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Tax reforms in the Visegrad countries and their relevance to the Ukraine situation

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Short description of the tax system

The Visegrad countries, namely Czech Republic, Slovak Republic, Poland and Hungary have established relatively matured tax systems, with all major taxes in place. This process was mostly completed in mid 1990s. The tax reform did not take place in vacuum, and it was part of the transformation process and strategy of these countries to join the European Union (EU).

The table below provides the basic information and reveals differences between the taxation systems.

Table 1: The main features of the tax regime in the V4 countries

	Czech Republic	Hungary	Poland	Slovak Republic
VAT regime				
rates	5 and 19	3,15, 25	3, 7, 22	19
turnover threshold*	35 000 EUR	35 000 EUR	10 000 EUR	35 000 EUR
Excise taxes				
gasoline	339,90 EUR/1000 l	407,56 EUR/1000 l	320,28 EUR/1000 l	375,53 EUR/1000 l
diesel oil	312,00 EUR/1000 l	334,71 EUR/1000 l	249,62 EUR/1000 l	331,30 EUR/1000 l
beer	0,752 EUR/hl/Plato	1,654 EUR/hl/Plato	1,5 EUR/hl/Plato	1,21 EUR/hl/Plato
alcohol	830,95 EUR/hl	756,05 EUR/hl	962,59 EUR/hl	605,70 EUR/hl
CIT				
rate	28	16	19	19
PIT				
rates	15, 20, 25, 32	20, 30, 40	19, 30, 40	19

Source: Excise Duty Table, EC, May 2004; VAT rates applied in the member states of the EU as on 1/9/2004, DOC/2008/2004-EN,
Note: VAT – value-added tax, CIT – corporate income tax, PIT – personal income tax
*VAT is payable only if a company's turnover reaches the threshold

Table 2. Tax revenues to GDP in V4 countries in 1999 – 2002
(%)

	Total	in this:							
		PIT	CIT	VAT	Excise	Social contributions	Customs	Property taxes	other
Czech Rep.	**36,4**	**4,8**	**3,2**	**5,6**	**3,5**	**15,0**	**0,5**	**0,3**	**3,5**
Poland	**33,6**	**4,6**	**1,8**	**7,4**	**4,0**	**9,6**	**0,6**	**x**	**5,6**
Slovakia	**31,0**	**3,5**	**2,0**	**7,4**	**2,9**	**12,7**	**0,4**	**0,2**	**1,9**
Hungary	**37,6**	**7,5**	**2,4**	**8,4**	**3,6**	**11,3**	**0,8**	**0,2**	**3,4**

Source: : IMF, World Bank, Mitra, Pradeep and Nicholas Stern, *Tax Systems in Transition*, World Bank Policy Research Working Paper 2947, January 2003,

Table 3. Share of tax and non-tax revenues of government and self-governments as share of GDP

	1999 - 2002
	% PKB
Czechy	41,1
Polska	40,4
Słowacja	40,4
Węgry	44,0

Source: : IMF, World Bank, Mitra, Pradeep and Nicholas Stern, *Tax Systems in Transition*, World Bank Policy Research Working Paper 2947, January 2003,

Having in mind that the EU harmonizes the indirect taxes and all the V4 countries had the same strategic goal – membership in the EU – the differences in the tax regimes are not trivial, but they are within the harmonized brackets of the EU. Tax system of the Slovak Republic is the most straightforward with limited number of rates and exemptions. The three other countries still have a few rates of the PIT. The highest rate of the CIT is in the Czech Republic, but the process of reduction of these rates is not completed yet.

The process of the tax reform was initiated by Hungary at the end of the 1980's by introducing all three main taxes, i.e. VAT, PIT and CIT. The other V4 countries followed and by 1994, all V4 countries had theses taxes in place. One has to observe that Ukraine completed this process in 1992.

Main process of the reforms

There have been witnessed three main processes since 1994. The first one has been to increase the revenues from indirect taxes and decreasing the revenues from direct taxes, mostly CIT. The main arguments for such strategy was to reduce risk of decreasing revenues during the slow down of the economy, and to provide more neutrality into the tax system (see table below for details). By and large countries decreased the rates of the CIT, and now they have lower rates than the average in the EU. At the same time they usually kept the initial rate of VAT, but they eliminated the exemptions in this tax, and increased the rates of the excise taxes.

Table 4: The main tax revenues during transformation (as % of the GDP)

	PIT		CIT		VAT+excise tax	
	91-95	99-02	91-95	99-02	91-95	99-02
Czech Republic	5,0	4,8	5,3	3,2	11,5	9,1
Hungary	7,0	7,5	3,5	2,4	11,6	12,0
Poland	8,2	4,6	4,4	1,8	10,2	11,4
Slovak Republic	5,5	3,5	7,7	2,0	12,5	10,3

Source: New Europe – report on Transformation, Krynica 2004, Instytut Wschodni

Some countries, like Hungary were very active to provide special tax privileges for large, international investors. Such procedures were found as harmful and contradicted with the state aid rules by the European Commission and were lifted as on May 1, 2004 the latest.

The second process was to make tax system compatible with the European Union regulations. This was done for instance by increasing the rates of the excise taxes till the minimum required by the EU, and to eliminate exemptions in the VAT regime. This process was spread over many years in order to avoid inflation shocks.

The third process has been to increase complexity of the system mostly by increasing various allowances, deductions and exemptions in order to secure various social and economic goals, like to increase demand for education, for housing, for R&D expenditure etc. This process led to high compliance costs, problem of interpretation of regulations and abuse of the system by taxpayers. Only Slovakia was able to eliminate this problem to much extent by introducing flat rate and single rate for VAT, and at the same time to revoke most of the privileges. The problem of overloading the tax system with special tasks was augmented by notorious changes of the tax system during the budget debates. It means that the most important amendments were adopted during the discussion on the Budget laws, but as changes in the various tax acts. These changes aimed to satisfy various needs mentioned above. The PIT was especially exposed to such practices, but the changes in VAT and CIT were also numerous and significant in all four countries. This process made the tax system unpredictable and costly for both administration and taxpayers.

In recent years one may observe (since 2000) that there is a tendency to limit the special treatment and privileges in tax system, which is linked to reduce the rates mostly in CIT and PIT. This means that the efficiency principle of tax system was taken seriously again. (nota bene: 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, economic 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.)

The tax issues got a high rank in the main legal acts. Namely, the constitution of the Republic of Poland provides, that taxes may be levied only by Parliament. So the power of executive is limited only to technical details of tax system, as defined in tax acts. This limits the changes of tax acts, but doesn't solve the problem entirely.

<u>Main problems</u>

Tax administration was a major challenge in the tax reform. 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. The costs of tax reform were also training and capital expenses for tax administration in the first stage of tax reform. There is one more aspect of this point. The costs and efficiency of tax administration depends on well-trained and equipped staff, but also on designing of the taxes, system of appealing of tax officer decisions to courts and civil servant rules. Poorly designed tax rules, which are not clear and ambiguous increase compliance costs of the tax payer. At the same time tax administration is exposed to corruption and costs of running such administration is high. The problem of complicated and unclear tax regulations remains probably the most important one in these countries, except Slovakia, which introduced the far-reaching tax reform in 2004. (Slovakia introduced the flat PIT rate at 19% and reduced most of allowances and tax privileges. At the same time single rate of VAT was introduced. It meant that the reduced rate was totally eliminated, and all goods and services are taxed with single rate of 19%. Lastly, the CIT rate was reduced to 19% to be in line with the PIT rate). Such problem is to certain extent limited by courts for administration issues, which may revoke or change administrative decision of the tax officers. Nevertheless there is a major problem of interpretations of tax rules and regulations.

The creation of the self-governmental units was an important part of transformation. Public responsibilities were delegated to theses units, but the own financial revenues were not fully secured. Local taxes provided only limited revenues for local governments and states' grants are main form of revenues. Moreover the rules of providing the grants have been changing and it limits the ability of the self-governments to plan multi-year projects.

The ratio of tax revenues to GDP in all countries is very high in comparison to their level of economic development. At the same time they are running the deficits in public finances. This means that reduction of tax revenues either by cutting rates or tax base should be executed steadily and with caution.

A list of taxes, fee and levies, which are in the tax systems of the Visegrad countries is very long. Some of them bring very limited public revenues, but at the same time they bring a high compliance and administration costs.

Tax harmonization, or as the EC states tax integration may be a factor, which may limit the scope of further steps of tax reforms even if the new directive is not passed. There are several ways to do so. First, the members states may put pressure on other countries in order to limit tax competition, for instance as far as CIT is concerned. Secondly, the European Court of Justice took some decisions on tax systems based on the Treaty's rules of non-discrimination, and free movement of capital, goods, services and labor. The bottom line is that the ECJ secures these rules, and prohibits some tax solutions which hamper these rules. But the main challenges, tax administration capabilities and clear regulations of the tax acts may be addressed by the national executives.

Lessons

1. The Visegrad countries had a full blood strategy for its transition process at least since the association agreement with the EU. It was clear what kind of institutional framework was going to be created. So perspective of accession was instrumental not only for designing some solutions of indirect taxation, but also to build administration capacity, and the whole institutional framework. This was probably the most important single factor of the tax reforms and their achievements. Ukraine ratified agreement on the Joint Economic Space between Russia, Belarus, Ukraine and Kazakhstan in 2004, and at the same time it made clear aspiration for the EU membership. This dualism in selecting the strategic goals will make tax reforms more difficult. For the V4 countries, a clear political perspective was instrumental for progress in tax reform. From the other side, Ukraine having the main taxes in place, should not replace them or introduce the new major taxes. Such moves would reduce investment attractiveness of the country and make tax system non transparent.
2. The major achievements of theses countries was to shift the main budget revenues from direct taxes, mostly profit taxes to indirect taxes, mostly VAT and excise taxes. This reduced the risk of high fluctuation of state revenues during the business cycle, and provided more economic efficiency into the system. This was also instrumental for attracting foreign investors. Ukraine clearly reduced its revenues from the CIT over last years. However there is still scope for farther rate cuts. The current rate of CIT is still high in comparison to the neighboring countries.

3. There is a clear tendency to broaden the tax base and reducing the top marginal tax rates in the income taxes in last years. Such moves (and accelerated appreciation, or tax transparency) are considered to be more efficient tools for attracting foreign investors then tax holidays for investors. Ukraine may follow such policies.
4. There remain numerous problems in tax system in most of the Visegrad countries. The most important ones are ambiguity of regulations and tax administration capability. This problem is elevated by the high frequency of amendments of tax acts, which usually are done at least once a year.
5. Problem of tax administration was addressed by technical progress, such as training and hiring, and by new equipment. There were also some legislative solutions, which aimed to protect the taxpayer rights. The most important one was to introduced the solution, that an appeal against decision of the tax authorities as final under administration proceedings, may be brought to court for administrative issues. Such solutions has at least two advantages. Firstly, tax payer right is protected from discretion power of tax officers. Secondly, court's explanation serves as interpretation of tax laws. In Poland there is two-tier courts for administrative issues, and there are 14 regional courts and the supreme court for administration. About 40% of the tax administration decisions is revoked by the court. Such solution may be useful in Ukraine. The risk of abuse of discretion power of tax officers will not evaporate with dissolution of the Central Tax Office.
6. The problem of ambiguity of tax regulations may be reduced by the constitutional rule that Parliament (Verhovna Rada) may not increase state budget deficit set by the Council of Ministers in the budget draft, including the new tax allowances or exemptions. This will not solve all the risk of non-clear amendments of the tax acts. Ukraine may follow the Slovak example to make its tax system easy and transparent. (to some extent it has already done).
7. There is an important problem how to tax the small business. There is no universal answer to that. The Hungarian reform of taxing small businesses from 2004 may be a good example to follow, or by and large to introduce the simple presumptive tax with simple tax base (e.g. revenues, or number of employees). The Hungarian simplified tax for entrepreneurs (EVA) under Act XLIII of 2002, is available to certain business units with a max. of HUF15 million annual sales revenue, VAT included, and active under the same legal form for at least two years. The tax rate is 15%, and this replaces VAT, the company car tax, the entrepreneur's personal income tax for sole proprietors and personal income tax payable on the entrepreneur's dividend base, the corporation tax for business companies and the personal income tax on dividends. The local business tax base is half of the EVA base. The current Ukrainian system seems still to be complicated, and difficult and costly to execute.
8. Tax frauds, e.g. in VAT refunds may be addressed by exchanging information with tax administrations from other countries. There is a good example of special administrative unit in one country, which deals with the major taxpayers, including exporters. Ukraine should address that problem due to serious tax arrears in VAT refunds. But first move may be done towards the large taxpayers.
9. There are numerous problems relating to power of tax officers, e.g. lifting and/or postponing of collecting of the tax liabilities. Tax expenditures are part of the state aid rules, and therefore are subject to the EU regulations in the V4 countries. Such problem remains in Ukraine. The power of such decision should have a ceiling at each level of administrative level.
10. The taxation of energy resources is to much extent harmonized in the EU, and further steps are foreseen (e.g. excise tax on electricity). Taxation of energy is Ukraine reveals

two shortcomings. Firstly, collection of taxes is not secured. Secondly, the level of taxation is low. The increase of taxes on energy may be linked to reduction of labor taxes, and in such way it may be favorable for the economy.

11. The grey economy is relatively big, and it reflects the weakness of administration, structure and unbalances of economy (unemployment and large small business sector) and high regulatory burdens. The best way to limit the grey zone is to provide adequate and reasonable institutional framework: a clear and transparent legal system, strong and capable administration, which create competitive markets. This is easier to say that to implement. In my view, the cost of reduction of the grey economy (which consists of very small and small firms and households) is high in comparisons to benefits.
12. The revenues from the environmental taxes and fees have been growing in Europe. In the future Ukraine may probably shift part of the taxation revenues from labor to natural resources.
13. The number of taxes and fees is too high for any standards in a country like Poland. One may say the same about Ukraine.