

József Papp

Freeing the hamstrung economy

T*he biggest problem of the Hungarian economy is that the heavily taxed white economy and the grey economy, which optimises tax payment by reducing it to the minimum, hamstring each other: “due to the funding needs of public expenditures that are excessive compared to the performance of the economy, high personal income tax and contributions should be paid. However, the SME sector is uncompetitive with prices that include all taxes and public dues payable on the wages of employees as required by law. Overtaxed households are also unable to pay for goods and services produced in the grey economy the price that includes all taxes and contributions! On top of that, those layers of the society that are unable to avoid tax payment must be heavily taxed because of the excessive size of the grey economy, the players of which hardly pay any taxes. And the grey economy is so swollen because of the unbearably high tax and contribution burdens!” (József Papp, 2006) Being so hamstrung makes the Hungarian economy uncompetitive and unable to grow.*

In this study I am going to prove that even if it wanted to, an average small Hungarian enterprise could not pay all the taxes and contributions, since it cannot produce as much added value as would be necessary to cover the employees' income, the expected profit of the entrepreneur, as well as all the deductions required by the state. Tax evasion is an objec-

tive necessity! In today's Hungary most employees of small and medium-sized companies – several hundreds of thousands of people – work in a two-channel wage system: they pay taxes on declared wages that are close to the minimum wage, and receive the other part of their earnings illegally, in cash. Enterprises can remain competitive only by maintaining this structure, which is beneficial for nobody.

At the same time, those players of the economy that could pay the high tax rates pay less than they should, or pay no tax at all. The highly productive multinational companies receive so much central support and tax benefits that their actual tax burden is significantly lower than the amount of taxes and contributions payable on the basis of the actual tax rates. What is more, the hidden economy has a much too big segment – first of all in the catering industry, trade, services to the population, agriculture and the construction industry – the players of which pay no taxes at all, although they would be able to do so.

With the help of a model I am going to prove that a radically transformed tax system that is based on the realities is able to free the hamstrung Hungarian economy, create a climate that can release the entrepreneurial energies suppressed by the current tax system, create the conditions for fast economic growth, and is

able to ensure the revenue sources of a reasonably reformed budget. In the new tax system the taxes and contributions payable on wages and enterprises would significantly decrease on one side. On the other side, though, the former VAT rate of 25 per cent would be reinstated, and a temporary wealth tax (not just property tax) would be introduced. Concurrently with easing the tax burdens of the enterprises, the sanctions on tax evasion must be drastically tightened: the general public should consider tax evasion a capital crime.

Today a growing number of people believe that it is inevitably necessary to reduce wage deductions and to radically transform the tax system. I am glad to see that this topic, which fundamentally influences our life and future, has become common talk. I hope that based on its novel approach, this study will be able to shed a new light on the basic issues to be solved and will help us find the right answers.

Only the thorough and deep analysis of the two-channel wage system can lead us to the specification of the optimum tax rates. Unfortunately, researchers have not yet analysed the phenomenon of illegal cash payments. This study is making the first steps on this way. I have been thinking for a long time about the responses of Hungarian enterprises to the challenges inherent in the high tax burden. I have interviewed a lot of entrepreneurs during the past years, I have studied and systemised pieces of news on illegal cash payments. This study combines these broad empirical experiences with the results of the corporate model presenting the changes of the tax system. The novelty of the study lies in the fact that it presents and justifies the macro-level consequences of the changes in the tax burden by modelling the volume and distribution of the GDP produced at micro-level, by the given company.

The new tax system proposed in this study is of course only one possibility to enable the

Hungarian economy to break out of its current, disgraced situation. Not necessarily the proposed measures, but some similar ones must be taken, there is no other way out. The sooner we set to it, the more successfully we will get through. If we are waiting until sufficient cover is accumulated in the budget for tax reduction, this type of tax reform will never be implemented!

UNBEARABLY HIGH TAX WEDGE

In the so called two-channel wage system, which has emerged in the SME sector out of necessity, employees are compensated for their work in the form of taxed (declared) wage and illegal cash payments. This is a reality that even the tax authority is perfectly aware of. Although the tax authority is using increasingly efficient methods in its fight, it cannot eliminate the phenomenon of illegal cash payments. The reason behind this is that for a majority of enterprises engaged in this practice, the unlawfulness manifesting in tax evasion is an objective necessity: due to their insufficient income generating ability they must give part of the wages untaxed, otherwise they would go bankrupt. And if they went bankrupt, their employees that have little value on the labour market would end up on the street. The state knows it well, too, this is why the legal sanctions that can be imposed on fictitious invoicing (which makes cash payments possible), and on the underlying bogus company schemes are rather “entrepreneur-friendly”, and have no deterring effect. In Hungary there are thousands of transactions every day in which the entrepreneurs in need purchase fictitious invoices in order to withdraw money from the company to cover in part or in full the employees' wages (and/or their own profits, or the bribe money inevitable for getting by).

But what does fictitious invoicing actually

mean? To understand it, let us first see how the channels of legal withdrawals work. One can legally withdraw money from a company only in two ways: as wage income or in the form of owner's profit (dividend). The tax burden on wage withdrawal is unbearable for many enterprises, and this is the biggest problem of the Hungarian economy. *Table 1* provides an overview of the current rates of taxes and contributions payable on wages.

The employer pays a contribution of 33.5 per cent on the gross wage. In addition, the personal income tax of 18 to 36 per cent, as well as the employee contribution of 17 per cent are deducted from the gross wage. Low gross wages make the earners eligible for tax credit, equalling HUF 11,340 per month if the annual income is below HUF 1,250,000. From the income falling between this amount and HUF 2,762,000 nine per cent can be accounted as tax credit each year. High-income private individuals must pay a four per cent solidarity tax on their income portion above the HUF 7,137,000 limit.

Today it is almost commonplace that "...from among the OECD member states only Belgium imposed higher taxes on wage incomes than Hungary. The Hungarian figure

is especially noteworthy in the light that the deduction rate is outstandingly high compared to the competitors of the region – and usually the lower income OECD member states. Therefore, from among the Visegrád countries Hungary can boast with the smallest net wages. (See *Chart 1*)

The tax and contribution burden (the so called tax wedge) accounted for 54.4 per cent of all labour costs in Hungary. The figures of the comprehensive OECD study show: the tax burden is 10 to 15 per cent higher than in the other countries of the region." (Portfolio.hu, 2008)

According to *Lajos Bokros*, the unbearable size of the tax wedge is the biggest obstacle to economic growth.

"The literature on taxation calls the ratio of all public dues payable on the net wage and the entire wage costs tax wedge. This indicator is significant since it influences market behaviour; it fundamentally influences the behaviour of both the employer and the employee. The employee is first of all interested in the net wage, i.e. the income in hand, while the employer is interested in the gross wage.

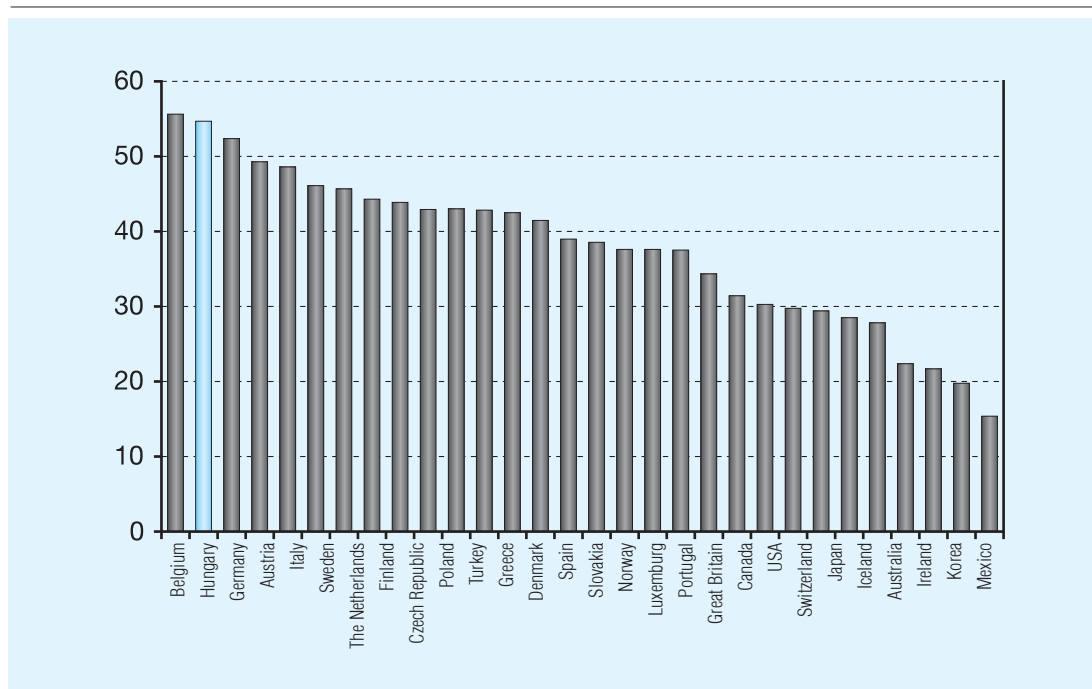
The tax wedge is extremely high in Hungary. Considering an average PIT of 24 per cent, and

Table 1

WAGE DEDUCTIONS	
(per cent)	
PIT tax rate, if the annual gross wage is less than HUF 1,700,000	18.0
PIT tax rate, if the annual gross wage is more than HUF 1,700,000	36.0
Employee contributions	17.0
Pension contribution	9.5
Healthcare contribution	6.0
Employee contribution	1.5
Tax credit/month (HUF)	11,340
Contributions payable by the employer	33.5
Pension contribution	24.0
Healthcare contribution	5.0
Employers taxes	3.0
Vocational training contribution	1.5
Flat-rate healthcare contribution (HUF)	1,950

TAX WEDGE IN THE OECD COUNTRIES

(per cent)



Source: OECD, Portfolio.hu

calculating with the employer contribution of 32 per cent and the employee contribution of 17 per cent, as well as with a certain average of the flat-rate healthcare contribution, the tax wedge equals 56 per cent. In the case of citizens who also pay solidarity tax, this value grows to 66 per cent, which means that the tax system deducts two thirds of the income equalling the gross wage costs. Their employment costs three times more for the employer than the income they finally receive. This high tax wedge – which already affects the majority of middle-class incomes – can in no way encourage employees to work more, or to encourage employers to create more jobs.” (Lajos Bokros, 2008)

For an average Hungarian small enterprise the excessive tax wedge makes the withdrawal of wages unbearably expensive. The payment of a net wage of one Forint would require the production of an added value 1.5–2 times that

size in order to pay the wages and the related contributions.

Dividends are a cheaper way of withdrawal: dividend can be paid by paying the 25 per cent dividend tax on the after-tax profit (16 per cent corporate income tax and 4 per cent solidarity tax). The tax wedge of capital income is only 40 per cent, i.e. relatively low compared to wage income, yet this option is seldom used instead of the withdrawal of wage income. Earlier it was set aside because the dividend had to be projected on the equity of the enterprise, and if that ratio was higher than twice the central bank's basic interest rate, the dividend above that value was taxed practically to the same extent as wages. This provision was revoked, however due to the tightening of anti-money laundering regulations and the threat of wealth gain investigations few entrepreneurs undertake to pay cash to their employees from divi-

dends due to the risk inherent in the regular withdrawal of large amounts of cash. Once the risk exists, they prefer the illegal channel of cash withdrawal, i.e. fictitious invoicing, which implies temptingly low tax burdens.

TWO-CHANNEL WAGE PAYMENT

The owner or the managing director thus withdraws the cover of wages paid in cash as the countervalue of the fictitious invoices, by way of fraud. The issuer of the fictitious invoice that is usually paid by bank transfer and not in cash returns the greater part of the money (gross invoice value minus VAT) to the owner of the enterprise in cash, who can use this money to pay part of the employees' wages in cash. Naturally, the VAT computed on the fictitious invoice is deducted from the VAT to be paid to the budget. In reality, the issuer of the fictitious invoice (which can be an overinvoiced part of a real invoice, but then the issuer of the invoice must buy a fictitious invoice to cover the overinvoiced part) does not provide any real service to the recipient of the invoice, other than making cheap and illegal cash withdrawal possible. The price for this "service" is usually 10 per cent of the net invoice value. If the entrepreneur does not pay the VAT either, the profit of the issuer of the fictitious invoice from the transaction equals 30 per cent of the net invoice value. This is a temptingly easy way of making money, thousands of people get rich on it despite the fact that conducting this business implies serious risks due to being illegal.

Nonetheless, fictitious invoicing does not primarily constitute VAT and corporate income tax frauds (naturally, those crimes are also involved), as it is suggested by the media and treated by the authorities.

[The National Bureau of Investigation started investigating the company headed by István Sz. after a bank reported a suspected money-laun-

dering case. Later it turned out that Sz. and his accomplices had established several companies in the names of homeless people, foreigners and jobless people who once saw better days with the help of lawyers (and an apprentice lawyer). These construction, machinery part trading and cleaning companies that existed merely on paper issued fictitious invoices for anybody for VAT reclaims or the reduction of the corporate income tax base.] (Attila Fekete Gy., 2007)

"Entrepreneurs buy such "services" not to hide their profits but to withdraw the money they give their employees in cash with the smallest possible burden". (József Papp, 2007) The "tax wedge" of fictitious invoicing is unbeatably low compared to the unbearably high dues payable on wages or even dividends.

Table 2 presents the operation of the two-channel wage system and the savings that can be achieved by its use. The declared monthly gross wage of the employee is HUF 140,000, plus he receives a net cash payment of HUF 50,000 from the owner of the enterprise. The first column of the table calculates the dues of the two-channel system and the actual net earnings, while the second column shows the gross wage and the public dues for the same net wage if all taxes and contributions were paid.

The savings are shocking: assuming average wages, the company can save HUF 108,663 a month per employee using the above-mentioned two-channel scheme. (In 2007, the average monthly gross wage in the competitive sector was HUF 177,376, excluding, naturally, the cash payments.) By evading the enormous tax wedge implied in legal wage payment, the entrepreneur, i.e. the employer of the employee maintains a wage system that is illegal, however the implied tax wedge is only 39 per cent, which practically corresponds to the dues payable on dividends. This means that the tax and contribution savings so achieved equal almost twice the net invoice value of the fictitious invoice accounted in the books.

Table 2

SAVINGS ON WAGES PAID IN CASH

	Two-channel wage system	Wages with all taxes paid at the current rates
Costs of purchasing fictitious invoices as a percentage of the net invoice value, %	10.0	0.0
Average monthly gross wage per person (HUF)	140,000	263,011
Employee's dues	23,800	44,712
Tax credit	8,115	0
Actual PIT	17,085	69,184
Actual PIT rate, %	12.2	26.3
Net wage	99,115	149,115
Wage supplement in cash	50,000	0
Total actual net wage income	149,115	149,115
Employer's contribution burdens	48,850	90,059
Net value of the fictitious invoice needed for the withdrawal of the wage supplement	55,556	0
Costs of purchasing fictitious invoices	5,556	0
Actual burdens of the employer	104,406	90,059
Total costs of employment	244,406	353,069
Structure of the costs of employment, %	100.0	100.0
Total net wage income, %	61.0	42.2
Total dues payable, %	39.0	57.8
Contributions and taxes, %	36.7	57.8
Costs of cash withdrawal, %	2.3	0.0

But who benefits from these savings? Is it the tax evading entrepreneur, or nobody, since these savings are only virtual savings given the fact that due to the low level of productivity the enterprise is unable to produce the added value that would serve as a cover for these savings, and this is what forces the owner to be engaged in fictitious invoicing. Unfortunately, in the overwhelming majority of the companies this the case: the average Hungarian entrepreneur cannot compete at a price that would cover all costs, including all wage related costs and contributions. As the well-known IT entrepreneur Pál Vadász complained in a lecture: “the market is not willing to pay these prices”. (Pál Vadász, 2006)

With *Tables 3* and *4* Pál Vadász proves that even the IT sector, which produces high added value, is unable to set prices that are sufficient to pay all wage related costs.

If the entrepreneur paid all dues, he would hardly have any margin for other costs, not to mention his profits. Naturally, Vadász is not saying that fictitious invoices must be bought, but rather that dues should be reduced. However, the memorable scandals of the IT sector testify about the fact that even listed IT companies, such as Synergon Rt, apply the practice of fictitious invoicing extensively.

“In its appealable ruling announced on Tuesday the Court of the City of Pécs found Tibor Vagyon, the figurehead of the infamous

Table 3

CAN WAGE COSTS BE OFFSET BY PRODUCTION	
Average invoiced hourly fee of IT professionals on the market	HUF 9,000/hour
Expected net hourly fee of IT professionals	HUF 3,000/hour
No. of working hours/month	160 hour
Net amount payable	HUF 480,000
Related gross wage	HUF 910,000
Employer's per capita total costs*	HUF 1,216,800
Sales revenues produced by the employee*	HUF 1,440,000
GROSS MARGIN	15,5%

* 84,5% of the prodedced sales revenue (margin) represents wage costs!

Table 4

WHEN WOULD THESE PUBLIC DUES BE BEARABLE?	
Average invoiced hourly fee of IT professionals on the market	HUF 13 500/hour*
Expected net hourly fee of IT professionals	HUF 3 000/hour
No. of working hours/month	160 hour
Net amount payable	HUF 480 000
Related gross wage	HUF 910 000
Employer's per capita total costs	HUF 1 216 800
Sales revenues produced by the employee	HUF* 2 160 000*
GROSS MARGIN	56,3%

* With the currnt public dues an average invoiced hourly fee of HUF 13,500 would be needed instead of the hourly fee of HUF 9,000!

Source: Pál Vadász: The emperor is naked or can wage costs be offset by production? Roving conference of economists, Nyíregyháza, 2006

company group known as the Pécs invoice factory guilty in committing businesslike, cumulative fraud causing especially great damage, and sentenced him to seven years in prison. His accomplice, who was the defendant in the second degree out of the 27 defendants in the criminal proceeding was sentenced to three years in prison. According to the Court, the prosecution proved that the state had suffered a loss of nearly HUF 1 billion due to the use of fictitious invoices issued on various activities and in various amounts by companies belonging to Tibor Vagyon's invoice factory between 1997 and 2000. According to the court, nearly two-thirds of the fictitious invoices were accepted by Synergon Rt. The prosecution brought charges against several managers of the com-

pany, however the court acquitted all of them but former CEO Zsolt Szalóczy from the charges. Szalóczy was sentenced to five years of imprisonment and a fine of HUF 2 million. Furthermore, he was deprived of his basic rights for several years, as well as of the right to hold leading positions in any business organisation. Then, without the motion of the prosecution, the court ordered his pre-trial detention due to the gravity of the sentence.” (Attila Fekete Gy., 2003)

At the time of the case Synergon Rt. employed over 300 employees. And although the company flourished, and kept receiving juicy assignments, paying the wages of so many highly qualified IT specialists while paying all taxes legally caused a problem even for the star company.

THE GDP IS NOT SUFFICIENT FOR THE PAYMENT OF ALL TAXES AND CONTRIBUTIONS

The application of the two-channel wage system in the small and medium-sized sector having a low productivity is the precondition for survival. In these companies the GDP per employee is painfully low, it is less than half of the average value of HUF 8.515.000/employee/year measured in 2006. (See Chart 2)

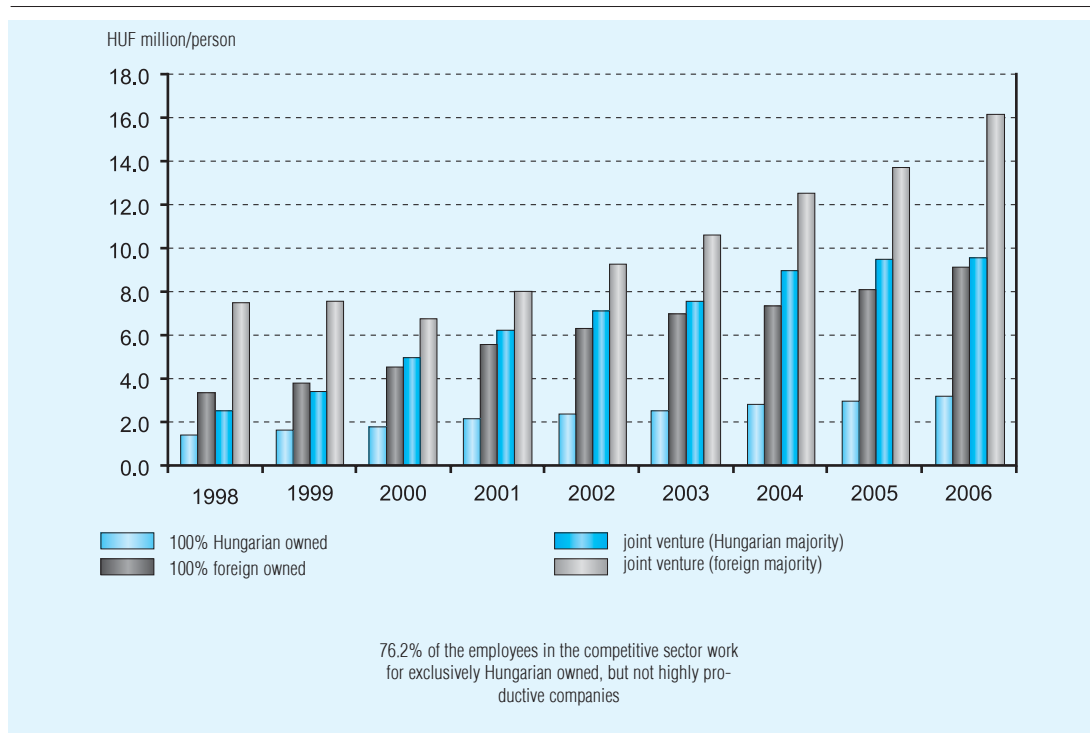
The research conducted by Zoltán Pitti extensively supports the assumption according to which the Hungarian economy is divided to the extreme, and shows a dual structure. The income generating ability of Hungarian owned companies – practically the SME sector – is only a fraction of the income generating

ability of foreign owned companies. According to Pitti, the situation is simply catastrophic compared to the EU average: “...there are 1,250,000 businesses for the 5 million active Hungarian citizens, but one third of these businesses do not operate. The 600 limited partnerships and private entrepreneurs produce only 4.5 per cent of the GDP. [...] In Hungary, performance per employee equals only one third of the EU average, but in the case of partnerships owned exclusively by Hungarians, this ratio is only 15 per cent. At the same time, these companies employ 76 per cent of Hungarian employees. As much as 57 per cent of new entrants to the labour market have qualifications, the remaining 43 per cent are trying to get by without them.” (Origo.hu, 2008)

Chart 2

ADDED VALUE PER EMPLOYEE AT HUNGARIAN COMPANIES

(1998–2006)



Source: Zoltán Pitti: The role of innovative enterprises in the implementation of the economic policy objectives, Interim report on research carried out in 2007 and 2008 by the Prime Minister's Office and the Hungarian Academy of Sciences, Hungarian Academy of Sciences, 2008

Due to the low productivity of Hungarian owned enterprises this sector is simply unable to generate as much GDP as it would be necessary for paying all expected taxes and contributions. In the following we model that an average small enterprise employing twenty persons (Company A) is unable to pay all dues even if its productivity exceeds the sector specific average productivity rate. Let us assume that the two-channel wages presented in Table 2 present the average earning relations of the enterprise. This company pays each employee an average monthly gross wage of HUF 140,000 plus HUF 50,000 in cash on average. (Of course, there can be employees on whose wages all dues are paid, and there can be others who get all of their wages in cash. Pitti's words also explain why employees receiving part or the entirety of their income in cash do not object to the fact that little or no contribution is paid for them, which jeopardises their future pension benefits. They do not protest because due their low level of qualification their labour market position is so weak that they are employed only if they accept the conditions of the unfavourable two-channel wage system.)

The model presented in Table 5 counts with the fact that the GDP produced by an employee of Company A equals 60 per cent of the national average, which is significantly higher than the average production of Hungarian owned enterprises. The entrepreneur should use the GDP of HUF 102 million to pay the wages, the accompanying contributions and other taxes (VAT, corporate income tax, solidarity tax, dividend tax, local business tax), the owner's withdrawals (dividends) – as well as banking costs – and for accumulation, investments and development. Putting it simple, the GDP produced by the company is the difference between the gross revenues and the gross value of purchased goods and services. The model calculates the corporate income tax and the dividend tax on the basis of the current tax

rates, provided that the owner of the company withdraws all after-tax earnings as dividend, and reinvests nothing. In the first column the model shows the GDP produced by the company according to wages paid in the two-channel wage system. The second column shows the situation that would occur if all dues were also paid on the net cash payments. The bottom part of the table shows the distribution of the GDP among net wages, all dues paid and owner's withdrawals. (In the model the deductions include the dues on wages, the VAT, the corporate income tax, the solidarity tax and the dividend tax.)

By studying the results of the model we may draw several conclusions. By purchasing fictitious invoices in the amount of HUF 13.3 million, Company A can save twice as much on the costs of employment, since it pays less wage related taxes and contributions. Should it act otherwise, it would practically have no profits at all. With the given income generating ability the owner of the company can realise profits only by evading taxes and forcing his employees to do so, too. It is terrifying even to think that if Company A paid all taxes, the state would deduct 65 per cent of the GDP it generated! This is mere nonsense!

Profit maximisation – the goal of entrepreneurial activities – can only be achieved by the introduction of the two-channel wage system. However, the remaining income is still insufficient for development, investments or for the creation of the conditions for growth. There is no doubt that the unbearable size of wage related taxes and contributions is the largest obstacle to the growth of the Hungarian economy!

(It is worth noting that the official value of the GDP per employee indicated in the model is much lower in reality if private entrepreneurs and self-employed micro-enterprises are also listed among employees. In their noteworthy study titled “How did we get here: Hungarian budget 2000–2006” László

Table 5

DISTRIBUTION OF THE GDP PRODUCED BY COMPANY A

	Two-channel wage system	Fully taxed wages at the current rates
Costs of purchasing fictitious invoices as a percentage of the net invoice value, %	10.0	0.0
Corporate income tax and solidarity tax, %	20.0	20.0
Dividend tax, %	25.0	25.0
VAT, %	20.0	20.0
Average monthly gross wage per person (HUF)	140,000	263,011
Wage supplement in cash	50,000	0
Total actual net wage income	149,115	149,115
Total costs of employment	244,406	353,069
GDP per employee in Hungary in 2006 (HUF thousand)	8,515	8,515
Number of employees	20	20
GDP per employee at the company relative to the national average in Hungary in 2006, %	60.0	60.0
Gross added value (GDP)	102,180,000	102,180,000
Total costs of employment/year	58,657,333	84,736,609
Net after-tax wage	23,787,600	35,787,600
Total contributions and taxes	21,536,400	48,949,009
Net value of the purchased fictitious invoices	13,333,333	0
Part of the revenue that remains after the deduction of costs other than employment costs (net added value)	85,150,000	85,150,000
Payable VAT=VAT of the added value	17,030,000	17,030,000
Pre-tax profit	26,492,667	413,391
Corporate income tax and solidarity tax	5,298,533	82,678
Profit and loss according to the balance sheet	21,194,133	330,713
Dividend tax	5,298,533	82,678
Owner's withdrawal (taxed dividend)	15,895,600	248,035
Total taxes and contributions	49,163,467	66,144,365
Distribution of the gross added value, %	100.0	100.0
Taxes and contributions, %	48.1	64.7
Total net wage income, %	35.0	35.0
Owner's withdrawal, %	15.6	0.2
Commissions paid to fictitious invoice issuers, %	1.3	0.0

Ohnsorge–Szabó László and *Balázs Rombányi* estimate this value to be HUF 4,966 million. If this is true, the statement according to which the average Hungarian small enterprise cannot produce as much GDP as would be necessary to pay all dues on wage income is even more relevant!)

With the help of the model it is worth scrutinizing the problem of the IT sector – which produces high added value – described by Pál Vadász. *Table 6* presents the GDP produced by Company *B*. Company *B* employs 50 employees and pays an average gross wage of HUF 350,000 and HUF 250,000 in cash to each

Table 6

DISTRIBUTION OF THE GDP PRODUCED BY COMPANY B

	Two-channel wage system	Fully taxed wages at the current rates
Costs of purchasing fictitious invoices as a percentage of the net invoice value, %	10.0	0.0
Average monthly gross wage per person (HUF)	350,000	881,915
Wage supplement in cash	250,000	0
Total actual net wage income	440,000	440,000
Total costs of employment	746,978	1,179,306
GDP per employee in Hungary in,2006 (HUF thousand)	8,515	8,515
Number of employees	50	50
GDP per employee at the company relative to the national average in Hungary in,2006, %	180.0	180.0
Gross added value (GDP)	766,350,000	766,350,000
Total costs of employment/year	448,186,667	707,583,830
Net after-tax wage	114,000,000	264,000,000
Total contributions and taxes	167,520,000	443,583,830
Net value of the purchased fictitious invoices	166,666,667	0
Part of the revenue that remains after the deduction of costs other than employment costs (net added value)	638,625,000	638,625,000
Payable VAT=VAT of the added value	127,725,000	127,725,000
Pre-tax profit	190,438,333	-68,958,830
Corporate income tax and solidarity tax	38,087,667	0
Profit and loss according to the balance sheet	152,350,667	-68,958,830
Dividend tax	38,087,667	0
Owner's withdrawal (taxed dividend)	114,263,000	0
Total contributions and taxes	371,420,333	571,308,830
GDP deficit=required loan from the owners	0	68,958,830
Required GDP	766,350,000	835,308,830
Distribution of the gross added value, %	100.0	100.0
Taxes and contributions, %	48.5	68.4
Total net wage income, %	34.4	31.6
Owner's withdrawal, %	14.9	0.0
Commissions paid to fictitious invoice issuers, %	2.2	0.0

employee. This more or less equals the expected net income of HUF 480,000 stated in Vadász's presentation. The per capita GDP (180 per cent of the national average) is also close to the HUF 15 million shown in the presentation.

The table shows that if Company B paid the gross wage of the expected net income

and all the related contributions, it would incur a loss or nearly HUF 70 million. Therefore, the model had to be expanded with the “loan from the owners” variable used for compensating the incurred loss. This means that in order to enable Company B to meet all of its tax and contribution payment obligations, the owner would be required to

provide a loan to the company. This is nonsense! What is more, the net income and the share it represents in the GDP is lower than that indicated in the table, since the model did not calculate with the four per cent solidarity tax payable on the monthly gross salary of HUF 881,915.

The fact that the entrepreneur should use his savings or take out a loan in order to be able to pay all taxes, beats even the 'clockwork with zero efficiency', a snappy metaphor coined by Péter Mihályi to illustrate that the tax system is nothing but an end in itself. "It is worth recalling Ferenc Jánosy's parable that he told in the well-known debate of the Petőfi Circle in 1956 on the relationship between the coal mines and the power plants. The mines give coal to the power plants, and in return the power plants give electricity to the mines. The then-existing Hungarian situation was close to the extreme possibility when the mines with low efficiency and the power plants with equally low efficiency served only each other. Thus, "the efficiency of the entire clockwork is zero – concluded Jánosy -, since it gives nothing to the external world". (Péter Mihályi, 2008)

ISSUERS OF FICTITIOUS INVOICES

It is known that the buyers mostly include Hungarian small and medium-sized entrepreneurs, however foreign owned companies are also engaged in more sophisticated ways of fictitious invoicing. But who are the issuers of the fictitious invoices? When setting up the categories I used my experiences gained while studying the SME sector for decades, as well as the works of the staff members of the National Bank of Hungary, Judit Krekó and Gábor P. Kiss. (See Table 7)

The table shows that tax payment can be evaded in two ways: either by using fictitious invoices, or by rendering performance without giving an invoice. Under fictitious invoicing I mean the writing-off of private consumption as costs, and part of the transfer prices of multinational companies that result in taking the profits produced in Hungary to countries with more favourable tax rates. Untaxed income withdrawn with the help of fictitious invoices forms part of the GDP observed by the HCSO, while non-invoiced performance is treated as non-observed economy (abbreviated

Table 7

TYPES OF TAX EVASION

VAT fraud	<ol style="list-style-type: none"> 1. Concealed consumption through the connivance of the entrepreneur and the buyer (non-invoiced performance) 2. Concealment of imports 3. Illegal VAT reclaim
Evasion of taxes on wage income	<ol style="list-style-type: none"> 1. Concealment of employee incomes: illegal work, or under-declared wages (partial cash payments) 2. Accounting of wage income as capital income (e.g. bogus contracts)
Evasion of taxes on capital income	<ol style="list-style-type: none"> 1. Companies: tax-base reduction, accounting private consumption as costs 2. Tax evasion by foreign owned companies (regrouping of incomes, e.g. through financing and transfer prices) 3. Concealment of capital income: on the basis of concealed entrepreneurial revenues (non-invoiced performance)

Source: Judit Krekó- Gábor P. Kiss: Tax evasion and the Hungarian tax system, Institute of Economics, Hungarian Academy of Sciences, Seminars, 2008

as NOE in international use) by economic statistics. (Report of the committee examining the whitening of the economy, February 2008, www.mkt.hu,)

Money withdrawn with the help of fictitious invoices and the GDP produced by way of non-invoiced transactions go to the final income owner's pocket in the form of wage income or capital income independent of the fact that the withdrawn income gets from the company to the private individual as a result of a VAT fraud or in any other manner. The category of the given "black" income depends on the disposition of the final income owner. The fictitious invoice factories that return 90 per cent of the net invoice value to the private individual representative of the recipient of the invoice and get the VAT and 10 per cent of the net invoice value in return, can dispose of 25 per cent of the untaxed part of the GDP produced by the invoice recipient if they do not pay the VAT to the state. This money is withdrawn from the banks by the bogus owners and managing directors of the invoice factories, and is transferred to the actual operator of the fictitious invoice scheme for some compensation (labour income). The latter receives income under both legal titles, since the invoice factory is in fact his enterprise.

Clarifying the final position of the income owner in the different categories of fictitious invoicing is important because this is the only way to assess unrealised budget revenues. The loss is different if someone gets illegal money as labour income, or in the form of capital income. (In the latter case the loss is much less.) I would like to refer back to the index of the tax wedge: in the case of gross wage income (that includes taxes and contributions, too), the loss is 56 per cent, while in the case of capital income, which includes the corporate income tax and the dividend tax, the loss is 40 per cent. The actual size of unrealised budgetary revenues can be obtained by quantifying

the tax wedges of illegal incomes based on the estimates. In other words, we answer the following question: How would the final income owners and the state have shared the illegally produced GDP if all taxes and contributions had been paid? (See Table 8)

However, it is worth examining the virtual loss of the state, since the comparison of the actual and virtual losses may lead to conclusions indispensable for freeing the hamstrung economy. In my opinion virtual budgetary losses can be obtained if we consider the entire illegal income net, and we calculate the accompanying taxes and contributions conversely. I would also like to remind you that taxes and contributions account for one and a half or two times the net wage income, while the dues on the net capital income equal 60 per cent.

Before analysing the correlations between the actual and virtual losses, let us consider the different types of fictitious invoicing.

Classic invoice factories

Bogus or fictitious companies in the sense that their owners and managing directors are inaccessible for the authorities (foreigners, homeless people, etc.), or even if they are accessible, they have no enforceable assets with which the damage caused could be reimbursed. In an invoice factory the money paid for the invoice is withdrawn, wherefore it has deficits in its books, and consequently it must vanish into thin air. This means that since the authorities cannot find the company at its registered office and both the managing directors and owners are inaccessible, the court of registration will delete the company from the company register, and the company will sooner or later be liquidated. The tax arrears of a company with no assets cannot be collected, and the owners and managers thereof can be convicted only in a tiresome process. Anyway, fictitious invoicing

is sanctioned rather mildly, and the corporate procedural rules – although they have become much stringent – still allow for establishing such firms and making them bogus. The number of liquidations is extremely high in Hungary. Although investigating this fact does not belong to the scope of this study, we cannot be wrong if we say that it can be explained with the large number of invoice factories. The real invoice factory operators know it well: their operational risk is reduced if their factory functions only for a short time, after which they let it go down the drain and establish a new company.

“The commissioning companies, which reduced their tax bases with the help of the invoice factory, signed a contract with one of the bogus companies owned by István Sz. and his partners, and then, “after the work was completed”, transferred the cost of the work. The recipient company transferred the amount right away to another (intermediary) bogus company, and that company to a third one, the “managing director” of which withdrew the money in cash. The role of the middlemen ended here. Sz. and his accomplices deducted the “fees” they were eligible for, and returned the rest of the money to the managers and owners of the commissioning company. According to the data of the National Bureau of Investigation, in the past two years more than HUF 3 billion was withdrawn in cash from the accounts of the fifty companies under inspection”. (Attila Gy. Fekete, 2007)

The invoice is usually issued for a fictitious activity the performance of which is difficult to be checked by the authorities: earthworks, education, consultancy, cleaning, advertising, etc. Since anti-money laundering legal regulations have become more stringent, the risk is higher when withdrawing higher amounts of cash from the banks. Sooner or later regular withdrawals become suspicious, which is

another cause for establishing newer and newer companies.

The primary buyers of invoice factory products are entrepreneurs that are forced to run a two-channel wage system, wherefore most of the money equalling the countervalue of the invoice and withdrawn in cash is wage income. From the GDP of HUF 300 billion that – according to my estimates – reaches the final revenue owner through the invoice factories untaxed, at least HUF 160 billion should be paid to the state. However, due to the low level of productivity, its enforceability is very questionable. On paper hundreds of thousands of people live only a little over the subsistence level just because they do not pay taxes on a significant portion of their net income. The size of the state's virtual losses (HUF 400 billion) represents the deficit in the GDP the production of which would be necessary to pay the taxes on the net incomes. The illegal institution of fictitious invoicing can be eliminated only with significant economic growth!

Companies paying the simplified entrepreneurial tax

By paying the simplified entrepreneurial tax, which currently equals 25 per cent of the gross revenues, the enterprise redeems all other taxes (provided the contribution payment obligations are fulfilled in another legal relationship.) When introduced, this apparently low rate tax seemed to be beneficial, but in fact it takes more away and gives less to the state. The fact is that a lot of companies paying the simplified entrepreneurial tax bind their extra capacities (the gross revenue potential between the actual turnover and the upper limit of HUF 25 million) with fictitious invoices. For a commission they help peer companies withdraw money without paying taxes, practically at no risk. Since the simplified entrepreneurial tax related

to the fictitious invoices is paid, the tax authority is no longer interested in investigating the fact of fictitiousness, its capacities are absorbed by other activities that are deemed to be more important.

In 2007 as much as HUF 152 billion was paid as simplified entrepreneurial tax. It is easy to calculate that last year the gross sales revenues of companies paying the simplified entrepreneurial tax evidently exceeded HUF 600 billion. If we assume that one fourth of it – HUF 150 billion – was used for the withdrawal of income produced in other enterprises, mostly as wage income, then the virtual loss of the state exceeds the amount that the state could collect from this tax type.

However, the ratio of income withdrawn with the help of invoices from companies paying simplified entrepreneurial tax is rather underestimated. This tax type (and the lack of risks in the concomitant fictitious invoicing), as well as the tax exemption of the minimum wage played a key role in that the two-channel wage system could become a general practice in the SME sector. “Although earlier there were some conflicts between the employer and the employee regarding the wages, today there is full agreement about the fact – in all companies but the Hungarian subsidiaries of several hundreds of multinational companies – that the entrepreneur and his employee (the two are often the same person) can peacefully coexist by setting the ratio of declared income and cash payments right.” (István Csillag, 2008)

István Csillag's lamentation is justified, yet unpleasant, since he was a member of the government that introduced the tax exemption of the minimum wage and the simplified entrepreneurial tax, and thus legalised the two-channel wage system instead of implementing a tax reform adequate for the performance of the SME sector.

Companies engaged in non-invoice based activities that are compelled to show expected revenues

Under the increasingly stringent tax rules – first of all under the threat of wealth gain investigations – more and more companies that generate revenues without issuing invoices are compelled to make sure that they present a turnover acceptable by the tax authority. However, this goal is mostly achieved by selling fictitious invoices and not with real transactions. The accountant of the seller and the buyer is usually the same person or company. The accountant coordinates the process, he/she knows which client has failed to issue enough invoices, and which client needs to receive invoices. The companies make sure to pay the VAT. This form of fictitious invoicing is practically risk-free, since no tax auditor could reveal the fictitious nature of such transactions.

The issuer of the fictitious invoice still does not need to enter the real turnover in his books, while he can deduct costs and on top of that he can make money on the transactions. The buyer of the invoice does not need to worry either, since the origin of the funds so withdrawn is known only to the accountant and the seller. And apart from getting extra earnings, the accountant ties his clients to himself/herself with these confidential services.

I assume that this form of fictitious invoicing is also mainly used for withdrawing wage incomes, and therefore the state incurs heavy losses. It is practically impossible to fight against it successfully, since the strong interests shared by the entities involved cover the scheme with an unpenetrable shield.

Off-shore companies

Earlier off-shoring was exclusively used by foreign owned companies with developed tax

planning schemes. However, today an increasing number of Hungarian owned companies allow themselves the “luxury” of having a supplier or owner registered in a tax heaven. The supply performance of off-shore companies is often completely fictitious, the value of the invoices they issue is often transferred to a bank account that ensures full anonymity for the actual owners, and from which the final owner can receive wage or capital income with minimum losses.

“Magyar Telekom is unable to present the annual report and the audited balance, because its auditor, the international auditing company PriceWaterhouseCoopers (PWC) is not willing to countersign it. Instead, the auditing company launched a proceeding against a subsidiary of the company, Telekom Montenegro, in connection with two consultancy contracts having a total value of HUF 700 million, which were signed irregularly according to the auditing firm. According to media information, the money spent on market research contracts could have been transferred to off-shore companies. What is more, the contract itself was signed with an off-shore company: it is possible that the paid amounts are not proportionate to the work performed, but the case may also involve the payment of lobby funds or tax evasion.” (Index, 2006)

While earlier off-shore companies represented a tool for withdrawing capital income, today they are increasingly used for hiding wage-income type funds from the tax authorities. Due to the lax accounting discipline of companies registered in tax heavens, the banking cards of off-shore companies can be used for paying for private consumption in Hungary and abroad alike, for withdrawing cash and accounting it as costs with fictitious invoices. The institution of off-shore companies practically questions the point of wealth gain investigations. However, the fight against it requires international cooperation across the continents. The European

Commission wants to become the engine of this fight. “In his statement given to Austrian newspapers, László Kovács also said that as a result of the tax conflict between Germany and Liechtenstein, he would submit to the Commission the expert opinion describing the new interest tax directive – which also addresses the issue of how tax embezzlements could be combated more efficiently – sooner than planned, already in May instead of the end of the year.” (NAPI Online, 2008)

Multinational companies that withdraw income exceeding the equitable profit margin by incorporating such income into the transfer prices

Invoicing among the subsidiaries of multinational companies is a favourite target of the tax authorities. Although the methodology of inspections has been significantly refined, foreign owned companies can still significantly regroup their revenues by exploiting the possibilities inherent in this invoicing practice, and take such revenues into countries that have the most favourable tax rates. A considerable part of the profit generated in the subsidiary is incorporated into the transfer prices, and is taken out of the country by transforming it into account carrying charges, often into tax heavens, where practically no tax has to be paid on such income. The entirety of this income represents untaxed capital income. Since companies that take profit out of the country do not pay dividend taxes in Hungary, they can “only” save on the corporate income tax: the estimated savings of HUF 100 billion also lead to a significant deficit in the state budget.

Apart from applying the complicated system of transfer prices efficiently, foreign owned companies do not despise using more aggressive tools of tax optimisation, such as invoice factory services.

8. táblázat

THE ESTIMATED VOLUME OF FICTITIOUS INVOICING

(HUF billion/year)

Fictitious invoice issuers	Gross added value	Including wage income	Including untaxed capital income	The actual losses of the state from taxes and contributions on wages	The actual losses of the state from taxes and contributions on capital income	The virtual losses of the state from taxes and contributions on wages	The virtual losses of the state from taxes and contributions on capital income	The virtual losses of the state total
Classic invoice factories (bogus companies)	300	250	50	140	20	375	30	405
Businesses paying the simplified enterprise tax	150	100	50	56	20	150	30	180
Companies engaged in non-invoice based Activities that are compelled to show								
Expected revenues	200	150	50	84	20	225	30	255
Off-shore companies	150	50	100	28	40	75	60	135
Multinational companies that withdraw income exceeding the equitable profit margin by incorporating such income into the transfer prices	500		500		100		125	125
Accounting private consumption as corporate consumption	200	150	50	84	20	225	30	255
TOTAL	1,500	700	800	392	220	1,050	480	1,530

9. táblázat

ESTIMATED VOLUME OF THE HIDDEN ECONOMY

(HUF billion/year)

Segments of the black economy	Gross added value	Including wage income	Including untaxed capital income	The actual losses of the state from taxes and contributions on wages	The actual losses of the state from taxes and contributions on capital income	The virtual losses of the state from taxes and contributions on wages	The virtual losses of the state from taxes and contributions on capital income	The virtual losses of the state total
Fictitious invoices	1,500	700	800	392	220	1,050	480	1,530
GDP produced by non-invoice based activities	1,800	1,000	800	560	320	1,500	480	1,980
Untaxed GDP (volume of the black and the grey economy)	3,300	1,700	1,600	952	540	2,550	960	3,510

“Between 2001 and 2005 the Hungarian subsidiary of Siemens transferred over HUF 800 million to seven bogus companies owned by homeless people that allegedly provided consultancy services to various divisions of the group. The consultancy companies that in fact provided no such services at all were organised and hired by András Zoltán Schrödtl for the medical technology, IT, energy and building automation divisions of Siemens.” (SG.hu, 2007)

Writing off private consumption as corporate costs

All types of enterprises – small, medium-sized and large companies alike – are over-inclined to use this form of fictitious invoicing. The risk is low, and in case they are caught, they must only pay the missing part of the corporate income tax. Yet, this form causes as much damage as the other types of fictitious invoicing. It also involves that money that could be legally withdrawn only as after-tax wage or capital income is spent on private consumption without paying taxes. If the taxes on this consumption were paid, only a significantly smaller portion of the products and services accounted could be purchased.

This form of fraud is primarily used for withdrawing wage type income, too, which causes significant damage to the state budget. Although the efficiency of tax legislation has improved a lot since the introduction of taxes on vehicles and telephone services used for private purposes, there is not much chance for further confining this method of fictitious invoicing. Partly because it requires disproportionately great efforts from the tax inspectors to prove private consumption, and also because the extension of normative taxation to other private purpose services and products would put disproportionately large administrative burdens on the enterprises.

I assume that each year the six modes of fictitious invoicing puts a GDP of HUF 1,500 billion into private pockets without paying taxes, more or less evenly distributed between labour and capital incomes. The actual loss of the state is around HUF 600 billion, while the virtual loss equals the amount of the income taken abroad. In other words, this much GDP should be generated in excess so that the final income owners could peacefully enjoy spending or accumulating their income that they got hold of with various tricks. (See Table 9)

I assume that a smaller portion of the hidden Hungarian economy is covered by fictitious invoices. The larger part of untaxed GDP is still produced in transactions in which no invoices are issued. Most of the income from non-invoiced transactions is spent as wage income, in an amount of HUF 1,000 billion per year according to my estimates. Due to non-invoiced transactions the state is deprived from revenues over HUF 800 billion.

In the table I tried to assess the volume of the Hungarian hidden economy: a GDP of HUF 3,300 billion – i.e. around 13 per cent of the official GDP – is not taxed at all. My estimates correspond to those of others, for example the estimates of *Csák Ligeti*, the acknowledged expert of the issue (Csák Ligeti, 2007) Approximately half of the untaxed GDP is black money used as wages, and the other half is capital income. Every year the state suffers an actual loss of HUF 1,500 billion. If only half of this amount could be collected, the Hungarian budget would have considerably less headache. But how much of this amount can we realistically expect to be collected by tightening the tax system?

Well, not too much. The report of the committee in charge of examining the whitening of the economy (www.mkt.hu) shows that in 2007 the budget realised nearly HUF 80 billion more revenues due to measures taken for the whitening of the economy, including the

increase in the staff of the Hungarian Tax and Financial Control Administration, the extra costs of which total HUF 7 billion a year. Compared to the fact that the state is deprived of an annual tax revenue of around HUF 1,500 billion, the collection of a net amount of HUF 73 billion is precious little. But it is impossible to have companies pay more as long as the wage related dues are not adjusted to reality. As we could see from the previous chapters the income producing ability of the Hungarian enterprises is so low that they are unable to produce as much GDP as would be necessary for the payment of all taxes and contributions. They are forced to commit fraud.

I do not undertake to estimate what portion of the illegally distributed income comes from necessity frauds, and what portion could be paid swimmingly by those enjoying it. However, as I stressed in my analysis of the groups engaged in fictitious invoicing, there are forms that are increasingly used by those entities whose tax-paying potentials are well above the Hungarian average. On the other side, though, the fictitious invoicing schemes they apply can hardly be controlled by the authorities. The duality of the Hungarian economy leaves its mark on the black economy, too. On one side there are hundreds of thousands of necessity tricksters from whom no more taxes can be collected. On the other there are the entities that could pay the taxes, yet they have the opportunity to evade them in part or in full.

The amount of collected taxes cannot considerably be increased merely by tightening the tax rules. In addition to the application of stricter sanctions against tax evaders, the tax rates must be concurrently reduced for the significant whitening of the black economy. In return, budgetary revenues in the law-abiding sectors will obviously decrease due to the reduced tax rates. To avoid the concomitant

problems, cuts must be enforced on the expenditure side and/or lost revenues must be made up for by other taxes. Precarious balancing can be avoided if we focus on the virtual rather than on the actual losses. According to the estimates of Table 9, if we consider the entire income distributed in the black economy net – and that is what it is – the state incurs a virtual loss of HUF 3,500 billion. However, the related margin is missing from the Hungarian GDP. What would happen if the new economic policy focused on the following issue: How to work off this virtual loss as much as possible, in other words, how to encourage enterprises to produce more GDP? In the following we are looking for the answers to this question.

AFFORDABLE AND EQUITABLE TAX RATES

The fundamental statement of this study is that in the current tax system Hungarian companies with low levels of productivity are unable to honestly pay all taxes. The use of the two-channel wage system, in which employees receive part of their wages untaxed, in cash, has become wide-spread. Hundreds of thousands of people (entrepreneurs and employees alike) are forced to commit fraud on a continuous basis in order to make both ends meet. They are able and willing to meet their tax payment obligations only under the lighter two-channel wage system. Let us see a tax system in which the tax rates would more or less correspond to this light burden, i.e. taxpayers would not be forced to cheat. (*See Table 10*)

The proposed tax system is a flat-rate system: both the PIT and the corporate income tax would be 15 per cent. Contributions would also be significantly reduced by 6.5 per cent (employer's contributions) and 7 per cent (employee contributions), respectively. The

Table 10

A POSSIBLE FLAT-RATE TAX SYSTEM

(per cent)

	Fully taxed wages at the current rates	Reduced rates
PIT tax rate, if the annual gross wage is less than HUF 1,700,000	18.0	15.0
PIT tax rate, if the annual gross wage is more than HUF 1,700,000	36.0	15.0
Employee contributions	17.0	10.0
Pension contribution	9.5	6.0
Healthcare contribution	6.0	4.0
Employee contribution	1.5	0.0
Tax credit/month (HUF)	11,340	0
Contributions payable by the employer	33.5	27.0
Pension contribution	24.0	20.0
Healthcare contribution	5.0	7.0
Employers taxes	3.0	0.0
Vocational training contribution	1.5	0.0
Flat-rate healthcare contribution (HUF)	1,950	0
Corporate income tax and solidarity tax	20.0	15.0
Dividend tax	25.0	15.0
VAT	20.0	25.0

dividend tax would remain the same, however the VAT would again be raised to 25 per cent, in part to offset reduced tax revenues. Tax credits and the flat-rate healthcare contribution would be abolished. The tax system would become much more simple and transparent. (The drop in tax revenues collected from the sectors that pay all taxes – which arises from the alleviation of wage related dues – should be offset by the introduction of new tax types to be described in detail in the next chapter.)

Table 11 compares the dues payable on the average wages at Company A in the two-channel wage system, as well as with the new tax and contribution rates. In the two-channel system the company ensures an average net wage of

HUF 149,115 by giving the employee a gross monthly wage of HUF 140,000, and HUF 50,000 in cash. The operation of this system costs the company HUF 244,406 each month. If the company paid all taxes related to the net wage, it would need to give a gross wage of

HUF 263,011 to an average employee, and the total costs involved would be HUF 353,069. This is exactly why the company is forced to apply the two-channel wage system, since if the extra tax burden of HUF 108,664 was paid, the entrepreneur would have no profits, not to mention funds for investments and development.

In the new tax system the same net income could be ensured with the disbursement of a gross wage of HUF 198,820. This would practically cost not more than the maintenance of the two-channel wage system, and the entrepreneur and the employee would not be compelled to connive and commit fraud. They would be able and willing to pay the taxes. Why would they cheat if they had the same amount of money with all taxes paid as in the case of fictitious invoicing?

Of course, the state incurs some loss, but only compared to the ideal situation in which the company pays all taxes and contributions.

Table 11

**THE COSTS OF EMPLOYMENT IN THE NEW SYSTEM
AT COMPANY A**

	Two/channel wage system	Fully taxed wages at the current rates	REDUCED TAX rates
<i>Average monthly gross wage per person (HUF)</i>	<i>140,000</i>	<i>263,011</i>	<i>198,820</i>
Dues payable by the employee	23,800	44,712	19,882
Tax credit	8,115	0	0
Actual PIT	17,085	69,184	29,823
Actual PIT rate	12.2%	26.3%	15.0%
Net wage	99,115	149,115	149,115
Wage supplement in cash	50,000	0	0
Total actual net wage income	149,115	149,115	149,115
Contributions payable by the employer	48,850	90,059	53,681
Net value of fictitious invoices required for the withdrawal of cash to be given as wage supplement	55,556	0	0
Costs of purchasing fictitious invoices	5,556	0	0
Actual dues payable by the employer	104 406	90,059	53,681
Total costs of employment	244 406	353,069	252,501
Structure of the employment costs, %	100.0	100.0	100.0
Total net wage income, %	61.0	42.2	59.1
Total dues, %	39.0	57.8	40.9
Contributions and taxes, %	36.7	57.8	40.9
Costs of cash withdrawal, %	2.3	0.0	0.0

This loss is virtual, since the missing tax revenues are not paid especially because the company is unable to produce the GDP that would serve as a margin. What is more, the state would receive more in the new system than in the two-channel one, since the company would pay more taxes instead of paying commissions to the issuers of fictitious invoices. In the two-channel system Company A pays a total of HUF 89,735 to the state after an average employee, and would pay HUF 103,386 in the new system each month!

In the new tax system the tax wedge of employment would be 40.9 per cent, i.e. practically the same as the current tax wedge of capital income. This is a rate that is equitable and affordable for the Hungarian enterprises.

Although illegal, the two-channel wage system could spread so widely because the burden on Hungarian enterprises became bearable only through this system.

Let us see how the GDP produced by Company A would be distributed in the new tax system. The first three columns of the six columns presented in Table 12 shows the distribution of the GDP produced by Company A in the two-channel wage system, with all current taxes paid, as well as under the new tax system. The other three columns show what would happen if productivity improved by 10 per cent, if employment grew at the same rate, and if net wages increased by 5 per cent as a result of the new tax rates.

In the new system the distribution of the

same amount of GDP would be in line with the income relations that emerged in the two-channel system. The only difference is that the entrepreneur's share would somewhat decrease and the state's share would somewhat increase. This is not good at all, since the deduction rate of 50 per cent is still much too high. No funds would remain for depreciation, investments and development. And the entrepreneur's profits seem small even in absolute terms. In fact, the taxes on capital income should be reduced even more at the expense of the state's share, and perhaps it would be better to keep the current VAT rate!

The table shows that compared to the two-channel system, state revenues would grow, albeit to a small extent only. Naturally, the amount of taxes and contributions payable in the new system would fall short of the value indicated in the second column (What would happen if all dues were paid?). The difference is HUF 14 million, however since the GDP that would serve as a margin is also missing, companies could not pay this amount even if they wanted to! This is the so called virtual deficit that Hungarian enterprises must reduce after being freed from the hamstrung situation. In return for the equitable taxes, the Hungarian SME sector must improve its performance by releasing the suppressed energies.

The last three columns of the table examine the impacts of possible performance improvement under the conditions of the new tax system.

■ If productivity improved by 10 per cent, and the number of employees and the average wage would remain unchanged, the gross added value produced by Company A would increase by nearly HUF 6 million. The surplus would be shared by the state and the enterprise. Tax revenues will reach the middle value between the revenues realised from the current two-channel system, and the tax revenues expected but not realised with the current tax rates (since the

companies cannot afford to pay such high taxes). With tax rates adjusted to this sector, these small and medium-sized companies could work off almost half of the virtual budget deficit they are responsible for. They should do nothing “but” improve their productivity by ten per cent! Is it an impossible task? I don't think so! The only thing to do is to work a little harder, in a more disciplined and organised manner, make better use of the existing endowments, and productivity will perceivably improve. The feeling of getting free from the hamstrung situation will evidently make this happen!

■ If at this productivity level, but with unchanged wages the company would employ 10 per cent more employees, a significant portion of the virtual tax deficit could be worked off from the surplus GDP created. The tax revenues would almost equal the amount that the state – vainly – expects with the current tax rates. A lot of entrepreneurs do not have more employees only because they find it too risky to continuously ensure the conditions for maintaining the two-channel wage system for a larger staff. Instead, they keep their performance low. An inspiring environment can put an end to this suppression, and the companies can increase their staff practically without investment projects. In the SME sector improving productivity by 10 per cent and increasing employment by 10 per cent would be sufficient to ensure much higher tax payments in the new tax system than in the existing one! For the time being, with the two-channel wage system in place, the amount of taxes actually paid by Company A is below HUF 50 million. However, with a slight growth in employment and productivity alike the state could realise over HUF 60 million in tax revenues. Not to mention the other benefits that the state could enjoy through the employment of tens of thousands of job seekers.

■ The last column of the table shows what

Table 12

DISTRIBUTION OF THE GDP PRODUCED BY COMPANY A

	Ttwo-channel wage system	Fully taxed wages at the current rates	Reduced tax rate	Productivity growth	Employment growth	Net wage growth
<i>Average monthly gross wage per person (HUF)</i>	140,000	263,011	198,820	198,820	198,820	208,761
Wage supplement in cash	50000	0	0	0	0	0
Total actual net wage income	149,115	149,115	149,115	149,115	149,115	156,571
Total costs of employment	244,406	353,069	252,501	252,501	252,501	265,126
The growth rate of net wages at the company, %	0.0	0.0	0.0	0.0	0.0	5.0
The growth rate of productivity at the company, %	0.0	0.0	0.0	10.0	10.0	10.0
The growth rate of employment at the company, %	0.0	0.0	0.0	0.0	10.0	10.0
GDP per employee in Hungary in,2006 (HUF thousand)	8,515	8,515	8,515	8,515	8,515	8,515
Number of employees	20	20	20	20	22	22
GDP per employee at the company relative to the national average in Hungary in,2006, %	60.0	60.0	60.0	66.0	66.0	66.0
Gross added value (GDP)	102,180,000	102,180,000	102,180,000	112,398,000	123,637,800	123,637,800
Total costs of employment/year	58,657,333	84,736,609	60,600,336	60,600,336	66,660,370	69,993,388
Net after-tax wage	23,787,600	35,787,600	35,787,600	35,787,600	39,366,360	41,334,678
Total contributions and taxes	21,536,400	48,949,009	24,812,736	24,812,736	27,294,010	28,658,710
Net value of the purchased fictitious invoices	13,333,333	0	0	0	0	0
Part of the revenue that remains after the deduction of costs other than employment costs (net added value)	85,150,000	85,150,000	81,744,000	89,918,400	98,910,240	98,910,240
Payable VAT=VAT of the added value	17,030,000	17,030,000	20,436,000	22,479,600	24,727,560	24,727,560
Pre-tax profit	26,492,667	413,391	21,143,664	29,318,064	32,249,870	28,916,852
Corporate income tax and solidarity tax	5,298,533	82,678	3,171,550	4,397,710	4,837,481	4,337,528
Profit and loss according to the balance sheet	21,194,133	330,713	17,972,114	24,920,354	27,412,390	24,579,324
Dividend tax	5,298,533	82,678	2,695,817	3,738,053	4,111,858	3,686,899
Owner's withdrawal (taxed dividend)	15,895,600	248,035	15,276,297	21,182,301	23,300,531	20,892,426
Total contributions and taxes	49,163,467	66,144,365	51,116,103	55,428,099	60,970,909	61,410,696
Distribution of the gross added value, %	100.0	100.0	100.0	100.0	100.0	100.0
Taxes and contributions, %	48.1	64.7	50.0	49.3	49.3	49.7
Total net wage income, %	35.0	35.0	35.0	31.8	31.8	33.4
Owner's withdrawal, %	15.6	0.2	15.0	18.8	18.8	16.9
Commissions paid to fictitious invoice issuers, %	1.3	0.0	0.0	0.0	0.0	0.0

impact it would have on the distribution of the added value if the average net wage of the employees was raised by five per cent given the increased staff and level of productivity. If we expect better work, we must pay more for it. Since higher wages also imply higher tax revenues, this restructuring of the wage system would obviously be detrimental to capital income despite the fact that – as we have stressed several times – the portion that remains in the entrepreneur's hands would remain low even in this new tax system. In addition to the owner's profits, much of the gross added value should be available for investments and development (not to mention the local business tax and the banking costs).

However, raising the ratio of net wage income is also a fundamental condition for economic growth. The income distribution that occurs given the favourable tax rates still favours the state in the case of Company A. Its share of 50 per cent is still too high! What is more! This ratio even exceeds the national average. Although it is not easy to access national data in this structure, and only 2005 figures are available, I managed to present that the sum of the revenue side of the budget (HUF 6,896 billion) and the paid social security contributions (HUF 3,266 billion) with which all tax and contribution categories included in the model can be compared equals 46 per cent of the GDP (HUF 22,055 billion). This seemingly favourable value can also be attributed to the dual structure of the Hungarian economy. In the case of Hungarian companies with low levels of productivity the ratio of state deductions remains high even at favourable tax rates. At the same time, in the case of added value produced by foreign owned companies that demonstrate outstanding productivity, state deductions represent a small ratio even at the current, high tax rates.

We are going to prove our statement with the income relations of the foreign-owned

Company C. (*See Table 13*) In the company that employs 1,000 people for an average gross wage of HUF 250,000, the productivity level per employee is twice the national average measured in 2006 (on the basis of Zoltán Pitti's figures). The company can easily meet its tax payment obligations even at the current tax rates (it pays all the wage related dues, however it does not need to pay dividend tax, since the final owner of the capital income pays it in his home country, or – save the mark! – in an off-shore heaven), and plenty will be available for the owners, too. It must be admitted though that the share of the employees' net wages is low – this is what high productivity means. The ratio of state deductions from the gross added value produced by the company is low: merely 42 per cent, a really ideal ratio. Since the bigger part of the Hungarian GDP is produced by foreign owned companies, it is understandable how the ratio of state deductions can stay below 50 per cent at macro-level, while in the case of Hungarian owned companies this value is well above this critical level due to the low income generating ability of such companies.

The table also shows what would happen if Company C also paid taxes according to the new conditions. It is shocking, and is also very positive from our point of view that the taxes of Company C would hardly decrease. Although the dues on wages would drop by around HUF 800 million, this would be almost offset by a surplus VAT payment of nearly HUF 600 million. The amount of taxes payable by the large tax-payer multinational companies would not fundamentally decrease in the new tax system!

One can draw further noteworthy conclusions regarding the dividend tax by analysing the correlations of the table. If they take the dividends they produce in Hungary abroad, foreign owned companies are exempted from paying the dividend tax in Hungary in accordance with the international treaties. At any rate, the dividend tax would total HUF 2 billion in the

Table 13

DISTRIBUTION OF THE GDP OF THE FOREIGN OWNED COMPANY C

	Fully taxed wages	Reduced rates
<i>Average monthly gross wage per person (HUF)</i>	<i>250,000</i>	<i>250,000</i>
Number of employees	1,000	1,000
GDP per employee at the company relative to the national average in Hungary in,2006	200.0%	200.0%
Gross added value (GDP)	17,030,000,000	17,030,000,000
Total costs of employment/year	4,028,400,000	3,810,000,000
Net after-tax wage	1,716,000,000	2,250,000,000
Total contributions and taxes	2,312,400,000	1,560,000,000
Net value of the purchased fictitious invoices	0	0
Part of the revenue that remains after the deduction of costs other than employment costs (net added value)	14,191,666,667	13,624,000,000
Payable VAT=VAT of the added value	2,838,333,333	3,406,000,000
Pre-tax profit	10,163,266,667	9,814,000,000
Corporate income tax and solidarity tax	2,032,653,333	1,472,100,000
Profit and loss according to the balance sheet	8,130,613,333	8,341,900,000
Dividend tax	0	0
Owner's withdrawal	8,130,613,333	8,341,900,000
Total taxes and contributions	7,183,386,667	6,438,100,000
Distribution of the gross added value, %	100.0	100.0
Taxes and contributions, %	42.2	37.8
Total net wage income, %	10.1	13.2
Owner's withdrawal, %	47.7	49.0
Commissions paid to fictitious invoice issuers, %	0.0	0.0

case of Company C. If this tax was paid, the deduction rate would exceed 50 per cent even in the case of Company C under the current tax rules. This fact means that on one hand it would be a large burden for multinational companies, too, if they had to pay all taxes. On the other hand they have a significant competitive edge over Hungarian owned companies that can avoid paying this tax type only by fraud.

NEW TAX SYSTEM, REASONABLY REFORMED BUDGET

In the first chapter we modelled the impacts of a new tax system in which the personal income tax would be a flat-rate tax, and would equal 15

per cent, just like the corporate income tax. Wage related dues would decrease by 13.5 per cent. The dividend tax would remain the same, the solidarity tax would be abolished, however the VAT would again be raised to 25 per cent, and a new tax type, the wealth tax would be introduced.

The results of the simulation show that the Hungarian SME sector, which protects itself from the excessive tax burdens compared to its productivity by applying the illegal two-channel wage system, would not pay less taxes at rates ensuring bearable tax burdens (similar to those achieved by fictitious invoicing) than today. What is more, if they did not have to use a significant part of their energies to mitigate the risks of fraud instead of using them for the creation of condi-

tions ensuring better performance, companies in this sector would pay a lot more taxes!

At the same time, the highly productive multinational companies that honestly pay all taxes on the employees' wages would not pay less tax either. The surplus VAT collected due to the higher VAT rate can offset the loss in tax revenue due to the reduction of the personal income tax rates and the contributions.

Let us see what impact the new tax system would have on the different tax types!

Wage related taxes and contributions

In 2007 the average monthly gross wage of an employee was HUF 185,004, and the number of employees totalled 2,760. In our model we examined the taxes on this average wage in the current and the new system. (See Table 14)

In the last column of the table we presented the differences between certain items of the two tax systems, projected on all employees and one year. It can be seen that at macro-level savings of almost HUF 500 billion are achieved in the costs of employment. Although part of it will be used to meet the increased VAT obligation, the rest will be the token of rapid eco-

nomical growth. Entrepreneurs will be able to use those funds for development and investments, i.e. to ensure the pillars of growth.

The net income of employees will grow by nearly HUF 9 billion. Although the higher VAT will drain some of this money, but the remaining sum is indispensable for three reasons.

① The growth in the internal demand for the products and services of the SME sector is an elemental condition for the rapid development of the companies operating in this sector. I would like to remind you of the fact that if productivity and employment grew just a little, the amount of taxes and contributions paid by the SME sector could hit historical highs!

② The net income of the population is all the more necessary, since the volume of non-invoiced transactions will drop only if people can afford to pay the prices that also include the reduced taxes. This is an indispensable precondition for ensuring tax payment discipline, which calls for mandatory invoicing.

③ The increased share of wage incomes from the GDP is also an indispensable requirement for the badly needed budget reform. Co-payment for public services (healthcare, education, etc.) is equitable only if the population has surplus income. The extra income is also a

Table 14

DUES PAYABLE ON THE AVERAGE MONTHLY WAGE

	Fully taxed wages at the current rates	Fully taxed wages at the net rates	Difference per employee (HUF)	Difference for all employee (HUF billion/year)
<i>Average monthly gross wage per person (HUF)</i>	185,004	185,004	0	0
Dues payable by the employee	31,451	18,500	12,950	428,913
Tax credit	0	0	0	0
Actual PIT	41,101	27,751	13,351	442,180
Actual PIT rate, %	22.2	15.0	0	2
Net wage	112,452	138,753	-26,301	-871,093
Contributions payable by the employer	63,926	49,951	13,975	462,861
Total costs of employment	248,930	234,955	13,975	462,861

precondition for expanding the unavoidable institution of mandatory pension.

According to the table, nearly HUF 450 billion less will be realised in PIT revenues, and the contributions paid will drop by almost HUF 900 billion. In 2007, the state yielded HUF 1,820 billion from PIT, and (in 2005) it yielded HUF 3,226 billion from social security contributions. One third of these revenues must be made up for! As we could see, in the case of the multinational Company C the VAT surplus can practically offset the reduced amount of PIT and contribution revenues, and, as we will see, the VAT surplus will be significant at macro-level, too.

However, part of the deficit of over HUF 1,200 billion exists only virtually. The reason behind this is that real savings are realised in the personal income taxes and contributions of employees working in the budgetary sector, i.e. they do not need to be collected! (In this sector the wages and contributions of the employees are covered from the taxes paid by the competitive sector.) *Table 15* shows the savings.

In 2007, the budgetary sector employed 748,000 people at an average monthly gross wage of HUF 206,307.

Altogether taxes of HUF 450 billion do not need to be collected, because less PIT and con-

tributions should be paid for budgetary employees in the new system! The actual tax and contributions deficit equals HUF 800 billion.

VAT

In 2007, budget revenues collected from VAT were HUF 20 billion shy from HUF 2,000 billion. If the upper VAT rate was raised from 20 to 25 per cent, VAT revenues could grow by HUF 400 to 500 billion. Half of the PIT and contribution deficit could be covered from the surplus VAT! It is commonplace today what a great mistake it was to decrease the upper VAT rate in 2006. VAT is the most easily collectible tax type, and being consumption related, it is also one of the fairest. Unrealised contribution revenues would be replaced by those who consume the most. This situation must be maintained as long as the surplus revenues from the rapid growth of the economy, freed from the hamstrung situation, restore the balance.

Corporate income tax

The corporate income tax rate is currently 16 per cent, however together with the solidarity

Table 15

DUES PAYABLE ON THE AVERAGE MONTHLY WAGE

	Fully taxed wages at the current rates	Fully taxed wages at the new rates	Difference per employee (HUF)	Difference for all employee (HUF billion/year)
<i>Average monthly gross wage per person (HUF)</i>	206,307	206,307	0	0
Dues payable by the employee	35,072	20,631	14,441	129,731
Tax credit	0	0	0	0
Actual PIT	48,771	30,946	17,824	160,121
Actual PIT rate	23.6%	15.0%	0	1
Net wage	122,464	154,730	-32,266	-289,852
Contributions payable by the employer	71,063	55,703	15,360	137,982
Total costs of employment	277,370	262,010	15,360	137,982

tax of 4 per cent 20 per cent of the profit according to the balance is paid as tax. In 2007, the state yielded HUF 510 billion from the corporate income tax, and HUF 178 billion from the solidarity tax, i.e. altogether less than 700 billion. The 15 per cent rate hardly makes any difference compared to the current rate. The statements compiled by *Éva Palócz* show that the rate of actually paid taxes was only 10.7 per cent in 2006, which can partly be attributed to the overly extensive system of items that influence the size of the pre-tax profit, and partly to the large volume of discounts given by the Hungarian government to companies running major investment projects. (See Table 16)

Tax benefits are given to entities with outstanding tax payment abilities, i.e. the multinational companies. They run major investment projects, and they can make use of the normative benefit provided for by the Act on corporate tax. This year, for example, taxpayers implementing investment projects worth over HUF 3 billion can use the so called development tax benefit. The benefit equals 40 per cent of the project value in the case of projects worth up to EUR 50 million. In the case of investment projects worth EUR 50 to 100 million, the tax benefit is 20 per cent of the part above EUR 50 million. If the total value of the project exceeds EUR 100 million, a tax benefit

of 13.6 per cent can be claimed for the part above EUR 100 million when paying the corporate income tax.

The tax benefits and large-scale subsidies are given to those who do not need them at all! This situation is disapproved by many.

For example, when analysing the low level of corporate income tax paid in 2006, *Tamás Mellár* pointed out: “If all enterprises had met the normative tax payment obligation, the state budget could have realised a surplus of HUF 370 billion. However, this was circumvented by the various tax benefits. And we still cannot say that the benefits encouraged the enterprises, since in 2007 their economic growth significantly fell short of the growth rate of the countries that joined the European Union together with Hungary. The situation could not be improved by industrial production either, which earlier grew at a dynamic pace. By the way, industry: according to balance sheet figures, the effective tax rate in the industry was 5.5%. Industrial companies paid a profit tax of HUF 91.5 billion, while the tax benefits they realised totalled HUF 102.9 billion.”(Tamás Mellár, 2008)

On top of that, allegedly to encourage investments, the Hungarian government provides these companies with subsidies granted on the basis of case-by-case government decisions. Since 2003 “investment projects worth

Table 16

CORPORATE TAXES AND TAX BENEFITS

	2005	2006
(1) Pre-tax profit	3,375.7	3,471.6
(2) Profit increasing items (32 types)	3,276.2	4,337.9
(3) Profit decreasing items (44 types)	4,708.6	5,957.3
(4)=(1)+(2)-(3) The base of the calculated tax	1,860.3	1,896.9
(5) Calculated tax	488.4	485.1
(6) Tax benefits (15 types)	120.8	112.1
(7) Payable tax	367.5	372.9

Source: Éva Palócz: The possible directions of the tax reform, KOPINT-Tárki Zrt., 2008

HUF 700 billion have been implemented through case-by-case government decisions and state subsidies of HUF 200–300 billion.” (Ibolya Vitéz F., 2007) The article also reveals that this type of investment encouragement is also the hotbed of corruption.

We can see that the corporate income tax has plenty of hidden reserves. By using these reserves, the introduction of the 15 per cent tax rate would not decrease, but instead increase revenues from this tax type, and would offset losses from the abolishment of the solidarity tax. Since these companies do not pay dividend tax either (see Table 17), due to the enormous volume of untaxed dividends it would not be unfair to introduce a certain repatriation tax. However, I am careful about demanding such a tax, since its introduction may violate international treaties.

Simplified entrepreneurial tax

As we could see, the abolishment of the simplified entrepreneurial tax is a major stage in the fight against fictitious invoicing. With the simplified entrepreneurial tax no longer in place, revenues of HUF 150 billion should be made up for. I must note that revenues from the simplified entrepreneurial tax grew fast in the beginning, but remained under the expected level in the last two years.

In the new tax system these companies would pay corporate income tax and dividend tax on the profits that remain after the deduction of costs. The tax wedge of capital income would decrease in the new system: from 40 per cent to 37.5 per cent. In 2007, the gross revenue of companies paying simplified entrepreneurial tax was around HUF 600 billion. If the simplified entrepreneurial tax of HUF 150 billion, which was collected last year, should be paid from the corporate income tax and dividend tax base, said com-

panies would need HUF 400 billion in profits, which can be comfortably realised from the GDP they produce. It is highly probable that the revenue loss from the abolishment of the simplified entrepreneurial tax would be replaced by the same taxpayers through corporate income tax and dividend tax payments.

Growing tax revenues from small entrepreneurs

I have pointed out several times earlier how fast the tax payment potential of the Hungarian enterprises could grow after they are freed from their bonds. The most critical segment of this sector comprises the smallest enterprises, i.e. (the nearly 700,000) private entrepreneurs, the almost 200,000 limited partnerships, as well as people performing household chores. It is well known that the ratio of untaxed income, and the share of non-invoiced transactions is relatively the highest in this segment. According to the HCSO, these enterprises produced a GDP of 3,825 billion in 2005 (to which we could add at least HUF 500 billion as non-observed GDP). If we deduct the employment costs of the employees from this amount (HUF 534 billion), we obtain the official GDP that the state and the entrepreneurs must share. That reserves do exist here – not only in the form of virtual, but actual tax deficit – is best shown by the fact that in their own rights these entrepreneurs paid only HUF 63 billion as social security contribution in 2005! It is not known how much PIT and flat tax these entities paid, but we are not mistaken if we state: the reduced rates must be paid by all entities in this sector. At least HUF 500 billion must be collected as surplus tax in order to offset the deficit that appears in the sectors of “law abiding” taxpayers.

Curtailment of subsidies

More and more people share the opinion according to which the Hungarian system of social subsidies cannot be sustained any longer. *András Simor*, the president of the National Bank of Hungary called for an expenditure reduction of HUF 2,000 to 2,500 billion in his article titled *Revival!* in the March 24, 2008 issue of the Hungarian daily *Népszabadság*. “The only problem is that our country runs a welfare system that the economy is unable to maintain. This is in part responsible for slow growth and the shortfall behind the neighbouring countries. In other words, if we do not implement changes, if we do not accelerate our growth, the high sums relative to the GDP that are currently spent on welfare expenditures will sooner or later be less – in absolute terms – than the lower percentage that the neighbouring countries spend on welfare today. And believe me that our neighbours spend less on such purposes not because there are less people in need in their countries, or because they are more immune to the problems of the poor, but because they have understood that their economies cannot afford larger welfare spending. Naturally, HUF 2,000 to 2,500 billion cannot be saved merely by cutting welfare expenditures. Expenditures must be significantly curtailed in other budgetary chapters, too, since the burdens of high state debts require us to have more frugal financial management than our neighbours in all areas.”

In contrast with the rational streamlining of social expenditures I see more chance in the elimination of corporate subsidies. I have already modelled the gist of the problem in relation to the taxes paid by the multinational companies. Corporate subsidies distort the competition, and the required margin must be collected in the form of taxes. Corruption in the distribution of subsidies cannot be eradicated.

It is always the case when those in charge of distribution decide about giving away somebody else's money.

Here we can agree with *István Csillag*, who writes the following in his above cited article issued in the daily *Népszabadság*: “Programmes designed to assist job seekers, train people whose jobs are threatened, or provide wage support treat the taxpayers' money as handsomely as in other cases of subsidies and supports. Nobody follows whether a former boiler-maker that was successfully retrained to be a hatmaker (I know it is a bit of an exaggeration) could find a job, and for how many years he was employed. Therefore these training centres and programmes “drain” the taxpayers' “gang money” for years and flood the labour market with hardly employable workforce. Retraining programmes consume nearly 1 to 1.5 per cent of the GDP (HUF 250–300 billion from the taxpayers' money each year). The utilisation of this enormous sum (3 to 4 per cent of the annual budget) is not accompanied by efficiency tests, on the basis of which it could be determined whether it is only school owners and the distributors of subsidies among the entrepreneurs who make a good deal, or employers in need of qualified workforce and job seekers also benefit from the programmes?” (*István Csillag*, 2008)

The financial management organisations of the agricultural sector also receive disproportionately large subsidies. We must not forget either that subsidies granted under the New Hungary Development Plan are co-financed by the Hungarian taxpayers, too: Hungary's payments to the EU reach almost HUF 200 billion a year. The entire plan should be reconsidered, at least in the sense that entities in the competitive sector should be granted subsidies exclusively if their tax revenue surplus can be quantified normatively, and the payment of such taxes can be guaranteed.

At least HUF 500 billion could be saved by radically curtailing subsidies given to the com-

petitive sector. This much less taxes will need to be collected. We must not forget that deductions by the state will remain high even with the reduced tax rates of the new tax system. It is vital to save on the expenditure side, too. The most efficient tool for this is to stop paying subsidies to entrepreneurs. The enterprise-friendly economic policy should not be based on the distribution of subsidies, but rather on ensuring a stable and predictable environment that encourages development. Low and affordable taxes represent the best and most efficient enterprise-supporting system! On top of that, this pertains equally to everyone, and is sector neutral in the most equitable manner.

Wealth tax

The tax revenues of the economic boom that will occur under the liberating effect of the new tax system and the rationally streamlined expenditure side of the budget can be balanced, already in the very short run. However, new tax types, such as the wealth tax, should also be introduced. This tax would have a dual function. On one hand, it could provide reserves for the management of the difficulties in switching to the new tax system. It could also provide a longer term remedy for the serious structural problems of the budget. The wealth tax should remain in place as long as the balance of the pension fund is restored. Last year the budget contributed HUF 841 billion to the social security funds!

Another painful problem of the Hungarian budget is the high debt service burden. In 2007 as much as HUF 1,110 billion was spent on this service. It is said by many, but perhaps most loudly by *László Gazdag* that the most important economic policy objective is to curb inflation, since a mere one per cent growth in the interest on Hungary's state debt of HUF 16,000 billion leads to an additional budget

expenditure of up to HUF 100 billion. (*László Gazdag*, 2007.) It would be reasonable to use part of the revenues from the wealth tax for the reduction of debts. The institution of the wealth tax should be maintained as long as the debts reach a reasonable level.

On the other hand, the wealth tax would also help restore the sense of social justice and at the same time it could implement the principles of family-friendly taxation that are difficult to enforce in personal income taxation. I would not recommend a rate for the wealth tax, but it is worth examining the Swedish example. In Sweden the wealth tax was abolished in 2007 after it fulfilled its mission. Swedish citizens with assets worth over EUR 200,000 had to pay a wealth tax of 1.5 per cent a year. People with assets worth HUF 50 million had to pay HUF 750,000 in wealth tax. The tax-base was calculated not only on the basis of real property, but also on the basis of the other types of assets and bank deposits. The introduction of the wealth tax cannot be rejected based on the argument that it is complicated. We must study the practice of countries that successfully apply this tax type. Taxing assets obtained from untaxed funds is an indispensable precondition for reducing or moral deficit!

* * *

In this study we have proved that there exists a tax system in which the tax burdens on live labour can be radically decreased while maintaining the balance of the – rationally reformed – budget. The new tax system will release the creative energies of entrepreneurs and employees who are now compelled to commit fraud on a day-to-day basis, and will serve as an engine for rapid economic growth. The players of the economy will realise that they can meet both ends meet even without corruption. It is a shame that in today's Hungary there are hundreds of thousands of necessity tricksters and

the leaders of the country do not seem to apprehend it!

No political party that is concerned about the future of the country can have a more important objective than that. If a wise and credible politician explains the people that taxes would be reduced to an affordable level, but in return it is expected that everybody would pay them, the citizens will understand and appreciate it. Credibility is extremely important: the new leadership must do its best to perceptibly reduce corruption in public

administration. It must meticulously watch the purity of the members of the government and of the members of Parliament. The legal regulations that make tax evasion one of the most despicable crimes in the eye of the general public can and must be adopted only in this morally restored environment.

The precondition for a new and competitive Hungary is the introduction of transparent and affordable taxes on one hand, and universal, draconian sanctions on tax evasion on the other!

LITERATURE

- BOKROS, L. (2008): A közteherviselés félreformja (The half-reform of common charges), *Élet és Irodalom*, 26 February
- CSILLAG, I. (2008): "Van egy álmom... a 2/3-os Magyarország" (I've got a dream ... the 2/3 Hungary) *Népszabadság*, 5 January
- FEKETE, GY. ATTILA (2003): Hét év a pécsi számlagyárosra, *Népszabadság*, (Seven years of imprisonment for the invoice factory operator in Pécs), 26 November
- FEKETE, GY. A. (2007): Számlagyár és pénzmosoda, Hárommilliárdot vettek fel fiktív elszámolásokkal (Invoice factory and money laundry, Three billion forints was pocketed using fictitious invoices), *Népszabadság*, 23 November
- FEKETE, I. – LIGETI, CS. – PATAKY, P. (2008): A gazdaság kifehéredését vizsgáló bizottság jelentése (Report of the committee in charge of examining the whitening of the economy), February, www.mkt.hu
- GAZDAG, L. (2007): A Bokros-csomag mítosza és a valóság (The myth of the Bokros package and reality), Lexecon Kiadó Hatalmas adóteher alatt nyög a magyar (Hungarians are shouldering an enormous tax burden), (2008) *Portfolio.hu*, 12 March
- KREKÓ, J. – P. KISS, G. (2007): Adóelkerülés és a magyar adórendszer (Tax evasion and the Hungarian tax system), *National Bank of Hungary NBH studies* 65
- KREKÓ, J. – P. KISS, G. (2007): Adóelkerülés és a magyar adórendszer (Tax evasion and the Hungarian tax system), Institute of Economics, *Hungarian Academy of Sciences, Seminars*, 8 November
- LIGETI, CS. (2007): A feketegazdaság, mint a nemzetgazdaság teljesítményének része (The black economy as a contributor to the performance of the national economy), *Hungarian Economic Association (MKT) Corvinus: Budapest Days of Economics*
- MELLÁR, T. (2008): Adócsökkentés, de kinek? (Tax reduction, but for whom?) *Magyar Nemzet*, 29 March
- MIHÁLYI, P. (2008): Támogatás a támogatásért? (Support for support?) *Élet és Irodalom*, 28 March
- OHNSORGE-SZABÓ, L. – ROMHÁNYI, B. (2007): How did we get here: Hungarian budget 2000–2006, *Public Finance Quarterly*, Issue 2
- PALÓCZ, É. (2008): Az adóreform lehetséges irányai (The possible directions of the tax reform), *KOPINT-Tárki Zrt.*
- PAPP J. (2006) : Bértülterhelés (Overburdening of the wages), *Népszabadság*, 5 December
- PAPP, J. (2007): A kényszer-csalók országa (The country of necessity tricksters), *Népszabadság*, 5 March
- PITTI, Z. (2008): Az innovatív vállalkozások szerepe a gazdaság-politikai célok megvalósításában (The role of innovative enterprises in the implementation of the

economic policy objectives), Interim report on research carried out in 2007 and 2008 by the Prime Minister's Office and the Hungarian Academy of Sciences, *Hungarian Academy of Sciences*, 26 February

PITTI, Z. (2007): A társas vállalkozások gazdasági teljesítményeinek tulajdonosfüggő jellemzői (The owner-dependant features of the economic performance of joint businesses), In: *Nemzeti érdek*, Year 1, issue 2

VADÁSZ, P. (2006): A király meztelen Avagy kitermelhető-e a bérköltség (The emperor is naked or can wage costs be offset by production? *Roving conference of economists*, *Nyíregyháza*, 7 September

VITÉZ, F. I. (2007): Beruházók eltított kedvezményei (The secret discounts of investors), *HVG*, 8 November

Employment Tax Evasion Schemes Internal Revenue Service, *US Department of Treasury*, www.irs.gov

Kovács a banktitok megszüntetését reméli (Mr. Kovács is hoping for the elimination of the bank secrets (2008) *NAPI Online*, 4 April

Lemondott a Magyar Telekom vezérigazgatója (The CEO of Magyar Telekom has resigned) (2006) *Index* 5 December

Sereghajtók vagyunk az innovációban (Hungary is a tail-ender in innovation) (2007) *Origo.hu* 27 February

Számlagyáros hajléktalanok a Siemens körül (Homeless invoice factory operators in the shadow of Siemens) (2007) *SG.hu* 29 November