ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
ГОДИНА XVIII, 2009, 1

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WEALTH TAX: PROS AND CONS

In Hungary the eighteen years period passed since the change of political regime has seen the formation of a socio-economic pattern in which there are practically no middle class in that sense of Western European society. People are better off than in the past across a range of measures but the benefits are not spread equally: there are winners or losers of the transition but nobody between. Strong and increasing polarization of the society has now become an obstacle to economic and social progress.

The paper analyses the possibility to increase the efficacy of the national economy in a totally new way as it admits the very important – even if indirect – role of the social cohesion and solidarity. If one cannot require effective work, responsible and rational decisions from tired, frustrated and more and more indifferent people all those factors which are capable to stop and reverse this process have a strong indirect effect on the economic performance of the country. The reorganisation of the taxation system towards wealth tax and the decentralisation of decision making on public spending could boost Hungary's integration into Europe and its social and economic development.

JEL: H24, H26, E24, E26

> *"A too great disproportion among the citizens weakens any state. Every person, if possible, ought to enjoy the fruits of his labour, in a full possession of all the necessaries, and many of the conveniences of life. No one can doubt, but such an equality is most suitable to human nature, and diminishes much less from the happiness of the rich than it adds to that of the poor."*
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> *David Hume: of Commerce, 1752*

With this study my aim was to analyse the possibility to increase the efficacy of the national economy in a totally new way as it admits the very important – even if indirect - role of the social cohesion, solidarity and common feeling in the matter. If one cannot require effective work, responsible and rational decisions from tired, sick, moody and more and more indifferent people – so most of the Hungarian society – all those factors which are capable to stop and reverse this process have a strong indirect effect on the economic performance of the country. Based on the examples of modern and successful countries, the reorganisation of the taxation system and the decentralisation of the decisions could boost both the integration of Hungary into Europe and its social and economic development.

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During the research project, first I collected foreign countries experiences from France, the United Kingdom, Finland, Sweden, Denmark, Germany, Spain and of some other countries (Luxembourg, Switzerland). Afterwards, I concentrated to working out recommendations concerning the details of the tax reform and decentralisation in Hungary.

In Hungary the eighteen years period passed since the change of political regime has seen the formation of a socio-economic pattern in which there are practically no middle class and middle sized enterprises both a mainstay for Western countries society. In the Hungarian society there are the wealthy and the poor as well as in the economy there are co-existing big corporations almost entirely controlled by foreign capital and a too large number of micro enterprises comparing to population.

While political stability could be guaranteed by a strong middle class, economic prosperity could be maintained by major contribution of middle size enterprises. The lack of the "centre" creates a political switch repeating each four years and recurrent economic instability necessitating an economic policy with social restrictions. Restrictions increase even more the difference between the wealthy and the poor as well as between economic performances and possibilities of the big and the small enterprises. Nowadays this process has become self-generating and Hungary which was two decades ago quite homogenous a country, is on the way towards Brazilian socio-economic pattern. This goes quite obviously in the contrary direction of that expected when joining the European Union and also conflicts with interest of old member countries.

I am convinced that this trend is not inevitable and that Hungary must not necessarily follow it. There is an alternative. In order to find it out we must clearly analyse factors reinforcing the above pattern and changes to be accomplished for putting the country on a new path.

More than twenty years of research activity and experiences of everyday life make me arrive at the following conclusions:

- Strong and increasing polarization of the society has become an obstacle to economic and social progress. Official macro-economic statistics – at least until recently – seem to contradict this, but they appear to contain serious methodological errors. Recent scientific findings proved that GDP growth as the most important indicator of economic progress is now extremely misleading and outdated. In my quality of researcher in economy I consider as my principal task to work out recommendations with the aim of increasing prosperity of the majority of people. Prosperity for the majority of people does not mean soundly progressing macro-economic data. Prosperity means rather the following things: having a job, finding satisfaction in it, having decent income and home, having time to relax and spend it in an intelligent way and so on. To achieve the above listed objectives it is especially necessary – besides a private economic sector of a sound constitution – that the public services in a large sense of the word (public health, education, public security, public transport, environmental policies, institutional system, etc.) could work at an appropriate level. Nevertheless, in the past eighteen years we have seen but the decline of the public sector.

- The current state of the public sector can be explained by two main causes: lack of financial resources and lack of ideas. While the last thing concerns the responsibility of the government in power, the lack of resources is to be explained more in details. Generations who had grown up and lived in the previous, more homogenous, egalitarian society were rapidly and seriously demoralised by the aggressive expansion of the new regime. Many of them felt that those becoming wealthy were not the talented and hard-working people, and efforts of several decades became valueless. Tax avoidance and corruption concern wide social layers, and its negative influence on public sector resources is at a far more extent due to wealthier people than to poorer.

- Tax avoidance is possible chiefly by reason of that the bulk of income tax is collected on the basis of officially proved and registered personal incomes. It is to be remarked that in Hungary only the public employees pay a tax proportional to their very incomes. In the private sector – dominated by small and mostly by micro-enterprises – the undertakers and the employees are registered almost exclusively at minimal wages. These individuals whilst not registering the bulk of their personal incomes make constant efforts to make their business incomes exempted by producing double bills and by putting down private expenditure as business costs.

- Corruption is in close relation with excessive material polarization of the society. For enterprises it is crucial to win public contracts. In a country plagued by public budget imbalances and, generally speaking, by a financially failing public sector, the salaries of public employees are at such a low level that it incites both parties to corruption: the one who gives and the one who accepts bribes. In Hungary even the foreign enterprises learnt the ropes quickly. The example of corrupted high level directors is followed, of course, at lower levels, too, although stakes are smaller and business relations are intermingled with family links instead of those purely financial operations.

On the basis of the above mentioned facts, I formulated the following hypotheses:

As the general sharing of taxation based on the registered income, on the one hand, is inequitable – for it charges very unequally certain social layers – and, on the other hand, is inefficient for unequal sharing of tax burden raises far less public money than the equal sharing, it is recommendable to put the emphasis of taxation on the wealth which better reflects social richness and is better demonstrable. In this way it could not happen that a poor family pays more taxes than a richer one. As in Hungary the wealth tax is for the time being practically an unknown, non-existing instrument but it is applied in a number of developed countries, in the course of the research I extracted and to analysed existing systems.

At the end of the 1990s, in OECD countries with wealth tax in effect, from the combined wealth tax and legacy duties an amount equal to 3-4 percent of GDP flowed into the public treasury each year. In Hungary legacy duties generate budget revenue of only less than HUF 1-2 billions. If we want revenue equal to 3-4 per cent of the GDP to flow into the Hungarian budget from the wealth tax to be introduced, this would mean an amount of HUF 900-1.200 billions a year. Budget deficit could practically disappear, so one of the conditions of the introduction of the euro could be realized with much smaller than expected socio-economic damages.

With the introduction of the wealth tax, resources for the public services could increase. But increased resources should not be spent in the existing structure. Now the matter is that the decision about the distribution and the spending of the public revenues is taken in 90 per cent by the central government. This mechanism generates a corruption of a very large scale at the highest levels. Giant projects – e.g. the construction of new metro-line in Budapest, or that of several hundred kilometres of new motorways for HUF hundred billions – are easy ground for diverting public money either in private pockets or in political parties' budget. People have a feeling that they are totally outsiders concerning decision making. For an efficient spending of public resources which serves better the needs of the population decisions concerning localities must be taken nearer to the people, at the lower level of the public administration. To be sure, the possibility of local corruption increases, but at lower levels it is more difficult to obscure the bad handling of the public money, or to force the approval of spectacular but useless investment projects. It is very probable that after the satisfaction of basic needs of local administration, there will be left no more money for other purposes.

Decentralisation could bring about a further decrease in the budget deficit, especially if there remained only two administrative levels as in Denmark where the 2007 Local Government Reform practically abolished the middle level. The 271 municipalities merged into 98 small regions, and the counties were replaced by 5 regions, the latter having only one important responsibility: hospitals.[2]

Novelty

When recommending a shift in public burden sharing towards wealth tax, I consider the potential for an increase of the economic effectiveness from a totally new aspect: actually I recognise the very significant although indirect role of social cohesion and solidarity. As one cannot expect tired, sick and more and more indifferent people to do effective work or make rational decisions, all factors able to stop and reverse this tendency may improve, even if indirectly, a nation's competitiveness.

Cons

The wealth tax, as a mean of taxation, came to the limelight at the end of the 1970s. By that time wealth tax had already been established mostly in Germanic and Scandinavian countries, and in that period of new enthusiasm it was extended to some Latin countries as Spain and France, an Anglo-American one (Ireland) and even Japan. The timing proved to be unhappy in that growing mobility of both

[2] See Larsen 2006

capital and persons, a side-effect of globalisation, underperformed governments' expectations about tax revenue.

Since then, many countries (Austria in 1994, Denmark in 1996, Germany in 1997 and Sweden in 2007) decided to abolish their wealth tax or changed it for a similar regime. Italy converted it into a local property tax and the Netherlands turned it into a tax based on net value of the capital assets. The main points of criticism about wealth tax are as follows:

- it may contribute to capital outflow, i.e. it can cause productive capital to leave and discourage foreign investors from entering a country – at least this was the factor for which Ireland and the Netherlands did away with wealth tax;

- it is not neutral enough, i.e. the different elements of the tax base on which the tax is raised are very unevenly affected, a reason for which the Constitutional Court in Karlsruhe stated against the wealth tax: while real estates were considerably undervalued, listed securities and financial assets could not be undervalued;

- it entails high management cost compared with relatively low returns, e.g. in the Netherlands the aggregated cost amounted to more than one fourth of the tax yield;

- it may distort resource allocation when it is levied both on corporate and individual wealth – as was the case in Germany or Austria;

- it is not as equitable as it appears to be, as during the last two decades, in each developed country with a wealth tax, the gap between rich and poor has increased at a speed never seen before.[3]

- it may not be in harmony with tax payers' solvability. It is especially true for real estates located in big cities or other fashionable places where prices are likely to go up very fast.

Pros

Before enumerating the arguments in favour of wealth tax I have to confess that during my investigation in the different tax regimes I was most of all impressed by the French "solidarity tax on wealth" (ISF). This tax is levied on the net worth (assets minus liabilities) above € 790,000 held by natural and in some cases of legal persons on 1st January. Tax rate varies from 0.55% for the lowest band to 1.80% above € 16,48 Mn.[4]

Taxable values are:

[3] See Heckly 2004
[4] See Barème de l'ISF

- properties (30% exemption for main residence);
- cash (and alike savings);
- means of production (e.g. company's drink stock);
- usufructuary right;
- furniture (5% flat rate or detailed account);
- financial placements;
- all sort of vehicles (cars, planes, boats, etc.);
- racehorses;
- jewels (gold, precious metals).

Exempted are:

- professional goods (of the main activity);
- business properties and shares (of the main activity);
- agricultural goods (partially);
- antiquities (>100 years) and veteran cars;
- intellectual property rights;
- capital value of annuity;
- employees' shares

French residents must include all worldwide assets, while non-residents are only liable for wealth tax on assets physically situated in France. However, in order to attract high-earning professionals there is a partial exemption for five years from ISF for most people moving to France after 6th August.[5]

Even if ISF has continually been criticised in recent years, there are arguments for its maintaining:

- it stimulates economic use of the wealth rather than treasure-accumulation;

[5] See Cabinet Gregory 2009

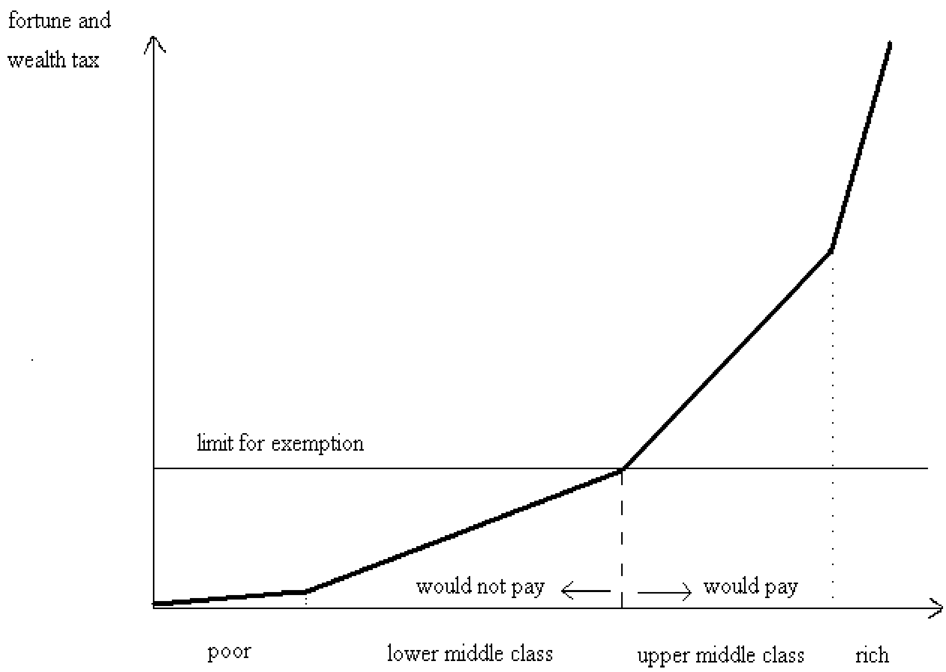
- it dissuades from living from rent – according to 1789s principles;
- it helps to reduce the national budget imbalance.

How to introduce wealth tax in Hungary?

Before introducing a new tax, it is good to clear first on whom to levy it and how much revenue to generate from it. At this point I have to refer to a study from a Hungarian sociologist, Zsuzsa Ferge[6], who ranked our society into four groups: poor (15% of the population), lower middle class (40%), upper middle class (35%) and rich (10%). When advocating the introduction of a wealth tax, I think it would be wise to levy it on the upper classes only, i.e. on the winners of the economic transformation process (see Figure 1).

Figure 1

Wealth tax in Hungary: a possible solution

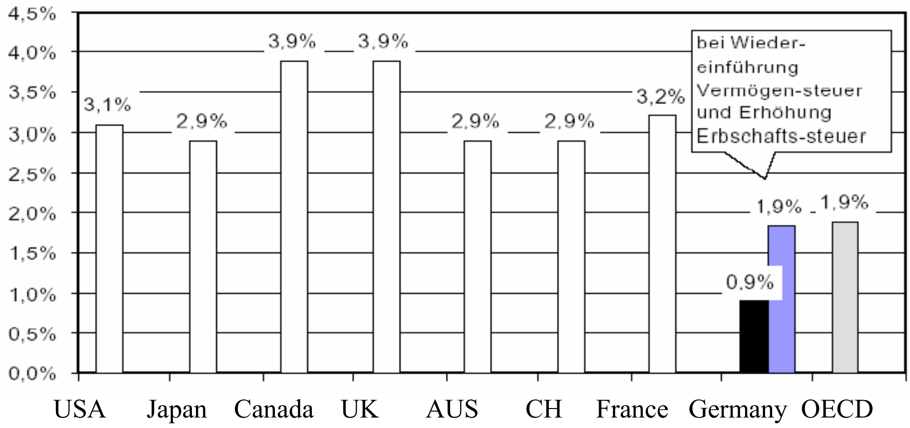


As for the revenue to be raised with it, a minimum of 3-4% of Hungarian GDP (i.e. € 3-4 bn) has to be aimed at, a level similar to that observed in countries where, in 1999, both wealth tax and inheritance tax were in vigour (see Figure 2).

[6] See Ferge 2006

Figure 2

Wealth and inheritance tax as a % of GDP



Source: Vermögen- und Erbschaftsteuer Ergebnisse der Untersuchung des *Deutschen Instituts für Wirtschaftsforschung* Wirtschaftspolitische Informationen ver.di Bundesvorstand Berlin - Bereich Wirtschaftspolitik – Oktober 2002 http://www.verdi.de/hintergrund/wirtschaftspolitik

A further question is what assets to be involved? The French ISF represents a good example: properties, vehicles, cash and alike savings etc. are covered by the tax. One thing is sure: the wealth tax should be levied on registered and controllable assets.

Nevertheless, under the circumstances of current life in Hungary, also the following are to be taken into account:

- as a significant part of personal fortune has been brought into companies, the wealth tax should be conceived in such a way that this fortune cannot escape from it;

- in order to avoid that fortunes be divided up among relatives – as it happened with the luxury tax levied on properties of a value of over HUF 100 mn (~€ 400,000) – on families living at the same postal address the wealth tax should be levied;

- it is important that the time factor be taken into account. By multiplying the sum of the tax to be paid by a simple regressive coefficient like 1/x, where x represents the number of years having passed since the acquisition of the asset, the process of getting rich and the obligation of paying the tax remain relatively close to each other in time, so there is a good chance the tax is actually paid;

- and finally, the tax burden should be alleviated for those whose fortunes are not due to unrepeated events of the transition (like privatisation), or loopholes in law, or simple tax avoidance but originate from taxed revenues. E.g. by offering the possibility of lowering the wealth tax by average personal income tax paid in the last 5-10 years.

Considering the above we can conclude that wealth tax in Hungary would have further "pros":

- an economically more homogenous society has more chance to be competitive world-wide;
- winners of the transition would be made entered the burdensharing of public finances;
- with more tax money collected the public services could be modernised.

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