

6 Nominal rates of Family Allowance were also increased in 1997, for the first time in five years. However, these rate increases did not go a long way towards compensating for the decline in the real value of Family Allowance since the start of economic transition.

Figure 4: Incomes and Taxes in the UK in 1997: Married Full-time Earner with Two Children and Spouse Not in Paid Work (assuming no housing costs or local taxes)



work⁷. From 1977 on, income tax allowances for children and Family Allowance were phased out, and replaced with Child Benefit, a universal per-child benefit that was more generous than Family Allowance but still low in relation to both average earnings and the cost of raising children. Child additions for social insurance benefits were also abolished in the early 1980s.

Family benefits in the UK in the 1990s were therefore almost exclusively means tested. Figure 4 shows how means tests targeted benefits on families with low levels of market income. Basic level Income Support for a non-employed couple with two children and no other income was worth about £100 sterling per week in 1997. But if one member of the couple earned £80 per week, then Family Credit, which was only available to working families, together with universal Child Benefit,

⁷ Later, Family Income Supplement/Family Credit would also become available to first lone mothers, and then all parents, who worked part-time.

would boost the family's net income to £180. However, in order to increase family incomes by a further £20, the employed person would have to earn £170: the combined incidence of income taxes and withdrawal of Family Credit at a rate of 70 pence for each extra pound earned ensured that effective marginal tax rates were extremely high over this range of earnings. Thus, if the wife of a low-paid man in the UK also entered low-paid employment, the family might not gain much in terms of net incomes, and might lose out if costs associated with travelling to work and child care were taken into account⁸.

The combined impact of the family (or breadwinner's) wage, inferior benefits for women with caring responsibilities and an orientation towards means testing that often deterred women from entering low-paid work, ensured that for most of the second half of the twentieth century women in the UK were not as active in the labour market as was the case in Hungary. Jarvis and Redmond (1997) argue that this factor helps explain the relatively higher rates of child poverty in the UK compared with Hungary in 1993.

However, the effects of economic transition had a huge impact on the participation patterns of both men and women in Hungary. Table 6 compares employment patterns among households with children in the UK in 1993 with those in Hungary in 1987 and 1995. This shows that among people living in households with children, the proportion of two-parent households where neither parent was employed increased more than fourfold between 1987 and 1995, from 2.5 to 11.4 per cent. This latter figure was higher than the total for the UK in 1993. In over a fifth (22 per cent) of Hungarian households, only the man was employed in 1987, but in almost two-thirds of these observations, the woman was on maternity leave. By 1995, the proportion of households where only the man worked had increased to nearly 32 per cent of all households with children; in half of these, the woman was on maternity leave. In the UK, very few women were on maternity leave, a reflection of the very short

⁸ Redmond and Sutherland (1995) and Evans (1996) explore the issue of poverty traps in the UK benefits system in considerably more detail.

Table 6: Family Characteristics of Households in the UK and Hungary (per cent)

Characteristics of households	UK 1993	Hungary 1987	Hungary 1995	Change in Hungary, 1987-1995
Couple, neither employed, with children, of which:	10.3	2.5	11.4	+8.9
woman on maternity/childcare leave	0	0.1	3.1	+3.0
Couple, woman employed, man not employed, with children	3.8	2.3	7.9	+5.6
Couple, woman not employed, man employed, with children, of which:	22.2	24.0	31.7	+7.7
woman on maternity/childcare leave	0.1	14.9	15.8	+1.0
Couple, both employed, with children	46.7	63.9	38.8	-25.1
Single person, with children, working	6.3	6.1	5.8	-0.3
Single person, with children, not working, of which:	10.9	1.1	4.4	+3.3
woman on maternity /childcare leave	0	0.2	0.6	+0.4

Sources: 1987 and 1995 Hungarian HBS and Jarvis and Redmond (1997)

period of eligibility for maternity benefits in the UK⁹. The proportion of Hungarian households with children where both the man and the woman worked was 64 per cent of all households with children in 1987, but only 39 per cent in 1995. This proportion is lower than that in the UK in 1993, where both members of a couple were employed in 47 per cent of households with children.

The huge reduction in dual-earning households in Hungary between 1987 and 1995 is partly explained by the withdrawal by both men and

9 This is explored more fully in Jarvis and Redmond (1997).

women from employment as a result of economic transition, but also by the large number of Hungarian women on maternity leave. Overall, in spite of the severe effects of economic transition, nearly 70 per cent of all active-age women with children in Hungary were working or were on maternity leave in 1995, compared with less than 60 per cent in the UK. Moreover, it is important to remember that while a considerable proportion of employed women with dependent children in the UK work part time, this is very rare in Hungary - nearly all employed men and women in Hungary work full time.

Therefore, in spite of the severe impact of transition, women with children in Hungary in the 1990s clearly still had a strong attachment to the labour market. Jarvis and Redmond (1997) put forward three reasons for this: first, the State encouraged them to do so, through the structure of benefits offered; secondly, the structure of earnings was such that both men and women were compelled to work in order to provide for themselves and their children; and thirdly, earnings differentials between men and women were considerably lower in Hungary than in the UK. Jarvis and Redmond (1997) argue that increased means testing, while improving the targeting of benefits in Hungary, might also have the effect of increasing the number of families with children in poverty in Hungary. In the next section, we simulate the impact of introducing a UK-style means-tested benefits system in Hungary.

The Impact of Increased Targeting in Hungary

In order to simulate the introduction of a more tightly means tested and targeted social security regime in Hungary we introduce three major benefits which feature in Figure 4 and form the backbone of the UK family benefits system - Income Support, Child Benefit and Family Credit¹⁰. General criteria for eligibility to benefits and rules for receipt as

10 Some important benefits, notably Housing Benefit, are not simulated because of the problems associated with developing comparable indicators of housing costs in the UK and Hungary. Housing Benefit, along with Child Benefit, Family Credit and Income Support, is more fully described in Redmond (1998a).

implemented in the UK are mostly maintained in the simulated Hungarian system¹¹.

Thus:

Child Benefit is paid in respect of all children in the household at a flat per-child rate, with a premium for the first child and an extra amount (Single Parent Rate¹²) for single parents, and is not subject to a means test.

Family Credit is only available to families where a parent is employed for at least 16 hours per week. The maximum amount of Family Credit payable depends on the number and ages of children in the family. This maximum amount is reduced according to a 70 per cent taper if family income (after tax and some disregards) is higher than a fixed threshold. Child Benefit is not included in the means test for Family Credit.

Income Support (which in the UK is a basic social assistance-type benefit) is only available where neither parent works, and is subject to a means test with very few disregards and a 100 per cent taper; that is, income of say HUF 1,000 from most sources, including Child Benefit, would result in a HUF 1,000 withdrawal of Income Support. Maximum amounts of Income Support vary according to whether the claimant is single or in a couple, their age (it is less generous for single people aged less than 25, and more generous for people over pension age), and the number and ages of children in the family.

In applying the benefits to the Hungarian situation, the following rules are maintained.

- The unit of receipt and means testing for benefits is the nuclear family (single people, couples without children, and single people or couples with dependent children). This is a departure from the

11 However, the Hungarian, rather than the UK, definition of a dependent child is maintained. The UK definition is more slightly restrictive than that in Hungary.

12 This was abolished in April 1998.

Hungarian practice of treating the resource unit for means testing as the household, or even the extended family.

- Benefit rates are set in relation to the Minimum Pension level (HUF 9 600) in Hungary in 1996, but the benefit relativities of the UK system in 1996/7 are maintained. Therefore, all benefit rates are translated into a proportion of the Income Support rate for a single adult. Under the UK system, a single working-age adult eligible for Income Support received a maximum of £47.90 per week in 1996-97; this is assumed to equate to HUF 9 600 under the Hungarian system. In the UK, a couple receiving Income Support would get £75.20 per week, or 1.57 times the single adult rate. Therefore, a couple in Hungary receives HUF 9 600 x 1.57, or HUF 15 072 per month if they are entitled to full Income Support. Similarly, Child Benefit for the first child in a family equals £10.80 under the UK system, or 0.225 times the single adult Income Support rate, so Child Benefit in Hungary is set at HUF 2 160 per month for the first child, or 0.225 times the monthly Minimum Pension rate.
- The three UK benefits are assumed to replace the following benefits in the 1995 Hungarian system: Family Allowance, Child Care Fee (GYED), Child Care Allowance (GYES), Child Raising Allowance (GYET), Social Benefit, and casual and long-term social assistance.
- One hundred per cent take-up of all three benefits is assumed. This is a potentially contentious assumption, since studies show that take-up of in-work benefits in particular tends to be less than complete. However, to assume incomplete take-up in a simulation exercise, it is necessary to choose those observations which do and do not take up benefits, and this is a perilous exercise without detailed information on take-up behaviour, which is not currently available for Hungary.

Table 7 shows the aggregate costs associated with introducing a UK-style means-tested system in Hungary with benefit levels set in relation to the Minimum Pension of HUF 9 600 per month. The total cost of social security transfers to families with children falls from HUF 157.8

Table 7: Simulated Aggregate Costs and Numbers of Claimants Under 1995 Hungarian Family Benefits Regimes and UK-style Means-tested System

	1995 regime		UK-style system	
	Expenditure (HUF billion)	Number of claimants (000)	Expenditure (HUF billion)	Number of claimants (000)
Family and Pregnancy Allowance	103.3	1 443		
Child Care Fee (GYED)	18.6	178		
Child Care Allowance (GYES)	13.4	184		
Social Benefit/Assistance	22.5	400		
Income Support			25.2	216
Family Credit			52.2	519
Child Benefit			63.3	1 484
Total	157.8		140.7	

Source: Microsimulation model, using 1995 Hungarian HBS, updated to 1996.

billion under the 1995 system to HUF 140.7 billion under the UK-style regime. As with the savings made to government coffers as a result of the April 1996 reforms, final savings are reduced by a loss in tax revenue of about HUF 1.5 billion. However, this still leaves a final saving of over HUF 15 billion, about HUF 1 billion more than is achieved under the April 1996 reforms. Because of its relatively low value, Child Benefit is 40 per cent cheaper than Family Allowance, although the number of recipients is about the same. Under the 1995 Hungarian regime, Social Benefit/Assistance is available for families with and without paid employment; hence the wider coverage (about 400,000 households) than is the case for Income Support, which is restricted to families without paid employment. Simulated Income Support costs are slightly higher than those associated with Social Benefit/Assistance. However, Income Support also replaces GYED/GYES for some claimants. Family Credit also replaces GYED/GYES in some cases where a woman's husband is employed. The importance of Family Credit, and the number of families affected by it, is indicative of the fact that many parents of dependent children in Hungary are employed on very low earnings.

Figure 5: Targeting of Family Benefits Under 1995, 1996 and UK-style Regimes: Households with Children

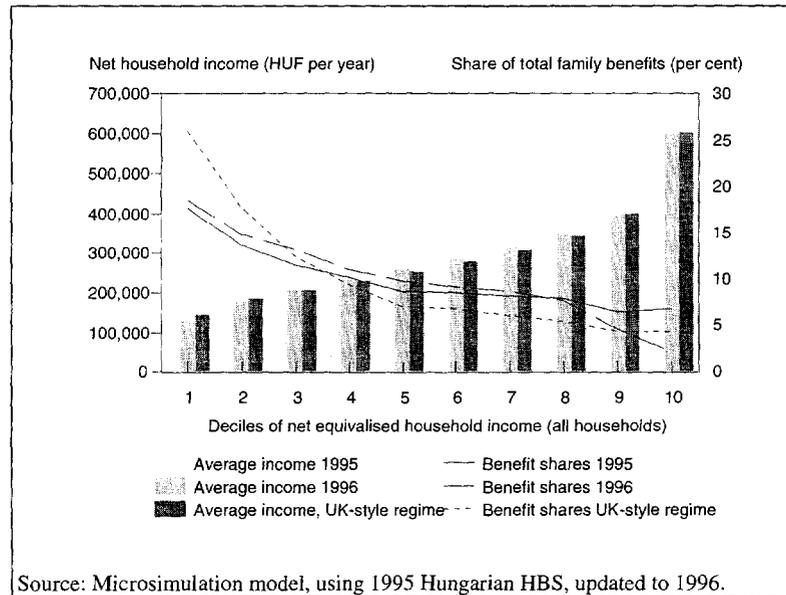


Figure 5 compares average incomes and the targeting of family-related benefits under the actual 1995 and 1996 regimes, as estimated by the microsimulation model, and under the simulated UK-style regime. It shows that under the UK-style regime, households with children in the bottom two deciles clearly gain from a move to increased means testing, which targets benefits towards the bottom of the distribution. Average equivalised incomes in the bottom decile increase from HUF 127 000 to 147 000 as a result of the policy switch from the 1995 regime to the UK-style regime - a gain of 16 per cent. This compares very favourably with the 0.6 per cent gain experienced by households with children from the April 1996 reforms. At the other end of the scale, however, households in the top decile only lose out fractionally (by about 0.5 per cent) under the UK-style regime compared with the 1995 regime. This is because Child Benefit in the UK-style regime, like Family Allowance in 1995 - but not in 1996 - is a universal benefit. Under the 1996 regime, average losses

Table 8: Decile Shares of Different Family Benefits Under a UK-style Regime (per cent)

Decile groups	Income Support	Family Credit	Child Benefit	All Benefits
Lowest	51.47	27.88	14.29	25.99
2 nd	16.41	25.80	11.73	17.79
3 rd	8.15	17.11	10.59	12.58
4 th	7.79	9.79	9.87	9.47
5 th	3.38	6.69	9.02	7.15
6 th	3.81	5.09	9.39	6.8
7 th	3.60	3.00	9.55	6.05
8 th	2.56	2.03	9.41	5.44
9 th	1.10	1.49	8.11	4.4
Highest	1.72	1.12	8.05	4.34
Total	100	100	100	100

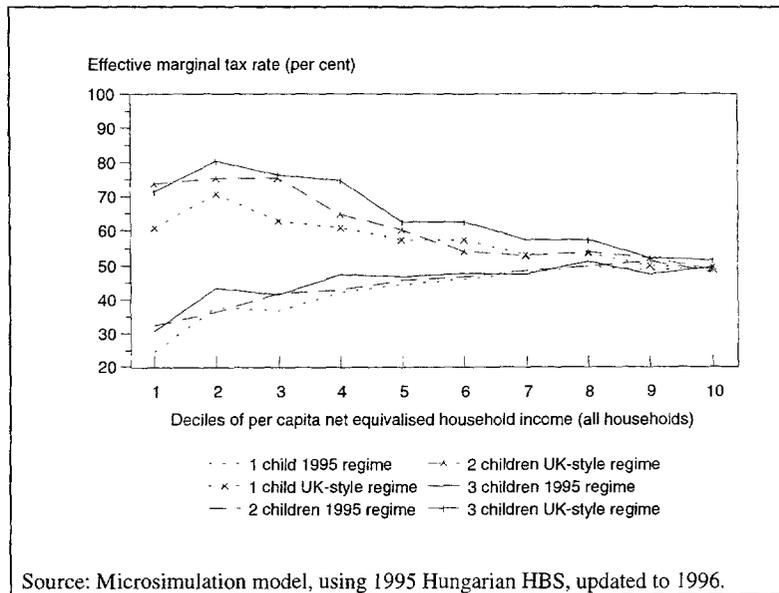
Source: Microsimulation model, using 1995 Hungarian HBS, updated to 1996.

among people living in households with children in the top decile amount to almost three per cent of their incomes.

If the aim of social security is solely to target benefits on those who have least, then the UK-style system is considerably superior to both the 1995 and 1996 regimes. Under the 1995 regime, 31 per cent of total expenditure on family-related benefits is concentrated on the bottom two deciles; this figure improves to 33 per cent under the 1996 regime, and to 44 per cent under the UK-style regime. In comparison with the 1995 regime, households from the fourth decile upwards lose out as the result of a switch to a UK-style regime. In comparison with the 1996 regime, households in the middle deciles get smaller shares of total family benefits, while households at the top, as we have seen, get slightly more.

Table 8 shows the distribution of Income Support, Family Credit and Child Benefit under the UK-style regime. Income Support is most heavily targeted at the bottom of the income distribution: more than half goes to the poorest decile. But Family Credit is also heavily targeted at the bottom: about a quarter of total expenditure on this benefit goes on each of the two bottom decile groups, with gradually decreasing

Figure 6: Average Marginal Tax Rates from 1995 and UK-style Family Benefit Regimes, by Number of Children: All Households with Earners and Children



concentrations in each decile group thereafter. This suggests that there are heavy concentrations of working families in the bottom deciles.

The distribution of Child Benefit is also slightly skewed towards the bottom of the distribution. This is indicative of the location of households with children within the distribution of incomes in Hungary. As was shown in Figure 1, households with three or more children are concentrated in the bottom deciles. Otherwise, Child Benefit is quite evenly distributed across all deciles. However, as is the case in the UK (see Figure 4), this means-tested system produces high effective marginal tax rates for a considerable number of working families. Figure 6 shows that compared with the effective marginal tax rates experienced by working families under the 1995 regime (which, as Figure 3 shows, do not change greatly as a result of the April 1996 reforms), the effective tax rates experienced by working households under the UK-style regime are very high, rising to over 80 per cent in the second decile, and remaining at over seventy per cent in the third and fourth deciles among households

Table 9: The Impact of a UK-Style Family Benefits System: Distribution of High Effective Marginal Tax Rates by Household Type (per cent)

	All	Effective marginal tax rates greater than 70%
Households with one child	39.4	29.0
Households with two children	47.0	46.2
Households with three or more children	13.6	24.8
Households headed by a single parent	9.5	14.7
Households where one member of a couple works	38.6	59.8
Households where both members of a couple works	52.5	25.4

Source: Microsimulation model, using 1995 Hungarian HBS, updated to 1996.

with three or more children. Among households with two children, effective marginal tax rates are almost as high in the bottom three deciles. Over a third of working households have effective marginal tax rates of 70 per cent or more. Table 9 examines in greater detail the characteristics of these households with high effective tax rates. This shows that households with three children are greatly over-represented: they constitute 13.6 per cent of working households in the sample, but 24.8 per cent of working households that experience high effective marginal tax rates. Households with single parents are also over-represented - they make up 9.5 per cent of the working sample, but 14.7 per cent of those with high effective marginal tax rates. Households with single parents and those where only one parent works together make up three-quarters of all households experiencing high marginal tax rates.

This suggests that if high effective marginal tax rates are seen as a deterrent to earn more from employment, then it is these households which will be most affected. In such a scenario, the practical solution for many families might be that one partner (usually the woman) might stay at home to care for the children, while the other partner (usually the man) might, with the help of in-work benefits, earn something approximating a 'family wage'. Two factors might militate against this kind of scenario developing for many families: first, women developed a tradition during

the Communist era of working full time, and they might be reluctant to relinquish the independence that this brings (Corrin, 1994). Secondly, unlike in the UK, where women's earnings are on average considerably lower than those of men, women's earnings in Hungary are almost equal to those of men. However, it is possible that over the long term a fully means-tested system of family benefits could begin to create permanent poverty traps that families find difficult to escape from, as has happened in the UK (see Jarvis and Redmond, 1997). The impact of the further extension of means testing in Hungary, particularly in terms of incentives to work, should be carefully considered before being implemented.

5 Conclusion

Several themes emerge from the analysis reported in this paper. First, it is clear that the legacy of the Communist regime in the area of family benefits in Hungary was a strong one. The Communist regime, and indeed governments dating back to the 1930s in Hungary, had developed a suite of near-universal benefits aimed at helping working parents raise their children. The popularity of these benefits outlasted the collapse of Communism, not least because their importance in family incomes increased as real earnings declined. This made their reform by the first post-Communist governments difficult, even in the face of a fiscal crisis and continued advice from international agencies. It was only in April 1996 that fundamental reforms were finally implemented. The reforms introduced means testing which aimed to exclude only families with very high incomes from the previously universal Family Allowance, and abolished the earnings-related Child Care Fee (GYED - for women on child care leave with children aged under three) in favour of an enhanced means-tested and flat-rate Child Care Allowance (GYES).

Using a new microsimulation model for Hungary, this paper shows that the effect of these reforms, in terms of their impact on household incomes, was mild and even benign. People living in households at the very bottom of the income distribution were actually slightly better off after the reforms, while people living in households at the top of the income distribution were the only ones who lost out substantially. But it is possible to argue that the reforms had a deeper psychological effect: they introduced the principle of large-scale and centralised means testing

for hundreds of thousands of Hungarian households. Even before 1996, the importance of means-tested benefits was increasing, as more people had recourse to social assistance schemes administered by local authorities, but means-tested benefits still constituted a relatively small proportion of total social security expenditure. The introduction of centralised means testing for Family Allowance (and by extension, Child Care Allowance) put in place an apparatus that had the potential to form the basis of a fully means-tested social security system. The introduction of other centrally-administered means-tested benefits in November 1997 gives further weight to the impression that social security in Hungary is undergoing a fundamental transformation.

One of the main purposes of this paper was to look beyond the immediate impacts of the most recent reforms and to examine the potential impact of a more fully means-tested system of benefits in Hungary. In effect, the microsimulation model was used to simulate the impact of introducing in Hungary the sort of centrally-administered benefits that are available to families with children in the UK, namely Child Benefit (a relatively austere universal benefit), Income Support (a social assistance scheme for non-working families) and Family Credit (a means-tested benefit for working families). It was argued that in the UK these benefits created a poverty trap which many families with children found difficult to get out of.

This analysis found that a similar scenario might arise in Hungary if the same sorts of benefits were introduced there: the targeting of benefits towards the poorest households would improve considerably, but at the cost of increasing effective marginal tax rates to prohibitive levels for a very large number of households, particularly those households where only one person worked. Under the current system, even after the April 1996 reforms, there are few direct disincentives for all parents of children to work, and even in spite of high unemployment and reduced provision of child care facilities, most women with children do work full-time. Under a UK-style system, many women in particular might find it less rewarding to work at all if their partner was already working. As Jarvis and Redmond (1997) argue, policies which over the longer term encourage increased withdrawal of women, particularly women with children, from the labour market are also likely to entrench the position

of many families with children at the bottom of the income distribution. This is particularly the case in Hungary, where people living in households with three or more children are already over-represented among households in the bottom deciles. The long-term effects of increased means testing in Hungary are in need of careful appraisal now, before additional schemes are introduced.

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