Crossroads or roundabout?

Foreword to the taxation policy compilation of Public Finance Quarterly

The 18-month history of Gazdasági Versenyképesség Kerekasztal [Economic Competitiveness Roundtable] has clearly shown that it takes a huge amount of naiveté to regard an across-the-board tax reform or even a barely perceptible change in the taxation system as a matter of the profession. In the nationwide series of debates – or rather, with a little malice, a cacophony of voices – about how to improve the taxation system, there are only a few points that seem to have generated a wide-scope agreement. Unfortunately, most of them are general slogans, such as "lower tax burdens are needed", "tax competitiveness of the Hungarian economy", and "the Slovak and Baltic examples should be followed", or simply "the taxation system should be simplified". It's impossible to achieve all these goals simultaneously, nor it is easy to interpret them, and the apparent accord only lasts until discussions into the details are started.

Early 2007 many jumped enthusiastically at the preparation works of yet another tax reform in Hungary, and even delivered a number of proposals by the end of the year. These had been devised in various workshops, and even though they had some common components, they recommended opposing solutions for a number of significant reform components. Each proposal was shelved eventually, but at least the general public had the chance to familiarise with the new concepts and hold one group accountable for the lack of property tax, the other for the postponement of a flat tax system, and the third for obstructing a generous tax cut.

The authors of the proposals had no illusions. They tried to adapt to the general view of the profession, but were unable to do it fully in either case. The general view of the profession can be described best by the aforementioned demands, which, however, can by no means be regarded as consistent. These are fancy slogans – of new-like solutions that have not necessarily been successful in other countries – but they lack international comparisons or feasibility studies in Hungary, nor are there any works about them that Pénzügyi Szemle [Public Finance Quarterly] would have published to demonstrate that there is no ultimate truth about tax reforms (or, in a humbler approach, the taxation system itself); and that a none-too-certain accomplishment of the expected results does require a giant leap – straight into the great unknown.

We have compiled the present issue of *Pénzügyi Szemle [Public Finance Quarterly]* with a conscious effort to selecting studies that give our avid readers

food for thought in almost all the important issues in the Hungarian taxation debates of 2007/2008. We harbour no illusions, either. Now in the summer of 2008, there is very little chance for a substantial restructuring in the Hungarian taxation system, as members of Gazdasági Versenyképesség Kerekasztal [Economic Competitiveness Roundtable] have indeed learnt from their experience. Chances for reforms are slim because there is no consensus among the profession as to the future of almost any of the taxation components[1]. And because more substantial changes are definitely rejected by at least three factors – or counter-opinions voiced in influential ears. And it's not even politics that takes the top spot.

❶International economic organisations urging fast-paced stabilisation in Hungary do not support any tax reduction before they are absolutely certain that the anticipated drop in the fiscal revenues triggered by such an action will not jeopardise the objectives of the convergence program even *in the short term.* They are probably happy about promises of an improvement in competitiveness *in the longer term,* but seem to stand to their strict principle of “a bird in the hand is worth two in the bush”.

❷In the Hungarian economics profession there is a very strong resistance to concepts of reduction in taxes and/or social contributions even though tax reforms are loudly supported by enterprise groups and encouraged by most major-league players in politics – verbally, at least. Those sceptic experts, however, fear not only an end to the *overfunding* of social transfer systems as a consequence of a substantial cut in public contributions but are concerned that the welfare system will collapse. In their main argument they say high-profitability labour deserves a generous social benefit system, just like in the Scandinavian states. However, the question is how strong this connection is *the other way around.* In other words, can a pricey and generous social system improve the quality of labour, or all there is to say is that high-profitability labour will indeed produce the higher costs of a quality social system? These two arguments or concepts are far from being equal, because the improvement in the quality of labour is questioned in the first, but the second one explicitly builds on such an improvement in labour quality.

❸Politics is the art of scales, even more so when somebody hurls himself or herself into it with appropriate support and long-term thinking. A thorough tax reform, however, will earn the government many more foes than friends. The explanation is simple: A tax reform will burden many players in the economy with additional costs in the short term, at the same time reducing the burdens of much fewer players. Of course, later many more will reap the fruits of faster economic growth generated by tax reform, but before that the government has to execute the reforms precisely *against them.* Also, the 'distributional coalitions', aptly described by *Mancur Olson,* can form quickly in rejection of the proposed reforms. Even all the six two-party combinations can develop separately among economic players A, B, C, and D to fight six different reform measures[2]. A duo would fight the implementation of property tax, two other players would stand up against plans to make the fiscal burdens of company car use transparent,

another two-party coalition would fight the additional 4% corporate tax, another would act to prevent consistent and accurate wealth examinations, and yet another duo would try to thwart the simplification – or the abolishment – of the current plethora of tax allowances. This way our imaginary model would have six miniature distributional coalitions without a word mentioned of a very wide variety of coalitions on the expenditures – or distribution – side.

Planned for 2009, the Hungarian tax reform was stranded the moment of launch not only because of primary political reasons, such as the break-up of the government coalition. Secondary political factors[3] played a much more significant role. The tax reform concepts – for instance those developed by Gazdasági Versenyképesség Kerekasztal [Economic Competitiveness Roundtable] and GKI Rt. [GKI Economic Research Co. Ltd.][4] – *were ab ovo* tabled within a concept of interconnected packages. It means that a reduction in tax burdens in a given scope were to be offset by increasing taxes or abolishing tax allowances in other scopes in a "break-even" approach. The authors of the concepts tried to align the planned steps of the tax reform to prevent the fiscal balance from deteriorating, because the precondition said the tax reform concepts should not address the entirety of fiscal policy, let alone the expenditures side. This latter had been regarded as a political issue right from the start, one which politicians had no intention of letting the economics profession manage at a substantial extent.

Then, it was not before long that it became clear that the restructuring in the revenues side was also a political issue. The assumed close correlation between a reduction in social contributions and job creation was not – and has not been since – accepted by all professional and political players. Due to the outcome of the referendum in the spring of 2008 and the ensuing changes in the government setup, government parties were explicitly scared of socially unpopular reforms, in particular those that could have undermined the redistribution positions of certain influential groups or sectors (farmers, families with various income positions, foreign investors, construction industry, financial sector, etc.). Any significant restructuring in the Hungarian tax system could interfere with the interests of significant social groups, and no one in Hungary is willing to take on additional burdens even if very attractive promises are made. And there are many in the community of tax advisors and auditors as well as in the government's fiscal apparatus who believe the danger of destabilisation of the taxation system is greater than there are advantages in a top-to-bottom re-tailoring of the fiscal "suit".

It is not the objective of our articles addressing taxation issues to increase the scepticism outlined above. A thorough restructuring of the Hungarian tax system is inevitable in the longer run because of cost competitiveness requirements. However, because of the political term but also under the pretext of the strict balance requirements of the convergence program, what is heard loud and clear in the cacophony of voices can still be delayed in the next one or two years. Namely, that *some kind of* a tax reform – with a redistribution of the burdens in a way to favour enterprises – will be a must for the country.

▫*Ms. Katalin Botos's* article tells us that the problems of public burdens have

raised the interests of nearly all former great economists. The three core functions of the taxation system – namely the roles of allocation, redistribution, and stabilisation – have to be achieved in such a way that they balance each other. Corporate interests attached to the first role, those of the society linked to the second, and those of economic policy inseparable from the third can only be aligned and harmonised by a government acting with a firm hand against distributional coalitions, and this is the point where this study in the development of theories could help readers understand analyses addressing the present at the same time seemingly making no references to current events.

■ The article authored by *Péter Elek* and *Ms. Ágota Scharle* has a role in our compilation: to help dampen the cacophony-feeling of the debate about the restructuring of the Hungarian tax system. Some participants in the debate not only publish their views, but take the liberty of explaining some of the basic – and widely recognised – theorems in the economics of taxation to their own taste or have even re-interpreted them to suit their goals. The authors provide a summary of the theory of optimum taxation that draws the attention of the readers to the fact that there is no such thing as a *single optimum taxation system*, primarily because requirements for the taxation system (for instance, the criterion of fairness) cannot be interpreted identically across the entire society.

Of course, there are better and worse solutions within the various packages, but none of them provides an optimum solution, not only for theoretic but also for practical reasons: Micro- and macroeconomic impacts of changes in the tax system cannot be measured accurately, nor can the role of impulses received by players in the economy from the fiscal system be assessed fully.

■ According to the growing majority of the profession, the restructuring of the Hungarian tax system is of public interest because the system in effect in 2008 serves the country's competitiveness in foreign direct investment and, in a close correlation, its macroeconomic stability at a decreasing extent. The study by *Gábor Kutasi* sheds light from multiple aspects to the fact that Hungary has fallen behind in the international tax race primarily due to bold reform measures taken by neighbouring countries. Hungary cannot sit idly for long as the attraction for foreign direct investments in Slovakia or Romania is being increased and traditional Hungarian advantages in competitiveness (the quality of labour compared to its costs, and a favourable geographical location) have become increasingly apparent in these countries, as well.

■ The conclusions drawn by *Gusztáv Báger* and *Gyula Pulay* depict a similar path but put an even larger emphasis on the time factor. Namely, the new tax legislation has to be in place by 2009, which enforces social fairness in addition to improving economic growth and competitiveness in such a way that the taxation system should also become more efficient in the process. These requirements, however, have not been met equally in neighbouring countries. Therefore, it should not be neglected that servile copying of the Slovakian tax system does not necessarily result in a better tax system in Hungary if *all three* requirements are to be met simultaneously and equally.

■ The structure of the taxation system will necessarily influence the longer-term path of economic growth. Aspects to the tax debate are delivered by *Ms. Adrienn Erős* that have been hidden in the background even though their assessment may help prevent economic policy from leading to other dead-ends in development. Two important issues are raised here. One of them is the necessary extent of fiscal burdens. Wagner's Law[5] is supported only partially by international data, but it seems very likely that public services of higher standards and easier access are required in a more developed economy.

The question arises whether a consistent downsizing in public service could be the only way of progress. This endeavour can only be justified in an Eastern European context where it has to (or can) be assumed that part of the public service institutions are operated inefficiently and irresponsibly (perhaps even with some corruption in play) and that these institutions can no longer be reformed. If new bases can be established for their operations, and education, health care or law enforcement can meet actual social demands as a result, then the concept that the society would be willing to pay more for these services is justified.

Securing government revenues, taxes and other contributions are not necessarily neutral to growth, in other words it does matter how they are weighted with a view to achieve faster growth. Ms. Adrienn Erős's study highlights tax types (such as social security and other contributions on wages, as well as property taxes) that could hold back the longer-term growth of the Hungarian economy. So, the strategic dilemma emerges whether a faster growth could be elevated as the number one priority in economic policy if sacrifices in social policy must be made in the short term in order to accomplish the objective.

Asset taxes and property taxes in particular[6] are an important component in the tax system of developed countries – with a higher level of development than that of Hungary – that have well-operated taxation systems. These taxes have multiple functions. Not only they ease the burdens on labour costs, lowering the implicit costs of labour for employers in the process, but they could create funds locally to finance municipalities. Many experts argue in favour of property taxes because visible assets – which in some cases have been accumulated from illegal moneys – would enter the system of public burdens, making taxes fairer.

Gazdasági Versenyképesség Kerekasztal [Economic Competitiveness Roundtable] has also affirmed the numerous professional advantages of property taxes, yet has taken a stand against their implementation in Hungary. The board based its rejection – born out of practical rather than theoretic considerations – on three main reasons. Firstly, it would be expensive and lengthy to assess each and every residential property in Hungary, and the result would be inaccurate. Secondly, the average income and/or asset position of a significant percentage of the Hungarian population is in sharp contrast to the value of their real estates (for instance, due to mass selling of council-owned homes at discount prices in the 1990s, the majority of which are owned by low-income pensioners). As a consequence, substantial social exemptions should be built into the system. The third counter-argument focuses on law-abiding taxpayers: Taxing property assets creat-

ed out of taxed income in reference to real estates hidden from taxes may cause moral and economic damages, and may even disturb balanced operation in the real estate market.

The study authored by *Gergely Kiss* and *Gábor Vadas* gives an expert overview of arguments in favour of value-based property tax, and one of its strengths, apart from taking serious counter-arguments from the profession into consideration, is a concept of taxing residential property in Hungary. The authors propose to resolve the dilemma of property appraisal by a "self-reporting" system where the tax authority would have the final say in case of unrealistic tax returns. This does not seem to be a very practical design, because the tax authority would be faced with an impossible task when many would try to categorise their properties as low-value (for instance because their real estates are of substandard condition), forming a kind of an 'obstruction coalition'. Part of the real estate pool of Hungary (for instance, run-down apartments in housing blocks in former industrial towns of the Communist era that have been vacated on a mass scale, or abandoned and unmarketable homes in villages of declining population) cannot be appraised at market prices in the first place. Therefore, the proposal outlined by *Kiss* and *Vadas* should be complemented by a solution where the government would be given the right of first refusal at the prices estimated by the owners.

Other potential counter-arguments are also covered by the concept thoughtfully. The study also tries to find a solution for the problems of low-income pensioner homeowners by offering a subtle system of exemptions, and would create the option of deducting property tax from personal income tax in order to protect those that pay high personal income tax.

An increasing number of countries try to link personal income tax with capital gains tax, but *Péter Halmosi* underlines that no ideal solutions have been designed in the most developed countries that boast the highest level of success in terms of fiscal policy. What is certain is that too high taxes on labour income could encourage their transformation into capital gains, and also that increasing the tax rates on capital gains – say, in deference to fairness – could cause macroeconomic damages as the propensity to make domestic investments declines.

Ms. Mária Lakatos shows in her study that contributions for social security and similar functions cannot be used merely to meet social demands or correct distressed social standing, because an excessive demand for solidarity could discourage employment. Social security and pension contributions are in many countries combined with the system of personal income tax at some extent. Since contribution rates are identical, any increase in their role could hamper the progressiveness of the personal income tax system.

Apparently, the studies authored by *Halmosi* and *Ms. Lakatos* have several common points. According to their experience, a tighter system of taxes and contributions could lower the number of taxpayers, and experience gained in Hungary in 2007 and 2008 has demonstrated that stricter control and enforcement can only increase the tax base at a limited extent and at relatively high costs. Therefore, components that encourage legal employment and tax payment should be given

priority. And once this apparently logical conclusion is accepted, the next step is to take sides in one of the most popular theorems regarding taxation.

The existence of the Laffer Curve is taken for granted by many, although no one has ever managed to prove this bell-shaped non-linear correlation[7] between tax rates and tax revenues. Therefore, the theory is true either partially, or in a modified form. If, however, it is proven, debates in tax policy will be given additional ammunition regarding the widely publicised assumption that lowering the tax burden might increase the tax base significantly.

■ Authors *Spiegel*, *Kogan* and *Templeman* try to get closer to the truth in their article by re-interpreting Laffer's original and popular theory. Their rather convincing analysis suggests that the Laffer Curve in fact acts a complex curve of multiple local maxima. If it is true, earlier verification attempts could have been contradictory because they analysed the development of the curve between certain tax rates.

The starting point for the analysis of the three authors also deserves acclaim. Their overview of past analyses about the Laffer Curve underlines two serious faults. Acknowledged in a wide scope, the theory of the single-peak curve is in fact the result of another fault in logic. *Spiegel* and co-authors have shown that a distinction should be made between individual and aggregate Laffer Curves, which is a highly important step because the Laffer Curves of individual taxpayers or taxpayer groups could be very different, and changes in their proportions might influence the behaviour and shape of the aggregate Laffer Curve substantially. It would be particularly interesting to see in the calculations of Hungarian tax reform concepts how differently social groups newly included in the taxation system will act when the tax base is extended in comparison to what has been assumed for a smaller tax base on the basis of the aggregate Laffer Curve(s) available for Hungary so far.

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When selecting the studies of this thematic compilation, we had no intention to take sides in the all-important conceptual or technical issues of the debates regarding the Hungarian taxation system, all we aimed to provide was fuel to encourage or speed up collective thinking. That the majority of the profession demands tax reforms louder and louder while at the same time being unable to agree upon a common minimum of the reforms cannot be held much longer. Meanwhile, one half of major-league politics is emphasising the political obstacles of reforms, and the other half is trying to raise the stakes by coming up with new tax reform ideas some of which seems to be up-to-date but others look downright adventurous, to say the least

To consciously use a mixed metaphor: It was time to steer the car of the Hungarian tax reform, wandering in a roundabout, to one of the exits so that it could accelerate. And the make of the car has not even been made clear yet…

Ádám Török

NOTES

[1] Including, but not limited to social contribution reduction, property or asset tax, flat or multiple-rate VAT with higher or lower rates, personal income tax, minor taxes, duties, tax allowances, “green taxes”; connections between black economy and the taxation system; control issues.

[2] This is just very simple example. Let's imagine how many reform measures can be objected by, say, 30 players that form seemingly small but all the more vocal coalitions. These are also 'distributional coalitions', because they stand up in favour of preserving the current distribution system.

[3] Here primary and secondary refers to the difference in perceptibility. Behind the coalition break-up there were (could be) reasons related to tax reforms as well, but minor chores to sabotage tax reforms had been made by many in the background much earlier.

[4] This latter is known in the professional community as “supergross design”.

[5] The size of the government increases as the per capita GDP grows.

[6] Imposed on residential real estates. Its implementation in Hungary, however, would be hampered by frequent mix-up of private and company assets, such as in the case of company cars. As a result, taxing residential properties raises an ethical issue. What should the tax authority's stance be in cases where someone is living in a high-value residential property which he rents at a low cost on the basis of a fictitious lease agreement, especially when the company that lets the real estate is controlled by the individual himself? The question arises how compliant it would be with the constitution and the freedom of business agreements if the tax authority defined the realistic nature of rent contracts.

[7] According to Arthur Laffer's intuitive but limitedly proven theory, the correlation between tax rates and tax revenues turns around beyond a certain point where any additional increase in tax rates will reduce tax revenues, but any reduction will increase them. An uncertainty in technical terms should be clarified here. Talking about the Laffer Curve, many refer to a single-peak parabola that describes the correlation between tax rates and tax revenues, others, however, use this expression for all functions describing any such connection. Here the latter version is used, which does not indicate a pre-defined form of the “curve” even if the name Laffer Curve is used.