

THE HIDDEN ECONOMY IN HUNGARY*

PÁL BELYÓ

In the Hungary of our days, like in other societies, legal and illegal activities, visible and invisible (underground) sectors, white, gray, darker and even pitch black economies exist side by side. Their sizes and scopes, however, are very different. Most countries generally draw a sharp dividing line between the hidden and the underground economies. This is because some activities are considered productive and legal in the economic sense even if they are concealed from the authorities in order to avoid payment of the income, value added or other taxes and the social security contribution, or due to the violation of legal regulations concerning for instance minimum wages, maximum working hours, certain health requirements, administrative procedures such as statistical or other returns.

At present, in Hungary there are billionaires who pay a mere 160 thousand income tax per annum on their reported, 'legal' income as well as people with a few hundred thousand HUF of income and declining.

The activities described as hidden economy may be positioned within a system encompassing all human activities, classifying and arranging economic actors and their economic activities in many dimensions. We may also describe the so-called black economy as hidden economy in conformity with the language of several western countries and international organizations. This is primarily because the concept of the black economy is close to illegal or criminal activities, it represents a much narrower scope than what is classified under this heading by the international statistical organization.

However, 'black economy' also covers activities which earn substantial income for certain individuals but do not originate in production, therefore cannot be included in the calculation of GDP. Such income from corruption, bribery, theft outside the productive sectors and similar practices represent a considerable volume in Hungary as well. These crimes do not increase the amount of goods available in the country in volume or value terms because they merely constitute the redistribution of existing income and wealth.

SIZE, SHARE, MAJOR TRENDS AND NATURE OF THE HIDDEN ECONOMY

The evolution of the current level of the hidden economy in Hungary has been closely interrelated with economic liberalization. Even though the hidden economy exists

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everywhere in the world, its proportion is substantially lower in developed economies than in Hungary, on average representing 4-10 per cent of GDP. Its most widespread forms that can be found practically everywhere are: black market trade, trade in unregistered products, black labour, tax avoidance and money laundering.

On the whole we can say that the hidden economy is an unavoidable feature, or even mode of operation, of the evolution and strengthening of the peculiar Hungarian form of capitalism. It is one of the major causes of the disproportionate development of the economy and social deformations, especially unfair competition, excessive tax burdens for an overly limited circle of taxpayers, and extreme income and wealth differentiation. In addition to the increasingly severe crime-related activities, the so-called soft forms of the hidden economy, condoned by public opinion, have become general, and affect practically every Hungarian citizen in some way. Where is the person who has never used the company car for private purposes, never participated, maybe inadvertently, in some tax-avoiding income redistribution scheme, or never 'purchased' untaxed labour or goods? These practices are so diverse that their mere collection and classification is a complicated exercise. In view of this it seems reasonable to say that today in Hungary the proportion of the hidden economy may be as much as 30 per cent of GDP. (Based on the expected 5700 billion HUF GDP at 1995 current prices, this is 1700 billion HUF.)¹

However, in the current environment of market economy, a new approach should be adopted for the analysis of the hidden economy. Thus it is the question: which is greater,

- the benefit to the enterprise/individual generated in the black economy, or
- the cost of the foregone income for the state and society?

The initial step towards the legalization of the hidden economy should be the creation of an entrepreneurial-economic environment that would automatically guarantee legality. This has several preconditions, for instance:

- the harmonization of the legal framework, i.e., the uniform and consistent re-creation of all the acts, decrees and regulations related to economic operations;
- the merging of entrepreneurial registers is of similar importance; the records of social security, the tax authority, the Central Statistical Office, customs and excise and potentially of commercial banks could be connected. Thus financial flows would be controlled from several aspects, and fictitious financial transactions could be caught.

Change of the ownership structure

Most of the activities within the hidden economy are related to the income redistribution as required by the state. The yield of the co-operation of the participants is the unpaid tax, which can be distributed between themselves. Inevitably, both the sellers and the buyers are accomplices and beneficiaries in most transactions.

Any economic policy aimed at legalizing the hidden economy must start from the fact that the participants in the hidden economy consider

- the costs and benefits of their hidden operations as compared with legal operations, and
- the yield of expansion and efficiency increase implemented with legal means as compared with the yield of tax evasion.

¹ *Laczkó Mária: Az illegális gazdaság aránya Magyarországon, 1970–1989 között. Közgazdasági Szemle. 1992. No. 9. 861–882. p.*

Therefore the main goal of economic policy may be to improve these ratios. The largest segment of the hidden economy is in the framework of legal organizations, intertwined with legal operations. These hidden activities are essentially aimed at reducing tax and contribution payment obligations. This is the area where the government proposes to use prohibitions and incentives in a co-ordinated manner to address the problem.

We also need to discuss the purely economic crimes where the operations are economic in nature but their express purpose is to obtain illegal benefits (e.g., fictitious VAT reclaims, intentional bankruptcies, embezzlement, non-payment of the excise tax). Such practices still represent a large volume; the modernization of the tax procedures, the improved efficiency of audits and the elimination of motivation can offer potentiality for addressing this issue.

The relationship of the hidden economy with the tax regime and the employment situation is fundamental. Two large categories of the income generated in the hidden economy relate to

- the concealment of employment and
- tax evasion by other means.

Since the reform of 1988, the Hungarian taxation system has been based on the principle of self assessment. This is a relationship rooted in trust, created by the state for the benefit of taxpayers who voluntarily comply with legal regulations. However, the economic transformation that started a few years ago has increased the number of those who abuse that trust. The causes include the fact that in Hungary the relationship between the collection and use of taxes is not yet clearly understood by the public, and tax discipline is at a rather low level. As a result of the gradual liberalization of economic law, there is a great scope for abuses. Legal regulations and criminal legislation facilitating the discovery of evaders have not been created to provide a balance for the principle of trust. Furthermore, the regulatory system is rather complicated, it changes frequently, and often forces taxpayers to pay taxes in excess of their capabilities. In the past years legislation has tried to adopt severe rules in respect of certain offenses, but has not achieved any notable results yet.

The concealed taxes and contributions are estimated to be around 450 billion HUF. Carrying forward the calculations of the Foundation for the Market Economy from 1992, this can be modified as follows.

- The beneficiaries of the VAT and turnover tax (buyers, sellers, suppliers) fail to pay approximately 120 billion HUF of taxes in respect of some 550-600 billion HUF of concealed taxable income.
- Owners and managers manipulating the corporate income tax fail to make some 800 billion HUF payment in respect of about 200 billion HUF tax base.
- Income owners conceal approximately 240 billion HUF contribution base, avoiding the payment of some 60 billion HUF in taxes.
- Employers and income owners fail to pay 160 billion HUF of contribution by concealing some 220 billion HUF income in respect of which social security and other contributions would be payable.
- The entities participating in foreign trade do not pay approximately 10 billion HUF worth of customs surcharge after an estimated 20-30 billion HUF worth of customs duty base.

Several estimates have been prepared about the size of the hidden economy in a sectoral or activity based breakdown. However, these do not indicate in the above manner

the costs and benefits of the illegal or unregistered activities in these areas. For instance, the exact cost of the approximately 600 billion HUF estimated turnover of the black market trade to legal trading operations is difficult to quantify. Similarly, it is difficult to assess who is the beneficiary and the victim, and what is the cost or benefit, of the fact that four fifth of the software used in Hungary is estimated to be stolen.

In 1994 GKI Economic Research Co. carried previous estimates forward in time, in order to analyse the sectoral breakdown of the private sector and the hidden economy in more detail. The analyses afforded interesting conclusions about the trends in domestic private and foreign ownership. It has become clear that initially domestic private ownership increased radically in sectors different from the ones where foreign capital entered. The contribution of the Hungarian private sector to the GDP in 1994 was already around 70 per cent in the construction sector, trade, catering and accommodation services, agriculture, auxiliary economic services and road transportation. On the other hand, foreign ownership is high in financial services, in the communications and also in the processing industry.

Furthermore, there is a difference between the orientation of domestic private capital and foreign capital even within the processing industry. Foreigners have built up positions primarily in the building material sector, food processing and machine industry, while the domestic private sector has a strong presence in metallurgy and metal processing, as well as in the textile and clothing industries, lumber and printing. The latter industries are not among the most profitable activities. However, hidden income is very high in trade, catering and accommodation services, construction, auxiliary economic services and road transportation. The proportion of hidden income is relatively low in Hungary in the sectors preferred by foreign capital such as financial services, communications and processing.

The costs of the hidden economy, as well as its benefits to its participants, may take diverse forms. Therefore further research is needed to map all the social deformations present in this area, to quantify financial benefits, actual and opportunity costs, to reveal the exact relationship and the existing effect mechanisms between the legal and illegal economies.

ON THE BORDERLINE OF ECONOMIC CRIME

The phenomena of the hidden economy should be classified on the basis of their relationship to the system of economic regulators, i.e.:

- there are income earning methods where the activity is not economic in nature and is illegal. These areas are well-known (e.g., arms dealing, ‘protection’ Mafia, receiving, drugs trafficking, other illicit activities) and are basically outside the scope of economic policy;
- other methods of income earning are clearly economic crimes. In such cases the activity itself is economic in nature, but its sole purpose is to gain wealth illegally. Examples are fictitious VAT reclaims, fraudulent bankruptcies, embezzlement, failure to pay excise tax, fictitious export transactions, etc. This type of activity is very substantial in Hungary;
- finally, there are income earning methods where the hidden economic activity is performed within the framework of legal economic organizations, intertwined with fully legal operations. The purpose of this hidden economic activity is the reduction of tax and contribution payment obligations for the enterprise. Today these activities constitute the largest segment of the hidden economy.

Main forms and techniques applied for concealing activities in the hidden economy

Certain general forms of conduct have emerged in Hungary which provide scope for the hidden economy. In the present environment, due to the absence of harmonization between legal regulations, the lack of sanctions for violation of specific rules, or the unenforceability of proposed sanctions, the black economy has ample opportunities to flourish while appearing legal. Some examples of such conduct include the following.

- Taxpayers engaged in taxable activities fail to register with the tax authority (court of registration), or even if they register, they do not meet their tax obligations. Tracking them down in itself is often difficult (if not impossible), and even if they are audited, any findings are bound to be unrealistic due to the lack of accounting records and documentation. Such ‘fly-by-night’ operations can enter the market as ‘normal’ enterprises.
- There is an increasing number of enterprises that report a loss in their tax returns and/or earn an income below the minimum wage. However, it is unreasonable to assume that the taxpayer would continue to maintain such an enterprise if it does not produce any notable income in the long term.
- The magnitude of cash transactions is increasing year by year. There is general consensus that cash transactions are uncontrollable and provide a hotbed for the black economy.
- In the current system, there is no control mechanism for the existence or growth of wealth which is one of the most important accumulation areas for the black economy. More specifically, a wealth increase audit that would provide a control on income tax payments is impracticable due to the lack of legal regulations. As a result, the illegal and untaxed income generated in the hidden economy can be turned into legal property without any problem, then it can be used to finance untaxed income generation in the black economy again.

Let us look now at a list of the most typical forms, techniques, procedures applied by the participants of the hidden economy to maximize their entrepreneurial or employment income while minimizing the related tax, social security and other obligations:

- omission of part of the sales income from the records,
- inclusion of fictitious material production costs among expenditure,
- deduction as production expenditure of an excessive part of household expenses,
- purchase and maintenance of cars,
- organization of business and study trips abroad,
- benefits charged to entertainment and advertising costs,
- new business acquisition commission,
- purchase discounts,
- misappropriation of products, materials or instruments,
- excessive benefits offered by foreign enterprises,
- year-end devaluation or “transfer” of inventories,
- off-the-record payments to registered employees,
- use of unregistered labour,
- barter transactions involving products or services with different values,
- parallel foundation of enterprises,
- economic activities of unregistered private individuals and the income derived from these.

The practices and methods indicated in the above incomplete list are generally used by registered economic organizations and sole proprietorships. However, there is even a longer list of economic activities performed by private individuals who failed to obtain a license or tax code for the activity concerned, or rendered directly to the consumer in addition to official activities:

- work performed ‘on the side’, i.e., industrial, construction or repair services rendered directly for the customer primarily outside work hours;

- household work performed for other households for cash consideration (cleaning, laundering, cooking); child care, nursing of the old or sick, private instruction to children and adults;
- unregistered rental of property (cottages, residential homes, garages, etc.), money lending, street markets, etc.;
- tips and gratuity payments;
- consumer fraud at shops and catering units (reduction of weight, over-billing).

The consequence of a policy which uses almost entirely the means of control

The extent and existing forms of the hidden economy are fundamentally affected by the government's financial policies, more specifically its fiscal and social policy. The findings of surveys examining the characteristics of the black economy indicate that four categories of factors are in an unambiguous relationship with the development of the black economy, namely:

- the direct tax charge on enterprises and private individuals,
- changes in the tax charge,
- the extent of the government regulation of the economy (intervention),
- standard of tax discipline.

The term black economy creates the impression that this is an independent structure, though a substantial part of it is closely related to legal economy. As the owner of a product paid for without a receipt, anyone may become a participant and victim of the black economy. Such a person is harmed as a member of society through the reduction of revenues to cover public expenditure; moreover, the purchaser of goods sold without a receipt may not complain about the product (in Austria there are legal sanctions against the purchasers of goods without a receipt as well).

The term black economy is well chosen because it indicates a certain degree of organization. Examples include 'gasoline bleaching' and some major tax evasion schemes. This term also hints at its frequent relationship with crime. Tax evasion may go hand in hand with other crimes, thus society may be criminalized in this manner very fast.

THE FUTURE OF THE HIDDEN ECONOMY

The concealment of income is a significant factor in the black economy of every society; its causes are fundamentally similar everywhere, and action against it is also necessarily similar.²

Every tax authority has to face the problem of uncollected revenues. They recommend more intensive audits and more severe sanctions. The loss of tax revenues may actually be considered of secondary importance, because there are more severe consequences: the jeopardization of the principle of general and proportionate sharing in taxation and the fact that the evasion and violation of tax laws may contribute to the violation of other laws as well.

Having looked at the key factors contributing to the development of the black economy, we may declare that aversion to tax evasion is on the decline all over the world.

² Dr. Árvay János – Dr. Vétés András: A magánszektor és a rejtett gazdaság súlya Magyarországon (1980–1992) GKI Rt. Budapest. 1994. 28 p.

The concealment of income clearly serves the purpose of maximizing the net income of taxpayers.

Consideration is probably given to the following factors:

- the probability of discovery,
- the size of fines and other penalties,
- the size of the average tax burden, progressivity and the tax free income category,
- the proportion of actual income and the unpaid taxes.

The probability of discovery and its increase may clearly reduce the amount of concealment. No unambiguous relationship has been proven between the severity of punishment and the extent of concealment. This may be due to the fact that punishments fall into the competence of constitutional legislation, whereas the audits themselves are the responsibility of the tax authorities.

The main motivation for tax evasion may be the high average tax charge. In addition, there are further other duties and charges which, if adequately high, may trigger tax evasion and the use of black labour. Some foreign research findings indicate that a 1 per cent increase in the tax charge results in an 8 per cent increase in concealed income. When the tax charge is increased, the increase in the concealed income is generally higher than that of actual income.

The degree of progressivity of the income tax is another motivation for tax evasions. The broadening of the untaxed income bracket generally reduces the volume of concealed income. In some industrialized countries, the reduction of tax rates and increase of the untaxed income bracket has not resulted in the loss of tax revenues so far because the reported income increased as a result.

However, there may not be a close correlation between the size of income and the frequency of concealment. High income households take the risk of concealment as frequently as their low income counterparts. It appears, however, that the higher the proportion of inadequately documented income, the more income is concealed. The increase of the proportion of taxpayers above the active working age is conducive to tax evasion.

The examination of the factors influencing income concealment indicates that the probability of discovery may be the factor that could act as a deterrent. This, however, is not supported by the fact that the duplication of the frequency of audits resulted in a mere 15 per cent fall in the size of concealed income.

The correlation between the qualifications of the taxpayer and the volume of tax evasion has been analyzed in several projects. Taxpayers with lower level qualifications are less familiar with the taxation rules, therefore they have less knowledge of the various sanctions and the consequences of tax evasion. However, people with higher qualification find it easier to manoeuvre among tax rules, and can act in tax evasion more effectively. The net result is that tax evasion is less prevalent amongst highly qualified taxpayers. This also means that more intensive audits may act as deterrents only for the more educated taxpayers, who represent the minority of all taxpayers.

Low level qualifications and unfamiliarity with sanctions may partly explain why the deterrent effect of penalties is smaller than often expected. Foreign literature recommends that if the concealment of income is excessive, tax discipline should be improved by the imposition of high fines and prison sentences.

Another useful practice is that in some industrialized countries taxpayers may inspect the register of taxes maintained by the local governments. This publicity represents social control that reduces income concealment by allowing access to third parties.

Interrelation between the tax system and employment

The most important objective nowadays may be to identify ways to make the hidden economy legal. Therefore, it is imperative to co-ordinate prohibition and incentives. If prohibition is the only method employed, the persons concerned will probably find ways to realize hidden income under the new conditions as well.

Therefore the advantages and disadvantages of any proposed change need to be weighed in every case. Apparently it is only in the long term, after significant changes in the structure of the economy, that we can hope to reduce the hidden income in the Hungarian economy to the level of the developed countries. As long as capital is weak, vulnerable and, partly as a result, aggressive in Hungarian capitalism, reported profits will be relatively low if the tax burden is high.

In the short term, the most spectacular results can be expected from the application of enforcement methods. In the course of this, the illegal activities performed in the hidden economy for the express purpose of tax avoidance must be tightly regulated, large transactions consistently controlled and prosecuted. The most common types of conduct are easy to catch. For instance, smuggling, counterfeiting (e.g. of food products, gas, etc.), production and distribution of products under state monopoly or subject to excised duties or taxes (e.g. spirits, tobacco products, fuels, gambling) can be influenced through police or law enforcement efforts. It is advisable to concentrate on the 'big shots'.

The types of activities as well as the product groups concerned are well known; even substantial enforcement expenditure would produce a return in a short time due to the enormous amount of hidden income. Tighter control is the responsibility of the police, customs and excise authorities, the road inspectorate and the market superintendence, but the complex character of such controls is a precondition for success. In addition to controlling the payment of customs duties, VAT and other taxes, investigating powers may have to be given to the tax administration, and auditing powers to the social security administration, which need to be co-ordinated with the other powers.

In order to reduce black labour, the introduction of on site labour inspections seem to be indispensable primarily in the construction industry, trade and transportation. Enterprises using a large amount of black labour should be severely punished, while the workers concerned should be subjected to much more lenient rules. Alternatives for controlling the unemployed should also be reviewed.

Complex economic policy tools must be used in legalizing the hidden economy. However, no package of measures can be effective without clear political commitment, because the lobbyists of the groups whose interests would be harmed by a particular measure can prevent professionally justified measures. It is important to introduce only enforceable rules.

Restrictive measures in themselves cannot be effective unless other measures influencing the economic environment are also introduced; these should be such as to be welcomed by fair enterprises.

The following is an incomplete list of the areas where results may be achieved in the short term:

- introduction of a flat rate tax;
- regulation of cash transactions in enterprises;
- legalization of a wealth assessment;
- control of certain cross border financial transactions;
- introduction of a register of enterprises;
- change of the tax burden;
- modification of the social security contribution rate;
- narrowing the scope of operation of illicit trade.

Looking at the long term methods for influencing the hidden economy we find that while illegal activities are too advantageous as compared with legal operations, and the use of legal methods promises a much lower yield than hidden economy does, there is little hope for preventing the expansion of the hidden economy and the continuous evolution of new techniques.

Projections on the development of the hidden economy are difficult to prepare for several reasons. On the one hand, as tax laws and other regulations change, the techniques of concealing income and output are also altered. The ever renewed techniques in turn create the general impression that the activity of the hidden economy is expanding. This is based on the assumption that new techniques are used in addition to the old ones. The changes of legal and economic regulations also eliminate certain techniques.

Inflation is another important consideration for purposes of a prognosis. The obvious solution is to carry ready-made estimates forward to multiply previous values by the rate of inflation. However, in the case of the hidden economy, this is a controversial technique, as the price increase of some activities within the hidden economy is significantly lower than the official rate of inflation. One example could be ‘on-the-side’ jobs, where the business is based on the premise that the service is cheaper as no invoice is required.

Key of long term tasks for influencing the hidden economy:

- harmonization of law,
- modification of the parts of the institutional system that can influence the black economy, and
- moral pressure.

One important task in the fight against the hidden economy to be solved is to make the tax regime complex and all-encompassing. One obvious tool may be the establishment of the Central Association of Taxpayers. In this, citizens could advocate their interests appropriately.

A good tax system may be considered as the basis of the society of a developed market economy. This would necessitate the creation of an institutional framework for the participation of citizens in the appropriate form, potentially by redesigning tax legislation in Hungary.

In the course of this, special emphasis must be laid on preventing the interpenetration of black economy and politics. Citizens should have a direct say in the formation of types of taxes and tax charges on every taxation level. Citizens should also have an opportunity to influence the work of tax authorities. This control can be very strong, and form the basis of the involvement of citizens in the struggle against the hidden economy.