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Financing of the general government

Notes to the volume of essays and studies entitled
Taxpaying Employers and Taxpaying Employees in a Corruption-Free Economy
by Tamás Bánfi – László Balogh (eds.)

(Béta Book Kkt, Budapest, 2011, 192 pages)

This volume of essays and studies raises an extremely exciting and important economic policy question of our days: How is it possible to sustain the financing of the Hungarian state, how is it possible to avoid national bankruptcy by excluding external indebtedness? The authors' answer is simple and comes straight to the point: the economy has to be freed from corruption; employment and growth have to be increased by creating new jobs, and all employers and employees have to be taxed. Each study in the volume presents new ideas and thus, as the authors also put it, disputable approaches as well. The question is whether we can come to the right conclusions if we only mechanically examine the optimal tax system from a practical aspect, i.e. disregarding theoretical considerations, the effect of the tax system on the efficiency of production, and the so-called Ramsey (1927) rule. In the spirit of the above I am disputing some of the thoughts raised in the studies, and I am expounding on some of their economic policy proposals.

As a *Prelude* to the volume, *Tamás Bánfi* examines the choices between the competitiveness of the Hungarian economy and the financing of the tasks of the state through regulating the degree of taxation. This simply means that tax increases reduce the competitiveness of the economy, but add to state financing, whereas tax cuts induce an opposite process. How can this paradoxical situation be resolved? Knowing the Hungarian employment and tax policies, the answer is an almost trivial formula: the total amount of taxes can be increased even if the tax burden is reduced, provided that the expansion of the scope of taxpayers entails a greater increase in the total amount of taxes. This can be attained through the achievement of four closely related goals, which are obvious

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for all Hungarian economists, but have been collected for the first time in this volume: creation of new jobs for the working-age inactive population; improving tax morals; reduction of corruption through limitations on cash transactions and domestic taxation of income of domestic origin. Each study analyses the feasibility of a particular goal and the means to achieve it.

The study entitled A MUNKÁTLANSÁG KÁRHOZATA (THE DAMNATION OF BEING UNEMPLOYED) by Tamás Bánfi and *Tünde Barabás* makes a proposal for setting the Hungarian and 'Roma Hungarian' (or rather Hungarian Roma) working-age inactive population to work. The authors do not speak in the usual general terms: they say clearly and specifically that for the working-age unemployed (inactive) people, jobs should be sought that can be done with their zero or minimum qualifications. Both fresh water and food have become strategic products by now; therefore, water management and agriculture – for which the climatic and geographical conditions of Hungary provide excellent opportunities – may be taken into account to a considerable extent in solving their employment problems. More specifically, the authors identified three sectors:

- construction, maintenance and guarding of water reservoirs and networks of canals;
- growing of vegetables and fruits;
- collecting medical herbs.

It is a well-known fact that in Hungary the improvement of employment is significantly hindered by the immobility of labour (families). Therefore, as a first step, the authors examine how the working-age inactive and unemployed population, averaging nationally at 42.7 per cent, is dispersed regionally. The highest dispersion rates (above 50 per cent) were found in Szabolcs-Szatmár-Bereg, Borsod-Abaúj-Zemplén and Somogy Counties. Dispersion is lower than that, but higher than the national average in Baranya and Tolna in Transdanubia as well as in Hajdú-Bihar, Heves, Nógrád, Bács-Kiskun and Jász-Nagykun-Szolnok Counties in the eastern part of the country. Further statistical measurements (of levels of schooling, etc.) support the public belief that these counties are at a disadvantage. Accordingly, work has to be given, and locally if possible, to the mostly unskilled unemployed people who live here. A number of questions arise, including to what extent the climatic and geographical conditions of these counties allow their employment in the three sectors identified; to what extent such developments can be competitive in the global economy; what skills are required in these sectors, etc.

With precise statistical and cultivation analyses the authors give very favourable answers to these questions. More than half of the population of the world is starving, potable water reserves are running low in some countries, and climatic changes make impossible the cultivation of certain plant cultures, especially those of vegetables and fruits, and hinder animal husbandry, etc. Under such circumstances, food, potable water, water management, etc. are becoming increasingly valuable in the global market, which offers favourable development opportunities for the Hungarian economy as well. In addition to the domestic demand, export opportunities also offer themselves. All this is also supported by the preferences of the present Hungarian government concerning the development of agriculture, which, of course, should not mean the postponement of the gradual rehabilitation of the Hungarian industry and the food industry in particular. The good-quality Hungarian cropland and the high-standard domestic expertise provide sufficient guarantee for the Hungarian agriculture to become competitive in the world market again. We may add that the development of the Hungarian industry requires a thorough review of earlier products and technologies that were

world-class prior to the democratic transformation and an analysis of their present competitiveness in the global market, and such development may be facilitated by production, to world standards, of newer products that meet the conditions in Hungary. The development of both areas can only be attained by raising the standard of agricultural and technical training, which also requires a resolute political decision as soon as possible.

What the authors propose here is actually the reversal of the processes stemming from the wrong privatisation policy of the democratic transformation, i.e. the partial restoration of earlier conditions. This is the idea which the authors themselves put forward, even though their study only highlights the destruction of medical herb collection. Obviously, their analysis aimed to point out the possibility to set even the unskilled unemployed to work, and that doing so may also contribute to increasing the total amount of taxes, i.e. to the improvement of competitiveness and to the maintenance of state financing.

In his study entitled Az egyszerű adórendszer (The simple tax system) *Gábor Kürthy* assumes that the Hungarian tax system is unnecessarily complicated because in addition to coverage purposes, taxes are supposed to achieve other goals as well. This latter approach would still be acceptable if it really served development or growth objectives, but the income redistribution function of the tax system should also be taken into account. The author proposes a simpler tax system, with disputable approaches to taxes on GDP.

The study remains within the framework of national taxation by assuming a closed economy and examines only the taxation of income from domestic production, which, although simplifying the issue, can be accepted as a 'taxpaying core'. Based on the Keynesian commodity-market macroeconomic basic correlations, circumventing the question of aggregation, it first offers an interpretation of the tax types to be introduced: value added tax, income taxes, consumption tax and property tax. Then it discusses two different approaches to the simplifications according to its calculations.

The model does not take account of dynamics; therefore, it disregards both depreciation and inflation, and considers the total GDP as the base of the value added tax. In the present system in Hungary the general sales tax (*áfa* in Hungarian) corresponds to this type of tax, concerning which the study shows that it is actually not paid on the total turnover, only on added value and indeed, only a portion of that, and it is paid by consumers. The so-called indirect calculation procedure could simplify the paperwork of payments and refunds. In the author's opinion, phasing out the category of exempt activities (exemptions from the general sales tax) would allow further significant simplification in terms of administration. Undoubtedly, this uniform approach would mean simplification on the basis of the lawn mower principle and would also add to the total amount of taxes, but it is a question whether the replacement of exemptions that are necessary from a social policy aspect due to the extraordinary differences in incomes would impose an even heavier burden on public finances both in terms of costs and administration. It would be interesting to prepare a background calculation like this as well, which would also allow deliberation.

The base of income taxes comprises earnings from work and capital, the separation of which is easy in theory, but almost impossible in practice. The author overcomes this difficulty by modelling the production of GDP using a Cobb–Douglas production function with constant returns to scale, and determines the respective shares of work and capital incomes with the help of the elasticity coefficients of the factors of production. In the model, a por-

tion of income taxes is received by the central budget, whereas the remaining part is social security revenue in the form of contributions.

The author would impose the consumption taxes on consumption *C* that appears on the absorption (and not on the output) side of GDP. He does not impose taxes on investment *I*, as it will produce consumer goods or indicates investment that already produces consumer goods. The issues of separating consumption and investment and of fairness arise here as well.

Property taxes are taxes imposed on wealth from savings. The criticism against the introduction of property tax, namely that the owner acquired his assets from his savings following the payment of income tax is rejected by the author with the simple argument that the income tax was paid at a rather low tax rate. The establishment of the tax base is very difficult here as well.

The simplest tax system in the author's model is where general government expenditures are covered only by the corresponding value added tax or only by income tax. (Here, and also with regard to what follows, a note is appropriate that in forming the taxes the formulas are correct, but their verbal explanation is often misleading.) Double taxation is indeed avoided in this case. Then why is it still possible to impose the consumption tax as well following the taxation of incomes, the author asks. His answer: 'because the income tax was not high enough', which is an ambiguous claim, since any tax is high for a taxpayer. Obviously, here and in similar replies it is to be understood that the income tax was not high enough to cover public expenditures. This system works only if the costs of the general government as a proportion of GDP are known exactly. And we know that it is impossible to precisely tell the amount of government expenditures in advance, although it can be planned, indeed, it should be planned for several years in advance. Moreover, the system works according to a too mechanical, uniform principle, and ignores the income distribution function of the tax system.

In another version of his simplified tax system, the author takes into account the contributions and the taxation of capital income as well. As it has already been mentioned, the GDP excluding the value added tax is broken down into gross work income and capital income by means of the production elasticity coefficients according to work and capital in the Cobb-Douglas production function, and determining those coefficients requires serious calculations, although various calculations show an almost constant two-thirds/one-third ratio. Following that, it is possible to determine employers' and employees' contributions and the personal income tax.

In connection with super-grossing, simplification in the author's approach would be for gross work income to be taken as the basis of calculating both contributions and the income tax. He would not make a distinction between contributions. The question is what tax rate would be applied to them. Justification is missing here as well, and also the consideration of the amount of contributions employers would be obliged to pay to still have sufficient funds remaining for development and increasing employment as well. In determining the personal income tax, a higher tax base is advantageous for the general government, but, given the flat tax rate, it is detrimental to employees with lower wages. The flat-rate personal income tax itself may be an incentive in an economy where it is possible to obtain higher incomes, but the Hungarian economy in its current condition cannot yet provide this opportunity. Moreover, it restrains domestic consumption, which, as a result of the decline in exports, significantly reduces economic growth.

Gross capital income is the base of the corporate tax, following the payment of which the after-tax profit is either paid in dividends or is

retained by the company for share capital increase. In the case of the dividend tax it disregards Tobin's q theory, i.e. that shareholders of a company lay claim to an acceptable real yield rate, which consists of the dividend rate above the portion of the after-tax profit retained for new investment and the capital value growth rate. The corporate tax rate represents a considerable weight in determining the former, so its magnitude requires much more complicated analyses than treating it, in the spirit of simplification, together with the exchange gain tax.[1] Exchange gain is always risky. Moreover, nowadays it is rather an exchange loss, but with imposing a tax on the exchange gain, time preference (and not the time value of money) poses a risk to both the shareholders and the state, and it is worth treating it together with the Tobin tax, i.e. with the taxing of financial transactions, which is not mentioned by the author, as he only examines the taxation of incomes from production.

With its model-type analyses, the study aimed at the inclusion of the tax policy in a system and at building up its anatomical structure. To this extent it is acceptable that the uniform treatment of the bases of various types of tax means some kind of simplification in the theoretical approach to tax policy. However, in the practice of tax policy one may not disregard its income redistribution function, the changing of the magnitudes of taxes facilitating development and growth and the inclusion of social allowances. This is also to emphasise that tax policy, being the practice of the tax system, is a social-policy and historical category. The financial situation and welfare of individual countries determine the tax-paying capacity of the population, which necessitates the creation of different tax systems. This is also a reason for accepting the editor's remark that tax harmonisation across the nations of the EU can only be successful in the case of those in an identical financial situation,[2] which, it should be added, assumes the elaboration of a common budget. However, this latter would lead too far, and would primarily question the sovereignty of Member States. Own budget and common monetary policy with the single currency, i.e. the separation of fiscal and monetary policies may and, apparently, does result in serious economic and social tensions in the less well-to-do Mediterranean countries of the euro area. Namely, the excessive strength or instability of the euro hinders both exports to non-euro area countries and incoming tourism from there, which results in a considerable deficit in the balance of payments, and leads to the indebtedness of the state in order to avoid national bankruptcy. The question is how this paradoxical situation can be resolved. This is one of the problems that were not thoroughly thought over upon the adoption of the euro, similarly to the possibility of reverting to the national currency, which could now be a solution for Greece in any case.

In his study entitled Egyszerű adórendszer – méltányos adóztatás (Simple tax system – reasonable taxation) Attila Bánfi releases a kind of pragmatic, fact-finding report on the magnitude of certain tax types, namely the mining rent and contributions that were either not imposed or not paid during and following the privatisation of the energy sector. Their total amount equals 35 per cent of the HUF 870 billion budget deficit planned for 2010, or 16.2 per cent of the planned HUF 1,881 billion personal income tax revenue.

In the author's opinion, when the current global financial crisis erupted, it was still conceivable that the crisis might have a positive outcome in terms of creating a new scale of values, i.e. 'mankind or at least the societies that provide a life model would be clever enough and would draw a lesson from the earlier overconsumption model', which would be expressed in taxation as well. The expectation

was unfounded, or at least exaggerated. There is no new model: for example, protection of the natural environment, which should enjoy priority, is still not considered a key issue. Justness and fairness in repairing the damages caused by environmental pollution continue to be rarely taken into account in the tax system.

In connection with imposing taxes on real estates he lists numerous well- or lesser-known reasons why it is not possible to introduce a value-based property tax as opposed to the area-based property tax. He agrees with the termination and non-introduction of the inheritance tax and the gifts tax, respectively, provided that the inherited wealth originated from work income.

The study itself is interesting; in addition to the short-lived domestic taxes it provides an insight into the property, inheritance and gifts taxes of individual countries as well as the irregularities experienced in establishing the various contributions. At the same time, the theoretical approach is missing here as well, for example the examination of the welfare of generations living together with regard to bequests, altruism etc. [See the excellent book by Blanchard and Fischer (1996).]

The study entitled OFFSHORE HELYETT NEMZETI ADÓZÁS (NATIONAL TAXATION INSTEAD OF OFFSHORE) by *Éva Péli* – as it is indicated in its subtitle as well – considers this form of tax minimisation not only a possibility but also a must in market competition.

The study makes a distinction between the concepts of tax haven and offshore, which are often used as synonyms. Tax havens usually mean insular countries or mini states that attract foreign capital with tax exemption or a low fixed tax or tax bargain. On the other hand, companies registered in the aforementioned countries but not performing any actual economic activity therein are considered offshore.[3] Earlier, capital used to 'flee' to these areas because of the zero or low tax rate. Nowadays, in turn, rather the more favourable conditions, the simplicity of establishing a company, the developed banking sector, EU conformity, the development of telecommunications, the avoidance of division of property in the case divorce, concealment of wealth etc. are the main reasons. The author considers offshore a necessary compulsion as well in the present global market competition, offering the only chance of survival for smaller national firms in the coexistence with multinational companies.

Readers will probably be surprised to read in the study that the largest tax haven in the world is the USA in terms of the annual number of company registrations. If a limited liability company founded in the State of Delaware does not pursue any activity in the USA, the owner is not a US resident and the place of business management is also abroad, the corporate tax for the company is a low fixed amount, its maintenance cost is minimal and it may apply the so-called flow-through taxation principle. At the same time, income from a US source is strictly taxed, together with the income earned abroad. Although the amendment entering into force on 24 February 2011 requires notification regarding the bank accounts of foreign-owned companies as well, it does not yet mean a real breakthrough in national taxation. The controversial nature of the situation is indicated by the fact that US firms are also present in the tax haven: 83 out of 100 listed US companies have registered affiliates therein.

While the opinion formed of offshore is rather negative all over the world, it would be a mistake to believe that the states that receive these firms do not benefit from their presence. As they do not pursue business activities, they do not impair the profitability of local enterprises, but they are significant sources of revenue for the receiving states, and, in addition,

they also create possibilities of employment. That is, only those countries do not have a share of the profit and have grounds to protest that do not participate in these international financial operations. These facts suggest that the operation of offshore firms can be restrained and 'forced' to domestic taxation only with single global regulation.

The study paints a detailed picture of various offshore firms, their foundation and the costs they incur as well as the techniques of their taxation and accounting, and their publicity. The study also analyses the special services of popular offshore centres like Hong Kong, the British Virgin Islands, Cyprus, the Cayman Islands, Dubai and Liechtenstein; it provides relatively detailed guidance as well, describing the precondition and techniques of opening a bank account.

The author provides a clear explanation to tax optimisation through international tax planning, i.e. the exploitation of the possibilities offered by international legal regulations. One example is the sale of the patent of a new method or new product, the licence right through an offshore firm, and another example is the financing of an investment from abroad through offshore firms. The objective of trading through offshore firms is to recognise the profit in a country where taxes are low. All the chapter points that describe irregularities in detail, for example, how individuals can legally access their money held offshore, or how a group of companies can redirect the profit of its affiliates to countries where taxes are lower, and at a much lower transfer price than the market price (at the accounting price between affiliates), minimising the tax to be paid, call the attention of readers to the unsustainability of the existing regulations.

Bilateral agreements between countries make the taxation of international transactions predictable and clear. Their goal is to avoid double taxation, which is implemented through exemption and imputation. The OECD examined the legal systems of individual countries on the basis of four criteria (no or nominal tax; prevention of the exchange of information; lack of transparency; absence of substantial activities), which it used for the classification of countries into as tax havens. 41 tax havens were found in 2000. Only 6 of them were willing to cooperate as regards the improvement of transparency and exchange of information (already 33 in 2007). The offshore financial centres were also identified on the basis of the relevant criteria (no tax at source; lax control; strong secrecy etc.), which, with one or two exceptions, classified tax havens as offshore financial centres as well. By 2009, already 38 tax havens indicated their intention to cooperate; only Andorra, Liechtenstein and Monaco refused to cooperate. Offshore firms trigger much criticism not only because of tax minimisation; it is even more dangerous that international terrorist organisations also use them for money laundering.

Two annexes close the study; one of them outlines the history of tax havens, whereas the other one lets the reader into the secret of the practical calculations of transfer price regulation, providing a complete picture of the operation of offshore firms. Although throughout the study it is suggested how unethical the operation of offshore firms is,[4] eventually nothing is told regarding the solution, how the principle of *national taxation*, which is also indicated in the title, could be enforced in order to have the taxes paid where the income was actually earned. Also missing is an explanation of *reshoring*, which appeared in recent years, and which repatriated numerous offshore firms mainly through the announcement of tax amnesty and the introduction of new regulations. All this shows that the solution lies in the favourable changing of the strict conditions and tax regulations that led to the evolution of tax havens and offshore firms.

The title of the last study, written by *Eszter Raciborski* and Gábor Kürthy, is REJTETT GAZDASÁG – KÉSZPÉNZIGÉNY (HIDDEN ECONOMY – CASH REQUIREMENTS). In Hungary, the notion of 'black economy' is better known than 'hidden economy'. Therefore, the authors attempt to characterise the latter, although we do not really receive an answer as to whether or when it is possible to use 'hidden economy' and 'black economy' as synonyms. [The study by Lackó (1995) contains a precise elaboration on this.] A review of the empirical estimations carried out to date should also be interesting, mainly from the aspect of the comparison between the calculations concerning the domestic hidden economy and the results of the study.

However, the subsequent theoretical outlook is less related to the main analysis of the study. The interpretation of the stylised model taken from the study by *Johnson – Kaufmann – Schleifer* (1997) is an especially head-splitting task for the reader. A number of questions arise. In Chart 1, for example, why does the rise of the straight line of the corporate mobility function exceed that of the straight line representing the portion of hidden economy as well as tax revenues and public goods? Thus, with the introduction of 'spider web' dynamics into this static model, equilibrium really is unstable. The interpretation of equilibrium is also missing here, i.e. that the labour market becomes clear at this point. Similarly, it is not worth burdening the reader with plausible assertions, such as 'as a result of taxation, hidden production expands at the expense of market production' (p. 166), or 'the entry and gaining ground of more competitive stakeholders force smaller market participants into bankruptcy or tax evasion to make ends meet' (ibid.). Obviously, the models concerned resulted in much more exciting findings, and the authors should have mentioned them.

The main objective of the study is to estimate the size of the domestic hidden economy for each year in the period between 2000 and 2008. The authors, similarly to others, carried out their estimates with the help of *Tanzi's* (1983) currency demand equation. Rightly, they set out from *Feige*'s (1986) study, but completely ignored the theoretical deduction given by the author and the relevant assumptions, which would have clearly led the reader to Tanzi's currency demand equation, together with its simplifying assumptions. Namely, those who do not know the studies by Feige and Tanzi, and would like to understand how to interpret the log-linear function on page 172, are recommended to read these studies in any case. In conformity with the tradition of the *Staff Papers* (IMF), they explain their theoretical and formalised deductions in a simple and crystal clear manner.

Tanzi (1983) estimated the changes in currency demand C as a proportion of M2 with explanatory proxy variables: the per capita income Y, the interest rate R paid on deposits, the WS/NI ratio of wages and salaries in the national income and income tax T. More exactly: he estimated the value of the $C/M2$ with the product function with certain exponent[5] of the explanatory variables; he linearised the product function with the help of the logarithm and provided it with an error term.

$$ln(C/M2)=a_0+a_1 ln(1+T)+a_2 lnWS/NI+ +a_3 lnP+a_4 lnY+\varepsilon$$

Given the time series of adequate length of the variables, regression estimate is used to determine the coefficients together with the standard error.

Hidden economy can be estimated as follows. Using the regression equations, the C/M2 ratio is calculated, then, knowing the values of M2, an estimate is calculated for the C' value of the currency demand for each year. In the next step, the T variable is assumed to be zero, whereas the coefficient of the other variables remains unchanged. C'' indicates the esti-

mated value of the resulting currency demand. The difference between C' and C'' shows the estimated holding of currency in individual years induced by the tax. In other words, it indicates the additional amount of currency that people hold because of the taxes, presumably in order to avoid them. Tanzi (1983) calls the difference 'illegal money'. ('Legal money' is shown by the difference between M1 and 'illegal money'.)

If the velocities of circulation of legal and illegal money are accepted to be identical, the GNP divided by legal currency holdings results in the uniform velocity of cash circulation. Multiplying that by the illegal cash holdings results in the estimated size of the hidden economy.

The authors follow exactly this calculation method, but in addition to the interest rate they take the price level, the value of purchases with bank cards, the official net amount of earnings and tax centralisation (tax type revenues/GDP) as a proxy of the explanatory variables.[6] Their findings show a slackening of the domestic hidden economy: while its estimated value amounted to 45.9 per cent of GDP in 2000, it declined to only 22.8 per cent by 2008. The first figure seems to be a little bit too high, but the average decline in the values shows that the domestic hidden economy is slackening.

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SUMMARY NOTES Primarily for those working in public finances and for economic politicians, the volume of essays and studies outlined (with minimum theory and mathematical deduction) an easily understandable and clear action programme in the labour market, tax policy and the reduction of the role of offshore havens and the hidden economy. The fundamental aim of the authors was to contribute with their analyses to the sustainability of the financeability of the Hungarian general government and to put forward proposals to help avoid national bankruptcy, while preserving the competitiveness of the Hungarian economy. Accordingly, the volume contains empirical analyses, although the individual studies briefly touch upon theoretical-econometric issues as well. The question is how much it deducts from the value of the book. To what extent can we agree with the theoretical economists who will miss the theory of corruption[7] or the matching theory of the labour market, etc.? If we accept, as several theoretical economists (Keynes, Kornai, etc.) did, that economic science has to set out from the examination of real issues, the book is recommended for studying from this aspect as well: numerous practical questions may receive theoretical approach and expounding from this volume. There are questions in economic science that really can only be answered with formalised theoretical mathematical deductions, and also there are ones (mainly related to economic policy) that can only and expressly be answered with logical arguments and not always with enumerating facts the reflect rationality. The majority of the studies here deal with the analysis of the latter issues, using logical and clear economic policy reasoning.

NOTES

[1] For more details, see Summers (1981) and Móczár (2008).

[2] In their remarks, the editors consider complete tax harmonisation (p. 63) excluded even over the long term. At the same time, their attitude towards the proposal of the EU on the common consolidated corporate tax base submitted on 16 March 2011 is not so rejecting, adding that Hungary, together with three other Member States, rejected its introduction. (p. 105)

[3] Later the author defines both tax paradise and offshore more precisely on the basis of the criteria given by the OECD.

[4] See the volume entitled Az offshore halála (Death of the offshore).

[5] This was Feige's (1986) first critical observation, because in his deduction the income tax may only be included in the estimate as an additive member.

6 In their regression equation, the sign of the logarithm is missing from before each variable, which may, of course, be a printing error.

[7] In a superficial wording, corruption is really the infamous "bundle of money handed over in a Nokia box", but the underlying reasons for corruption have s substantial body of theoretical literature. See, for example, Lackó (2006), Csekő (1992), Galasi – Kertesi (1987).

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