BUDGET DEFICITS AND INDIRECT TAXES: DURING THE POLITICAL INSTABILITIES
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COSAR, Nevin

Abstract

The main purpose of this study is to examine a relationship between budget deficit and indirect taxes in political instability. Between 1985 and 2003, budget policies were influenced by unstable political conditions. In order to explain the financing of the budget deficits under the political instabilities. In the first part of the study, theoretical developments will be explained. Second, Turkish political and economic conditions will be analyzed. Third, econometric tests and results will be discussed. We propose that indirect taxes are more utilized than direct taxes during the political instability periods

JEL Classification: H61, H62, C33, C5
Key Word: Budget Deficit, taxes, cointegration analysis

1. Theory

Growing government expenditures and the budget deficits are frequently examined themes in macro-economic policy analysis. Budget deficits are determined by several factors, for example; revenue indeficiency, increasing government expenditures, etc. For coalition periods some new factors must be added to these elements. For example, under the unstable political conditions, political polarization and coalitions cause some lags in reform processes which, in turn result in budget deficits. Uncertainty in the results of the elections and in the foreign exchange system bring about many forecasting difficulties in forming of the state budgets which leads to budget deficits. Instruments, utilized by governments for the deficit

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finance are domestic, and external debts and monetization. But, there are some constraints on utilizing the financial resources by the governments. In this context, sustainable deficit level is the most argued subject. If existing deficit is greater than the sustainable deficit level, goals of the program must be revised or fiscal policy must be shifted (We will not argue monetarist arithmetic, FTPL, and Barro’s proposition in this study).

In theory, there are three approaches concerning the financing of public expenditures. The first approach takes into account the real effects of the financial policies, while the second one emphasizes nominal effects. Irrelevance theory, is the third approach for the financing of public expenditures, denies real and nominal effects. According to Irrelevance theory, citizens know that increases in public expenditures will be resulted in tax increases.

Friedman’s(1978), and Buchanan and Wagner’s (1977) works we could examine the theoretical framework more closely. According to Friedman taxes are the important tools for reducing the budget deficits. He emphasizes that increasing taxes cause larger budget deficits not growing expenditures. Buchanan and Wagner think that taxes are not the cause of the spending but solution for the budget deficits. Opposite of Friedman, they think that tax increases can meet budget deficits.

Barro(1974), and Peacock and Wiseman (1979) approach to the problem from the expenditure-tax hypothesis. Tax smoothing hypothesis proposed that increases in government expenditures are followed by tax increases which are permanent in character. Wildask rejects this view, depicts that government expenditures and taxes are independent from each other. Since, during the rises in taxes expenditures will not change, increases in taxes can reduce budget deficit.

The most of the empirical tests on budget deficits and taxes are for developed countries. For example, Manage and Marlow (1986), and Ram(1988) show that taxes are the cause of expenditures in the
U.S.A. Miller and Russel(1990) find that there is a reciprocal deterministic relationship between government expenditures and taxes.

Owaye (1995) investigated the relationship between expenditures and taxes for G7 countries for the period between 1961 and 1990. Except for Japan and Italy, it is showed that this relationship is reciprocal. Chang (1999) is tested this relationship for Latin American countries. Darrot (2002) tests for Tunisia ve Lebanon, and Chang ve Ho (2002) for Taiwan.

In this studies, one of the important point is that the structure of the government is neglected. The structure of the government is very important for the relationship between public expenditures and taxation. Diversity of opinions in coalition governments causes rises in public expenditures and enlarges the budget deficits. Despite the fact that, each coalition member desires to balance the budget, polarization and tension in the parliament bring about greater budget deficits.

According to Bussiere and Multer (1999), political instability is determined by a) political polarization in the parliament, b) coalition governments, c) undecided voters and fickleness of the voters, d) the control and timing of the elections. They emphasize the relationship between political instability and budget deficits. According to them, political polarization and coalitions cause some retards in the reform processes which result in budget deficits.

According to Cukierman and Edwards (1992), due to possible shift of governments, political instability and polarization, political system rely on more seigniorage. In that case, seigniorage (and/or in coalition period) is replaced the taxation in order to finance budget deficits. Tax system is not efficient in this situation. A.Hossain ve A. Chowdhury (1998), emphasize on these points for developing countries; a. Soft budgets and macro-economic populism cause public sector deficits, high inflation rates, and increasing external imbalances, b. political instability results in budget deficits; budget deficits bring about a deterioration in nominal and financial responsibilities.
In this paper, we expect that coalition governments cause some problems in decision making processes and policy implementations. High tension in the parliament also influences decision making process in a negative way. This, in turn, results in inefficiency; Especially, in taxation.

2. POLITICAL INSTABILITY AND TURKISH ECONOMY

a) General Characteristics of Political Developments in Turkey

The 1980s were very complicated period of the Turkish politics and the economy. Between 1980 and 1983 political instability is the low, because of the military coup of 1980. Military Coup opened a new era in Turkish politics and the economy. Following this era, ANAP (Motherland Party) came to office and single party era started in 1983. But, the rise of terrorism created increasing problems in the politics and the economy which continued until 2000s. In this era, social and political discontents and coalition governments will be analyzed as a part of political instabilities.

Political instabilities are seen as a result of polarization in the parliament, coalition governments, voters indecisiveness and unstable voting, early elections, and terrorist events. In the process of political instabilities, political polarization and coalitions caused lags in reforms; disagreement in coalition governments on reforms resulted in budget deficits. Under the uncertainties, results of the elections also gave rise to difficulties on estimated budget deficits. High inflation rates affected the demand for domestic money, the stronger currencies demanded increasingly. The decreasing domestic demand for money reduced seigniorage gains. High inflation also stimulated bribery, corruption, unregistered economy, tax avoidance, and tax evasion. Since, increasing the direct taxes could cause tax avoidance and tax evasion, which caused a decline in direct taxes. In that case, governments would select either borrowings or indirect taxes. In this study, we will test the relationship between budget deficits and indirect taxes. We assumed that during the budget deficits, since direct taxes could not be increased, indirect taxes will be raised. Political instabilities after 1980
The number of the political parties joined the elections was the important indicator of the political instabilities in Turkey after 1980. In 1983, the number of parties were three. This reached to 21 in 1999 election. While the increasing in the number of parties, the unrepresented votes in the parliament also went up. Such as, in 1983 it was 1.1 %, in 1987 19.8 %, in 1995 14.4 %, in 1999 18.8 %.

In Graph 1, the results of the elections are showed. The results of the elections depicts the instability of th parliament. The results could fluctuate among the parties from one election to another. So, if one party won one election, in the second or third election could lost power. Voters were looking for a new parties in the next election. So, we could say that the number of partisan voters were few. The structure of the politics directly affected the structure of the parliament and made parliament infragile and fragmented.

Comparing the results of elections between 1991 and 2002 showed voters fluctuating and unstable attitudes to the political parties. DSP, the winner of the 1999 election lost power and could not pass the 10 % barage in 2002 election. CHP could not pass the barage in 1999 election became a second party in 2002. Newly found party AKP won the 2002 election. AKP won the elections in most of the
provinces in Turkey. Permanent changes in governments and in politics increase the fragility of stability. In this context, one of the interesting point was that the balance between the central and extreme votes. In Graph 2, it is seen that central votes are falling, extreme votes are rising. (Bildirici M., 2000)

Graph 2 Central and Radical Votes

Graph 2 shows the voters behaviors which is fluctuating. Votes are switching to extreme political parties. This situation is very important for political instability. Voters are permanently searching for a new parties in order to solve their problems. There is not partisans, pragmatically switching from one party to another. The situation of the ruling party of 1999 election lost most of the voters in 2002. Unstable voters are moving to opposition parties. (Bildirici M., 2000; Eren E. and Bildirici M., 1999b, 2001)

The unstable voters, their identifications and second choices are seen in Graph 3. Voters’ searching brought about political instability and political instability push the voters searching. Right and left party voters define themselves as others not the rightists and leftists. This depicts that voters can not identify themselves or not find the concepts those define themselves. 30% of voters define themselves as others.

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1 C.Left showes central left votes, C.Right central right, Rel. Religious, Nat. nationalist
Graph 3 Political Identifications of Voters of The Parties Until 1999
Source: Eren E and Bildirici M 1999, 2001

This type of voters shift the winner of the elections from one election to other. The ruling party could shift depending on the voters behaviors.

One of the important characteristics of the political instability is unstable, shifting behaviors of the parliamenters. Unstable is called as staying in the selected party or leaving the party by passing the another political party. Unstable number of parliamenters influence the ruling party and the governments. Such as, twentieth ruling period which was commenced with 1995 elections, witnessed a severe instability in politics. Between 1995 and 1999, crises in Usual period for general elections were 5 year. But, with 1995 election crises in governents and in political regime were increased the political instabilities. These political instabilities were depended on the period of the parliament and representation crises. The length of the legislation period was terminated in 3 years 4 months and 24 days. It was the shortest period in parliamentary history. This affected the coaliton governent’s functions. The members of the coalition changed often in this short period. As it was seen in Table 1, three governents were set up.

Table 1 Governors Between 1995 and 1999

<table>
<thead>
<tr>
<th>Party</th>
<th>Beginning</th>
<th>Final</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>REFAHYOL (RP/DYP)</td>
<td>28.6.1996</td>
<td>30.6.1997</td>
<td>1 year/2 days</td>
</tr>
<tr>
<td>ANASOL-D (ANAP/DSP/DTP)</td>
<td>30.6.1997</td>
<td>11.1.1999</td>
<td>1 year /6 Months/ 11 days</td>
</tr>
<tr>
<td>DSP (Minority)</td>
<td>11.1.1999</td>
<td>18.4.1999</td>
<td>3 Months / 7 days</td>
</tr>
</tbody>
</table>

Source: Tuncer E., 1999

In this period, rotations in governents and among the parliaments were a characteristic of this period. It is called as representation crises. Shifting balances in the parliament created representation
problems. Table 2 shows the parties and their parliamenters in the parliament.

Table 2 Parties in the Parliament and The Number of Parliamenters

<table>
<thead>
<tr>
<th></th>
<th>24.12.199</th>
<th>28.2.199</th>
<th>22.2.199</th>
<th>24.2.199</th>
<th>30.7.199</th>
<th>17.4.199</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5</td>
<td>6</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td></td>
</tr>
<tr>
<td>RP</td>
<td>158</td>
<td>158</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>DYP</td>
<td>135</td>
<td>135</td>
<td>92</td>
<td>92</td>
<td>96</td>
<td>89</td>
</tr>
<tr>
<td>ANAP</td>
<td>132</td>
<td>124</td>
<td>139</td>
<td>139</td>
<td>138</td>
<td>130</td>
</tr>
<tr>
<td>DSP</td>
<td>76</td>
<td>76</td>
<td>63</td>
<td>63</td>
<td>61</td>
<td>59</td>
</tr>
<tr>
<td>CHP</td>
<td>49</td>
<td>49</td>
<td>55</td>
<td>55</td>
<td>55</td>
<td>53</td>
</tr>
<tr>
<td>BBP</td>
<td>0</td>
<td>7</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>DTP</td>
<td>0</td>
<td>0</td>
<td>22</td>
<td>22</td>
<td>21</td>
<td>19</td>
</tr>
<tr>
<td>MHP</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>DP</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>FP</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>122</td>
<td>145</td>
<td>144</td>
</tr>
<tr>
<td>DEPA</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAG</td>
<td>0</td>
<td>0</td>
<td>160</td>
<td>38</td>
<td>12</td>
<td>29</td>
</tr>
<tr>
<td>BOS</td>
<td>0</td>
<td>0</td>
<td>8</td>
<td>8</td>
<td>9</td>
<td>13</td>
</tr>
<tr>
<td>TOP</td>
<td>550</td>
<td>550</td>
<td>550</td>
<td>550</td>
<td>550</td>
<td>550</td>
</tr>
</tbody>
</table>

(1) The date of General Elections, (2) Parliamenters of BBP left the ANAP, (3) RP was shut down (4) FP set up a group in the parliament (5) the decision of early elections. (6) end of the 20th period.

As it is seen on Table 2, the biggest party RP was shut down two years after the 1995 election. A new party FP was set up, and parliamenters of RP went to FP. The DYP had 135 parliamenters in elections, but at the end of the period it was 89. The number of parliamenters of ANAP was 132, first dropped to 124, then went up to 139 at the end of the period decreased to 1930. The number of DSP’s parliamenters went down from 76 to 59. CHP could increase its number of parliamenters from 49 to 53. In 1995 election there was not any independent nominee, but before the 1999 election this increased to 29. 262 parliamenters shifted the parties which was the 47.6% of total members of the parliament. 98 of them changed their parties more than once (Tuncer E., 1999). One parliament shifted from one party to another 10 times, 9 parliaments 8 times, and 50
This confusion in the politics brought about political instabilities, economic instabilities and worsening economic conditions. One of the indicator of the relationship between political instability and economic instability was pessimism of voters and priorities for solving the problems. The election 2002, voters searched for stability and votes went to AKP. As a result of the elections, political instabilities became less.

The other factors which were affected political instability: terrorism, bribery and corruption. Between 1990 and 2000 terrorism was an important factor in instabilities, but in the 2000s bribery and corruption became in front.

b) The Structure of the Turkish Economy

Public sector has an important place in the Turkish economy, although this trend was tried to be revised after 1980’s. In 1980, with the announcement of a new policy of liberalism, economic policy shifted from inward oriented industrialization policy to export oriented industrialization policy in Turkey (Önis Z., 1991, p.27-41). The stabilization policy which was announced on January 24, 1980, revised development and growth policies within the framework of an open economy and free market model, aimed at reducing the role of the government in economy, preventing the inflation, decreasing the budget deficits, increasing exports, reducing the wages. This new orientation produced dramatic changes in the nation's economic development strategy and directly influenced the scope of the public sector in the economy. Turkish economy was restructured constantly. Such as, the foreign exchange market was deregulated, the capital market was established (1982). Istanbul Stock Exchange was reopened (1985).

With the elections of the 1983, stability measures were terminated by the ANAP government. Government expenditures increased, terrorist events in South-east region fostered this process. Budget deficits and financing of this deficits increased instabilities in Turkish economy. After 1984, financial needs of the public sector itself shaped the course of development of financial markets. Public sector
auctions for government securities started in 1985. Interbank money market was rearranged in 1986 and Central Bank started open market operations in 1987. Finally, capital flows were freed in 1989. Since 1986, governments became the major supplier of securities. The persistence of the large public sector deficits, despite its monopoly status, the government became in a disadvantageous position in the weak financial markets which kept interest rates high. As a proportion of GNP (Gross National Product), Public Sector Borrowing Requirement (PSBR) rose from 4.6 percent to 7.4 percent between 1985 and 1990. It was 10.2 percent in 1991, 10.6 percent in 1992, 12 percent in 1993. After 1993, the ratio decreased to 5 percent. With 1996, the ratio increased to 8.6 percent, in 1998 to 9.4 percent, and to 15.5 percent in 1999. With ‘The Disinflation and Fiscal Adjustment Program’ which was announced at the end of 1999, the ratio fell to the 11.8 percent in 2000, but in 2001, with ‘The Liquidity Crises’ it went up to 16.4 percent. The share of government expenditures in Gross National Product (GDP) was 14% between 1981 and 1990, it increased to 20% in 1991 onwards. State Economic Enterprises which had bureaucratic and over-employment problems led to growing public sector deficits with political deformation and corruption in politics.

Problems are Growing

“The 1987 is very important year for Turkish economy, in the sense that it marked the return to fully competitive politics. The referendum of 1987 intensified the political struggle and placed pressure on the party in power to follow policies of ‘populist’ economic expansionism. ANAP lost general elections in 1991. The coalition government of DYP (the True Path Party) and the SHP (Social Democratic Populist Party) came to power in 1991. The full convertibility of the Turkish Lira in 1989 resulted in a dramatic increase in the international capital inflows to Turkey. The economy expanded at a faster rate than would otherwise have been possible and the rising capital inflows provided a way of satisfying the distributional claims of the key groups (Önis Z. and Aysan A.F., 2000,p.129).”
As a result of this process, Turkey has experienced high budget deficits, a rapid increase in government expenditures, inflation and political instability throughout the 1990s. The role of government expanded in the economy. Before 1980, governments had utilized seigniorage and inflation for financing public sector deficits; after 1983, the revenue from these resources decreased. The introduction of convertible Turkish Lira and the other financial tools brought about decline in the demand for money, but demand of other tools increased. As a result of changes in financial techniques, government revenues decreased. Between 1963 and 1980 the growth of real national income averaged around 10 percent and the growth of real demand for money was 2.33 percent. Between 1981 and 1995, growth of real national income stood around 10 percent, but the demand for money decreased to 1.8 percent. This situation shows that the governments utilized numerous types of financial resources for financing the budget deficits, especially indirect taxes and domestic borrowings from capital and money markets became the main instruments in the economy.

Since, the beginning of the 1980s successive governments have made significant efforts to change the structure of the tax system. The most important features of the post-1980 tax reforms were providing adequate income to local governments and the introduction of Value Added Tax. From 1985 to 1990 the relative importance of income taxes declined because of discretionary tax rate reductions and the value added tax. Instead of moving toward the use of direct taxes, which is normally the case in the process of modern economic development, the strategy of export-led industrialization led the government to rely increasingly on domestic indirect taxes (Karatas C, 1992, p.41-62). During the coalition periods, impossibility of proposing an increase in direct taxes and a wide tax evasion shifted the structure of the tax system from direct taxes to indirect taxes. In 2000, the share of indirect taxes in total tax revenues had already gone up to 60 percent. The share of direct taxes declined from 58 % in 1984 to 35 % in 2003. Graph 4 shows the development in the Turkish Tax Structure.
During the military Coup from 1980 and 1983 political instabilities were at the low level. In tax system, the share of direct taxes in total tax revenues was 60%. It went down to 47% in 1985. At the end of the 2003 it went down to 35%. In this process with political instabilities, the share of indirect taxes in total taxes increased. Problems in the tax collection methods, inadequate tax organizations and low tax effort affected budget financing policies. This policies were formed to collect more indirect taxes, which is easiest way to do it, instead of struggling for structural tax reforms under the instabilities in politics.

After 1985, government utilized more and more indirect taxes and internal borrowing instead of seigniorage put more pressure on budget deficits and external debts. Tax policy was shaped under the control of the IMF’s directions, mainly by increases in indirect taxes.

3. Data and empirical result

a) Data
In this part of the study, the methods of budget deficit finance will be examined in Turkey, between 1985 and 2003. 1985 is the starting point for this study, because of the profound regulations in economic, fiscal and legal spheres. As a result of increasing public sector borrowing requirement, budget deficits expanded. Growing interest
rate payments became the half of the consolidated budgets in Turkey. *But, domestic borrowings is kept outside of this analysis.* We object to test the relationship between indirect taxes and budget deficits. The final year of our study year is 2003. There are two basic variables in the study. One of them is the ratio of budget deficits to GNP, the other one is the ratio of indirect taxes to total tax revenues. Data is provided by State Statistical Institution, Ministry of Finance and State Planning Organization.

**b) Empirical Result**

In this research, first, the relationship between indirect tax revenues and budget deficits will be examined. Cointegration analysis is used in this study. In context of cointegration analysis, Granger (1981, 1991), Granger and Weiss (1983) and Engle and Granger (1987) have shown that, even though a given set of series may be non-stationary, there may exist various linear combinations of the individual series that are stationary. The desire to estimate models that combine both short and long run properties and maintain stationary in all of the variables has prompted a reconsideration of the problem of regression using variables measured in their levels. Cointegration is a necessary condition for error correction models to hold. The procedures for testing cointegration are the two-step residual–based procedure for testing the null of no cointegration due to Engle and Granger (1987) and Johansen (1991), the system-based reduced rank regression approach (Bakirtas T., Karbuz S. and Bildirici M., 2000, p.24)

As Guisan (2001) pointed out in her article that cointegration tests had some perils. According Guisan, cointegration tests fail very often to recognise causal relations and, on the other hand, that approach does not always avoid the peril of accepting as causal relations those that really are spurious. However we are aware of the perils which Guisan emphasizes

By using cointegration analysis the relationship between budget deficits and indirect taxes is tested in the long run. The stationary of variables was checked by using the augmented Dickey-Fuller (ADF) unit root and Philips–Perron (1988) test techniques. The optimal lag
number of series was determined AIC criteria. In Table 3, level indicates that null hypothesis for variables must not be rejected. It seems that first difference was stationary and that null hypothesis can be rejected.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Level</th>
<th>First Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect Taxes</td>
<td>-1.525</td>
<td>-6.51</td>
</tr>
<tr>
<td>Budget Deficit</td>
<td>-1.9</td>
<td>-5.52</td>
</tr>
</tbody>
</table>

In the next step, The Engle-Granger’s two-step procedure is used for testing. A direction of the interaction will be determined with Engle-Granger test.

The growing budget deficits affects the change in indirect taxes and tax rates. The result for this cointegration regression are given below.

\[
\text{Indirect taxes} = -2.82 + 2.13 \times \text{budget deficit} \\
\text{\hspace{1cm}} (-24.5) \text{ (3,7)} \\
R^2 = 0.97 \hspace{1cm} \text{DW}= 0.65
\]

It will be applied the ADF test to the residual of the regression, we obtain a t-value the 5 % critical value. Null hypothesis of no cointegration can rejected and we can accept that there is a relationship between indirect taxes and budget deficits.

In order to prove the robustness of the cointegration results, it was carried out Johansen estimation procedure which uses full information maximum likelihood framework.
Table 4. List of Eigenvalues

<table>
<thead>
<tr>
<th>Null</th>
<th>Max. Eigenvalues</th>
<th>CV</th>
<th>Trace</th>
<th>CV</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>14.1</td>
<td>14.07</td>
<td>33.97</td>
<td>18.63</td>
</tr>
<tr>
<td>At most 1</td>
<td>6.6</td>
<td>3.76</td>
<td>2.79</td>
<td>6.65</td>
</tr>
</tbody>
</table>

The test restriction of no more than r cointegration vectors against the alternative of r+1 such vectors. The trace statics test restriction of no more than r cointegration vectors against the alternative of r=0. The hypothesis must not be rejected by both the maximum eigenvalue and the trace statistic values at the 95% level.

And in the final step, in order to search a long-run relationship between indirect taxes and budget deficits, we used error correction model. Model results are below.

Table 5. Error Correction Specification

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficient</th>
<th>t</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>0.34</td>
<td>2.76</td>
</tr>
<tr>
<td>Δ Public Deficit</td>
<td>1.10</td>
<td>41.26</td>
</tr>
<tr>
<td>U_{t-1}</td>
<td>-1.84</td>
<td>-8.68</td>
</tr>
</tbody>
</table>

R^2 = 0.98  DW 2.12; RSS= 0.016; SE= 0.012; X^2_{sc}(1)= 0.056; X^2_{FF}(1)= 0.256; X^2_{N}(2)= 1.5; X^2_{H}(1)= 0.056

As it is seen on Table 5, all variables are significant. The result of our analysis suggests short and long run elasticies of 1.10 and 2.3. These show that budget deficits play important role in taxation. If we question the role of political instability in this situation, we put a dummy variable in the analysis which contains political instability. Since the relationship between indirect taxes and coalition governments is very important, we tested the model with dummy.
Table 6. Error Correction Specification with Dummy Dependent Variable: Δ Indirect Taxes

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficient</th>
<th>t</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>0.70</td>
<td>1.10</td>
</tr>
<tr>
<td>Δ Public Deficit</td>
<td>1.09</td>
<td>3.91</td>
</tr>
<tr>
<td>U_{t-1}</td>
<td>-1.4</td>
<td>-4.68</td>
</tr>
<tr>
<td>Dummy</td>
<td>0.8</td>
<td>2.68</td>
</tr>
</tbody>
</table>

R^2 = 0.75  DW 2.08  F= 25.11  SE= 0.02

The diagnostic tests indicate no misspecification. The test with dummies shows very significant results in Table 6.

Change in budget deficits influences the indirect tax ratios. The share of indirect taxes in total tax revenues is increasing in Turkey. Especially, during the coalition periods indirect taxes were increased while direct taxes had very limited changes. Turkey had coalition governments in the 1990s. We propose that, indirect taxes are favored by the governents, because during the coalitions it is less harder to increase indirect taxes and to persuade coalition members than to modify direct taxes. It is also difficult to get an approval of direct tax proposal in the parliament. Because, coalition members do not want to take responsibility of the direct tax proposals which increase the tension of the parliament. According to Tanzi(1994), tax proposals become distorted during the drafting stage to such and extent as to be unrecognizable.

Once the laws are drafted and approved, extensive new regulations are needed. What the government really controls (with the cooperation of the legislature) is the statutory tax rates and some statutory definition of the tax bases. During the coalition periods it is hard to propose a change in direct taxes. There is a extensive pressure on the goverment and on the parliaments. Stronger classes can affect tax drafts in the parliament. One of the crucial facts is that tax reforms remained as a permanent problem on the agenda of Turkish politics. The tax reforms applied in 1960, 1971, 1980 could be put into effect only during military regimes, while in the 1990s International Monetary Fund (IMF) has been the main factor behind
the tax reform proposals in Turkey. IMF forced to increase the tax revenues, but source of the revenue did not take into account. Whether direct taxes or indirect taxes did not make any difference for IMF, and hardships in increasing direct taxes stimulated governments to raise indirect tax rates.

4. Conclusion

This paper has examined the empirical relationship between budget deficits and indirect taxes between 1985 and 2003. The empirical findings suggest that during the coalition periods indirect taxes are more utilized than direct taxes in order to finance budget deficits. There is a positive and strong relationship between budget deficits and indirect taxes.

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