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Tax theories – what is the message of the history of theories for today?

In modern economy social policy is at the highest level in the hierarchy of policies. All other policies: the economic policy, sectoral policy, including the industrial and agricultural policy, transport policy, energy policy, monetary and fiscal and foreign exchange policy as well as science policy must serve social policy purposes.

The political forces with the popular mandate to govern must have a clear vision about the society they want to create and about the main characteristics of that social concept. Namely, whether individuals or families are its basic units, whether income differences are small or large, how public welfare is interpreted, and whether it expects more or less from the state. As a matter of fact, the whole constitutional system must indicate an ideal social structure to be achieved and it is the obligation of the prevailing power to make every effort to further that. The constitutional system adopted after the change of regime was, as a matter of course, civic democracy based on the respect of private property.

Economic policy as a whole must aim to implement the selected social concept.

Civic democracies have several different models. Some are based on laissez-faire society, while others, striving to build a welfare society, assign greater role to the state. The model of social market economy, the one that Hungary chose, in theory, after the change of the political system, had developed from ordo-liberal ideas. In this model the economy is left to be shaped basically by market forces, but a strong social net is operated.

These are naturally ideal forms, nevertheless, there are several developed countries which fall into one or the other category.

BUDGET AND TAX POLICY

In Hungarian practice, the various political groups have highly different views on the actual form of social market economy. It is practically one of the obstacles to Hungarian development that the model is very differently interpreted by the different governments one after the other. As a result, there is no uniform framework for changes.

In any case, financial policy, both monetary and budget policy, has an important role to play in implementing economic policy.

The budget, in principle and in theory, is a tool to implement economic policy, including tax policy.

In principle, because – as *István Hetényi* cites – theories are never realised in their pure form, for the current tax systems are always developed *as a result of lobbying activities.* (Hetényi, 2006, page 14) The expenditure side also changes as a result of political fights.

According to the classical theory, fiscal policy has three functions: *allocation, redistribution and stabilisation.* Allocation and stabilisation are essential factors influencing specifically economic policy, while redistribution is mainly important for social policy. We must say, at the same time, that it is also extremely important for economic policy, it benefits from it as redistribution helps those not represented on the demand side to become people with disposable income, and by doing so, provides a market for a number of productive sectors when otherwise they could not have re-channelled their savings which found no investment opportunities as profit into economy.

The function of allocation is to handle the imperfections of the market. "The market is not able to ensure the supply of public goods, because individuals cannot be excluded from it which may give rise to free riding... [...] There may be under-consumption in respect of certain goods (national defence) and over-consumption as regards others (energy carriers). Through its allocation function, the state is able to approximate the demand and supply of these goods to the social optimum." (Orbán–Szapáry, 2006, page 7) The above-mentioned areas represent state functions in the most traditional sense. Public funds were used already in the ancient world to build roads, water systems by soldiers who were themselves – in certain cases – also financed from public funds. The question can be raised now whether certain infrastructure investments could nevertheless be financed from extra-budgetary resources, using private funds perhaps with some sort of budgetary guarantee. So much the more because the "poor government – rich people" problem has become regular in the developed economies. If we take into consideration the magnitude of the budget deficit in some EU-countries, while the population (of the euro-zone) makes a more than 10 per cent saving on its income, it is understandable that governments struggling with high deficit are trying to put more and more burden on the private sector. This is the backdrop for the PPP-schemes *(public-private partnership).* Putting the burden of financing on the private sector can only be successful if private savings are really significant, if there is abundant free capital and if investors consider it a good investment that the state leases the completed project from them. It means that the sole burden on the state is the current cost of the leasing. What happens is that the income flow is reversed via the government guarantee: the private sector pays tax to the budget, and the budget rechannels it to certain individuals in the private sector in order that they provide public services from private investments. With the PPP-scheme the government is relieved of the burden to make the one-off capital investment. It is true, however, that the price to be paid by the state in a given case is an endless debt during the "repayment" of which taxpayers are to pay not only for the public service itself but also for the profit of the private company for perhaps an infinitely long time.

Income differences can be moderated by the state through redistribution. This can be done through the tax system or via direct transfers. There are arguments to support both solutions. Direct transfers can be more targeted, while allowances tied to tax provide a better incentive to work since they can only be granted to those who have a taxable income.

The third, the stabilisation function, is – strictly speaking – an economic task. Its purpose is to dampen the fluctuations of the economic cycles through automatic stabilisers. The tax system bears the brunt of that. Progressive income tax does not only play a part in redistribution and proportionate public burden-sharing, but it may have an effect of flattening the economic cycles. The moderation of fluctuations may increase the potential output of the economy. The market always has "a cleansing effect" – but it does matter what losses are incurred by society as a whole. Smaller fluctuations represent smaller adjustment losses.

A LITTLE HISTORY OF TAX THEORY

For the men of our times tax is the natural powers of the state, a tool which can be used by governments with a parliamentary majority, without further ado, to implement their economic policy and political concepts.

This situation is the "result" of historical development. The inverted commas are justified here, because in several cases, the above opportunity is – regrettably – not only used but abused by governments, and their aims do not necessarily coincide with public welfare. It is advisable to cleanse the present-day complicated tax system from the daily detritus of actualities, from the pressure to make revenue at any expense, and examine what leading experts of the theory of economy in the developed industrial society thought about the above question half a century ago.

First of all, it must be pointed out that theory has not made the issue as simple as it seems today: "Show me a chimney that smokes and I will right away impose hearth tax on it." Theoretical experts were looking for *principles* along which the amount of resources needed by public finance could be rationally established.

Tax interpretations

Tax has a number of interpretations. Back in 1885, *Gyula Kautz* wrote about tax: "...it will be referred to as a civic sacrifice or gift from some people to society as a whole, then it will be referred to as a legal or property insurance fee; then again as an aid to the state to make governance possible and a sacrifice of private benefits for the common good, [ ] and finally as a service for the community whereby intellectual assets are exchanged for material ones and cultural and political values for economic ones." (Kautz, 2004, page 129)

Two basic approaches can be found here: the necessity of taxation should be accepted like an *insurance* principle, since that is a prerequisite of the protection of the social order based on private property, or alternatively, it should be considered as *the price of services* which citizens can expect from public institutions or from public authorities in return for paying tax.

Both approaches are in a certain sense based on *private law,* on the principle of quid pro quo. This is especially true for *duties* within the state's sources of revenue, although it partly applies to administrative costs, too. Administration, law enforcement, national defence "traditionally" belong to the public domain. It should be mentioned, however, that it is not possible to consider all police and military costs as incurred for the public interest, so in this sense they must be treated as "insurance costs" incurred by citizens. It is unquestionable that the operation of the army and the police theoretically serves the protection of citizens, so there is an insurance element in it. Strong police guarantees the protection of private property and life (in so far as it does). The protection of the country's territorial integrity may also mean its protection from hordes of marauders and looters. On the other hand, since law-enforcement organisations are subordinated to state power, at times they may also serve partial interests. According to the Marxist approach, they may serve the interests of class rule, but whatever other social and sociological theory is applied, the police and the army may merely protect the self-interests of the power elite. There are several examples for that in today's world politics, especially in non-democratic societies.

Therefore, these costs cannot fully be included in public expenditure interpreted on private law basis, since they do not always serve taxpayers as a whole but sometimes only group interests based on orders given by the central government.

There is a need for law enforcement under any circumstances. In so much so that the work of the "official" organisations is not sufficient. A good example for that is the formation of the Hungarian civil guards by civil initiation independent from the government. But we may also mention the American National Guard which serves similar protection purposes. Attempts should be made to make sure that the elements of community service do dominate in the activity of the police and the army.

As regards the essential feature of taxes concerned, the general statement can be made that it is by no means *traceable exclusively to the above-cited individualistic, private law bases.* It is their essential collectivist political feature that they are enforceable. While in the case of private law decisions it can be considered whether one should take out an insurance or buy a service, but when it comes to taxes, the private individual is obliged to make transfer payments for the interest of the community as a whole and and taxes are collectable.

As a matter of course, the definition of tax according to public law was formulated long time ago.

"The concept of tax which corresponds to today's interpretation had already been defined, in its essence, by the *ancient peoples* which had reached a higher development stage of the state" – writes *Farkas Heller* in his book published well over half a century ago (author's italics). (Heller, 1943, page 134) In the modern times as well as in the ancient democracies taxes fell under *ordinary revenues.* The boundary between private law and public law became indistinct in the Middle Ages. The reigning princes were engaged in subsistence farming relying principally on the yield of their own estates. Consequently, taxes *changed into extraordinary revenues* collected under a separate agreement. It is just the opposite of the system adopted in modern states where in most cases privately owned means of production are used for production, there is cash management and the state's primary source of revenue derives from tax. In this sense, the state's own proprietary revenues are now included in the extraordinary category as most state-owned enterprises in the competitive sector as well as the infrastructure sector have by now been re-privatised in Hungary and in a number of developed and emerging countries.

It is understandable that the revenue structure of the treasury was completely different *in the Middle Ages.* The medieval system was a natural outcome of feudal state organisation, in which there was no direct contact between the monarch and his subjects, since the majority of the subjects, the vassals owed allegiance to their lords, so the monarch could only use their services with the consent of their lords.

The "individualistic theory of the state"- to quote the term used by Farkas Heller – has reached its zenith in *Rousseau's* social contract theory.

TAX THEORIES

Based on the "social contract", the state is formed at the initiation of individuals. The modern tax concept derives from that and it is close to the notion of "service state" which is becoming more and more widespread today. According to that, *tax is a fee paid by citizens for the services provided by the state.* A well-known quotation from *Montesquieu* says that each citizen contributes to the revenue of the state a portion of his property in order that his tenure of the rest may be more secure…

This is the exchange or *quid pro quo theory* of taxation. Others have called it the benefit theory. According to Farkas Heller, *Sully, Petty, Turgot, Mirabeau, Justi, Krönke* and *Sismondi* have also held that view. *Thiers* has simply looked upon the state as a huge property insurance institution. (Heller, 1943, page 136) In *Emil Sacks*' view, the so-called economic theory of tax does not need to be supported by any other principle falling outside the economy (as opposed to the collectivist political theory, i.e. based on public law, in which the principle of *equity* must be applied to establish the rates of taxation). Accordingly, each citizen buys services, public services in proportion to his income and that is considered a sufficient guidance. There is of course an element of truth in the saying that the thief is feared more by those who have more to lose, so it is justified that they should contribute more to the state for its protective function. It can however be said that the principle of equity requires that the rich should contribute more to the community burden.

Although based on the ability-to-pay principle, the *economic theory of tax* slightly differs from the individualist approach, because it accepts the existence of *collective necessities* rather than looks upon the state primarily from the perspective of the individual. Although collective necessities clearly arise in the interest of individuals, they cannot be felt as directly by them as private necessities. The level of compulsory services is defined by the community rather than individuals.

According to the so-called *organic theory of the state,* the explanation behind taxation is not the services provided to citizens nor the concept of “do ut des”, “I give so that you may give”, rather the necessity of *communal existence.* Tax is not raised by contributions but it is imposed. Nevertheless, *tax charge, tax burden can rationally be realised on the basis of economic principles only.* Therefore, a merely political consideration of any kind will not be enough to develop a consistent tax theory.

FUNDAMENTAL PRINCIPLES OF TAXATION

The maxims of taxation were already laid down by *Adam Smith.* (Heller, 1943, pp 139–144)

- The first requirement is that tax should be levied in proportion to an individual`s *ability to pay.*
- The second maxim is that the tax each individual is bound to pay must be *determined clearly* and not arbitrarily; it should be clear what the taxpayer should pay. Moreover, a legal aid centre should provide legal assistance to citizens in this subject area.
- The third is that tax should be levied *at the time* when the contributor has the necessary resources to pay it. This is the principle of tax liquidity which may be implemented in different manners according to the tax type concerned. It is hardly possible to collect tax from agricultural producers before harvesting their crop. Similarly, value added tax is to be paid if the sale has been effected.
- Finally, it is an important consideration that taxpayers should pay as little as possible over and above the amount it brings to the treasury, i.e. collection *should not incur high costs,* as it would unnecessarily increase the burden of taxpayers.

These principle were often violated by governments mainly by putting the bulk of the tax burden on the poorest strata of society. The system of tax farming, a cause for a lot of suffering, is a painful memory from the past.

There are several points of departure for trying to find an answer to the equality of taxation. We may start out of the fact that tax should be charged in proportion to an individual`s ability to pay, which is a possible interpretation of equality. Another way of looking at it is that the degree of sacrifice made by each individual should be equal. It is of course difficult to give an answer to the latter approach from the individualistic point of view.

The ability to pay meant levying an equal proportion of tax on everyone. On the other hand, the question becomes somewhat more complicated if we consider the principle, already cited when discussing the physiocrats, according to which principle only net income can be taxed. The ability to pay tax begins where there is net income after the deduction of production costs. In respect of employees, the minimum "production cost" is to ensure their own subsistence which is necessary for reproducing their working capacity. This has led to formulating the principle of tax free poverty level .

By deducting the amount of the poverty line, we get to *degressive taxation.* It may be debated, however, whether the physical or social poverty line should be taken as a point of departure. The latter is obviously a changing category. According to Farkas Heller's interpretation, the poverty threshold may vary from one social group to the other, assuming that people who are higher up on the social scale incur certain expenses required by their social status. It would be an utterly difficult task to attempt an objective assessment of that.

Income may derive from *work or property.* It is apparent that people who only have the income of their work and no pension benefit must necessarily make savings to make a living in their old age. This has led to the division of *funded and non-funded* income, or as it is currently referred to: capital-funded income and net income from work. It was found justified to levy higher tax on the former than on the latter. The principle could be applied by imposing a separate property tax in addition to taxing income. Moreover, when taxes were charged on the basis of the ability-to-pay principle, it had to be taken into account *how many members there were in the family.* It cannot be disregarded that a family man must also support the members of his family. If that is not taken into consideration for tax assessment, family men will be put in a disadvantageous position compared to single people. This approach looks almost as if social principles were introduced into the tax theory, but as Farkas Heller writes: it "is nothing else but taking the ability to pay into account for taxation".

The so-called *sacrifice theory* approaches the issue of taxation from an other perspective. It starts from the assumption that taxation is a burden: a burden for everyone. The principle of equal sacrifice would justify that *the proportion of that sacrifice should be equal.* It is evident that a rich citizen feels it less that his necessities are limited even if his taxes are relatively high. This logic has led to *progressive tax rates.* The sacrifice theory of taxation is economically based on the *marginal benefit theory* according to which the pressure to satisfy our needs diminishes as the disposable income increases. It is obvious that people will spend their income, first, on the most essential necessities, and if they have to pay tax, they will do it at the expense of the least important personal expenditures. In line with the logic of the marginal benefit theory, the needs that can be satisfied widens with the disposable amount, and the marginal benefit of money decreases as income grows. The conclusion has been drawn that in the different social groups the decline in the marginal benefit of money was greater than the increase of income. This has given rise to the theory of *graduated progressive taxation.* Scholars – including *Stuart Mill* – already back in the days of early capitalism directed attention to the fact that taxes should not work against capital accumulation. It is therefore worth thinking over whether progressive taxation is applicable for it keeps back activity and, what is even more, encourages tax evasion. Tax evasion may produce an opposite effect to what the intended objective is. Tax theory has thus shifted the emphasis from the subjective to the objective basis by focusing on similar tax brackets instead of the person of taxpayers. With his household surveys and price level calculations, *Irving Fisher* has provided measurable foundations for the tax theory. Heller writes: "the value of money depends on the purchasing power of the currency, it is therefore the reciprocal of the price level". (Heller, 1943, page 158) In different places and under different price situation, the value of money for households is dependent on the price level and the income level. The *marginal benefit of money* for different household groups can be well assessed by using price statistics and household statistics.

Inving's theory was refined by *Ragnar Frisch.* As a result, taxation could be based on reliable principles with theoretically supported rather than arbitrarily established tax rates.

Of course, graduated taxation, too, has a downside: as regards income close to brackets creeps changes can be erratic. It can be moderated by increasing the number of brackets and by introducing "halving" techniques for the value limit. The progressivity of tax rates means the application of *open progression,* whereas *hidden progression* is used for the deduction methods.

ONE TAX – MORE TAXES?

The multitude of taxes, no doubt, means an inconvenience to citizens. They are incomprehensible, and it is difficult to measure their consequences. That is why the idea of having only *one single tax* came up as early when modern public finance began to be developed. (There is nothing new under the sun, think of the flat tax gaining ground today.)

In the initial debates the first question was who should bear the tax: the producer or the consumer?

The physiocrat theory especially advocated that concept, and thus would have made landowners pay a high price for the elevated position the landowning class in their theory on the assumption that the only value-creating means is the land… A more extended version of this train of thought was having one single *capital tax,* since land was not regarded as the only capital. Finally, the argument was put forward for a *single income tax* starting from the principle that everything is income that is generated above the production costs, net income, so it is subject to taxation. This was based on the view that one aspect of economic life – for instance, consumption, luxury, productivity or income – is suitable for assessing burden-bearing capacity.

There were, however, several questions raised against the single tax. Taxes must ensure the growing communal needs of modern society. Every tax type has its limitations which must be respected in order to protect the source of tax. It must be a fundamental principle of all tax policies to maintain and protect the sources of tax.

Although we see a revival of the ideas of tax simplification and single tax today, in practice, the *combined systems* are still more widespread.

One of the most important tasks of economics is to create a tax system the components of which ensure the implementation of the maxims of Adam Smith in a well-harmonised manner. They ensure a sufficient amount of public revenue at low cost with proportionate burden-sharing. In a well-constructed tax system the possible disadvantages of the individual tax types are compensated by the advantages of the others and the system can adjust to the ever-changing economic reality.

LESSONS LEARNT

The idea of the service state is not a new invention. Many before us have considered it carefully what can be expected from the state looked upon as the association of free citizens, and then what are owed to the state. It is, however, also true that taxation is one of the most unloved obligations in the world, a burden which all taxpayers would like to shift to others. The necessity to collect taxes reflects a reverse approach: "Ask not what your country can do for you – ask what you can do for your country" – but expressed in a style far from as elegant. It means that the country, or more precisely, the prevailing government has accumulated such a large extent of debts that it is willing to discard the above-cited ever-precious maxims of taxation.

And that may be the source of serious problems. Scholars from the past warn us

- not to overburden the sources of revenue,
- not to withdraw incentives for savings and investment, and
- to bear in mind that the maintenance of families and the education of children form part of human capital costs.

The key forms of tax include *today* the value-added tax, personal income tax, excise taxes, corporate profit and dividend taxes and property taxes. Source tax is charged on financial savings and exchange profit tax on securities. Contribution payment also functions as a kind of tax as it is prescribed by law, it is mandatory for all and can be collected by public authorities. In reality, social security contributions have been removed from wages and salaries and constitute now the forms of forced saving – in certain arrangements combined with solidarity.

It can be seen that the focal points of the tax systems are shifted to consumer taxes in order that taxes and contributions on wages and thus the costs of production could be decreased, and the capital relieved of too large burden. That is perhaps the imperative of the society after modern industry. But the third principle must be borne in mind: we must also be capable of maintaining our family. It is especially important in the light of the concerns caused by the current demographic trends.

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