

THE REVERSE LEARNING

Overview of tax reforms – challenge of transition, integration and beyond

Maciej H. Grabowski¹
Gdansk Institute for Market Economics

Abstract

The economic transformation provided unique challenges and opportunities in reforming tax systems. And thus it put much more pressure on reformers to deliver optimal tax system than on “old” European leaders. In the last 15 years since the beginning of the economic transformation reforms, nearly all 27 post-socialist countries have adopted the three main taxes typical for a market economy, namely personal income tax, corporate income tax, and value added tax. However, there is great diversity in the detailed solutions, rates, deductions, allowances and tax bases applied to these taxes in these countries.

In recent years, it has been observed a clear tendency to broaden tax bases and reduce the top income tax rates. In spite of this, serious problems persist, as regards further improvement of the functioning of the system, increasing its transparency and homogeneity, providing neutrality and limiting implementation problems. By and large, tax reforms in the transition countries were by any standards significant, and in some countries successful and brave. The ability to face challenges and to deliver results among political leaders in some transition countries was impressive. Policy objectives, administrative capabilities and economic challenges are not homogeneous in the current EU-member states. These circumstances require a space for undertaking the various policies among the member states, including tax policies.

¹ Maciej H. Grabowski is at the Gdansk Institute for Market Economics.

1. Background of tax reforms in transition countries

Tax reform is a main part for transformation process². A collapse of communist system and transition towards market economy and democratic political regime provided a unique situation for the tax and fiscal reforms. Allocation of assets was previously done with the public hand, and it was far from optimal. Transition to market regime meant reallocations of assets. A new tax system was only an element of a new institutional framework, which influences allocation decisions of any investor. Therefore costs of reallocation linked to such tax reform was be considerably lower.

The economic transition process towards market economy brought both unique and universal considerations for a tax reform³. A newly created economic system with its regulations and legal framework was to set up almost from scratch. Institutional order usually is a result of the public debate, the long political process and historical limitation of current status quo. Beginning of transformation was a period of rather romantic approach to reforms. Interest groups and lobbies were not well organised, and even the painful reforms were widely accepted by society.

The economic transition brings unique challenges, which are not considered when tax reforms are disputed in the developed countries. Some of these challenges are discussed below. All these points could be subjects for a separate paper, but are listed to remind arguments.

- (i) New role of taxpayers. Taxes played only limited role in planned economy. They were a part of the allocation system, next to fixed prices, subsidies, and credits. Number of taxpayers was low, and a range of discretion of tax officers high. Taxpayers, which were mostly state-owned enterprises, did not have the strong incentives to reduce (read: look for loopholes) their tax liabilities. This situation was changed dramatically in transition. There are many private firms, they operate in market environment, and therefore they have strong motivation to reduce their tax liabilities. Transition costs of tax reform are also training and capital expenses for tax administration. In the first stage of tax reform, temporary revenue losses due to inexperience of operating and enforcing may be expected.
- (ii) Unique opportunity due to lack of adjustment processes in economy. Reallocation of assets linked to transformation reduced costs of a tax reform. However a tax reform is not taking place in vain. Most countries of Central and Eastern Europe expressed their aspiration for the EU memberships. This was one of the factors why these countries implemented a VAT tax in place of a turnover tax, a corporate income tax with accounting standards, a personal income tax, an excise tax and ad valorem custom tariffs. Local taxes and property taxes are not subject for harmonization, and therefore they remain in many countries still underdeveloped.
- (iii) Newly created tax administration. The tax administration was to much extend created during transition, and it had a very limited experience. Such situation has its own advantage. It is easy to promote and to train tax inspectors, because they don't have "old", useless habits and knowledge of previous tax system. Moreover a resistance for any change among high rank tax officers is limited. Nevertheless there is a high need for training and learning-by-doing process.
- (iv) Tax evasion. Societies in transition countries used to operate in a very specific environment, in which not paying taxes was socially, accepted behavior. This is one of the reasons, why tax evasion is probably high. Strong gray and black economy, which emerged during transition, benefited from weak enforcement, and resulted from strong incentives to operate illegally.

² David M.G.Newbery (ed.) (1995): Tax and Benefit Refom in Central and Eastern Europe, CEPR, London

³ op.cit.

- (v) Lack of clear vision of economic strategy (and/or two-steps forward one-step back approach). The transition process was not leaner and was not fixed for good at the beginning of it. In other words a full blood institutional strategy for transition process has not been designed and implemented in any country. As far as the economic policy is concerned it was far from clear what kind of institutional frameworks was going to be created. The statements like: facilitating open competition and securing rights to property, or encouraging private sector development, or role of government is to provide the right regulatory and economic environment in which enterprises can flourish and compete, could be found in many speeches of political leaders of these countries, but were not helpful for designing tax system compatible with new institutional order.

Next to special transition problems, there are universal considerations of tax system reforms such as⁴:

(i) Efficiency principle.

This principle calls for a tax system, in which economic agents' decisions are indifferent to taxes. In other words, if there were not any tax system, decisions would be the same. Tax system is neutral for economy. Any tax imposes costs on economy. These costs may be classified into three groups: tax burden; costs of tax administration, and compliance costs of taxpayer. Therefore efficiency principle should be applied into these three groups of costs.

(ii) Incidence principle.

Tax revenues should reflect costs of public goods provided by government. Public goods, like education, health care, juridical system, certainly influence economic decisions, like investment, and savings. The high tax revenues allow financing high costs of public goods, but are contradicted to efficiency principle, and therefore they may be harmful for the economic prospects.

(iii) Equity principle.

This rule calls for an equal distribution of the tax burden, so a wide range of taxpayers should pay taxes. In theory fairness may be achieved in two ways. Each taxpayer pays as high tax as is value of benefits (public good), which he consumes. This rule is rather difficult to implement, because it is hard to estimate how much public good is provided for each member of the society. Second approach calls for ability to pay tax. It means that tax system should be designed in that way that willingness and ability to avoidance and evasion is minimized. This usually calls for simple rules of taxation and low tax rates, and for fair, uncorrupted tax administration as well as adequate penalties for tax fraud.

(iv) Stabilization principle.

Tax policy, as a part of the fiscal policy may be used to stabilized economic growth. Stabilization policy reduces risk of fiscal crisis (or general economic disequilibrium), and provides better background for long-term economic development. This may reduce costs for economy due to f.i. adjustment to external supply shock.

2. Tax reforms in the new EU member countries

In the EU-8, the tax reform process has not been uniform across countries. Hungary was the first country to undertake reforms, introducing PIT, CIT and VAT taxes at the end of the 1980s. Most of the other countries from this group introduced these taxes in 1991–1994. The

⁴ for instance: James, S. and C.Nobes (1992): The economics of taxation, Prentice Hall International, Herfordshire

only exception is Slovenia, which introduced VAT as late as in 1999 (see Table 1).

The personal income tax regime introduced in the EU–8 countries generally included a large number of brackets and rates, usually five or six. Throughout the 90s, there was a tendency to reduce the number of rates to no more than three. The exception was Slovenia, which has maintained the same six rates as introduced in 1993, with the highest rate equal to 50%. On the other hand, first the Baltic States and last year Slovakia introduced a flat–rate tax with a single PIT rate. The reduction in the number of rates was accompanied by limiting the tax exemptions and deductions available to taxpayers, thus broadening the tax base. With the exception of Slovenia and the Baltic States, the PIT regulations and tax rates have been subject to numerous changes.

The introduction of corporate income tax by the countries of the EU–8 also took place at the beginning of the 1990s. However, different countries introduced different solutions. Latvia and Lithuania implemented a scheme with three tax rates, and Hungary, with two. The other countries adopted a single CIT rate, which initially ranged from 29% in Estonia to 55% in the Czech Republic. Most CIT systems allowed for substantial deductions, including tax holidays for foreign investors. The Hungarian system appeared to have been the most favourable for foreign direct investment in this regard.

The decade of the 90s and the beginning of the 21st century saw the emergence of two trends. Firstly, countries moved in the direction of lowering CIT rates, introducing one rate or even abolishing the tax altogether, if profits are invested (for example Estonia). The reduction of tax rates was particularly noticeable from 2000 onwards and it has led to a closer realignment of CIT rates, which now range from 16% to 28%. At the same time, the scale of deductions and exemptions has been reduced. The latter trend was also due to the fact that, as these countries aspired to EU membership, they were required to adopt the EU rules on state aid. They limit the scope for supporting enterprises via tax measures. In the case of Hungary, where these solutions were particularly favorable for investors, this meant that negotiations with the EU in this area were concluded only at the Copenhagen summit in December 2002. Hungary finally renouncing its aggressive tax measures aimed at luring foreign investors.

VAT was introduced in these countries in the place of turnover tax. Previously the turnover tax systems had undergone radical changes, for example in Czechoslovakia in July 1990, negative rates of this tax were abolished and only four rates introduced, replacing the several hundred that had been in existence previously. The EU–8 countries adopted VAT over the years 1988–1995, with the exception, as has been mentioned, of Slovenia. During the 1990s and until 2003, VAT rates were not subject to frequent changes, particularly as regards the standard rate. Slovakia is the exception, having introduced a single rate of 19% in 2004, and the Czech Republic, which lowered its standard rate from 22% to 19%. The lists of goods and services covered by reduced rates changed to a greater extent. This was also the result of the accession process of the EU–8 countries.

Table 1. Major changes in PIT, CIT and VAT taxes in the EU–8 countries

Country	PIT	CIT	VAT
Czech Republic	1994: 6 rates 15, 20, 25, 32, 40, 44% 1996: abolition of 40% rate 1997: abolition of 44% rate, restoring of 40% rate	1991: 55% 1993: 45% 1994–1998 gradual reduction of the rate to: 35% 2000: another reduction of the rate to 31% 2004: 28% rate	1993: standard rate 23%, reduced rate 5% 1995: standard rate reduced to 22% 2004: single 19% rate, lowering of registration threshold

	2000: abolition of 40% rate		
Estonia	1993: 3 rates 16, 24 and 33% 1994: flat rate 26%	1991: 3 rates 15, 23 and 30% 1992: single 35% rate 1994: rate lowered to 26% 2000: abolition of the tax, if profits are invested	1991: 10% rate 1992: standard rate 18%, 1994: limiting of exemptions 2000: reduced rate 5%
Lithuania	1991: rates from 18 to 33% 1994: single 33% rate	1991: basic rate 29% 2000: rate lowered to 24%	1994: VAT basic rate 18%, reduced rate 9% 2000: reduced rate 5% 2001: second reduced rate 9%
Latvia	1991: 5 rates from 15 to 35% 1997: flat rate 25%	1991: 3 rates 15, 25 and 35% 1993: basic rate 25% and higher rates for financial sector and trade 1995: single 25% rates 2001: rate reduced to 22%	1992: 10% turnover tax 1992–1993: rate raised to 12% and 18% 1995: VAT standard rate 18% 2003: reduced rate 9%
Poland	1991 – 3 rates 20, 30 and 40% 1994 – rates raised to 21, 33 and 45% 1997–1998: top rate reduced to 44% and 40% 1999: 3 rates 19, 30 and 40%	1992: 40% rate 1998–2002: gradual reduction of the rate to 27% 2004: rate lowered to 19%	1993: standard rate 22%, reduced rate 7% and numerous exemptions, 1994–2002: gradual curtailing of exemptions
Slovakia	1993: 6 rates from 15 to 47% 1994: top rate reduced to 42% 1999: 7 rates from 15 to 47% 2001: top rate reduced to 42% 2002: 5 rates from 10 to 38% 2004: flat 19% rate	1993: 45% rate 1994: rate reduced to 40% 2000: rate reduced to 29% 2001: rate reduced to 25% 2004: rate reduced to 19%	1993: standard rate 23%, reduced rate 6% 1999: reduced rate raised to 10% 2003: standard rate 20%, reduced rate 14% 2004: single 19% rate
Slovenia	1993: 6 rates 17, 35, 37, 40, 45 and 50%	1994: 30% 1996: 25%	1999: standard rate 19% reduced rate 8% 2002: reduced rate 8,5%

Hungary	1988: 10 rates: 20, 25, 30, 35, 39, 44, 48, 52, 56 and 60% 1990: 4 rates 15, 30, 40, 50% 1992: 3 rates: 25, 35 and 40% 1994: 2 rates added: 20 and 44% 1997: 6 rates: 20, 22, 31, 35, 39, and 42% 1999: 3 rates 20, 30 and 40%	1989: 40 and 50% rates 1990: rates reduced to 35 and 40% 1991: 40% rate 1994: 36% 1995: 18% rate 2002: limiting of investment deductions (acc. to EU rules); and introduction of simplified system for companies (including individuals running businesses) with turnover up to 15 million HUF, 15% rate 2004: 16% rate	1988: 3 rates 0, 15 and 25% 1993: standard rate 25%, reduced rate first 6, then 10% 1995: reduced rate raised to 12%
---------	---	---	--

source: Mitra, P. i N.Stern, *Tax systems in Transition*, WPS 2947, 2003; *VAT rates applied in the member and accession states of the European Community*, DOC 2402/2003 EN; *State of small and medium sized business in Hungary 2002*, Hungarian Institute for Economic Analysis, Budapest 2002, Kwang-Yeol Yoo, *Corporate Taxation of Foreign Direct Investment Income 1991-2001*, OECD, ECO/WKP(2003) 19, Paris; Semjen, A. and L. Szakadat, *Fiscal Centralization in Central Europe*, IREF

3. Tax reforms in the Balkan countries

In some of the Balkan countries, reforms associated with the economic transformation, including those of the tax systems, were largely determined in the context of military conflicts taking place until the mid-90s and the absence of real prospects for the EU accession. In addition, the weakness of government structures, which limited tax reforms, was particularly significant in the countries created after the break-up of Yugoslavia. As a result of this, reforms of the tax systems were implemented at a varying pace in the countries of the region. VAT is yet to be introduced in Bosnia and Herzegovina and in Serbia. It is also worth noting the simplified PIT systems in both these countries, with low flat rates on labour income and a unique regressive CIT in Bosnia and Herzegovina.

The political situation has resulted in the tax regimes in Kosovo and in the Serbian Republic of Bosnia and Herzegovina being different from those of the parent countries, i.e. Serbia and Bosnia and Herzegovina, respectively. Therefore, one can speak of nine tax systems in seven Balkan countries. The Kosovo tax system was introduced by UNMIK (a UN body) and as such is a unique example of an institution created in practice without internal pressures or political dialogue. As a result, a relatively simple and taxpayer-friendly system was created. For example, VAT has a single rate of 15%, covering nearly all goods and services.

The trends with respect to the taxation of income were similar to those observed in the EU-8 countries. CIT rates were being gradually reduced and the number of PIT rates was also being cut. It needs to be added that the rates for both these taxes are very low in some Balkan countries, lower than in the EU-8 countries. In Serbia and Montenegro, the corporate income tax rate equals 14% and in Macedonia, 15%. The countries also use other incentives for foreign investors. PIT rates in Bosnia and Herzegovina, Kosovo, Serbia and Macedonia are also very low (see: table 2).

Table 2. Major changes in PIT, CIT and VAT taxes in the Balkan countries

Country	PIT	CIT	VAT
Albania	6 rates from 5% to 30%	30% rate	1996: 20% rate

Bosnia and Herzegovina	Flat rate of 10% for income from work, other income covered by rates from 30% to 50% In B–H, Serbian Republic: 9% rate on income from work and 4 rates, from 0% to 25%	30% rate In B–H Serbian Republic 20%, 15%, 12% and 10% rates (regressive schedule)	Sales tax: 24% and 10%, food: 0% B–H Serbian Republic : 20% and 10%, and 0%
Bulgaria	1992: 6 rates 20%, 24%, 28%, 32%, 36% and 40% 2002: rates from 0% to 29%	2000: 25% rate, 20% for small businesses 2002: 23.5% rate	1994: 22% rate, 1999: reduced to 20%; exemptions
Croatia	1994:00:00 2001: 3 rates from 15%, 25%, 35% 2003: additional rate of 45%	1994: 20% rate	1998: 22% rate, 0% on books, basic food, medicines, municipal and financial services exempt
Macedonia	2 rates: 15% and 18% (previously: 3 rates from 23% to 35%)	15% rate (previously 30%)	2000: 19% rate, reduced rate 5% on electricity, agricultural products
Romania	2003: 5 rates: 18%, 23%, 28%, 34% and 40%	2003: 25% rate (previously 38%)	1993: 22% rate and 11% reduced rate 2003: 19% rate and 9% reduced rate, exemptions: financial and public utility services
Serbia and Montenegro	14% flat rate on income from work; from other income rates of 10%, 15% and 20%	rates: 20%–30% 2003: 14%	Sales tax: 20% rate, exemptions: public utility services, some food products 2005: VAT, 8 and 18% rates
Kosovo*	2002: 3 rates 0%, 5% and 10%	2002: 20% rate for big companies and simplified for small businesses	2001: VAT rate 15%, few exemptions 2002: reduction of turnover registration threshold to EUR50.000

Source: as in table 1

* – According to UN resolution 1244, Kosovo is administered by UNMIK. Starting from 2000, the tax reform in this region is carried out by the international administration and is independent of decisions by Serbia and Montenegro.

3. Tax reforms in the CIS countries

The CIS countries have made considerable progress with tax reforms since the beginning of the 1990s. However, this progress is not uniform and after the initial stage of transformation, when the majority of the countries adopted the framework of a new tax system, for example a very similar VAT system, some of them later adopted a more comprehensive approach to the tax system. This implied adopting tax codes covering all taxes and procedures for assessing and collecting them. This was the case in Kazakhstan, Georgia, Kyrgyzstan, Moldova and Uzbekistan in the mid–90s and in Russia and Tajikistan at the end of the 90s. Azerbaijan adopted its Tax Code in 2001.

At the beginning of the 1990s, nine out of the 12 CIS countries adopted VAT with the same rate of 28%. Over time, the majority of the countries reduced this rate, usually to 20%. Countries from the region applied and continue to apply numerous exemptions to this tax. In some of them, for example Georgia, Kyrgyzstan, Russia and Armenia, the list of goods and services exempt from VAT has been gradually reduced.

Income taxes, both PIT and CIT, were also introduced at the beginning of the 1990s, mostly in the years 1991–1992. The tendency to reduce the top rates of PIT and CIT is

noticeable also in these countries, but the scale of the reductions is smaller than in the EU–8 countries. In the case of personal income taxes, the reduction of the top rates (for example in Georgia and Ukraine) did not bring about significant changes in revenues from this tax. These countries largely employ a discretionary approach to foreign investors in the sense of the tax burden.

Table 3. Major changes in PIT, CIT and VAT taxes in the CIS countries

Country	PIT	CIT	VAT
Armenia	1992: rates and brackets in line with CIT	1992: 4 rates 12%, 18%, 25%, 30%, numerous exemptions and deductions for foreign investors	1992: VAT with 28% rate 1993: rate reduced to 20%, numerous exemptions 1994–2001: reduction of the number of exemptions, raising of registration threshold
Azerbaijan	1992: 6 rates from 12% to 55% 2001: 2 rates 14% and 35%	1992: 3 rates 25%, 30% and 35% 2001: single rate of 24%	1992: VAT with 28% rate 1993: rate reduced to 20%, numerous exemptions 1995–1996: reduction in the number of exemptions, 1998: rate lowered to 18%
Belarus	1991: 8 rates from 9% to 40%	1991: 24% rate	1991: 20% rate and reduced rate of 10%
Georgia	1992: 5 rates from 12% to 40% 1994: top rate cut to 20% and 4 rates 1996: number of exemptions and deductions reduced	1992: rates from 17% to 35% depending on sector 1993: standard rate – 20% and additional rates depending on sector 1997: abolition of tax breaks	1992: introduction of VAT with a 28% rate, then its reduction to 14% 1995: standard rate raised to 20%, 10% rate for food products. numerous exemptions 1996–1999: reduction in the number of exemptions
Kazakhstan	1992: top rate 30%, 1993: raised to 40%, 4 rates; 1995: number of brackets increased to 6 1997: top rate reduced to 30%, and in 1998: number of brackets to 4	1992: standard rate lowered to 35%, and then to 25% (plus additional rates) 1994: single 30% rate 1997: special rate of 20% in special economic zones	1992: introduction of VAT with a 28% rate together with lower rates for food 1995: standard rate lowered to 20% 1998: reduced rate for food and agricultural products, exemptions of other services
Kyrgyzstan	1992: 5 rates, top one of 40%; 1995: income in-kind included in tax base, lowest bracket raised, 1997: 6 rates 1999: top rate lowered to 33%, number of brackets to 4 2001: 2 rates: 10% and 20%	1992: lowering of top rate from 45% to 35%, and other rates depending on sector 1994: rate reduced to 30% 1996: single 30% rate and simplified tax for small businesses 2001: rate cut to 20%	1992: VAT with 28% rate 1993: rate reduced to 20%, numerous exemptions 1996–2001: reduction in the number of exemptions

Moldova	1992: 7 tax rates from 10% to 40% 1997: two rates 20% and 32%; 1998 top rate reduced to 28%, and in 2002 to 25%	1992: standard rate 32%, other rates depending on sector from 1.5% to 55% 1998: reduced to 28% 2002: reduced to 25%	1992: VAT with 28% rate, lower rates for food products 1993: rate reduced to 20%, numerous exemptions 2002: 5% rate for agricultural products
Russia	1992: 3 rates: 12%, 20% and 30% 2001: flat rate of 13% and abolition of many deductions	1992: standard rate 32% and other rates depending on sector 1994: to 37%, then reduced to 30% 2002: rate reduced to 24%, deductions and exemptions abolished	1992: VAT with 28% rate, lower rates for food products 1993: standard rate reduced to 20%, reduced rate 10%, numerous exemptions 1994: additional turnover tax of 3% 2001: reduction of exemptions
Tajikistan	1992: rates from 10% to 60% 1995: top rate reduced to 40%, and in 1997 raised to 47%, and in 2002 reduced to 20%	1991: standard rate 35% other rates depending on sector 1993: reduced to 32% 1994: raised to 40% 1997: reduced to 30%	1992: VAT with 28% rate, small number of exemptions 1993: rate reduced to 20% 1994: additional turnover tax of 3% 1997: abolition of turnover tax
Turkmenistan	n.a.	1993: 3 rates 25%, 30% and 35%	1993: standard 20%
Ukraine	1991: 4 rates with the top one of 30% 1994: top rate raised to 90%, number of brackets to 8 1995: top rate reduced to 60%, number of brackets to 7 1996: top rate reduced to 40%, number of brackets to 6	1992: rate reduced from 35% to 18% 1994–1995: rate raised to 30%	1992: VAT with rates of 22% (for goods with floating prices) and 28% (for goods with administered prices), 1995: rate reduced to 20%, numerous exemptions
Uzbekistan	1992: 7 rates from 12 to 60% 1993: 6 rates, top one of 50% 1994: 4 rates, top rate 45%, in 1995 reduced to 40%, a year later raised to 45%, and the number of rates to 5	1992: standard rate 18% plus numerous exemptions and other rates depending on sector 1996: standard rate 37% 1997 – 1999: gradual reduction of standard rate to 33%	1992: VAT with 30% rate, retail and services excluded 1993: rate lowered to 25%, retail included 1994: rate lowered to 20%, retail included 1995–1996: rates lowered to 18% and 17% 1997: rate raised to 18%, introduction of reduced 10% rate for food 1998–1999: raising of standard rate to 20% and reduced rate to 15%

Source: Stepanyan V., *Reforming the tax system – experiences of Baltics, Russia and other countries of the former Soviet Union states*, IMF, WP 03/2003; Mitra, P. and N. Stern, *Tax systems in Transition*, WPS 2947, 2003, Kwang-Yeol Yoo, *Corporate Taxation of Foreign Direct Investment Income 1991-2001*, OECD, ECO/WKP(2003) 19; Ebrill, L. and O. Havrylyshyn, *Tax reform in the Baltics, Russia, and other Countries of the Former Soviet Union*, Occasional Paper 182, IMF 1999

4. Main results, trends and challenges of further tax reform

There is a clear tendency towards the broadening of tax bases and reducing top marginal

tax rates. This is also a tendency seen in the OECD countries. In the case of income taxes, this has reduced the pressure on taxpayers to conduct so-called tax planning in companies. From the viewpoint of microeconomic efficiency, it also results in smaller distortions with regard to investment financing and capital allocation. In the case of some countries, it has also been possible to introduce a VAT system with a single rate and very few exemptions, resulting in higher efficiency and lower operating costs of the tax system. This was the case, for example, in Slovakia and Kosovo. The second tendency is to move from revenue from direct taxes towards indirect taxes as the main source of tax revenue. This is aimed at increasing the stability of tax revenue. And it also provides less distortions for capital allocation.

The direction of change in the size of respective tax revenues has not been homogenous in the analysed groups of countries. While the EU-8 and Balkan countries experienced a decline in revenues from PIT in the analysed period, the CIS countries saw the reverse take place. This was related to improvements of the tax administration in the CIS countries.

Meanwhile, there were no differences between the three analysed groups of countries when it came to the direction of changes in revenues from CIT. In each of the three groups, a significant decline in revenues from corporate income taxes took place. The decline in CIT revenues affected the EU-8 countries the most, with revenues from this source falling almost by two-thirds. An increase in CIT revenues was observed only in Slovenia, where income from this source almost doubled

The direction of change in revenues from PIT was not homogenous in the EU-8 group of countries. In Poland, revenues from PIT declined from 8.2% to 4.6% of GDP; a significant decline in PIT revenue also took place in Slovakia. Meanwhile, in all three Baltic States, general government revenues from this source increased.

Social contributions and VAT on goods and services are the two main sources of government tax revenue in the countries undergoing transformation. Unlike the EU-15 countries, where personal income tax has a much greater fiscal significance than VAT, in the Central European and CIS countries, PIT plays a less significant role. The farther east, the lower the PIT revenues in relation to GDP. There are much greater similarities among the analysed groups of countries when it comes to corporate income tax, although in this case, too, the Western European countries use this source of revenue to a greater extent than happens with the economies undergoing transformation.

Figure 1. Revenues from main taxes in EU-15, EU-8, Balkans and CIS (as % of GDP, as in 2000)

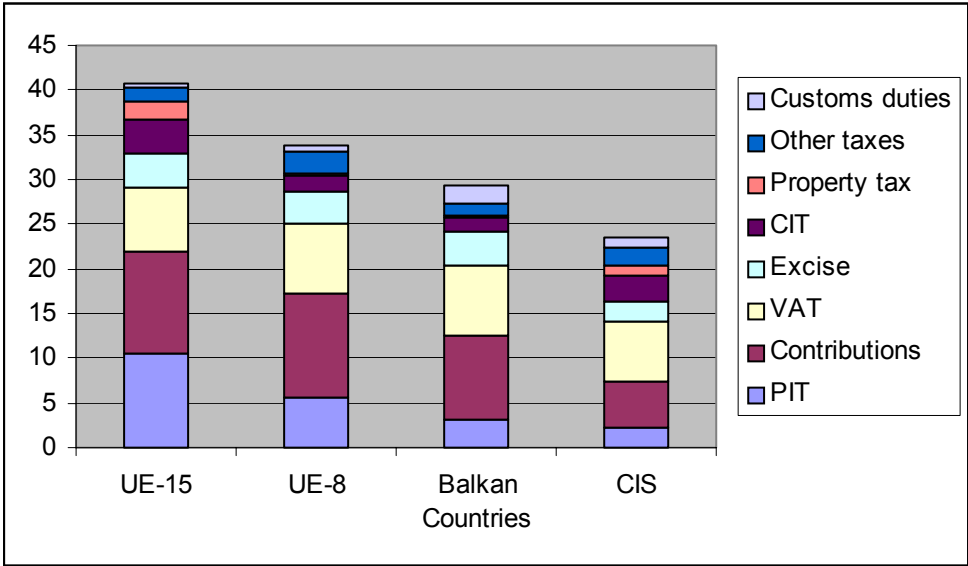


Table 4. Tax revenues in the transition countries during the period of transformation (as % of GDP)

Country	PIT		CIT		VAT and excise		Contributions	
	91 – 95	99 – 02	91 – 95	99 – 02	91 – 95	99 – 02	91 – 95	99 – 02
Czech Rep.	5.0	4.8	5.3	3.2	11.5	9.1	15.8	15.0
Estonia	7.1	7.4	7.0	0.8	10.7	12.7	8.1	11.0
Lithuania	4.6	7.3	8.4	0.5	9.4	11.4	6.9	7.7
Latvia	5.0	6.0	2.8	2.1	10.4	10.8	12.0	9.2
Poland	8.2	4.6	4.4	1.8	10.2	11.4	9.6	9.6
Slovakia	5.5	3.5	7.7	2.0	12.5	10.3	10.3	12.7
Slovenia	5.0	4.2	0.7	1.3	10.1	13.5	12.5	15.5
Hungary	7.0	7.5	3.5	2.4	11.6	12.0	13.5	11.3
EU–8 countries	5.9	5.7	5.0	1.8	10.8	11.4	11.1	11.5
Albania	0.1	0.8	3.3	1.6	7.2	8.1	3.1	3.7
Bulgaria	5.2	3.6	4.5	2.5	6.8	12.0	11.9	7.8
Croatia	3.7	2.9	0.9	1.4	18.1	18.4	13.7	13.4
Macedonia	5.8	4.8	1.2	1.2	8.2	11.3	19.2	10.8
Romania	7.2	3.3	6.1	1.9	10.1	8.0	9.1	11.2
Balkan countries	4.4	3.1	3.2	1.7	10.1	11.6	11.4	9.4
Armenia	1.3	0.9	5.2	1.3	3.8	9.6	1.8	2.8
Azerbaijan	2.2	1.9	7.6	2.5	5.6	7.2	9.9	2.2
Belarus	0.0	3.0	12.1	3.6	x	11.3	12.9	11.9
Georgia	0.6	1.9	1.0	1.1	1.7	6.8	0.9	1.8
Kazakhstan	2.0	2.1	2.2	6.5	3.2	5.4	6.3	3.6
Kyrgyzstan	1.9	1.4	3.1	1.5	6.0	8.3	5.9	3.5
Moldova	1.7	1.4	4.6	1.9	10.8	12.2	2.9	7.4
Russia	2.3	2.1	9.1	4.3	7.2	10.0	9.7	7.7
Tajikistan	2.6	1.2	6.8	0.6	7.0	7.5	9.2	1.9
Turkmenistan	0.3	1.9	4.1	2.5	8.1	7.0	3.5	3.4
Ukraine	3.2	4.9	7.9	4.3	8.9	10.1	11.4	9.0
Uzbekistan	3.6	3.6	6.4	3.2	12.9	12.6	0.7	6.7
CIS countries	1.8	2.2	5.8	2.8	7.1	9.0	6.3	5.2

Source: Mitra, Pradeep & Nicholas Stern, Tax Systems in Transition, World Bank Policy Research Working Paper 2947, January 2003, Lorie, Henri, Priorities for Further Fiscal Reforms in the Commonwealth of Independent States, IMF Working Paper WP/03/209

The majority of countries that are currently not EU members have retained the possibility of granting considerable tax deductions and exemptions to foreign investors. Small and medium-sized enterprises have been covered by simplified forms of taxation, usually based on presumptive taxes. This does not mean that many problems associated with the taxation of

such enterprises, such as the borderline between income from work and income from capital, or appropriate delimitation of access to simplified forms of taxation, have been resolved. This is often the result of the weakness of the tax administration, but also of introducing extremely complicated and variable forms of taxation in some countries.

The most commonly cited internal barrier to the effective implementation of a tax system is the tax administration's limitations in the efficient collection of new taxes and servicing the rapidly-increasing number of taxpayers and tax reporting entities. It is also pointed out that the introduction of the principles for the functioning of a modern tax administration occurred after a delay with regard to changes introduced in the tax system itself.

Meanwhile, the most effective external factor conducive to the implementation of tax reforms has been the prospect of European Union membership. Of course, this is particularly the case for indirect taxes, covered by legal harmonisation as part of the EU and its members. On the other hand, the influence of the World Bank, the IMF and the EBRD, or the conditioning of access to financing from these sources, has probably been rather weak. Technical support provided to these countries has also not proved to be a decisive factor, particularly in the CIS and Balkan countries. On the other hand, it is not easy to isolate each of the factors that has played a role in determining the pace and form of tax system reforms.

The main problem in the majority of countries is the high and sometimes rising level of public expenditure and hence the pressure to increase tax revenue. This tendency is likely to continue in the future. The problem of fiscal adjustment is particularly significant in countries with a high ratio of public expenditure to GDP. Therefore, among the analysed countries, it is mainly the EU-8 countries that face this problem, as their levels of spending are excessive considering their level of economic development.

From the viewpoint of economic growth, the elimination or limiting of tax mechanisms preventing neutrality on product markets remains a major problem in many countries. This is true for some of the Balkan countries and the majority of CIS countries. Among the EU-8 countries, the gradual shift to stable revenues from the taxation of value-added and further use of taxes for the internalisation of external costs associated with the deterioration of the environment could become a medium-term target of further reforms of the tax system.

5. Tax competition or tax harmonization

Growing competition among tax systems, which are supposed to be one of the factors increasing countries' competitiveness, has resulted in convergence of corporate tax rates in many countries around the world in recent years. However, two points need to be made. Firstly, taxes are just one of many factors determining a given country's economic environment. Such factors as political and macroeconomic stability and the volatility of exchange rates are first-order considerations for multinational investors. Secondly, focusing only on tax rates and their comparisons is of limited use. This is not only because of the high level of discretion in making decisions regarding tax holidays for investors in many of the analysed countries. It means that a country with a high nominal tax rate can offer an investor, for example, a 10-year complete exemption from income tax. The point is that in order to make an accurate comparison of the tax burden placed on investors, it is necessary to take into account many more features of the tax system and macroeconomic circumstances. This is because, from the viewpoint of an investor, what matters is the final result of the operation of the factors influencing the calculation of the rate of return on investment in the investor's home country. Aside from the corporate income tax rate itself, these factors include the exchange rate and inflation rate during the investment period in the country accepting the investment and in the investor's home country, depreciation rates for different types of assets (machinery, buildings, intangibles, etc.) throughout the investment period, and the means of financing the investment and the associated costs (financing with debt, equity or retained

profits)⁵.

In the analysed countries there have been sizeable reductions of CIT rates since 2000. A similar trend can be observed in all the OECD countries since the end of the 80s, and in their case, too, this tendency has gained momentum in recent years.

Table 5. Changes in CIT rates in the years 2000–2003 by country groups

Countries	Number of countries that reduced the CIT rate in the 2000–2003 period	Number of countries with a CIT rate lower than 25% (as of the end of 2003)
EU-8	7 out of 8	7 out of 8
Balkan countries	3 out of 7	7 out of 9 (incl. Kosovo and Serbian Rep. in B&H)
CIS countries	2 out of 12	6 out of 12
EU-15	10 out of 15	1 out of 15

Source: Grabowski, M., M.Tomalak, Tax system reforms in the countries of Central Europe and the Commonwealth of Independent States, in: *New Europe – Report on Transformation*, Instytut Wschodni, Warsaw 2004

The figures in the Table 5 clearly show that the majority of the 27 analysed countries have low corporate income tax rates, compared to the ‘old’ EU members, even taking into account the reduction of these rates in many EU countries in recent years. This implies that the tax cuts in the EU countries were rather moderate in scale. Meanwhile, reforms in this area in the countries undergoing transformation were much deeper and covered not only the new member countries, but also the CIS and Balkan countries. Recent figures indicating a significant increase in FDI inflows into the Balkan countries seem to indicate that changes in the tax systems may have been one of the factors contributing to this.

The European Union went through a few stages of tax harmonization and the major achievements were accomplished. But the problem of tax distortions and of harmful versus fair competition in taxation systems is coming back.

The European Union is a consequence of the integration efforts of its members. As John Kay⁶ stated that the integration may be done through harmonization (Bismarckian approach) or through competition (Jeffersonian approach). The first approach is based on assumption that integration requires setting rules of tax system and policies, for instance in form of legally binding regulations by the member states. The Jeffersonian approach presumes that there is space for member states to promote integration through their own institutions settings, and then the consequences of these rules will follow. Sijbren Cnossen puts it simply as “choice (...) between prescription and adaptation⁷”. Both approaches have deep, historical traditions in the European countries⁸. They are also reflected in the

⁵ Kwang-Yeol Yoo, *Corporate Taxation of Foreign Direct Investment Income 1991-2001*, OECD, ECO/WKP(2003)

⁶ Kay, John (1993): *Taxation Policy and Economic integration*, in A.Knoester (ed.): *Taxation in the United States and Europe: Theory and Practice*, New York, St. Martin Press. One has to observe that this definition of the tax competition differs from the concept that tax competition is only a process of reducing the corporate income tax in order to attract the foreign direct investors.

⁷ Cnossen, S. (2001): *Tax Policy in the European Union: A Review of Issues and Options*, www.ocfeb.nl

⁸ There are more deeply rooted beliefs on taxes in the European countries, which were instrumental in designing the tax systems in the EU member states. For instance, taxes are taken much more bearable than injustice or poverty in some countries, and the opposite approach is true in the other countries.

discussions on how to integrate the tax systems in the EU, as well as how they may be supportive for the potential growth and convergence in the enlarged European Union. But they also illustrate the major differences in the historical and political backgrounds in the members states of the European Union. Eventually, we have to consider the proper mix of both approaches.

Enlargement process led to the situation, where the European Union consists of countries at the very different stage of economic development⁹, and the heterogeneity of the EU is much higher now, than it used to be. The eight transition, and recently accession economies will need a few generations of the convergence process to achieve the economic development level of the old member states. The main Treaty's rule is subsidiary (art. 5), which also applies to the tax policy. By and large this may lead to incoherent tax tools as the instruments to reach different policy objectives by member states. Articles 98 and 99 par. 1 of the EC Treaty provides rules for coordination of economic policies, but coherence of the policy instruments, including tax instruments may not be easy to achieve.

The UE-8 as well as the Balkan states tax less heavily capital (CIT and property taxes). Also the revenues from PIT is relatively small. This may be a result of different tax base (limited tangible assets in the EU-8 to be taxed), but also it may reflect the policy objectives to attract the investment.

Such situation may lead to tax distortions which may be reduced by tax harmonization. This may than increase the political tensions between countries, which would not have instruments for their internal policies. The space for undertaking own economic policy has been limited by shifting part of the sovereignty from the member states to the EC, for instance in monetary policy, in trade policy, or in competition, state aid or (partly) in tax policy. Tax competition may ease political distortions, and also leads to tax integration.

The above mentioned arguments on tax integration don't exhaust the full list of them in favor of both tax harmonization and tax competition. At least two points have to be brought here. The process of competition between countries on institutional settings may bring positive and negative effects. The institutional frameworks of transparent, well-designed and low-cost security market provides incentives for investors and corporations to be listed. Such institutional framework would be probably mimic by other markets in order to attract new clients, or at least not to lose the old ones. So we may expect the race-to-the-top in institutional settings. The tax competition may bring economic and political distortions. Discrimination of residents and non-residents in taxes on moveable (f.i. income from savings, or capital) provides incentives to locate assets into countries, which provide the best solutions. This may lead to the "race-to-the-bottom", and finally to erode the tax base of moveable assets in *any* country, and to increase the other taxes. Tax harmonization seems to be the right recipe. From the other side tax competition may be a solution to the democratic accountability problem. Tax harmonization may weaken this accountability and distance citizens from decisions on public expenditures. It may also rise the level of tax rates, and thus to limit the overall European competitiveness.

There is also a strong point that the tax competition is not only among the EU member states. At least the countries, which are close to the EU and are emerging, stable economies, are part of the game, such as the Balkan states, the CIS countries and the Mediterranean countries. There is a growing question on the tax competition and tax harmonization of the corporate income tax in the EU member states. Devereux, Griffith and Klemm¹⁰ found out that the development of the corporate income tax regimes in the EU and G7 countries in the

⁹ This statement is widely recognized and there is not need to support it with statistical data. It was also underlined by the Sapir's Report "An Agenda for A Growing Europe", chapter 8.

¹⁰ Griffith, R. and A.Klemm (2004): What has been the tax competition experience of the last 20 years?, Institute for Fiscal Studies, WP04/05

last twenty years may be summarized, as follows: (i) statutory rates fell, (ii) tax bases were broadened, (iii) effective tax rates fell for profitable projects, but remained fairly stable for projects that just break even or make low profits, (iv) tax revenues remained stable as proportion of GDP. There is some interdependence in tax rates, and mobile factors are more interdependent, but it is very difficult to draw any conclusions, what are the reasons for government's tax setting behavior. The problem with these conclusions is, that they were drawn from the analysis of the relatively homogenous group of countries. After accession of 2004, there is less homogeneity among the EU countries. So one may expect this interdependence in tax setting behavior will be more significant, since the taxation policy at the level of member states will be undertaken in different circumstances and will have different objectives.

The evidence of tax integration of the corporate income tax is illustrated in the table 6 below.

Table 6. Top nominal and effective corporate tax rates in the EU-15 and EU-8

	1995		1999		2002	
	nominal	effective	nominal	effective	nominal	effective
EU-15	38,0	10,1	35,9	14,6	31,4	13,8
EU-8	30,7	14,6	29,2	9,9	20,6	9,6

Source: World Bank EU-8 Quarterly Economic Report, October 2004

Remark: Effective corporate tax rate is calculated as a ratio of taxed paid by corporations (from national accounts) to tax base (aggregate profits, or operating surplus).

The data from the table suggest that there was a relative increase of tax burden in the EU-15 and a relative reduction of tax burden in the UE-8. The gap of the effective tax rates in 2002 was almost the same as in 1995, but now the tax burden is higher in the EU-15, not in the EU-8 countries. There is not one simple explanation of this observation, and the business cycle is one of the factor, next to changes in the institutional framework. At the same time the gap between nominal rates increased, however these rates were reduced in both groups of countries.

6. Prospects of further tax integration

There have been major achievements in the tax integration. The current approach of the EC is that harmonisation of some rules of direct taxes is needed, and some measures are either completed or planned (like home state tax, Common Consolidated Base Taxation). The Commission states that it doesn't consider to harmonize full EU company tax. The unanimity rule for taxes would make it anyhow very difficult to progress. Many the member states are rather reluctant to shift their sovereignty to the EU in these issues.

There is scope for further tax integration, and one may expect next steps in this regard. The main method will probably be different to what we have seen in last 15 years. The statutory method will go down. From one side the new directives, like on Common Consolidated Base Taxation will require political national acceptance to be enforced in practice. Secondly, non statutory solutions will be more common. This will be due to more heterogeneity of the member states.

The growing role of the European Court of Justice in tax issues will be preserve, and the rulings of the ECJ will shape the national tax systems more than the new directives. This method of tax integration will apply mostly to the corporate income tax, for instance to discrimination rules of transfer prices and thin capitalization. These may lead to increase of tax planning in corporations, and as a result to more tax competition. Integration through competition will lead to soft regulations, f.i. through open method of coordination and peer pressure. Its effectiveness will also depend on progress in other fields like financial markets and services market integration.

Gradualist approach to further tax integration will be observed. It is caused by the differences in providing public goods and structure of public spending. Policy objectives, administrative capabilities and economic challenges are different in the current member states too. These circumstances require a space for undertaking the various policies among the member states, including tax policies.