

**Institute for Private Enterprise and Democracy, Poland**

**Institute for Market Economics, Bulgaria**

**Institute for Liberal Studies, Slovakia**

**Needs for Deregulation  
of the Tax Systems in Central Europe:  
A Comparative Study**



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## Introduction

An over-regulated tax system creates similar hindrances to business development to those caused by a high taxation burden. The cost of compliance with tax regulations may take the form of **financial costs**, due to the payment to consulting firms or employees, and **time costs**, of the managers or business owners, who must spend a significant part of their working hours dealing with tax issues. A complicated tax system also increases the cost of tax administration for the government. Therefore, a number of countries address the issue of tax deregulation in their policy and introduce a tax system more adjusted to the needs of businesses.

Tax complexity has also become a problem in Central and Eastern Europe, despite the fact that the tax systems in the region were formed only a few years ago. Regulations introduced in these countries, which were transforming their economies, were at the beginning relatively simple. Then, as the years went by, new regulations and executive instructions were added. **Flexible tools came into use, which were based on individual interpretation of regulations rather than explicit criteria.** Tax systems in Central Europe started to suffer from a common disease: growing bureaucracy syndrome. Therefore, three think tanks, **Institute for Liberal Studies from Slovakia, Institute for Market Economics from Bulgaria and Institute for Private Enterprise and Democracy from Poland**, decided to elaborate on the report on the Needs for Deregulation of the Tax System in the respective countries. In our opinion, in order to meet the challenge of competition, transforming economies need:

- Simplification of the tax system;
- Evening of disparities between taxes paid by individual groups of taxpayers;
- Restriction or elimination of the flexibility of decisions on tax issues;
- Limitation of the tax allowances, exemptions and other exceptions to the rule of the general character of the taxation system.

All these issues are addressed in our study. According to the three organizations which have prepared the report, there is a growing need for the **reduction of the role of the state and the adaptation of the tax system to the actual capabilities of the private sector.** Only when this is achieved, can the growth rate be increased and the economic relationships based on partnership with Western countries be built. Cooperation with the business community may facilitate the achievement of the above-mentioned objective. Therefore, our organizations decided to base the assessment of the current situation and our recommendation for change on the opinions of representatives of the business community.

Surveys conducted in the three countries showed that entrepreneurs support a reduction in the number of tax rates. They also consider that the top rate should be a maximum of two times higher than the minimum rate. Tax declarations should be simplified and the frequency of submitting PIT declarations should be less frequent than now.

Problems with tax complexity are very strongly related to tax subsidies and tax reliefs, which are included in tax systems to achieve selected economic objectives. Opinions on the macroeconomic effects of tax relief are rather different in the three countries. There is a relatively strong belief in the stimulating role of investment tax incentives in Bulgaria, while in Slovakia only less than 2 percent of entrepreneurs recognize the stimulating role of tax exemptions and allowances. In Poland only one sixth to one-fifth of entrepreneurs find an

economic stimulation mechanism in tax relief. These results show that lifting investment tax incentives is supported only in Poland and Slovakia.

Proposed amendments to the current tax system can be based on the experience of the United States and Western Europe. Therefore we decided to include a brief presentation of the tax systems of the USA, UK, Sweden, Italy, Switzerland and Germany. We included the countries that have successfully deregulated their tax systems, as well as countries like Germany, which have made an attempt at tax reform but have not succeeded yet. All these experiences are useful for discussion in Central and Eastern Europe. We hope that our report will start a debate on the most appropriate tax systems for countries in our region.



# 1. Basic Features of the Tax System in Slovakia, Bulgaria and Poland

Tax systems in Slovakia, Bulgaria and Poland differ, and comparative study of these systems would be difficult to understand without a presentation of the basic characteristics of the tax systems in the respective countries. We do not intend to present in-depth analysis of taxes in the three countries, but to focus only on basic issues.

## 1.1. Main Characteristics of the Slovakian Tax System

The present structure of the tax system was introduced in the Slovak economy through a tax reform on January 1, 1993. Its basic components are:

- direct taxes:
  - ⇒ income taxes (personal income tax and corporate income tax);
  - ⇒ real estate tax (tax on land, tax on buildings, real estate transfer tax, inheritance tax, gift tax, road tax); and
- indirect taxes:
  - ⇒ value-added tax (universal tax on consumption);
  - ⇒ selective excise duties;
  - ⇒ tax on international trade and transactions.

### A. *Characteristics of personal and corporate income taxes*<sup>1</sup>

Personal income tax is a general income tax levied on individuals with permanent residence in the Slovak Republic. The tax covers all forms of income earned by private individuals; i.e., income from contingent activity and employment, income from business activity or other independent income-earning activities, income from capital gains, rent income, and other income. According to the Law, the PIT construction is progressive, with five tax rates, ranging from 15 percent to 42 percent. Corporate income tax is levied on all legal entities with a registered office in the Slovak Republic (with some exceptions; e.g., National Bank of Slovakia), with a common tax rate of 40 percent.

Regarding the characterization of the economic impact of the tax system, it is important to note how the deviations from and/or exemptions to the general tax law are solved, and in which areas they are concentrated.

In the case of the tax on personal income, the following items are exempt from taxation:

- interest on foreign-currency deposits;
- interest on home savings deposits, including that on state premium.

With regard to special tax rates, from the point of view of economic policy, mainly the application of the 15% rate is important:

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<sup>1</sup> Income Tax Act No. 286/1992 Zb. with subsequent amendments.

- on interest, premiums, and other income from savings deposits on passbooks, certificates of deposit, and similar deposits, shares and temporary bonds, yields on bonds, participation certificates, certificates of deposits, and similar deposits; and
- on dividends from the earnings of limited liability companies and limited partnerships.

In general, the law on the taxation of personal and corporate income can be evaluated as comparable to similar laws in advanced market economies. At the same time, we must state that some aspects of taxation are not adequately covered by this law, some provisions are out of date and need amendment, and the law contains some distorting provisions.

The law on the taxation of personal and corporate income supports both savings and investment, but contains no provisions designed to support job creation. The support for savings is laid down in the law in the form of a reduced tax rate on income from capital gains (special rate on savings deposits, tax exemption for yields on shares held for more than a year, etc.). However, the law does not provide enough support for collective investment, which is the institution most supporting people's propensity to save.

In addition, it is necessary to state that the law does not contain provisions for the support of long-term saving in other forms, and/or in other financial products. These products are usually savings for the purchase of a home and for old-age insurance (pension funds, additional old-age insurance). In the case of home savings, the law provides a tax exemption for interest on such deposits (including state premiums).

In its present shape, the law contains several instruments for the support of investment (in the form of tax concessions and mechanisms for the depreciation of tangible and intangible fixed assets). The first is the institution of the so-called tax credit. This product was designed to support the start-up of small businesses. In practice, however, it has no effect, for several reasons. One of most important is the fact that the possibility of reduction does not apply to contributions to insurance funds, which are calculated on the basis of the full tax base (not reduced by the tax law).

The next provision designed to support investment is a tax exemption for income earned through a reduction in the purchasing price of privatized assets (Article 19, letter p). This provision deforms the structure of the law by giving preference to a certain group of business entities. Therefore, the provision should be amended by accepting a more general formulation for the support of investment.

With regard to the support of investment through depreciation of fixed assets, the present law on the taxation of personal and corporate income divides tangible and intangible assets into five groups, with a period of depreciation ranging from 4 to 50 years, while the taxpayer can choose between linear and accelerated depreciation. The mechanism of depreciation should act in support of investment and innovation. In the present law, however, the effects of depreciation are largely lost. The following problems arise:

First, the value of SK 10 thousand is still used as the criterion for the inclusion of a tangible asset or right in fixed assets. This limit, which prevailed during the period before 1989, is already non-functional. Secondly, the minimum period of depreciation under the provisions of this law is four years. In the case of some products, even four years is a long period.

Several deforming provisions got into the law as a result of the pressure of trade unions:

- contributions to the social insurance fund in the amount of a minimum of 0.6 percent of the actual payroll;
- contributions from employers to the travel expenses of some groups of employees;
- meal contributions paid by employers, in the amount of 55 percent of the price of the meal;
- contributions from employers to voluntary additional pension insurance, in the amount of 3 percent of the payroll.

These provisions were adopted under pressure from trade unions after the cancellation of some subsidies and allowances financed from the state budget (e.g. for transport). However, these types of social expenses should be the subject of collective negotiations and incorporated into collective agreements.

## ***B. Real estate taxes***

Real estate taxes include road tax, real estate tax (tax on land and buildings), inheritance tax, gift tax, and real estate transfer tax. Within the Slovakian tax system, real estate taxes are construed in a way similar to that in advanced market economies. With regard to the business environment and its impact on the entrepreneurial sector, real estate taxes do not represent a serious problem. In spite of this, there are numerous deformations in this area:

- the real estate transfer tax was originally designed (like the inheritance tax and the donation tax) as a one-time tax replacing notary charges. At present, however, its implementation is hindered by the building of real estate for sale (e.g. housing construction). For the support of the real estate market, and the indirect support of investment shares, it is necessary to consider the possibility of a substantial reduction in this tax, and/or its limitation to the non-commercial transfer of property;
- in agriculture, real estate tax (on land and buildings) is levied only on transfer of property;
- in the case of the road tax, the tax burden appears to be disproportionately high on trucks, trailers, and saddle trailers, complicating the financial situation of private transporters. The amount of the road tax should be reconsidered for these cases.

## ***C. Indirect taxes***

The nucleus of the system of indirect taxes is the Value Added Tax. It is designed as tax on consumption, levied by means of the invoicing method. From the point of view of taxpayers (i.e. corporate entities), the main problem — under the conditions of the Slovakian economy — arises from the administratively demanding implementation of the value-added tax; namely, the mechanism of advance payment, in which the entrepreneur in fact provides credit to the state budget for 30 days.

The basic VAT rate has been set at 23 percent; selected types of goods are subject to reduced VAT (6 percent). The reduced rate is applied mainly to food-related goods, health care, and some other types of goods. Slovakia's basic VAT rate at the level of 23 percent is one of the highest in Europe.

## **1.2. Basic Features of the Bulgarian Tax System**

The Bulgarian tax system is to a great extent in line with European standards. Taxes are levied on income — both personal and corporate, consumption, and property. The major principle in Bulgarian tax legislation is territorial taxation; i.e., all incomes realized on Bulgarian territory are taxed. Both direct and indirect taxes are applied. A value added tax of 18 percent was introduced in April 1994. Since July 1996, the VAT rate is 22 percent.

The major principles introduced with the new set of tax laws up to 1998 are: neutrality (lack of tax exemptions and reliefs), yearly taxation of income and property, self-taxation (every taxpayer declares his obligation to the state himself), and a tendency toward decreased differentiation in rates. Subject to taxation are both local and foreign persons, the latter taxable only for incomes in Bulgaria.

### **Stability and Predictability of Tax Legislation**

Since the beginning of economic reforms, tax legislation has been changed due to short-term, mainly fiscal reasons. Regulations were often changed several times in a year, or even retroactively. Due to the overall macroeconomic instability in the last years the tax laws were adjusted to the short-term conditions in the country; i.e., inflation, budget deficit, etc. Taxes often turned into a residual value — tax levels and procedures were adjusted to the figures on the expenditure side, which of course were quite flexible. Another major characteristic of all Bulgarian tax laws is their imprecise nature. Being complicated and imprecise, laws are accompanied by so called "implementation rules," which clarify or even interpret the laws.

#### ***A. The new CIT Law***

The basic tendency in corporate taxation is the abolishment of tax exemptions and reliefs. Corporations are taxed with a 10 percent municipality tax and a 30 or 20 percent central budget tax on the remaining part of the taxable profit. The criterion for the above differentiation is the level of annual profit for taxation, with a cut-off point of BGL 50 million. Income on government securities and interest on bank deposits are not taxed for local persons. However, foreign persons are taxed 15 percent of such incomes. Dividends and other capital incomes are taxed by 15 percent when they are distributed. There are no tax allowances on investment purchases, and depreciation is deemed as expenditure only in a scope defined in the Profit Tax Law. Also, risk provisions on receivables are taxed by 30 percent. Tax declarations are submitted once a year. However, companies pay monthly advance installments, calculated on the basis of 1/12 of their previous year's profit. Overpaid tax is not refunded.

Compared to the previous law, which was in place until the end of 1997, the new legislation is rather neutral and restrictive. The only relief is provided to those who employ disabled people. However, this was not accompanied by a respective decrease in nominal tax rates.

#### **Lump taxation**

A certain group of corporations and sole proprietorships is subject to the so-called "lump taxation." Companies with annual turnover of less than BGL 75 million and engaged in certain fields of activity, such as accommodation and hotel business, restaurant business, retail trading, a number of handicrafts (tailors, hairdressers, plumbers, carpenters, etc.), are obliged

to pay an annual fixed tax. The whole list of activities is explicitly detailed in the Law on Personal Income Taxation.

The arguments of the government for the introduction of lump taxes were mainly connected with the inefficiency of the tax administration.

### ***B. Personal Income Taxation***

The Bulgarian personal income tax is based on the domicile principle. Local persons are taxable for their worldwide income, while foreign persons are taxed on income derived in Bulgaria. Local persons, once taxed abroad, may retrieve the tax paid on income in the other country up the limit of their obligation according to the Bulgarian legislation.

The new income taxation system is rather neutral, with no or very few incentives.

Personal income taxation is based on the annual calculation of gross income received. Monthly advance payments are applied to wage-earners, and a 15-percent advance installment for all others, once the accumulated income exceeds the tax-exempt level. Overpaid taxes are not refunded after the end of the year, unless on income received under a labor contract.

Gross income for taxation includes income derived from wages, activities as a sole proprietor, handicrafts, services, "free-lance" professional fees, copyright remunerations, rent or other incomes, not explicitly mentioned as "exempt income." Non-taxed incomes are: pensions, scholarships, interest on bank deposits and government securities, dividends already taxed at the source, and inherited income (local inheritance tax is due, however).

Though the number of tax rates applied is only four (20%, 26%, 32% and 40%), the ratio between the maximum and minimums tax rate is 2:1. Tax exempt income is up to DEM 50 monthly, and the maximum tax rate is applied to income exceeding DEM 1,280 monthly.

### ***C. Taxes on property***

Real estate, as in most countries worldwide, is subject to taxation in Bulgaria. The new improvement in 1997 was the change in the philosophy behind this tax: it had previously been based on the assumption that one should carry the "burden" and the obligations that go hand-in-hand with wealth. The idea that only well-to-do people would be able to possess, in the general meaning of the term, is quite unusual in Bulgaria; 85 percent of Bulgarian citizens own their dwelling, which means that the base of discontent embodies nearly the whole population.

### ***D. Value Added Tax and Excise Duties***

A value added tax of 18 percent was introduced in April 1994. In July 1996, the rate was increased to 22 percent, mainly due to fiscal problems and pressure from the IMF. The indirect taxation system is relatively simple and harmonized with EU legislation (Sixth VAT Directive). There exist only two rates: 22 percent and 0 percent, for exports. Effective from January 1, 1998, new regulations on registration and tax refunds have been installed.

The major characteristics of the current VAT regulations are: VAT refunds can only be claimed by those registered under the VAT Law, and the registration threshold is a 12-month turnover exceeding DEM 75,000 (DEM 50,000 for exporters); tax declarations and tax

payments are made monthly, while VAT is refunded only after a six-month compensation, with tax obligations that will arise during that period (45 days for exporters); financial, insurance, health care, legal and educational services, sale of enterprises as a whole, betting and gambling, and rent, are not subject to VAT taxation.<sup>2</sup>

Three major problems stemming from the current VAT regulations can be distinguished: first, the abolishment of the “volunteer registration” for small companies, which from now on would not be able to be refunded VAT paid on inputs; second, the period of the VAT refund is quite long, and thus entrepreneurs lend a credit to the state; and third, the nominal rate of 22 percent is unacceptable.

Excise duties are levied on spirits, tobacco, gambling business and other luxury goods, generally promoting reasonable consumption and creating negative incentives for the consumption of harmful products.

The tax reform - what did it change?

Various interpretations of what the economic consequences of the tax reform might be can be made. It introduced neutrality, more simplicity, and decreases the opportunities for tax evasion. Even more, for the first time in years, the tax laws to a great extent correspond to one another. But there still remain a number of unsolved problems: nominal tax rates are unbearably high; only VAT regulations provide for tax refunds, which itself is complicated and rather slow; and the introduction of neutrality was not accompanied by a respective decrease in tax levels, thus inspiring moods against the principle of the reform.

### **1.3. The Most Important Features of the Polish Tax System**

The Polish tax system is composed of state taxes and local taxes. State taxes provide more than 95 percent of total tax income. The main elements of the state taxes are: Personal Income tax (PIT), Corporate Income Tax (CIT) and Value Added Tax. Apart from regular taxes, there are excise taxes imposed on gasoline, alcoholic beverages and tobacco products. Local taxes include: real estate tax, agricultural land tax, and a tax for dog owners. According to the Main Statistical Office, in 1995 PIT contributed 27.5% of the budgetary incomes, 23.8% came from VAT, 14.3% from excise taxes, and 10.8% from CIT (Statistical Yearbook 1995, p.497). In the following years a tendency to increase indirect taxes and decrease direct taxes was observed.

#### ***A. Value Added Tax***

The most important state tax is at present VAT. VAT is paid only by enterprises with annual sales over PLN 80,000, or by enterprises with sales below 80,000 that want to pay VAT. Registration of VAT sales is done by electronic cash desks (for enterprises with sales over PLN 200,000 a year) or manually (the rest of the enterprises).

In Poland in 1998 there are five VAT rates: 0 percent for exports, 7 percent for food, children's clothing, toys, medicines, construction, tourist services and some others, 12 and 17

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<sup>2</sup> A list of eight goods, such as bread, milk, water, medicaments, etc. are exempt from VAT until July 1, 2001. The level of VAT due on real estate deals is the difference between the 22% deduction and a local tax, defined in the Local Taxes and Fees Law.

percent temporary rates for some energy products, and a basic 22 percent rate for everything else. Some products and services are exempt from VAT: agriculture, health services, educational services and non-processed food products.

The most important VAT problems are related to the very complicated system of qualifying goods for different rates, the questionable system of refunding VAT to exporters and other firms, and the discretionary policy of the fiscal authorities in relation to taxpayers' claims.

### ***B. Personal Income Tax***

Personal Income Tax lost a lot of its importance for the economy in the second part of the nineties. The first reason is the legislative mess caused by finance ministry errors. In 1995 the changes in PIT were adopted too late by the parliament, and the government was not able to protect the tax system from discretionary "gift" allowances. In Poland a part of income (up to 15 percent) could be excluded from the tax base when it was devoted to charitable activities. However, there were no detailed regulations on who could benefit from charitable activities or how to prove expenditures. As a result taxpayers declared charitable support for their fathers, grandmothers, uncles, children and friends. About half of taxpayers used this kind of allowance in 1995 and 1996. Thus, in those years taxpayers decided themselves which rate was applicable to them.

The second reason for the decreasing role of PIT is the fact of reduced rates in the last years. In 1992 initial rates were 20, 30 and 40 percent; in 1994 they had risen up to 21, 33 and 45 percent, and starting in 1996 they were gradually reduced to the level of 18, 30 and 40 percent by 1998. The effective tax rate of PIT was never higher than 18 percent, due to the many allowances (at present it is about 16 percent). Therefore, the thinking of millions taxpayers was directed at activities which allowed them to receive tax relief. An interesting curiosity is the fact that in 1995 it was possible to exclude from the tax base expenditures for video cassette recorders, under the condition that they were to be used for professional purposes. From 1996 the tendency of reducing PIT rates has been accompanied with the tendency to reduce tax allowances. The general opinion is that PIT proved to be more friendly to taxpayers than it was expected to be at the beginning. The most important PIT problems concern: the simplification of PIT reporting, and the reduction of rates and tax allowances.

### ***C. Corporate Income Tax***

Corporate income tax (CIT) was never considered to be a serious problem by enterprises in Poland. It was imposed in early eighties, when central planning was the major system of running the economy. This tax was very stable (40 percent), with allowances for investment and export activities. In 1997 it was reduced to 38 percent and in 1998 to 36 percent. It is planned to reduce this tax to 32 percent by the year 2000.

It is very important to underline that stock exchange capital gains are not taxed in Poland. Dividends from corporations are taxed at a flat rate of 20 percent.

### ***D. Local taxes***

Local taxes never played an important role in the Polish tax system. The most important element of local taxes, a transportation tax, was lifted in 1998, and included to the excise tax for gasoline. Before 1998 car owners were obliged to pay a tax differentiated on the cubic size of

their cars' engines. This tax caused the most taxpayer protests and finally was abolished in 1998. Within 2-3 years a reform in the real estate tax is expected. The amount of this tax will not depend on the size but on the value of the real estate. This change is planned for the year 2000.

### ***E. Tax procedures***

One of the most important problems of the Polish tax system is a lack of stability. Tax regulations are changing every year. Some tax regulations in the nineties were introduced in violation of the legal rule *lex retro non agit* (they came in force before they were accepted by the parliament). This caused protests by taxpayers. Finally the constitutional court stated that tax changes should not destroy confidence in the state of law and ordered the legislature to announce changes at least 30 days before their implementation.

Another important problem of fiscal procedure is the discretionary policy of tax offices. A lot of tax regulations are not precise, and this allows fiscal offices to provide their own interpretation of legal regulations. Such "opinions" are afterwards considered a source of law. Of course, entrepreneurs and taxpayers are fighting against this practice.

### **Fiscal policy perspectives for the nearest future**

The year 1998 brings some new chances for the deregulation of the tax system in Poland. The new government declared its support for the simplification of the tax system, especially the reporting requirements. Something which can destroy the logic of the system is a proposal by part of the governing coalition to introduce some new family allowances (child-related allowances). In 1998 the system seems to be stable. Greater changes are expected for 1999.

## **2. Deregulation Needs in Central and Eastern Europe**

### **Comparative Study of Slovakia, Bulgaria and Poland**

#### Introduction

The gradual introduction of democracy in Central European countries brought the need for change to the taxation system for the private sector, based on the experience of Western countries. Presently all three countries analyzed in the report have modern systems based on VAT tax, as well as personal and corporate income taxes. However, the introduction of the modern system did not reduce the problem of the implementation of tax regulations. Some of these problems are common to the majority of countries in the region. One of the most important is the growing role of bureaucracy. In many cases tax administration in Poland, Slovakia or Bulgaria in practice creates the tax regulations. The possibilities for individual interpretation of tax regulations by tax officers are enormous. Commentaries and explanations produced by the Ministries of Finance or Tax Offices are treated as law, despite the fact that sometimes these explanations are not in line with the law, as accepted by the parliament.

Discretionary treatment of the business community by the tax administration is combined with high tax burden. VAT tax oscillates between 22-23 percent. Income taxes reach 40 percent in Poland and Bulgaria, and 42 percent in Slovakia. The maximum rate is paid for relatively low income. Also, tax procedures are complicated and consume a significant amount of work. Frequent changes to tax regulations, obscure laws and the generally low quality of the laws



make the taxpayers' position very difficult vis a vis tax administration. The position of different groups of taxpayers is related also to their legal status. Corporations pay different income taxes than unincorporated businesses. Relatively high taxation levels and the complication of the tax procedures result in a broad informal sector and tax avoidance.

The similarity of the basic problems of the business community in Central and East Europe incline the three institutes in Poland, Slovakia and Bulgaria to analyze the need for deregulation of the tax system in these countries. The entrepreneurs' survey on the preferences to deregulate the tax system took place at the end of 1997. The methodology of the survey was described in each country report. Here we compare the results of the three surveys.

## 2.1. Personal Income Tax (PIT)

### 2.1.1. Number of PIT Rates and Dispersion Range

In the survey the entrepreneurs were asked whether the number of PIT rates should increase, decrease or remain unchanged. The replies are included in Table 1.

Table 1 Entrepreneurs' Preferences on the Number of PIT Rates

Bulgaria		Slovakia		Poland	
Preferred Solution	%	Preferred Solution	%	Preferred Solution	%
		Increase number of tax rates to 7 or 8	12.2	Increase number of tax rates to 5	11.8
Remain present 7 rates	29.7	Remain present 6 rates	31.7	Remain present 3 rates	37.3
Reduce number of tax rates to 2	18.8	Reduce number of tax rates to 2 (basic rate and increased rate for very high incomes)	29.3	Reduce number of tax rates to 2 (basic rate and increased rate for very high incomes)	34.3
Reduce number of tax rates to 5	25.7	Reduce number of tax rates to 4 or 5	14.6		
Introduce flat rate	25.7	Introduce flat rate	12.2	Introduce flat rate	16.6

Source: Survey

The number of PIT rates differs in the three countries, from three tax rates in Poland to seven in Bulgaria in 1997 and six in Slovakia. The attitude of entrepreneurs seems to be related to their previous experience with the changes to the tax system. The most important issue is the level of tax rates. If a decrease in the number of tax rates is combined with an increase in the tax burden, businesses prefer to keep the numerous tax rates and pay lower taxes. Reduction of the PIT rates in Bulgaria<sup>3</sup> in 1998 was combined with an increase of the taxation burden for taxpayers with average and high incomes. Therefore, in this country support for the further scaling down of the tax rate to two basic rates is relatively low. In Poland and Slovakia, around a third of the businesses would prefer to have the tax system based on two basic rates: the first for low and average incomes and the second for very high incomes. Cross-tabulations in the Bulgarian survey, however, prove that those 25 percent who support linear taxation are strongly motivated and also propose the abolishment of tax incentives and relief.

<sup>3</sup> In 1998, the number of tax rates in Bulgaria was reduced from seven to four.

According to the above-presented data, a majority of entrepreneurs in Central and Eastern Europe support a reduction in the number of tax rates. However, if we exclude the entrepreneurs who support the idea of five tax rates in Bulgaria and compare only the data related to the reduction of the number of rates in 1998, we would be able to observe similar support for a reduction to half of the tax rates in the three countries, ranging between 45 and 56 percent. It shows that about half of the entrepreneurs would prefer to reduce the number of tax rates.

Apart from the problem of the number of PIT rates, the dispersion range seems to be a very important issue. Experts dealing with tax systems modeling maintain that a dispersion between the lowest and highest rate above a factor of two does not promote fiscal honesty. The preferences of the surveyed businessmen on the optimal level of tax dispersion are presented in the following table.

Table 2  
Optimal Dispersion between the Lowest and Highest PIT Rates

Bulgaria		Slovakia		Poland	
Dispersion Range	%	Dispersion Range	%	Dispersion Range	%
Up to 2.5	28.7	2.5	18	2.50	16
2.14	5.9	3-4	15.4	2.14	14
2	22.8	2	38.5	2	45
1.66	24.8	1.66	10.3	1.66	13
1	17.8	1	15.4	1	12

Source: Survey

The data included in the above table show that majority of entrepreneurs in the three countries consider that the top rate should be a maximum of two times higher than the minimum rate. Dispersion of two or lower was considered as optimal by 65 percent of interviewed businesses in Bulgaria, 64 percent in Slovakia and 70 percent in Poland. The average preference for PIT rate dispersion<sup>4</sup> was 1.95 in Poland, 2.0 in Slovakia and 1.88 in Bulgaria. The results are close to two in all countries. However, the strongest need for a low progression can be observed in Bulgaria.

### 2.1.2. Maximum PIT Rates

The surveyed entrepreneurs propose the establishment of a marginal tax rate at a significantly higher level than at present. More than 2/3 of those surveyed maintain that the marginal rate should start from a level equivalent to 5-10 average incomes. The entrepreneurs' opinions are presented in the following table.

Table 3  
Preferred Starting Point of the Marginal Tax Rate

Preferred Starting Point of the Marginal PIT Rate	Percentage of respondents		
	Bulgaria	Slovakia	Poland
2 x average income	10	-	8.4
3 x average income	11	-	21.1
5 x average income	24	23.1	37.9

<sup>4</sup> The average preference of the PIT rates dispersion was obtained by multiplying percentages of respondents by preferred dispersion.

7 x average income	18	7.7	17.9
10 x average income	37	48.7	14.7
20 x average income	-	12.8	-

Source: Survey

Using the rule described in the above paragraph, the average preferred start level of the marginal PIT rate was estimated. It amounts to 5.42 times the average income in Poland, 6.69 in Bulgaria and 9.12 in Slovakia. This result shows that the maximum PIT rate should start at the level of at least six average incomes. In Slovakia there is strong support for setting up a maximum tax rate at the very high level of 10 average incomes.

The entrepreneurs were also invited to indicate their preferred minimum and maximum PIT rates. On the average they stated:

Table 4  
Minimum and Maximum PIT Rates

Min/max PIT rates	Bulgaria	Slovakia	Poland
minimum PIT rate	16.7%	11.64%	13.7%
maximum PIT rate	26.67%	34.58%	30.4%

Source: Survey

In comparison to the maximum 40-42 percent and minimum 20 percent rates in 1998, the differences seem quite large. Entrepreneurs in Bulgaria, Slovakia and Poland prefer a decrease in both the starting rate and the top rate. The maximum rate should be about 30 percent, although in Slovakia businesses would accept a higher rate, at a level of around 35 percent. Presently Slovakia has the highest marginal rate, and probably business people do not see the possibility to decrease it by more than 10 points.

Most of those surveyed consider that the present marginal PIT rates discourage honesty in tax declarations. Therefore, entrepreneurs take steps to decrease the amount of reported income. Thanks to these efforts, they pay significantly lower taxes. The surveyed entrepreneurs in the three countries were asked to estimate "savings on taxes." The results of the research are presented in Table 5.

Table 5  
Estimations on Tax Avoidance by Taxpayers at the Maximum Rate

Amount of Marginal Tax taxpayers avoid paying ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
80-100% of due PIT	3.1	16	6.9
50-80% of due PIT	16.5	27	30.7
30-50% of due PIT	41.2	40.5	48.5
10-30% of due PIT	25.8	13.5	10.9
10% of due PIT	13.4	3	3.0

Source: Survey

To estimate the average tax avoidance range, the percentages of respondents were multiplied by averages of range brackets. The result was 47.9 percent for Poland, 32.4 percent for Bulgaria and 37.6 percent for Slovakia. The differences in the three countries are significant, although in all countries the level of tax avoidance is relatively high. Accordingly to the opinion of the entrepreneurs, marginal taxpayers avoid paying between 30 and 50 percent of their taxes.

The received results show that according to the business community keeping marginal PIT rates at a high level (40-42%) does not produce satisfactory tax inflows. Of course these results can only be considered as estimations. It's also important to underline that entrepreneurs tend to present their opinions in a more negative way than things are in reality. However, these data show that high rates don't lead to high PIT inflows.

### *2.1.3. Differentiation of PIT according to Different Income Sources*

In Slovakia and Poland the majority of those entrepreneurs surveyed prefer to maintain the present differentiation of income taxation according to different income sources. This opinion was expressed by 56 percent of Slovaks and 60 percent of Poles. In Bulgaria the situation is different, mainly because of the lack of any differentiation (only T-Bill yields and interest on deposits in banks are tax exempt). Probably this is the reason for the majority of the entrepreneurs to demand differentiated income taxation. About 70-72 percent of respondents would prefer the introduction of such differentiation. The highest support for tax differentiation might be explained by the relatively neutral tax regulations in the country at present — as a rule, entrepreneurs always criticize the current tax system.

Business people in Central Europe consider having different rates of taxation for capital gains, personal incomes and agricultural incomes to be relevant. In the majority was a group which sees benefits in the present regulations and accepts a more complicated tax payment procedure. About 30-40 percent of those surveyed consider it better to simplify regulations and introduce uniform taxation for incomes from different sources.

### *2.1.4. Simplification of Tax Procedures for Very Small Firms*

Depending on the existing simplicity levels in the different countries, 64 percent of entrepreneurs in Bulgaria, 87 percent in Slovakia and 74 percent in Poland said that very small firms with low sales should be taxed by lump sum taxes. In relation to very low incomes (not exceeding minimum wage), the entrepreneurs proposed that they not have to submit an annual PIT declaration. These entrepreneurs considered that people with very low income should not pay advance tax payments. Most of the entrepreneurs thought that annual tax declarations should be shortened, and limited to a maximum of two pages (56 percent in Bulgaria, 78 percent in Slovakia and 64 percent in Poland).

### *2.1.5. Apparent Losses and Price Transfers to Firms with Tax Exemptions and Incentives*

It seems to be an interesting observation that a lot of firms submitting tax declarations to Tax Offices report permanent losses. They do this thanks to different prices and cost maneuvers. A lot of them do not declare all of their incomes and profits. The entrepreneurs surveyed considered that situations of producing permanent losses are rather impossible in longer periods. This opinion was expressed by 35 percent of Bulgarian businesses, 41 percent of businesses in Slovakia and 51 percent in Poland. At the same time, 33 percent in Bulgaria, 46 percent in Slovakia and 29 percent in Poland stated that this situation is absolutely impossible in longer periods. These answers are proof of entrepreneurs' decreasing acceptance for permanently hiding incomes. The entrepreneurs in Poland are more hesitant in expressing their opinion.

The surveyed entrepreneurs were also asked what the frequency and range of income transferring is to firms with tax exemptions or incentives. The results of the research are presented in the table below.

Table 6

## Frequency and Range of Income Transferring to Firms with Tax Exemptions and Relief

Frequency and Range of Income Transferring to Firms with Tax Exemptions or Relief is ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Common (touches 80-100% of firms with tax exemptions or relief)	11.9	10.8	7.2
Very frequent (touches 50-80% of firms with tax exemptions or relief)	10.9	35.1	17.5
Quite frequent (touches 30-50% of firms with tax exemptions or relief)	33.7	27	41.2
Moderate (touches 10-30% of firms with tax exemptions or relief)	14.9	21.6	21.6
Rare (touches up to 10% of firms with tax exemptions or relief)	21.8	5.4	12.5

Source: Survey

The result shows that according to business people about 50 percent of the firms who are eligible for tax exemptions or relief are a target for transfer pricing. More precise estimations show that transfer pricing touches 39.3 percent of firms with tax exemptions and relief in Poland and 47.9 percent of such firms in Slovakia. This means that the tax-exempted sector of firms destroys the fiscal honesty of the rest, significantly reducing tax inflows. The problem is especially severe in Slovakia.

## 2.2. Corporate Income Tax (CIT)

Concerning CIT, the situation in the three countries is different. Poland has flat tax, while the other two have more or less progressive systems. Bulgaria has two rates, of 28 and 37 percent, and the threshold is DEM 50,000 of taxable profit. CIT arouses the least controversy in Poland, due to the fact that this tax had been very stable since its inception in the early eighties. The rate of CIT had been established at the level of 40 percent since then. Recently it was reduced to 36 percent and a program for gradual reduction to 32 percent in the year 2000 was also introduced. This situation causes entrepreneurs to evaluate PIT in a very positive way. In Bulgaria, the business community is divided into two nearly equal groups - 53 percent of businesses prefer a flat tax, and 47 percent support a progressive scale similar to the PIT one. In Slovakia more than 1/3 support progressive corporate tax and 2/3 would like to have a flat CIT.

### 2.2.1. Preferences towards CIT Model

The surveyed entrepreneurs were asked what their preferences are towards a CIT model. The results are presented in the following table.

Table 7

## Preferences towards CIT Model

CIT should be ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Flat rate of 30% (without tax exemptions and relief)	34.3	33.3	33.7
Flat rate of 32% (with slight tax exemptions and relief)	13.1	25.6	41.6
Flat rate of 40% (with large tax exemptions and relief, as in present situation)	5.1	5.1	8.9
Progressive (similar to PIT)	47.5	36	15.8

Source: Survey

The results of the research show that there is a visible preference for low rates without significant tax exemptions and relief. In all three countries, 1/3 of the businesses surveyed strongly support a low flat tax without tax relief. However, countries differ in their attitude toward flat versus progressive tax, as described above.

### 2.3. Tax Exemptions and Relief

Tax exemptions and relief are among the most important elements of the Polish tax system. They exist on much a smaller scale in Slovakia, where tax relief is only granted to companies who hire disabled employees and businesses important to the nutrition of the population. In Bulgaria, the tax system is rather neutral, especially since investment incentives were abolished in 1996.

According to the intention of legislatures, tax exemptions and relief are intended to stimulate strictly-defined activities of businessmen and taxpayers. These activities are defined in the economic policy of the given government. Opponents to a high role for tax exemptions and relief say that they destroy the logic of the tax system, change initial and basic economic intentions of taxpayers and direct business activities at “wrong” targets. They also state that tax exemptions and different kinds of relief change the structure of supply and demand, leading to a situation in which the portion of GDP “distributed” by the government is higher than widely announced official figures . A question which arises is the following:

*What is the relation of entrepreneurs to tax exemptions and different kinds of relief?*

The tables below contain the entrepreneurs’ responses to these questions. The tables deal with problems such as evaluation of present systems of tax exemptions and relief, evaluation of the economic meaning of tax exemptions and relief, preferences as to how to shape the system of different kinds of relief, and possibilities for eliminating some tax reliefs.

Table 8  
Evaluation of the Present System of Tax Exemptions and Different Kinds of Relief

Meaning of tax exemptions and relief	Percentage of respondents		
	Bulgaria	Slovakia	Poland
They stimulate avoidance of tax payment	38.4	31	49.0
They sometimes stimulate business development but sometimes give undesirable effects	38.4	34	38.7
They encourage more effective business activity	23.2	2	12.3
Do not make much difference		33	

Source: Survey

According to the results it is possible to admit that 1/3 of the business people in Slovakia and Bulgaria and half of the entrepreneurs in Poland have a negative opinion of tax exemptions and different types of relief. One-third in each country observes both positive and negative effects of tax relief. The countries differ significantly in the evaluation of the positive effect of tax incentives. The strongest belief in the positive role of tax incentives can be observed in Bulgaria, which is rather a negative attitude towards the current system without incentives, than a positive evaluation of something already existing. The attitude of the business community in Slovakia toward tax incentives is rather negative or indifferent.

The general conclusion on entrepreneurs' opinion on tax exemptions and relief is that it is very diverse. However, a critical approach to different kinds of tax relief prevails in all countries.

The next question was focused on the evaluation of the macroeconomic impact of tax exemptions and relief. The respondents received several qualitative statements on the meaning and could choose as many of them as they wished. The results of the research are presented in the table below.

Table 9  
Evaluation of the Macroeconomic Meaning of Tax Relief and Exemptions

Opinions - Statements	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Tax exemptions and relief are used by persons who are more familiarized with tax system rather than by those who need them	62	25.1	66.7
Tax exemptions and relief stimulate tax manipulations and cause serious tax inflow reduction	32	12.5	50.0
Tax relief is received by only a few but everybody pays for it	36	11	43.1
Tax incentives used by very few discourage the others	26	13.8	
Tax relief which is commonly used is not considered as tax incentive			26.5
Tax relief and exemptions received by a few discourage the rest from honest activity	20	16.5	19.6
Tax relief reduces consumption and increase investment	11	2.8	20.6
Tax exemptions and relief stimulate desired business activities	29	1.8	16.7

Source: Survey

Opinions on the macroeconomic effects of tax relief are very differentiated in the three countries. There is a relatively strong belief in the stimulating role of investment tax incentives in Bulgaria, while in Slovakia only less than 2 percent of entrepreneurs recognize the stimulating role of tax exemptions and allowances. In Poland only one-sixth to one-fifth of entrepreneurs find some economic stimulation mechanism in tax relief. In connection to the above question were also asked to present their preferences in regard to the practical use of tax allowances and exemptions. The results of the research are presented in the table below.

Table 10  
Preferences toward the Practical Use of Tax Relief and Exemptions

The best solution is ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Granting tax relief and exemptions to those who can demonstrate that gained benefits can be used for new workplaces, new investment, although everybody must pay for the advantages to only a few.	59.2	37.2	45.0
Granting tax relief and exemptions to the maximum number of entities, so that nearly all feel stimulated. Nearly everybody receives and uses tax relief	24.5	30.2	35.0
No tax relief nor any tax privileges	16.3	32.6	20.0

Source: Survey

The results presented in the table above show that nearly 2/3 of those surveyed realize the negative impact of tax breaks. However, most of them (who would limit the use of tax relief to those who can demonstrate benefits to society) still believe that there exist "good businessmen" who deserve tax incentives. These figures are quite stable in the three countries. The higher

support for privileges in Bulgaria might be explained as mentioned in the above paragraphs. Simultaneously, the number of entrepreneurs who oppose the introduction of tax relief is the lowest in Bulgaria. Slovak entrepreneurs are divided into three nearly equal groups. Slightly more than 1/3 of the entrepreneurs in that country does not accept broad use of tax relief.

The conclusion of the above research is the following: generally the entrepreneurs in Slovakia and Poland are against tax reliefs. However, the business community do not accept the abolishment of tax relief without suitable compensation.

Another conclusion which arises from the analysis of the above questions shows that the common acceptance of the present system of tax relief is relatively low in Poland or Slovakia and more widespread in Bulgaria. Most of those surveyed maintain that tax relief encourages dishonest activities which cause the reduction of tax inflow. In Bulgaria a relatively large group of businesses see positive impacts from tax relief.

## 2.4. Value Added Tax (VAT)

Value added tax is one of the most important revenue sources for the budget in all three of the countries studied. All of them introduced VAT in the 1990s. The actual systems differ significantly. The simplest VAT system exists in Bulgaria. The system in Slovakia is more complicated, while that in Poland is extremely sophisticated. This differentiation in VAT systems leads to different attitudes in the entrepreneurs surveyed in the three countries.

Analysis shows that the highest preference for maintaining the present system is observed in Slovakia. Over 54 percent of those surveyed preferred the present system with 2 rates. On the opposite side is Poland, with only 23 percent acceptance for the present system. In Bulgaria the level of acceptance for the present system is about 1/3. The reason for the low level of support for a uniform VAT system is the fact that all goods and services are taxed at the relatively high rate of 22 percent. In Poland, the low preference for the present number of VAT rates is mostly caused by the complexity of the system. Something striking in this comparative study is the very high preference for a single VAT rate in Poland. Over one half of the entrepreneurs surveyed in Poland were in favor of the maximum possible simplification of the VAT system. The general conclusion drawn from the research is that the highest number of business people dissatisfied with the current number of VAT rates is observed in Poland.

### 2.4.1. Number of VAT Rates

In the Central European countries compared in the study, VAT systems differ significantly. In Bulgaria there is a 22 percent uniform tax for all activities and types of taxpayers. The only exemption is export, with a 0 percent VAT rate. In Slovakia there are two VAT rates (besides export) - the regular rate of 23 percent, and 6 percent for food and some other products. Poland has the most complicated VAT system, with five rates: 7 percent, 12 percent, 17 percent, 22 percent and 0 percent for goods exempt from VAT. The differences in the three VAT systems led the research teams to ask the question of whether to reduce or increase the number of VAT rates. The results of the survey are presented in the table below.

Table 11  
Preferred Number of VAT Rates (Domestic)

The proper solution is...	Percentage of respondents		
	Bulgaria	Slovakia	Poland



One rate	35 (present system)	17	54
Two rates	Differentiation of VAT rates was preferred by 65% of respondents	54 (present system)	0
Three rates		10	0
Four rates		0	20
Five rates		0	23 (present system)
Six rates		15	3

Source: Surveys

#### 2.4.2. Complexity of VAT Procedures

In order to learn the opinion of the entrepreneurs concerning simplification of VAT procedures, they were asked how they evaluate the complexity level of VAT regulations. The data are presented below.

Table 12  
Complexity of VAT Regulations

Regulations concerning VAT are ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Complicated, unclear and imprecise	9.9	21	45
Require excellent orientation and knowledge not possessed by the average entrepreneur	36.6	36	36
Relatively complicated	17.8	28	35
Relatively easy to use for every accountant	5% did not answer; the rest chose easy or relatively easy	13	8
Simple and easy to use		1	2

Source: Surveys in three countries, more than one response allowed.

The results shown in the table prove that entrepreneurs in Slovakia and Poland have a very critical opinion toward VAT regulations. The Bulgarian VAT system is rather simple, and therefore discontent with the regulations is lower. The major problems in this country are considered to be the system of VAT refunds and the high registration barrier. The highest degree of criticism of the complication of VAT procedures is also visible in Poland. In Slovakia also might be observed a serious level of discontent. The results found in all three countries show that VAT simplification is urgently needed. The following table presents the entrepreneurs' preferences with regard to simplification of VAT procedures.

Table 13  
Entrepreneurs Preferences for the Simplification of VAT

VAT regulations should be simplified concerning ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland *
VAT refund	70	31	50
Formalities in the rules for filling out and registration of invoices	25	22	51

How various groups of commodity qualify for the different VAT rates (Slovakia, Poland); Other problems (Bulgaria)	5	46	66
---	---	----	----

Source: Survey in three countries; \* = more than one answer allowed

The data included in the table above show that the higher the number of VAT rates, the higher the preference for simplification of the rules for various categories of goods' qualification for different rates. The second conclusion drawn from the data shows that the highest preference for simplification of the formalities connected with filling out invoices is in Poland, and the highest preference for shortening the period of VAT refund is in Bulgaria. These preferences reflect the weak points of the VAT systems in the given countries.

#### 2.4.3. VAT Coverage

The problem of VAT coverage is very controversial. Generally, small service people and tradesmen oppose full VAT coverage. In this research the surveyed companies were mostly covered by VAT, and this influenced the received results. The entrepreneurs were asked whether all firms should be taxed by VAT, and if not, what should be the minimum amount of sales necessary to start VAT taxation. Replies to this question are included in the table below.

Table 14  
VAT Coverage

VAT Coverage	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Should all firms be VAT taxed?	54	45%	79%
If not what should be the minimum sales level at which to apply VAT? \$/year	\$ 46 600*	\$33,000 SK 1 million	\$27,000 PLN 72,000

Source: Survey in three countries; \* if volunteer registration for smaller entities is provided.

#### 2.4.4. Optimum VAT Rate

The entrepreneurs surveyed in three countries were also asked what they considered to be an optimum VAT rate. The results are shown in the table below.

Table 15  
Optimum VAT Rate

VAT Rate	Average		
	Bulgaria	Slovakia	Poland
Optimum VAT RATE	15.5%	11.3%	12.8%

Source: Surveys in three countries

Paradoxically, the higher the existing VAT burden, the higher the preferred VAT rate is. This is especially visible in Bulgaria. In Slovakia, where there is probably the least problematic VAT regime, there is also the lowest optimum preferred VAT rate. However, if we compare the

<sup>5</sup> There might exist a turnover threshold which distinguishes between those who are obliged to register for VAT taxation and those who can choose to do so, and also a threshold which distinguishes between those who should register and those who are not allowed to do so. The latter is the case with Bulgaria. Therefore, the conclusions derived further down are to certain extent misleading.

highest VAT rate in a given country with the preferred rate, the difference is 6.5 percent in Bulgaria, 9.2 percent in Poland and 11.7 percent in Slovakia. It seems that entrepreneurs in Slovakia feel a very strong need for a decrease in the VAT rates. The less radical view of Bulgarian entrepreneurs might be explained by the extensive public debate on the indebtedness of the Bulgarian economy, as well as the severe financial and macroeconomic disaster of 1996-1997 which made all taxpayers aware of fiscal necessities.

## 2.5. Preferences for Systematic Solutions

The entrepreneurs surveyed in the three countries were also asked to indicate their opinions on the tax system as a whole. Below are presented the research results concerning different issues important to the whole system.

### 2.5.1. Frequency of Changes to Tax Regulations

Very frequent changes in tax regulations causes difficulties with proper understanding of the system. Very few businessmen can afford to be constantly informed about neverending amendments in legislation. As a result entrepreneurs often make errors and get penalized. The entrepreneurs were asked what they considered to be an acceptable frequency of changes to tax regulations. The results are indicated below.

Table 16  
Acceptable Frequency of Changes in Tax Regulations

Acceptable Frequency	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Every five years	56	40	66
Every four years	5	19	14
Every three years	12	28	17
Every two years	15	14	1
Every year	12	0	2

Source: Survey in three countries

The data presented in the table show that in all countries studied there is a high preference to stabilize the tax system, and reduce the frequency of changes. The entrepreneurs' demand for stabilization is very strong: more than 70 percent of those surveyed preferred introducing tax changes no more often than once in three years.

### 2.5.2. Political Transparency of the System

Tax system is considered to be the basic regulatory and redistribution system in economy. In some cases the tax system can be used as means for the implementation of political ideas of the current leadership. All solutions which are based on high burdens for one group and privileges for the "favored few" destroy the political neutrality of the system. This is why the research teams asked whether entrepreneurs considered the tax system in the respective country politically neutral. Another question concerned the "fairness" of the present tax system. The results are presented in the table below.

Table 17  
Political Transparency of the Tax System

Question	Percentage of respondents
----------	---------------------------

		Bulgaria	Slovakia	Poland
Is the tax system politically neutral?	YES	60	20	17
	NO	40	80	83
Are the present criteria on tax rates fair?	YES	57	34	12
	NO	43	66	88

Source: Survey in three countries

The data included in the table seem striking. More fairness is required in the setting up of tax rate criteria. In Bulgaria, the level of belief in the political neutrality of tax regulations probably stems from two major factors: first, there exist no or very few tax breaks, and second, most Bulgarian governments have taken into account the burden of foreign debt servicing of, and negotiated amendments to the tax regulations with the International Financial Institutions.

### 2.5.3. Proportional versus Progressive Taxation

The surveyed firms were also asked to indicate whether the system of taxation of companies should be proportional, progressive or kept the same as at present. The results of the survey are as follows:

Table 18  
Preferred Method of Taxation

Companies should be taxed...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
by a proportional rate	24	47	62
big companies more, small business less	61	53	18
as at present	15	0	20

Source: Survey in three countries

The data in the table above show a strong support for the higher taxation of big companies in Slovakia and Bulgaria. On the contrary, in Poland there is a strong preference for proportional taxation. In Poland and Bulgaria there is a low level of preference for maintaining the present system.

### 2.5.4. Tax Collection Procedure and Height of Tax Rates

The basic principles implied in a tax system seem to be one of the most important issues in evaluating its efficiency. Two significant problems in this area are: the pace of tax collection and the height of tax rates. The attitudes of the entrepreneurs toward balancing these issues is presented in the table below.

Table 19  
Preferred Tax Collection Procedure and Amount of Tax Due

The best solution is ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Collect faster, but at reduced rates	71	12	44
At present rates, but prolong payment terms	22	86	26

Source: Survey in three countries.

The preferences of entrepreneurs concerning the relationship between the pace of collection and the height of tax rates show quite different inclinations in the three countries. In Poland and Bulgaria there is a higher preference for reducing tax rates and increasing the pace of tax

collection (especially in Bulgaria). Quite the opposite case is shown in Slovakia, where prolonged payment terms appear crucial. The opinions of entrepreneurs reflect the most important problems of the tax systems in the given countries.

### 2.5.5. Tax Progression and Tax Relief

The problem of progression in taxation seems to have a classic character. This classic character is connected with alternative costs and effects. With a high level of tax progression and significant tax allowances it is possible to direct the behavior of taxpayers certain areas. On the opposite, a system with limited taxation and low tax allowances might be designed. The first system is more government-oriented, while the second gives more freedom to taxpayers but no stimulation. Of course this is an old liberal question, as to whether individuals require governmental stimulation. The opinion of entrepreneurs is presented in the table below.

Table 20  
Preferences towards Matching Tax Progression and Relief

The situation which stimulates both entrepreneurs and employers for providence and entrepreneurship is ...	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Highly progressive taxes and huge tax reliefs stimulating desired activities	28.3	33	35
Small progression and small relief	58.6	16	33
No progression and no relief	13.1	51	32

Source: Survey in two countries;

The compared results received in Poland and in Slovakia are very similar. The only difference is a significantly higher preference for no progression and no relief in Slovakia over that in Poland. On the opposite side, Polish entrepreneurs are more inclined for slight progression and relief than Slovaks. In general the survey did not create a clear picture of the entrepreneurs' opinions. In Bulgaria business people answer quite cautiously with no clear preference. The only certain observation is the fact that the minority prefers high progression and relief.

### 2.5.6. The Tax System and Social Policy

The tax systems in numerous countries include social policy instruments. However, implementing social policy instruments in a tax system can change its operation and main functions. As a result the tax system plays a more and more important social role, rather than simply collecting tax due. In order to learn the attitudes of entrepreneurs toward this issue, the question as to whether social policy instruments should be included in the tax system was asked. The results of the survey in three countries are shown in the table below.

Table 21  
The Tax System and Social Policy

Should social policy functions be included in the tax system?	Percentage of respondents		
	Bulgaria	Slovakia	Poland
YES	57	27	28
NO	43	73	72

Source: Survey in three countries

As shown in the data above, Polish and Slovak entrepreneurs have nearly the same opinion: namely, that social functions should be excluded from the tax system. Bulgarian entrepreneurs have a more positive attitude toward the inclusion of social functions in the tax system. The

political and economic developments of the transition period in Bulgaria resulted in the entrepreneurs' (especially SMEs' ) self-perception as being a socially weak group in need of aid.

### 2.5.7. Reporting Requirements

Reporting obligations seem to be one of the most important difficulties of the present tax systems in the three countries studied. The entrepreneurs' opinions on different aspects of reporting requirements are presented below.

Table 22  
Difficulties in Income Tax Reporting Obligations

How do you assess the income tax reporting obligations of companies?	Percentage of respondents		
	Bulgaria	Slovakia	Poland
Too difficult	29	0	45
Not too difficult, but could be more simple	61	52	49
They do not cause problems	10	48	6

Source: Survey in three countries

Table 23  
Preferred Frequency of Submitting Tax Declarations

Tax declarations should be required for a period of...	Percentage of respondents				
	Bulgaria			Slovakia	Poland
	PIT	CIT	VAT		
Monthly	19	6	33	X	38
Quarterly	20	29	39	X	62
Semi-annually	6	16	8	X	X
Annually	55	49	20	X	X
Not required in the case of abolition, liquidation or bankruptcy	X	X	X	X	43

Source: Survey in three countries; X = lack of data

The results presented in the tables above show that there is room for improvement with regard to tax declarations. They should be simplified and the frequency of submitting declarations should be less frequent than now<sup>6</sup>.

## 2.6. Simulation of Expected Effects of Deregulation on Enterprises

Entrepreneurs are a group of people who have (or, at least, should have) good skills in evaluating the efficiency of economic policy instruments. This is obvious, because running a private firm requires the ability to make different decisions and choices concerning such issues as employment, taxes, sales, and many others. The ability to predict the future results of today's actions is characteristic for private entrepreneurs. Therefore, the entrepreneurs surveyed in the three countries were presented with the following deregulation hypothesis.

Please imagine that the government has introduced a Program of Tax Deregulation Reforms. As a consequence the maximum rate of PIT has been reduced to 30

<sup>6</sup> When there is the possibility for a tax refund (VAT), there is a need to speed up declaration; when there is no tax refund (CIT and PIT), there is a need for less frequent declaration periods (which is quite rational).

percent and CIT has been lowered to the same rate. VAT has been set up at a level of 14 percent. Every possibility for tax relief and exemptions has been eliminated. The tax system has been simplified to the maximum possible extent, including tax accounting and reporting duties.

After this presentation, the surveyed entrepreneurs were asked what results such deregulation of the tax system would have for their firms. The following response was received:

Table 24  
Effect of Deregulation of the Tax System on Enterprises (after 2 years): Opinion of Entrepreneurs

Possible Effect	Percentage of indications (YES)			If YES, by what percent (average)			Average increases (negative indications included)		
	Bulgaria	Slovakia	Poland	Bulgaria	Slovakia	Poland	Bulgaria	Slovakia	Poland
Increased investment	70.3	85	78	19.63	36.6	15.5	11.7	31.1	12.1
Increased sales	90.1	70	67	26.27	17.1	16.2	23.7	12.0	10.9
Increased employment	64.4	68	48	24.89	15.3	9.9	16.0	10.4	4.8
Increased consumption by business owners	49.5	73	43	17.41	23.5	11.1	8.6	17.2	4.8
Reduced administrative costs	34.7	66	55	14.31	56.9	10.9	5.0	37.6	6.0
Increased capital assets	68.3	94	78	16.21	19.9	14.7	11.1	18.7	11.5
Reduced time consumption of accountancy	57.4	76	89	17.71	54.6	14.7	10.2	41.5	13.1
Increased profitability	70.3	88	79	18.21	22.7	11.4	12.8	20.0	9.0
Improved financial liquidity	49.5	90	69	18.38	40.7	11.2	9.1	36.6	7.7
Concentration on business instead on bureaucracy (time)	51.5	72	81	24.69	66.0	16.6	12.7	47.5	13.3

Source: Survey in three countries and own computations

The general observation about the expected effects of deregulation for enterprises based on the simulated situation is that entrepreneurs evaluate the possible effects as significant. Slovak entrepreneurs are even enthusiastic about these effects. In Bulgaria and Poland the assessment of positive effects is more moderate than in Slovakia, but is still very high. Detailed analysis indicates that entrepreneurs foresee the greatest effects of deregulation in increased investment. As a result the capital assets of companies will also increase significantly. Reduction and simplification of taxes is expected to cause an increase in sales. In Bulgaria the level of increase expected is the highest. Entrepreneurs from all three Central European countries see a possibility for increased employment in their companies. Visible results are expected in cutting administration costs. A significant improvement in time management is also expected.

## 2.7. Simulation of Effects of Deregulation on the National Economies of Central European Countries

The researchers' intention was to translate a microeconomic approach into a macroeconomic simulation. The results of the survey in the three countries are presented in the table below.

Table 25

Effect of Deregulation of the Tax System on the National Economy (after 2 years): Opinion of Entrepreneurs

Possible Effect	Percentage of indications (YES)			If YES, by what percent (average)			Average increase (negative indications included) in %		
	Bulgaria	Slovakia	Poland	Bulgaria	Slovakia	Poland	Bulgaria	Slovakia	Poland
Increased production	85.1	94	85	21.31	11.3	17.5	18.1	10.6	14
Increased investment	93.1	97	85	21.15	19.1	12.1	19.7	18.5	10.3
Increased employment	80.2	84	69	16.84	6.5	19.2	13.5	5.5	8.4
Increased profitability of enterprises	74.3	97	67	13.72	11	14.9	10.2	10.7	9.9
Reduced shadow economy	62.4	91	74	24.23	28	9.2	15.1	25.5	6.8
Reduced production costs	57.4	68	74	15.45	10.9	9.2	8.9	7.4	6.8
Increased consumption	79.2	83	80	18.38	14.4	9.9	14.6	12.0	7.9
Increased preference for saving	67.3	89	73	16.8	14.5	9.2	11.3	12.9	6.7
Increased accumulation of capital	53.5	90	70	15.36	16.6	8.9	8.2	14.9	6.2
Reduced employment in fiscal service	50.5	54	80	17.26	x	12.7	8.7	x	10.2

Source: Survey in three countries and own computations; x = data not accessible

The results presented in the table above are very impressive. The entrepreneurs in all three countries consider that the impact of tax system deregulation on the national economies in their countries will be even stronger than the effects on their own enterprises. Entrepreneurs foresee a very strong impact of tax system deregulation on production, investment and something which is crucial in Central European countries: a reduction in the level of “shadow economy.” Business people consider that the reduction and simplification of taxes will increase the competitiveness of the national economies of their countries. As a result production costs will decrease. The new system will facilitate increased consumption. The results received in the three countries differ not as the problem of directions is concerned, but in the strength of the expected effects. Slovaks see the strongest impact of deregulation in the reduction of shadow economy, increased investment and increased savings. Bulgarians see the strongest impact of deregulation in increased production, increased investment and reduced shadow economy. Poles see the strongest impact of deregulation in increased production, increased investment and decreased employment in fiscal service. Generally, Polish entrepreneurs are slightly less enthusiastic about the impact of deregulation on their national economy than Bulgarians and Slovaks. However, they too are very optimistic about this impact.

## 2.8. Approach of Business Organizations to Deregulation of the Tax System

At the end of 1997 the survey results were enriched by interviews with major business organizations in Bulgaria, Slovakia and Poland.

It is important to underline that the interviewed businessmen's organizations are member-oriented, and lobby for solutions comfortable to their members. In some cases their approach is different from that of entrepreneurs generally. The position of business organizations toward the deregulation of the tax systems in the Central European countries is presented in the table below.



Table 26

## Business Organizations' Standpoint on Effects of Deregulation of the Tax System

Issue	Country		
	Bulgaria	Slovakia	Poland
Height of tax rates	Decreased significantly	Decreased significantly	Decreased significantly
Number of different rates	Differentiation of VAT rates	VAT rates remain the same, decrease PIT rates	Decrease in both VAT and PIT rates
Dispersion of rates	Reduce	Reduce	Reduce
Social functions of the tax system	Expand	Reduce	Significantly reduce (one organization proposed expansion)
Reporting obligations	Decrease frequency	Decrease frequency	Decrease frequency
Complexity of taxes	Could be simpler	Not too complicated but could be simpler	Extremely complicated and need simplification
Tax reliefs	Introduction of tax reliefs for SMEs only	No clear vision expand investment incentives	Maintain as at present
VAT refunding	Make faster	Make faster	Make faster
Stability of the system	Increase	Increase, reduce uncertainty	Increase significantly
Progressive versus linear PITs	Reduce progressive support semi-linear	Keep progressive	Some organizations for linear, others for progressive

<p>Differences between Business Organizations and Entrepreneurs in general</p>	<ol style="list-style-type: none"> <li>1. They are split on the effects of tax exemptions and relief, with a slight advantage toward tax incentives.</li> <li>2. Regarding VAT differentiation, the argument is whether there should be different rates for dealing with different goods and services.</li> <li>3. They differ when asked about tax reporting periods.</li> <li>4. There is no serious debate on the issue, mainly because business organizations have never measured the possible implications of the introduction of a flat tax; therefore their bargaining position on the issue is weak, and a diverse opinion prevails.</li> </ol> <p>Entrepreneurs and most SMEs state all of the respondents prefer linear taxation with slight or no exemptions, at a rate of 30-32%. On the other hand, they state that bigger companies should be taxed at higher rates. The explanation for this might be that the current levels of CIT for companies with annual profit above DEM 50,000 is 37%, while at the same time there are no exemptions (such as for investment purchases, etc.).</p>	<p>Data not available</p>	<ol style="list-style-type: none"> <li>1. Some organizations, like the Union of Polish Crafts, proposed increasing the number of rates in PIT and introducing a tax deductible amount equal to minimum wage. These solutions are similar to the German system, to a certain extent. However, at present Germans are very critical about their tax system which is considered as much too socially-oriented.</li> <li>2. Crafts organizations proposed the building of social mechanisms into the tax system. They proposed introducing a tax-deductible amount for each child amounting to PLN 1,800 per year (Dec. 1997 ~ US \$500). This is entirely opposite to the general opinion of the surveyed group.</li> <li>3. Both chambers and crafts organizations were generally against abolishing tax reliefs. Their opinion was to some extent contradictory. They also proposed reducing tax rates and maintaining tax reliefs. However this standpoint can be explained by tactical reasons. It would be uncomfortable for them to propose the abolishment of tax relief, as some of their members benefits from them. In the opinion of the Institute they preferred to have some room for negotiation with government. It is important to underline that chambers showed a higher level of willingness to abolish tax reliefs in exchange for reduced rates, than did crafts organizations.</li> <li>4. The Warsaw Chamber of Commerce proposed introducing a law imposing full bookkeeping for enterprises with sales over PLN 1.8 million, while the present regulations require it from about PLN 1.6 million (ECU 400,000), so the difference is slight. This means that some business organizations are not well-familiarized with the present tax legislation.</li> <li>5. The lobbying policies of different business organizations are not coordinated. This is why single organizations are relatively weak. It's easy for the government to handle them with different proposals and consequence do nothing.</li> </ol>
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Source: Interviews in three Countries

In analyzing the business organizations' standpoints, it is possible to state that they mostly reflect the same opinions as those of the entrepreneurs which were presented in the survey. Differences appear when the interests of general entrepreneurs are opposite to those of business organizations' members. These are connected with interest groups and lobbying. However, these phenomena are natural in a democratic system.

### 3. Country Reports

#### 3.1. Tax System Deregulation in Slovakia

This analytical study of the complications associated with tax collection, tax levels, and structure as seen by the business sector is based on a questionnaire with closed questions. It was designed so as to enable adequate qualitative data collection as well. The empirical survey encompassed 51 businesses active in a variety of areas: public health, agriculture, metallurgy, retail and wholesale trade, financial and legal counseling, food industry, construction, tourism, mechanical engineering, chemistry, ecology, real estate agencies, exhibitions and mail order business. Different sectors were evenly represented in the survey, except for retail and wholesale trade and agriculture, whose representation was approximately two points higher than the average.

#### Personal Income Tax

**Table 27**

#### What problems did you encounter because of different rates in the income tax structure?

Problems	Percentage
Having to prepay tax is not fair (you keep making advance payments even if you end up with a loss)	36.5%
Serves as a disincentive to business operations	33.3%
Difficult to calculate total tax	9.5%
Makes advance tax payments difficult	9.5%
Other <sup>7</sup>	8.0%
Enables income equalization	3.2%

Source: Survey

Having to prepay tax to a large extent makes the life of small and medium entrepreneurs difficult, as the amount of payments (monthly or quarterly) depends on their tax liability in the preceding tax period. The only exception applies to taxpayers whose previous tax liability did not exceed:

- a) SKK 50,000; in which case the entire tax due is payable by the deadline for filing tax returns;
- b) SKK 500,000; in which case advance payments are due on a quarterly rather than monthly basis (unless the tax liability for the previous period fell below SKK 50,000).

<sup>7</sup> The "Other" included these complications/lack thereof:

- disastrous payment discipline;
- lack of transparency, leading to ample tax avoidance opportunities;
- no difficulties;
- the entire philosophy of individual income tax is too complicated;
- paying advances towards eventual tax liability slows down business in the subsequent year.

Any other exception is at the discretion of the tax authorities and is dealt with on a case-by-case basis. It follows from legislation and surveys of small and medium businesses that the lower tax limit which allows for exemption is too low and, with regard to higher income groups, such relief is typically granted in association with deferrals of advance payment due dates.

Business respondents proposed solutions for the inequitable income tax treatment of low-income individual entrepreneurs. In particular, such solutions included a millionaire's tax, reducing the tax burden of low-income individuals at the expense of those with higher revenues, and setting the base tax limit at SKK 150,000.

**Table 28**

**Do you believe it would be reasonable to:**

Preferred Solutions	Percentage
Retain current number of rates (6)	31.7%
Reduce number of rates to 2 (base rate for middle incomes and a raised one for very high incomes)	29.3%
Reduce number of rates to 4 or 5	14.6%
Increase number of rates to 7 or 8	12.2%
Implement a single individual income tax rate	12.2%

Source: Survey

Progressive rates are by taxpayers as a basic principle of determining tax rates. The possible reduction of the tax burden with regard to low-income groups that is offset by higher rates for higher-than-average income groups would provide more maneuvering room to a relevant class of taxpayers. The deductibility of expenses, with regard to which some very strict rules apply that in most instances serve as a disincentive and fail to bring about the desired effect, is a major tax base assessment problem.

At present the ratio between maximum to lowest tax rates is 2.8. 38.5 % of respondents believed it would be sensible to reduce the ratio to 2. This opinion was to a large extent consistent with the idea of reducing the number of rates to two, with part of the tax burden being shifted to high-income taxpayers. 18% of respondents would reduce the rate ratio to 2.5, while 15.4% believed that linear taxation (a ratio of 1.0) would be efficient. 15.4% would rather increase the ratio to 3.0 or 4.0, while 10.3% of respondents were in favor of the UK model, where the ratio is 1.66.

**Table 29**

**Minimum income tax rate should be:**

Tax rate, %	Response, total = 100.0%
10	52.8
15	19.4
5	13.9
20	5.6
12	2.8
7	2.8
30	2.8

Source: Survey

**Table 30**

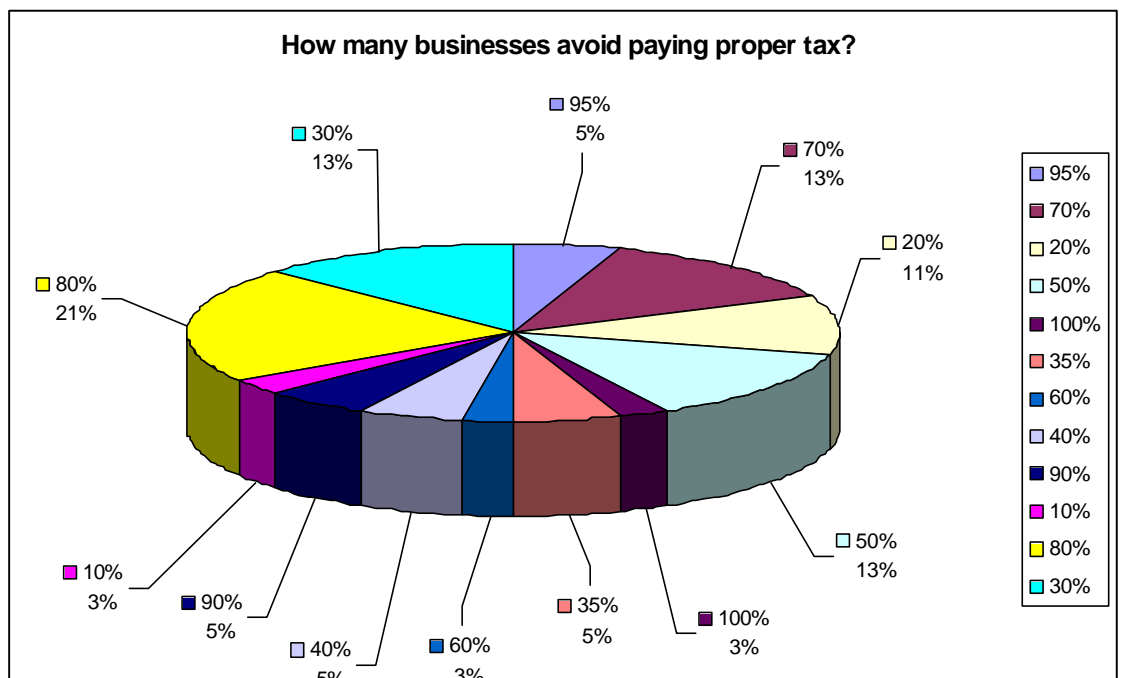
**Maximum income rate tax should be:**

Tax rate, %	Response, total = 100.0%
30	30.6
35	22.2
40	13.9
50	11.1
25	8.3
20	5.6
38	2.8
45	2.8
36	2.8

Source: Survey

48.7 % of respondents felt it would be reasonable to apply maximum rate to personal incomes in excess of 10 times Slovakia's average per capita annual wages. 23.1 % of respondents favored a marginal rate applied to incomes in excess of five annual wages, while 12.8 % believed that a ratio of 20 would warrant marginal rates. 7.7 % of respondents would rather that such rates be applied to incomes seven times greater than Slovakia's average annual wages.

36.8 % of businesses in the survey consider a 40% marginal rate as a penalizing burden rather than a tax. 9 % of respondents thought that a 50% rate would be a penalizing instrument, while 10.5 % of respondents already considered a 30% rate to be penalizing. According to respondents, the current marginal rate (42%) does not have a taxation effect but is used rather as an income penalty (87.5 % of respondents). Therefore, it would be appropriate to adjust the marginal rate downward and, perhaps, apply it to the portion of income that exceeds SKK 1 million.



It follows from the above figure that most respondents (21 %) thought that 80 % of taxpayers avoid paying the proper amount of individual income tax. 40.5 % of respondents believed that taxpayers paid about 30–50 % of their proper tax, 27 % thought taxpayers pay about 50–80 % of their required amounts, 16.3 % of participating businesses estimated the amount at about 80–100 % and 13.5 % of respondents estimated that tax dodgers pay only 10-30 % of their required

amounts. The smallest group of businesses thought that tax dodgers paid about 10 % of their proper individual income tax.

The vast majority of the participating businesses were convinced that private enterprises cannot be permanently operated without profit, although the tax authorities argue that some businesses do not generate profit and therefore avoid paying tax or defer their tax liabilities.

**Table 31**

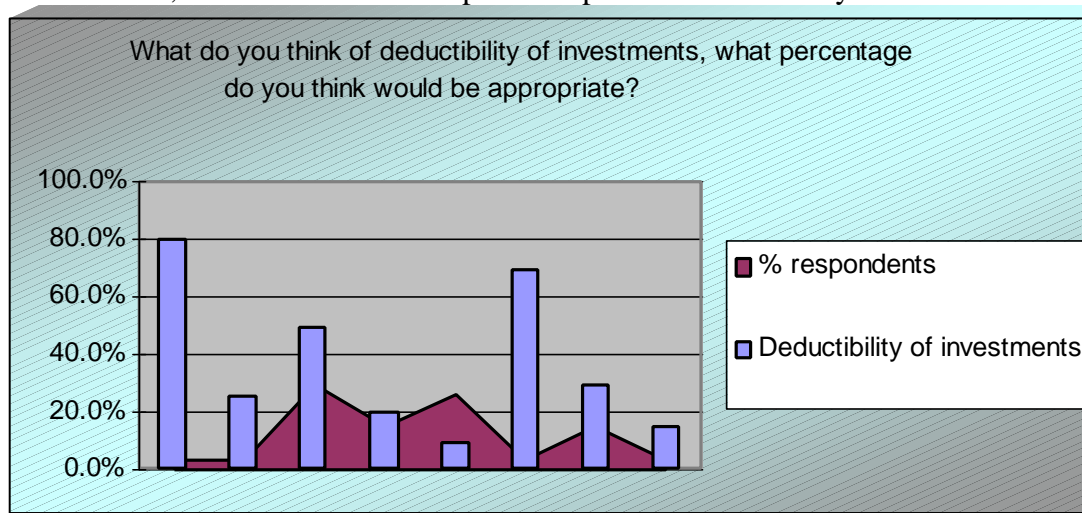
**Do you believe private businesses can be permanently operated without profit?**

Answers	Percentage
Yes, of course	12.2%
No rather than yes	41.5%
Certainly not	46.3%

Source: Survey

The current mechanism of determining and collecting advance payments under individual income tax liability is basically acceptable to 75.6 % of respondents, with 24.4 % being in favor of paying a flat amount toward their future liability.

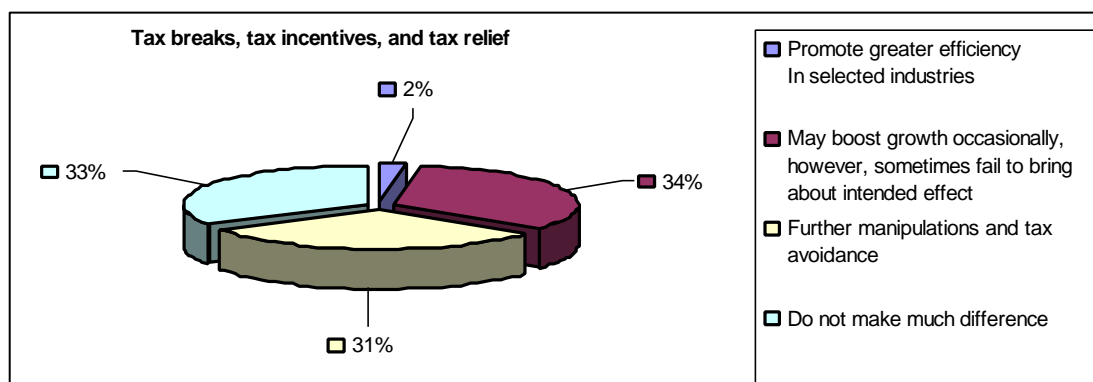
Most of entrepreneurs (78.6 %) believed that those who manage their own businesses should receive a tax allowance for investments. Current tax legislation only provides for deductions in the amount of expenses that were provably incurred to achieve, secure, and sustain revenues. 82.1 % of respondents regarded the currently applicable rates at which expenses can be recognized as deductible without the need to prove their deductibility as inadequate, and thought the current arrangement was to a large extent a disincentive. It follows from the next figure, that 25 % of respondents prefer a level of 50 % of total investments from the tax base to be deductible, and about 18 % of respondents prefer a deductibility level of 20 %.



In terms of scope and structure the current annual tax return forms are rather unacceptable for small and medium entrepreneurs. 78 % of respondents would therefore prefer simpler tax return forms, not exceeding two pages in length. Other surveyed businesses were happy with the current forms.

**Tax Relief, Breaks, and Incentives**

In the Slovak tax system, tax relief is only granted for employment of disabled people and to businesses important to the nutrition of the population. Other types of relief are at the discretion of the authorities. The tax relief system, however, generally fails to provide the desired incentives to business and, on many occasions, is counterproductive.



**Table 32**

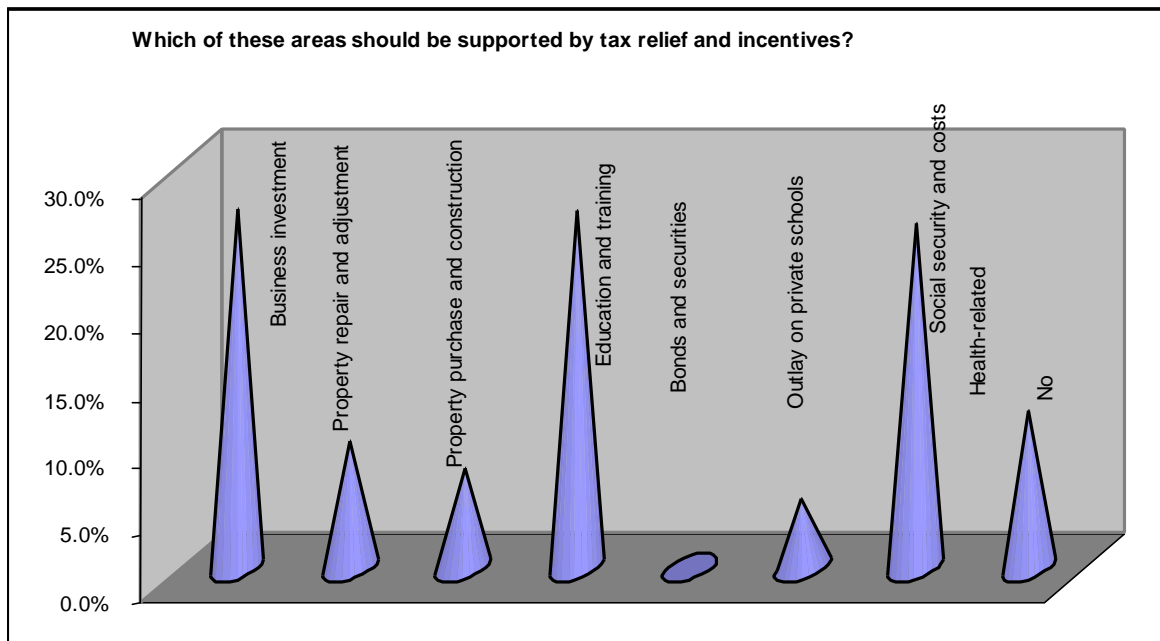
**What do you think of the macroeconomic efficiency of incentives in the form of individual and corporate income tax breaks?**

Macroeconomic efficiency of incentives	Percentage
Such incentives and breaks are used by businesses that can capitalize on them, rather than those in need	25.1%
Incentives and breaks that taxpayers use do not encourage the desired effects	16.5%
In Slovakia's economy such practices are not used on a large scale and are insignificant in terms of their macroeconomic effects	16.5%
Tax breaks granted to some taxpayers discourage others from completing their returns properly	13.8%
Tax incentives and breaks encourage manipulations and ultimately reduce tax revenues	12.5%
Most taxpayers pay full taxes for the benefit of a small number who enjoy tax breaks and incentives	11.0%
Tax incentives and breaks encourage lower consumption and greater investment	2.8%
These incentives and breaks promote economic activity	1.8%

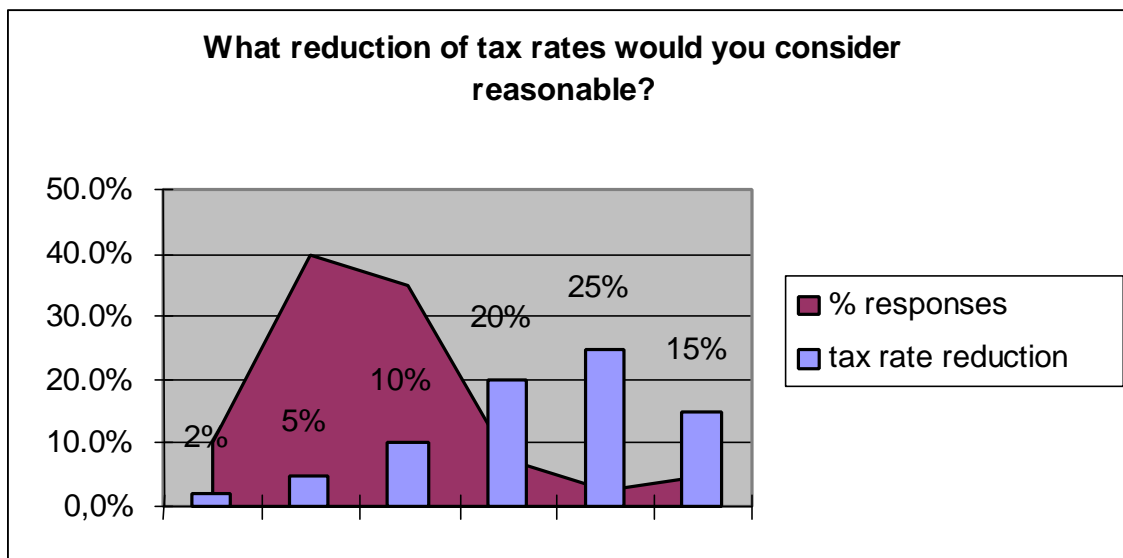
Source: Survey

It follows from the survey that in Slovakia's economy tax breaks and incentives do not fulfill their basic mission; i.e., to support and promote business activity; nor do they enable the investment required for restructuring. Rather, the system discourages most businesses and imposes an additional burden on them for the benefit of a small group who can make the best use of such preferential treatment.

Most respondents (37.2 %) would be in favor of tax breaks, relief and incentives only for such businesses that are able to prove that they can generate investments and new jobs. 32.6 % of the businesses surveyed would be inclined to support the termination of all forms of preferential tax treatment granted to select taxpayer groups. This option, frequently discussed in Europe's advanced economies, makes manipulations and abuse of such instruments fairly difficult. The final alternative envisaged tax relief for as many businesses as possible in order to stimulate them (30.2 % approval rate). As a result, most taxpayers would be able to reduce their tax liability and all would be involved in generating more revenue. However, employing this alternative would call for effective and functional administration and compliance review.

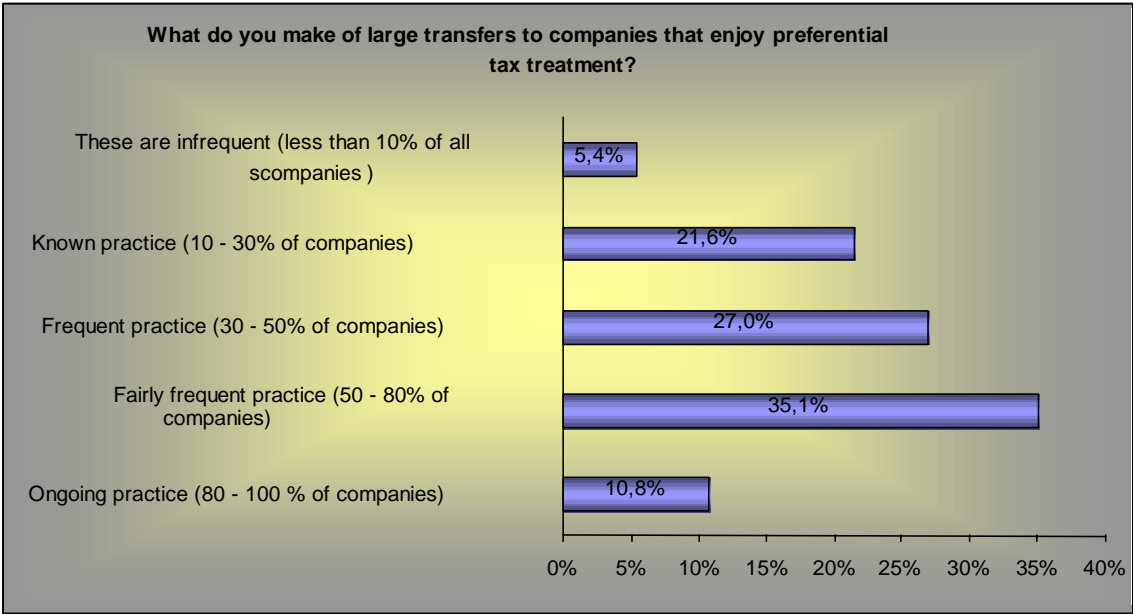


It follows from the figure that, according to respondents, tax relief should primarily be granted to three core areas that are either directly or indirectly involved in promoting small- and medium-size businesses. The emphasis on the preferential treatment of health and social payments is more likely to be the result of an excessive burden imposed by obligations in these areas.

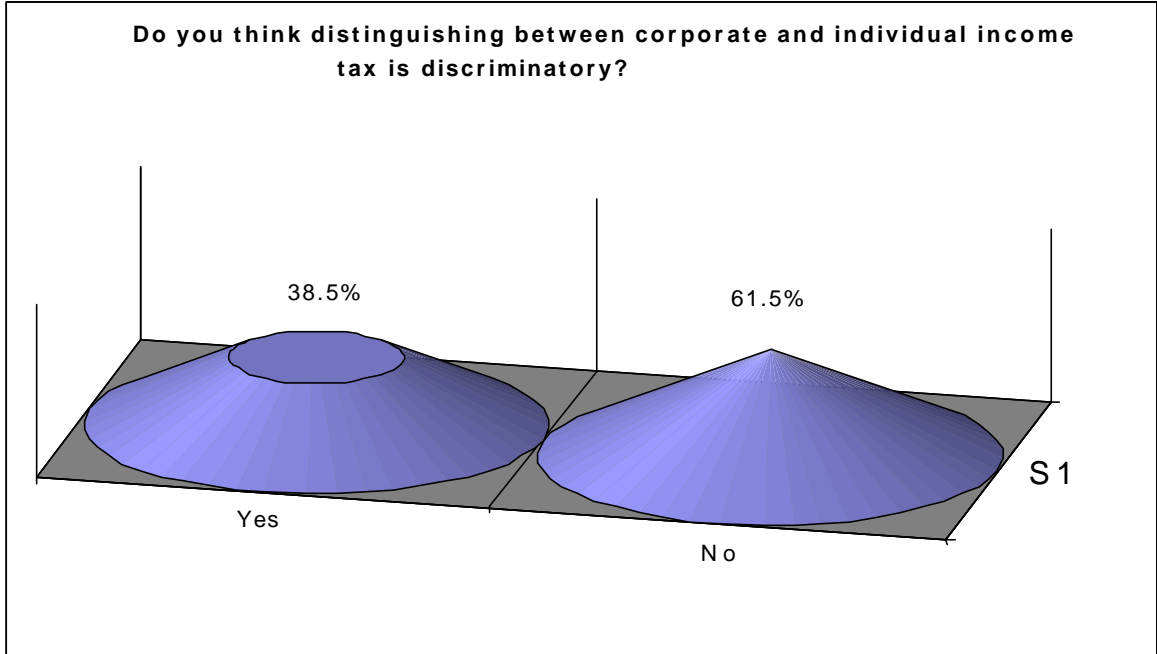


Most of the businesses surveyed (63.2 %) believed that no taxpayer groups should be exempted from income tax. The groups that, according to other respondents, might be exempted included (in the sense of legal persons and physical persons — entrepreneurs): non-profit associations, small low-income businesses that do not employ external labor, self-employed persons with annual sales of up to SKK 250,000, graduates of primary and secondary school during their first year of employment, and towns and communities that receive business revenues. However, wider application of tax exemptions usually leads to shift in economic activity towards those companies which enjoy preferential tax treatment, and this shift deforms the economic structure. As the following figure shows, Slovak entrepreneurs see this shift as occurring very frequently.

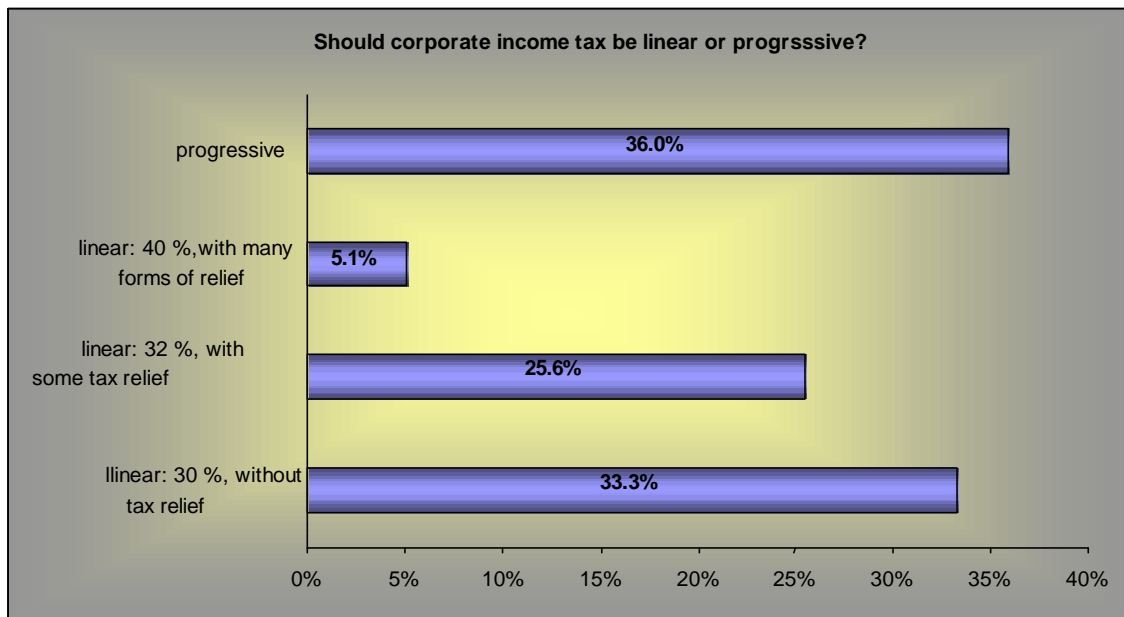




**Corporate Income Tax**



Most of the businesses (67.5 %) thought that owners of limited liability companies should be allowed to have their revenues taxed using individual income tax provisions only. This would enable them to avoid double taxation by corporate and individual income tax.

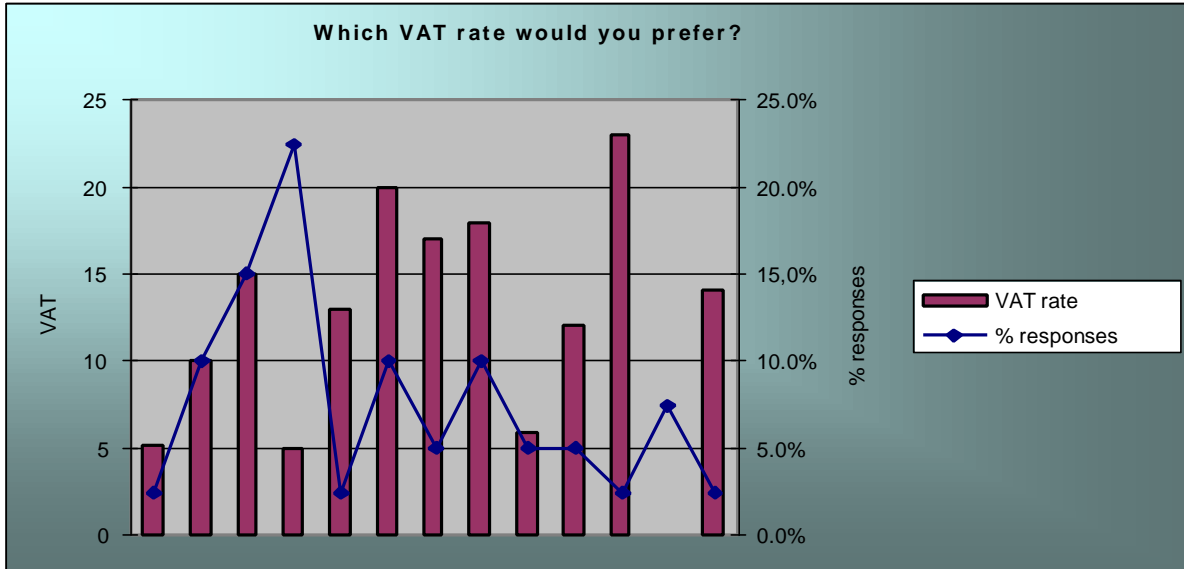


Most respondents were in favor of a progressive corporate income tax, similar to individual income tax. The second most numerous group preferred linear taxation without tax breaks. Both alternatives feature an element of taxation equality, which participating respondents felt was absent from the present system.

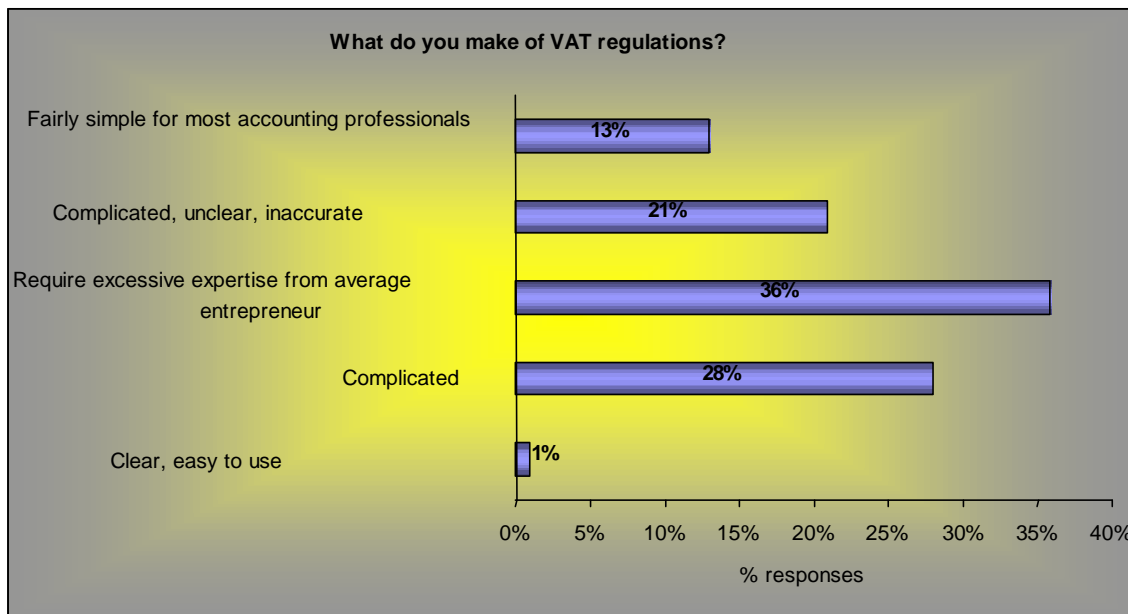
### **Value-added Tax (VAT)**

Most of the businesses surveyed (59%) were comfortable with the current VAT rates. VAT in Slovakia has been designed to be compatible with the taxation mechanisms of the advanced European economies. 17% of respondents believed that a single-rate VAT would be appropriate, with exports taxed at a zero rate. 15% thought it would be sensible to increase the number of VAT rates to six, while the remaining 10 % were in favor of a single rate overall. 55 % of respondents held the view that certain businesses should be exempted from VAT. Businesses should be included in the VAT system depending on their sales.

Annual sales threshold suggested by the businesses surveyed fell into the range SKK 0.25-10 million, with SKK 1 million being proposed most frequently. Sales of SKK 0.5–1.5 million were the most often recommended quarterly limits.



Note: a zero VAT rate should be applied to a limited number of goods and services, such as those designed for export, certain foodstuffs and essential goods.



According to most respondents, the current VAT regulations in Slovakia are not acceptable to local businesses from a formal standpoint. A lack of transparency and the complicated nature of these regulations hinders the growth of small- and medium-businesses. Therefore, improvements in the form and content of VAT regulations will be another key element in measures aimed at promoting business.

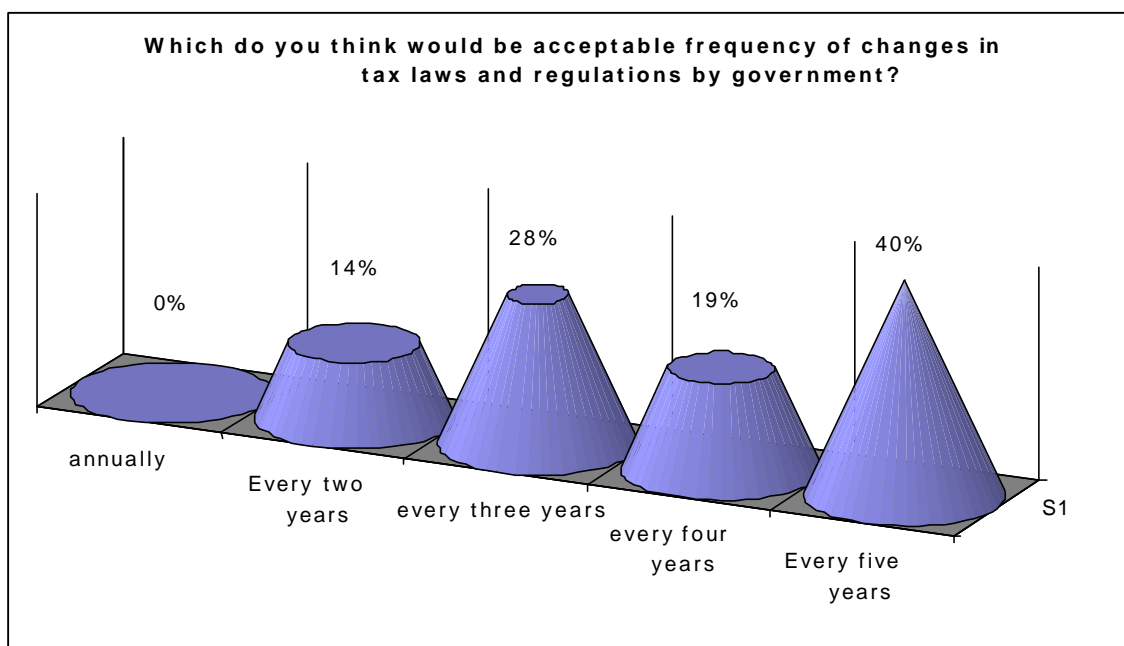
Most respondents (46 %) reported that assigning goods and services to VAT rate categories was their most daunting task. The second most complicated activity (31 % of respondents) was the accounting of VAT refund claims. Invoice completion and filing formalities constituted the third most significant problem (22 % of respondents) relating to VAT collection and payments. Respondents believed that the current VAT structure bears many deficiencies that to a large extent complicate business operations. The following are some of the problem areas pointed out by businesses in the survey, as well as proposed improvements. In addition to the matters discussed earlier, their proposals were to:

- Simplify interpretation and make it unequivocal;
- Eliminate the lack of unequivocal interpretation;

- Shorten the advance payment period, which means that businesses must de facto provide 30-day credits to the state budget;
- Enable VAT payments by bills of exchange mechanisms;
- Exempt investments from VAT;
- Reduce penalties resulting from oversight and accidental shortcomings.

### Proposals for Tax System Deregulation

From the part of the questionnaire which is devoted to the tax deregulation proposals of entrepreneurs, several interesting directions for deregulation are implied. For the first, from the point of view of business sector, changes to tax legislation occur too frequently. Most of the respondents (40 %) would prefer a five-year interval between amendments to the basic tax laws.

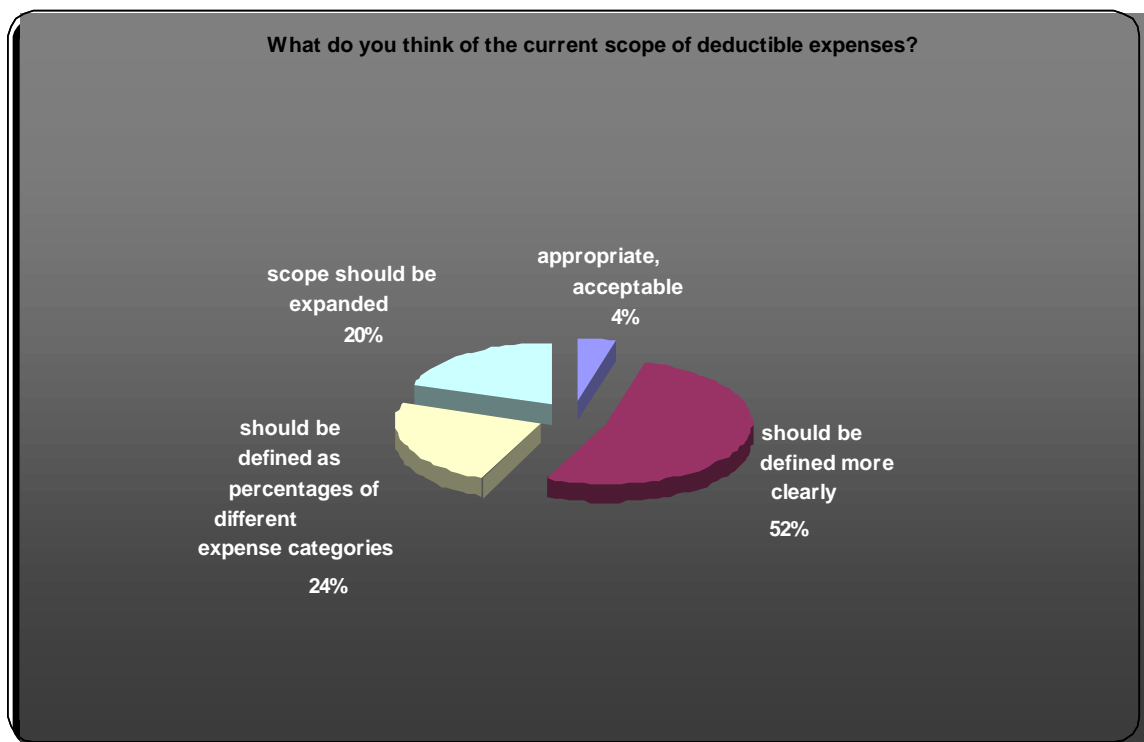


Dangerously, 80 % of respondents consider the tax system to be under the heavy influence of the political constellation. Moreover, 95 % of respondents see the tax system as demotivating in the sense that they fear paying taxes, and the criteria for the setting of tax rates is considered as not fair by 66 % of respondents.

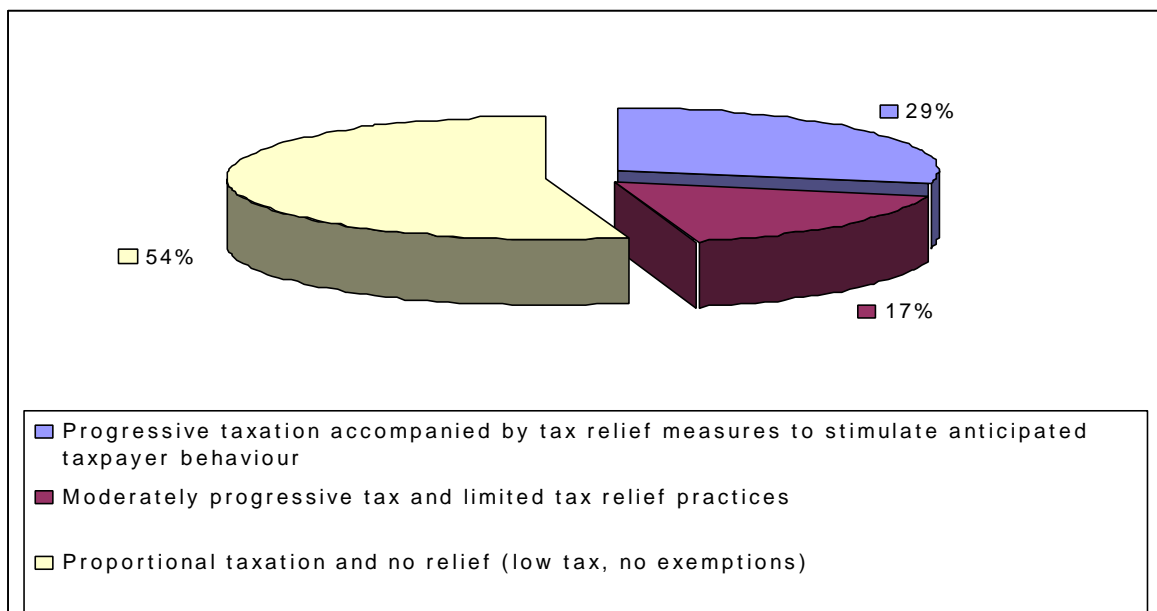
The above findings suggest that some of the respondents would like to address social policy issues through taxation. However, most businesses in the survey (73 %) were in favor of retaining a social security system apart from the tax system.

Entrepreneurs find the current scope of expenses deductible from the tax base to be a serious problem. Only 4 % of respondents consider the current situation to be satisfactory.

**Figure**



With regard to the support of business activities, one-half of respondents prefer low taxes with no tax exemptions and the next 17% prefer tax exemptions only to a limited extent. Thus, 71% of respondents favor the same conditions for all without a wide amount of tax exemptions, relief and breaks.



With regard to income tax reporting requirements, 52% of respondents did not find these requirements overly complicated but would be happy if they were simplified. In contrast, 43% thought they were excessively challenging and extensive. Five % of the participating businesses did not complain about reporting obligations.

Half of the participating businesses thought that big enterprises should be at higher rates than small ones. The remaining respondents felt comfortable about the current state of this aspect of the tax system.

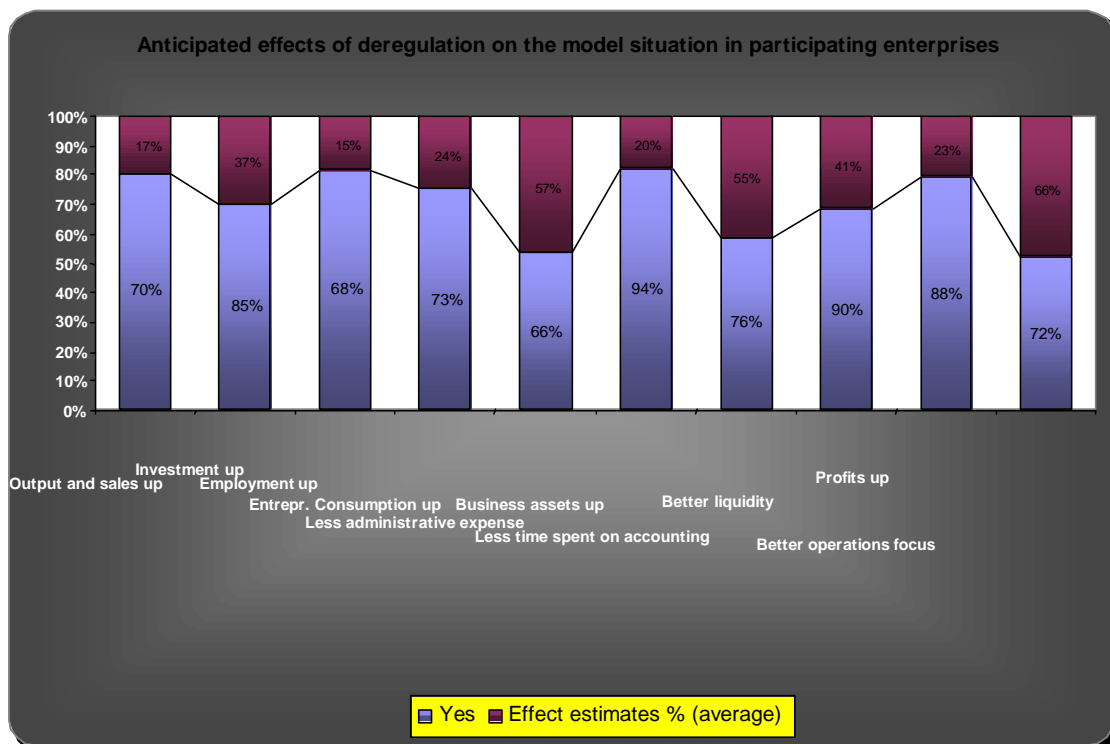
Most of the participating businesses (86 %) did not have serious problems concerning the deadlines for filing tax returns. All respondents thought that having to file tax returns once a year was a reasonable frequency. However, the problem resides (as was mentioned above) in the frequent changes to tax legislation, the unclear and ambiguous nature of the changes and the insufficient information links between legislators and taxpayers.

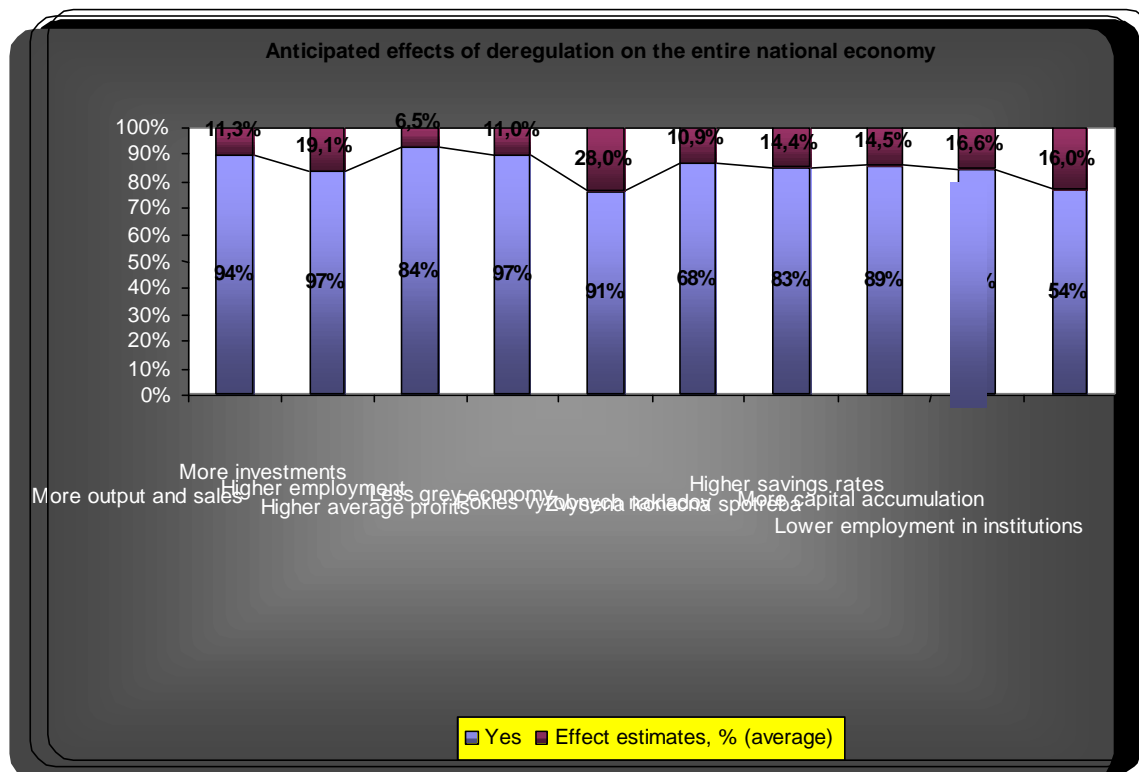
### Effects of Tax Regulation

At the end, entrepreneurs were suggested a hypothetical tax reform designed as follows:

- reduction of individual tax to 30%;
- reduction of corporate income tax to 30 %;
- introduction of single-rate (14 %) VAT without possibility of exemptions and breaks;
- simplification the tax system and tax accounting to the maximum extent possible;

According to the business people, the implementation of such reform would, in two years, lead to the following consequences





Figures 14 and 15 depict the expected effects of the tax reform described above in detail. As follows from the figures, entrepreneurs expect a higher impact on the macroeconomic level than on the level of their own businesses. On microeconomic level expectations are concentrated in lower administrative costs and less time devoted to bookkeeping and accounting, better financial position and the possibility to devote more attention to core business activities. Also important, but less than the other effects, is an increase in investments. Entrepreneurs expect the lowest impact on the level of production. Surprisingly, entrepreneurs are more optimistic concerning the macroeconomic effects of tax reform. Respondents expect the greatest effects in the reduction of shadow economy; expectations of other types of possible effects are more or less linear. This fact implies the conclusion that on the individual business level it is difficult to assess the possible macro effect of changes in an unbiased way.

### 3.2. Tax Deregulation in Bulgaria

#### 3.2.1. Introduction

The Entrepreneurs' Attitude to Tax Reform survey was conducted between November 1997 and January 1998. It took place simultaneously with parliamentary hearings and the adoption of new basic tax laws: the Law on Personal Income Tax (December 10, 1997), and the Corporate Tax Law (December 5, 1997). The VAT Law was significantly amended as well (November 21, 1997). Some of the target issues in the questionnaire are dealt with in the new regulations, especially with regard to simplification and the abolishment of tax exemptions and reliefs. Thus, the survey grasps a peculiar moment: the answers given manifest entrepreneurs' attitudes toward both old and new "rules of the game."

The questionnaire was answered by 101 companies (represented by proprietors, managers or accountants) in 23 cities around the country. We consider it representative for private businesses in the country in terms of sectors, size of the companies, and form of juridical

registration. The major sectors included are retail trading and services (43.6 %), light industry (24.8 %), transport (5.9 %), construction (5 %), and other (20.7 %).

The size distribution in terms of number of employees is as follows: up to six people (49 %), 7-30 people (26 %), and 31 people or more (25 %). Types of juridical registration are: sole proprietorships (60.4 %), limited liability and joint stock companies (31.7 %), and others (7.9 %); this basically represents the distribution in the private sector.

### 3.2.2. Personal Income Tax

**Table 33**  
**Number of PIT rates**

Number of PIT rates	Percentage
Keep the present 7 rates	29.7
Decrease the number of rates to 5	25.7
Decrease the number of rates to 2	18.8
Introduce a flat tax	25.7

Source: Survey

The answers to the question above are quite controversial. The attitude of entrepreneurs seems divided among the marginal solutions, with a slight preference toward the 1997 system with seven rates. The reason for that outcome lies in the new tax scale of four rates, which is to be introduced in 1998. Though there are only four rates, the tax burden increases quite steeply, from 20% to 40%. The answers are therefore determined predominantly by the level of the tax rates and the actual burden imposed by them.

The results, however, reveal two basic groups of taxpayers: the first consists of supporters of tax differentiation (75 %) and the second is comprised of those who oppose it (25 %).

Moreover, those who prefer differentiation also want steep differentiation (more rates). This could be motivated by an expectation that they themselves would fit the lower rates and thus would save on taxes.

**Table 34**  
**Progressive vs. linear scale**

Dispersion Range	Percentage
up to 2.50	28.7
2.14	5.9
2.00	22.8
1.66	24.8
1.00 (flat tax)	17.8

Source: Survey

The distribution is quite even, with a slight leaning toward higher dispersion. As we shall come to see further on, a quite large group of respondents considers taxation to be a tool of social policy. However, we can't derive reliable conclusions from this outcome, given the answer to the next question on the preferred level of minimum and maximum tax rates. Moreover, this demonstrates that the main problem bothering entrepreneurs is the level of the tax rates rather than the progressiveness of the scale.

**Table 35**  
**Minimum and Maximum PIT Rate**

PIT Rates	Average
The minimum PIT rate should amount to .....%	16.7 %
The maximum PIT rate should amount to .....%	26.67 %



What maximum PIT rate can be treated as a penal burden?	29.66%
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Source: Survey

Given the fact that the current levels are 20% and 40%, we see a strong necessity to decrease the maximum tax rate, with a slight decrease even in the starting rate. The answers to both questions show one and the same attitude: tax levels above 30% are considered unacceptable. The following table shows that the highest rate should be applied to taxpayers with seven or more times higher income than the average. The answers below look strange, at least when compared to the figures above. Obviously, 21 % would agree to pay the maximum rate when exceeding three times the average income; i.e., either the present marginal rate of 40% is acceptable to them, or they earn less than three times the average income. The latter explanation sounds rather unreasonable.

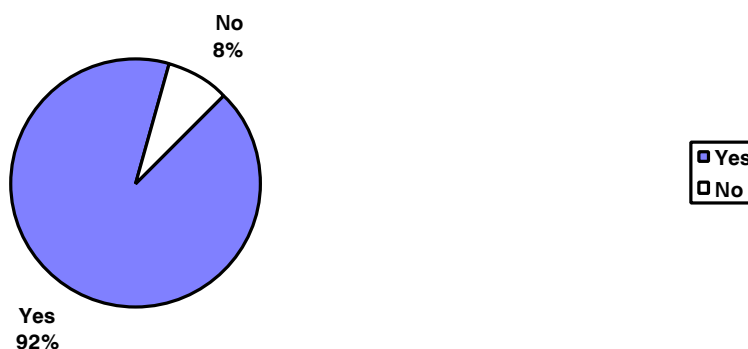
**Table 36**  
**Preferred Start Level of the Marginal Tax Rate**

Preferred Start Level of the Marginal Tax Rate	Percentage
2 average annual salaries	10
3 average annual salaries	11
5 average annual salaries	24
7 average annual salaries	18
10 average annual salaries	37

Source: Survey

## Tax Avoidance

*Express your opinion: does the present maximum PIT rate discourage taxpayers from paying tax?*



While the business community is not equivocal on the construction of the tax system, it sounds quite explicit on the level of PIT. The equivocal response to that question is also (probably) indirect evidence of the scale of tax evasion practiced in Bulgarian conditions.

*Please try to estimate the level of savings by taxpayers who avoid paying the highest rate of tax.*

**Table 37**  
**Estimation on Tax Avoidance by Marginal Taxpayers**

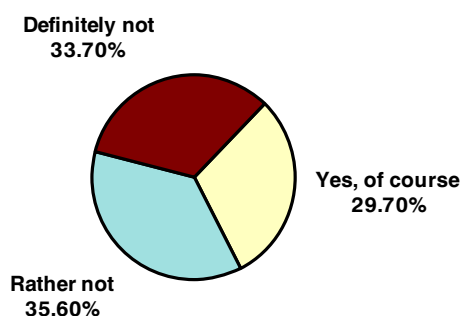
Marginal taxpayers avoid to pay...	Percentage
They pay about 80–100% of required PIT	3.1

They pay about 50–80% of required PIT	16.5
They pay about 30–50% of required PIT	41.2
They pay about 10–30% of required PIT	25.8
They pay 10% or less of required PIT	13.4

Source: Survey

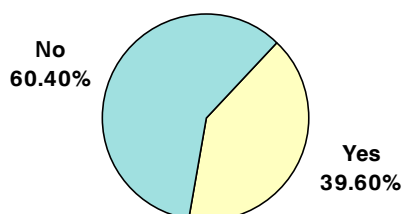
The results are not surprising. More than 80 % of respondents think that the “big” taxpayers contribute less than half of what they should pay. However, we cannot derive a direct relation between the attitudes toward tax avoidance and the structure of the PIT rate scale. Rather, it is connected to a general disbelief in the ability of the tax administration to do its job. The results also demonstrate still-existing latent leftist attitudes, even among the business community; big taxpayers are presumably perceived as tax evaders.

*Asked whether a private company can permanently make losses, the entrepreneurs stated:*



Since the survey was conducted among representatives of the business community, the respondents are used to operating in terms of gains and losses. To be a private entrepreneur and constantly generate losses is impossible, from both an economic and a humanitarian point of view. The 29.7 % of respondents who claim that loss-generating operation in the private sector is possible can be treated as the percentage of potential tax-evaders. The idea of constant loss-making can be analyzed in the context of the endless VAT refund quarrels. While in 1994 almost every single entrepreneur was against the introduction of VAT, now the general complaint about the new VAT regulations is against the elimination of volunteer registration. Apart from exporters, only loss-makers would gain from being a VAT-registered firm.

*Concerning PIT for small business, should advance tax payments be paid by a lump sum, without calculation of every detailed account?*

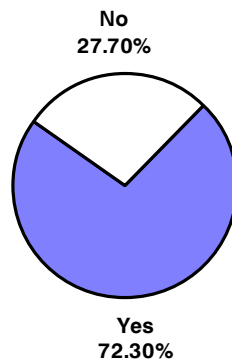


The result is quite explicit. The complicated tax declarations demanded by the tax administrations on a quarterly basis (for sole proprietorships) do not create so many problems as assumed. On the contrary, entrepreneurs are quite afraid of the possibility that they will pay more than they actually owe. They prefer to calculate their taxable income regularly and pay the

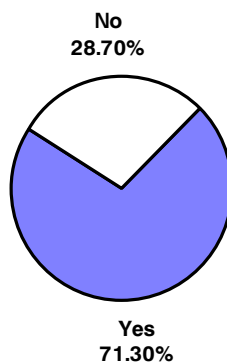
exact sum due. The result can also be treated as evidence of the low level of confidence in the fairness of the “rules of the game” imposed by the state.

### On Tax Differentiation

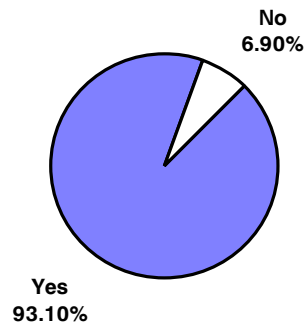
*What is your opinion about PIT differentiation — is it reasonable to differentiate PIT rates according to the different income resources; e.g., salary, wages, capital gains, property, rent?*



*What do you think about PIT differentiation by groups of taxpayers — do you accept different rates of PIT for single persons, couples, families with numerous children, single parents with children, etc.?*



*Do you think that PIT paid by entrepreneurs managing individual proprietorships should be reduced in any proportion to their level of investment?*

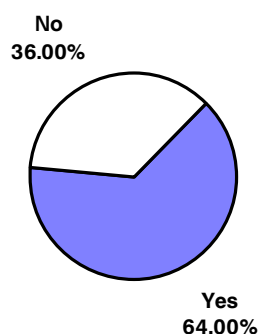


*If you accept investment expenses as a case for reduction of PIT, please indicate the adequate percentage of tax reduction level.*

**Average 11.91%**

The above questions reflect the entrepreneurs' general attitude toward tax exemptions and tax neutrality. To better understand the figures, one should know the following: first, in 1996 all tax reliefs on investment purchases were abolished; the current system is relatively neutral regarding sources of income, taxpayers and the use of the income; and third, the issue of tax exemptions and reliefs as tools for stimulating private companies is used very actively by all political parties. Therefore, the results reflect attitudes toward the current system, which is by default negative, as well as "what I heard on the TV"-driven thinking. The only figure that seems reliable to draw long-term conclusions from, is the 11-12% tax rate on investment purchases. This means that the business community would accept taxation on investment up to that level.

*Do you think that small companies with limited sales could pay PIT by lump sums?*



Though the results are in favor of lump sum taxation, the entrepreneurs' attitudes are not equivocal. If connected with the answers on the possibility to pay advance contributions on a fixed basis, the conclusion is that entrepreneurs are afraid of overtaxing by lump sum taxation and fixed advance contributions. Moreover, 88 % of respondents state that paying PIT in advance on incomes lower than the minimum wage is unacceptable. Given the complicated system of tax refunds, the outcome is not surprising.

### **Complicity of Tax Procedures**

**Table 38**

**Express your opinion about the questionnaires of the Annual PIT Declaration**

Annual PIT declaration:	Percentage
should be shorter and simpler (max. two pages)	56.6
are adequate	20.2
should be more extensive	3
should be a common standard for all groups of taxpayers (without privileges)	20.2

Source: Survey

**Table 39**

**What are the major difficulties caused by the current seven-rate scale (open)?**

Major difficulties	Percentage
--------------------	------------

No difficulties	43.6
The amount of the tax	5.9
The complication of the scale	8.9
Other	11.9

Source: Survey

Though the answers to the above two questions might seem contradictory, more than 56 % consider the current tax declaration forms too complicated and in need of simplification and uniformity. On the other hand, when asked to explain what difficulties they meet in calculating their tax due and filling out tax declarations, most of the entrepreneurs state that the current scale creates no problems. This might mean: a) once the “rules of the game” are established, the players adjust fast, and b) the complexity of tax declarations leads to higher expenses for accountants (and therefore, provokes a negative attitude) but does not significantly affect the normal functioning of the company.

### **Concluding remarks**

Although a preference for levying a single tax rate is shown by considerable share of opinions, the idea of a reduced number of tax rates as a whole does not enjoy backing from those interviewed. The data reveal two basic groups of taxpayers: those who are “for a differentiation” (about 75 %), and others who are “against differentiation” (about 25 %). Higher preferences for PIT differentiation could be motivated by hope that their own company can be placed in a more favorable rate group and be able to save on taxes, not the opposite. As a whole, the results do not confirm the hypothesis that adjustment toward less or greater differentiation, are influenced by self-assessment of the most proper tax level. Those who are inclined to accept higher taxation, and those who expect a lower income tax amount (below 22 % of those interviewed), have one and the same opinion, preferring more rates in the scale. The data confirms the conclusion that PIT-scale complexity is not related to the PIT level. No understanding exists that a simplified scale structure will positively influence entrepreneurs’ general tax expenses.

The fundamental factor defining considerations toward PIT is its level. Consequently, expectations arise that the highest rate should be levied on incomes above the equivalent of seven average salaries. At the same time, the majority of those interviewed consider that the present maximum rate of 40% encourages tax evasion, including even bigger companies (those with a staff of over seven people). The companies’ assessment is that 70 % of taxpayers levied according to the maximum rate, are actually paying less than 50 % of their tax due. About 90 % consider that the present tax system does not encourage “fair play” in economic reality. Despite the fact that over 60 % of those interviewed do not approve of advance payment of income tax, a considerable part of them find some merits in this procedure. In this respect, the expectation of a totally negative reception of advance payment is not confirmed. It is true, however, about companies established as sole proprietorships. The relatively positive attitude toward income tax advance payment corresponds to other data in the present research, establishing the inclination toward more frequent, but smaller, tax installments.

72 % of those interviewed consider that PIT rates should be diversified according to different income sources (for instance: investment activity profits, bank transaction returns, salaries and wages, farming income, rents, etc.). The results confirm the observation that a flat income tax ideology is not accepted positively and is not interpreted as a chance for a general decrease of expenses.

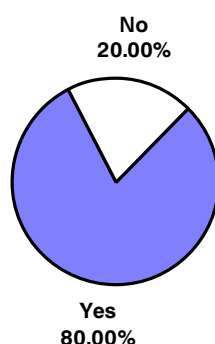
The greater part of the companies (71.3 %) approve of imposing lower PIT rates on underprivileged social groups. This is more typical for bigger companies. Small business is not inclined to accept the above, maybe because it considers itself to be a non-privileged group in

the present economic environment. It seems that the social function of taxes is expressed mostly in the chance for tax evasion, rather than as a real support for marginalized social groups. Opinions supporting the Lump Tax Project prevail in a greater part of the companies surveyed. Nevertheless, it should be kept in mind that the respondents approved of this idea basically, without being informed in detail about the law and the exact calculated rate level. Should the tax authorities want companies to have the right to actually select the form of their tax levying, they must inform the taxpayers in detail.

The results indicate that the present tax declaration form is viewed as complicated and too extensive. Nevertheless, the remaining answers in the present research show that the declaration form is hardly the most significant factor in changing attitudes toward the tax as a whole. Obviously, the main factors for any changes are related to the tax level, while the form and procedure problems are not taken as a serious obstacle confronting business development.

### 3.2.3. Corporate Income Tax

*Do you think that owners of small limited liability companies should have the possibility have their incomes taxed only by PIT, avoiding simultaneous taxation by CIT (as in the regulations in the United States)?*



The message is quite definite: double taxation is a heavy burden for small enterprises.

### Flat tax vs. progressive tax

*Do you think that CIT should have a linear formula (tax payable is a fixed proportion of the declared profits), or a progressive formula ?*

**Table 40**  
**Preferences toward CIT Model**

CIT should be...	Percentage
linear, at a rate of e.g. 30 % (without tax reductions and exemptions)	34.3
linear, at a rate of e.g. 32 % with few possibilities of tax reductions	13.1
linear, at a rate of e.g. 40 % with many possibilities of tax reduction	5.1
progressive, similar to PIT	47.5

Source: Survey

The attitudes are concentrated at the extremes: either a flat tax with no exceptions, or a highly progressive scale. As for the 34.3 % who favor a flat tax system, they also appear in the previous questions on PIT. What is striking here is the 47.5 % who would prefer a progressive tax scale. The explanation might be:

First, the meaning of “progression” is vaguely defined. Regarding PIT, most of the respondents stated a preferred tax rate scale of 17 to 27 %. The dispersion rate is about 1.6. If that kind of

taxation is understood as “progressive,” then the answer makes sense. Generally, the same level of dispersion between the minimum and maximum tax rates is interpreted differently according to the nominal level of the rates.

Second, as mentioned earlier, general attitudes are strongly affected by public political campaigns. For several years one of the most common (political) messages was that small companies should be stimulated by means of tax allowances. Of course, giving to one means depriving the others, and that is how the idea of progressive taxation gained support.

### **Concluding remarks**

At first glance, the results give the impression that the simultaneous imposing of income and profit tax is perceived as unfavorable regarding small and medium business (80 %).

Meanwhile, a considerable portion of Limited Liability Companies (35.7 %) are inclined to pay both taxes. The suggested explanation is that the total amount due of both taxes can be lowered by means of transferring real PIT to the CIT rates, mostly through the deduction of expenses from amounts due.

The data imply that from a fiscal point of view, the aggregate tax income from both taxes would hardly exceed revenues from a single tax (for instance, from PIT only).

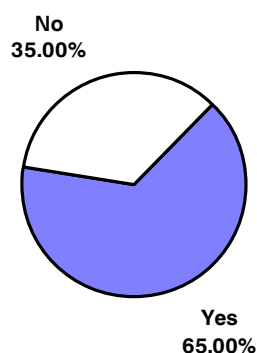
The results suggest two opposing preferences: for a “linear” CIT scale, and for a “progressive” scale. The distribution is approximately 50-50, and this means that the scale’s composition is not of great importance for businesses at the moment. The data’s implied meaning at least confirmed the natural expectations about lower rates.

The majority of those interviewed is sure that advance installments are doubtless a comfortable way to regulate budget accounts inflow. (Almost 60 % consider that this way “fresh” money is drawn from companies). At the same time, a smaller portion of 20-40 % (with a different interpretation of the question) think of advanced payment as appropriate for their companies.

### **3.2.4. Value Added Tax**

#### **Differentiation of tax rates**

*Do you think that the VAT rate should be differentiated?*



At present, the VAT rate is 22% and is uniform for all activities and legal forms of business entities. The only tax exception is provided for exporters. As one can see from the next couple of questions, most entrepreneurs prefer differentiated VAT treatment. This is to be explained by: a) the massive use of VAT as a political campaign tool, and suggestions to stimulate different activities through VAT reductions; and b) while the current system is quite neutral and simplified, the VAT rate is still quite high and the VAT refund process is slow — and all of these factors provoke a negative attitude. The only criterion that allows for neutrality is state vs.

private ownership; 70 % think that the VAT rate should not be differentiated according to type of ownership.

**Table 41**  
**What criteria for differentiation would you choose?**

Criteria:	Yes	No	Not answered
type of goods	46.5	44.6	8.9
state vs. private companies	15.8	72.3	11.9
commercial vs. industrial companies	41.6	47.5	10.9
foreign vs. local companies	30.7	56.4	12.9
other	5.9	56.4	37.6
uniform rate	29.7	63.4	6.9

Source: Survey

*In your opinion, what level of VAT rate is most preferable ?*

**Average 15.54%**

The average figure is quite self-explanatory: the acceptable VAT level is 15.5%; i.e., 6.5% lower than at present. The difference is significant, pointing out one of the major problems with VAT — its high level.

### **Complexity of VAT Regulations**

**Table 42**  
**What do you think about the VAT regulations?**

Regulations concerning VAT are:	Percentage
Too complicated	17.8
Require knowledge which is too difficult for an average entrepreneur	36.6
Knotty, unclear, not precise enough	9.9
Not answered	5

Source: Survey

**Table 43**  
**In your opinion, the VAT regulations need to be simplified concerning:**

Simplicity	Percentage
The VAT refund procedure	70.4
Formalities in the rules for filling out and registration of invoices	24.5
Other	5.1

Source: Survey

About 70 % consider the VAT regulations complicated and difficult to comply with. This might be explained by the frequent changes in VAT legislation. However, asked to point out what the major problems with the regulations are, 70.4 % of the entrepreneurs name the VAT refund. Together with the level of the VAT rate, the tax refund seems to be one of the “hot” issues with regard to VAT.

Some 25 % still have some problems with invoicing and other documentation.

**Table 44**



### What would you change in the VAT regulations?

The proper solution is:	Percentage
Nothing	2
The level of the VAT rate	21.8
Procedures for VAT refund	28.7
Other procedures	19.8

Source: Survey

The answers to the above question summarize the general attitudes regarding the VAT regime. Being part of a highly open economy, Bulgarian companies, and especially exporters, are strongly dependent on receiving fast VAT refunds. Also, the rate of 22% is obviously higher than the level considered to be reasonable and acceptable. The next question confirmed the common belief that the minimum registration barrier of DEM 75,000 in annual turnover, introduced on January 1, 1998, creates serious problems, especially for small export-oriented companies. In order to comply with the new regulations they have to enter fictional transactions, artificially increasing the companies' turnover.

### Table 45

#### What do you think about the introduction of the VAT registration barrier of min. DEM 75,000 annual turnover and the abolishment of volunteer registration?

Options - statements	Percentage
This relieves the SME of paying one more tax	19
This does not change anything considerably	19
This creates significant difficulties for the SME and exporters	56
Other	6

Source: Survey

### Concluding remarks

The general attitude toward tax differentiation is backed up by the results regarding VAT. The greatest preference is for differentiation based on the criteria of "commodity groups" (46.5 %), and "manufacturing vs. trade" (41.6 %). The understanding is that differentiation will lower taxes, rather than the opposite. At the same time, a preference for granting incentives to specific economic activities can be noticed.

The present VAT differentiation regulation is accepted as comparatively positive. The entrepreneurs are in favor of a certain simplification process according to the "average" entrepreneur's knowledge. A general acceptance exists for a VAT registration threshold, close to the existing one of BGL 75 million (BGL 83.5 million). However, this threshold is generally accepted only if volunteer registration below that minimum is provided for. The preference for reducing the VAT rate to 15% can be assessed as realistic.

Companies' comments are mostly related to desires for greater flexibility and the speeding up of VAT reporting. The forms that are proposed extend the possibility of declaring the refundable VAT amount in the course of each transaction. Another basic VAT disadvantage is the registration barrier to small companies. More than half of those interviewed (56 %) consider that this will particularly trouble small producers and exporters. Maybe this is even more true about emerging small businesses.

### 3.2.5. Tax Exemptions and Reliefs

### Table 46

#### Express your opinion about the present practice of tax reduction exemptions and incentives...

Opinion:	Percentage
They encourage more effective activity in selected branches	23.2
They sometimes stimulate development but sometimes they give undesirable effects	38.4
They encourage tax manipulations to avoid payments	38.4

Source: Survey

Though 65-80 % of entrepreneurs responded in favor of tax exemptions in the previous questions, 38.4 % believe that they are a source of tax avoidance, and 38.4 % think that they allow for some undesirable consequences. The only explanation is that very few want a systemic solution to the problem. Most entrepreneurs hope to find opportunities to lower taxation for their own companies. Looking at the distribution of answers to the next question, the connection is even more evident. Most respondents realize that exemption and relief do not achieve the desired macroeconomic effect. However, most of them require a more differentiated tax system.

**Table 47**  
**Preferences toward the Practical Use of Tax Reliefs and Exemptions**

Do you think that:	(valid % Yes)
incentives are used by people who know how to use them rather than by people who need them	62.0
most taxpayers pay full taxes for the few beneficiaries of tax incentives	36.0
tax incentives encourage tax manipulation and finally reduce budgetary income	32.0
incentives stimulate economic activity	29.0
tax incentives used by very few discourage the others	26.0
exemptions for a limited number of taxpayers discourage people from making honest tax declarations	20.0
incentives stimulate a reduction in consumption and increase investment expenses	11.0

Source: Survey

**Table 48**  
**Please define your preferences concerning the practice of PIT and CIT reductions:**

The best solution is:	Percentage
Tax reductions should be given to businesses who demonstrate an ability to create investments and new places of employment.	59.2
Tax reductions should be given for a maximum number of subjects, with the purpose of stimulating their activity. If most taxpayers are beneficiaries of tax reductions simultaneously all of them will generate increased income	24.5
I prefer a lack of any form of tax privileges for particular groups of taxpayers which are covered by the rest of taxpayers	16.3

Source: Survey

According to the data, 60 % of respondents realize that the existence of tax allowances and reliefs results in tax avoidance. Given the answers on the need for differentiation of VAT, this means that allowances or reliefs are accepted only if the entrepreneur himself can make use of them, while they are generally considered to be a source of tax avoidance with regard to the “others.” The evidence lies in the next table on income transfers.

### Concluding remarks

The general view seen in the answers received is that tax preferences are evaluated mostly as a chance for tax evasion. It should be noted that the negative macroeconomic consequences of preferences granted, are estimated as comparatively seldom. Rather, the negative effect of tax relief can be noticed sooner as favoring some groups, and not favoring others. The prevailing standpoint on preferences is for them to become fair and accessible. Behind the answers in this section of the study lies a stronger desire to access privileges at any price, rather than to remove them, and thus benefit everyone.

Despite the prevailing viewpoints about income tax's social function, a remarkable part of those interviewed (almost 40 %) believe that taxes must be paid by everyone. A similar number (40 %) show the attitude that the PIT scale should not extend preferences to tax-payers from socially weak groups. The explanation of these 30-40 % could be found in suspicions regarding the justice of grants and the tax system's inability to control tax fraud, as well as in pure psychological factors and traditional values.

### **3.2.6. Number of tax rates, tax exemptions, simplicity of taxation procedures**

#### **1. Correlation of attitudes in favor of "flat tax"**

The aim of the calculations below is to prove whether the answers to the different questions referring to the number of tax rates coincide. All figures in the tables represent how many of those who responded in a certain way on the key questions have also answered the same way to questions with similar meaning.

Key questions regarding tax rates differentiation:

##### **1. Do you think that companies should be taxed:**

Opinion:	Percentage
by one rate	24
big companies more, small business less	61
as at present	15

Source: Survey

##### **2. Which solutions, in your opinion, encourage entrepreneurs and employers to higher activity?**

Solution:	Valid % "Yes"
taxes increasing progressively and simultaneously substantial tax reductions stimulating desired behavior of taxpayers	28.3
small progression and limited practice of tax reductions	58.6
no tax progression and no tax reductions (low taxes and no exemptions)	13.1

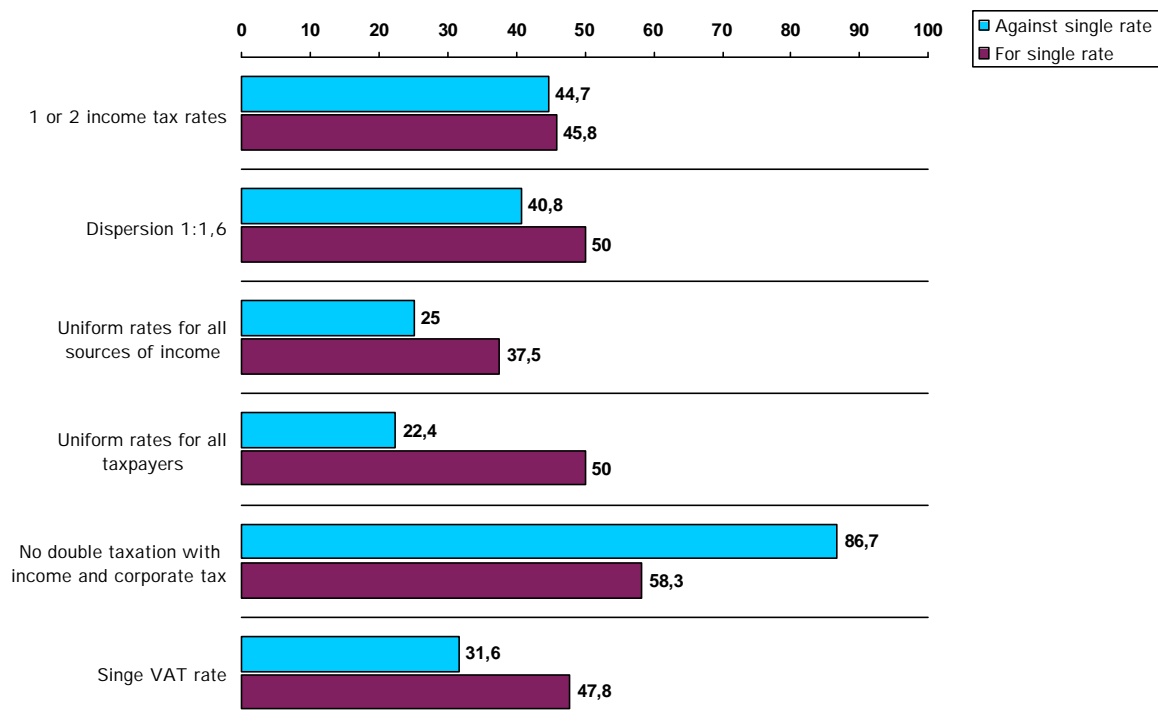
Source: Survey

As answers suggesting inclinations towards "flat tax" we treat:

1.: by one rate

2.: no tax progression and no tax reductions (low taxes and no exemptions)

Correlation between answers on key questions and other questions related to tax differentiation



Source: Survey

The correlation provided above reveal that the prevailing part of those who opted for a single rate for all companies also share the idea of a single tax rate when answering other questions. The strongest relationship appears to be between the attitude toward a uniform tax rate according to the size of the company, and the idea of a single VAT rate and equal taxation for all groups of taxpayers. An exception is the negative relationship with the idea of avoiding double taxation by CIT and PIT.

As a whole, the idea of neutral (according to size) taxation is well-embraced in the general context of single-rate taxation.

When the question's emphasis is on what the best way of stimulating entrepreneurs and employees is, the correlation is even more easily distinguished. As a whole, those who prefer a single rate with no exemptions and reliefs as an incentive for business and labor activity, also opt for single-rate taxation when answering the other related questions.

The perception of single-rate taxation is more recognizable in the context of stimulating business activity, rather than related to uniform taxation according to company size.

The general conclusion is that there exists a certain group of respondents who consciously favor single-rate taxation (flat tax).

## 2. Attitudes towards tax exemptions and reliefs

A key question of the "no exemptions" ideology is:

**Table 51**

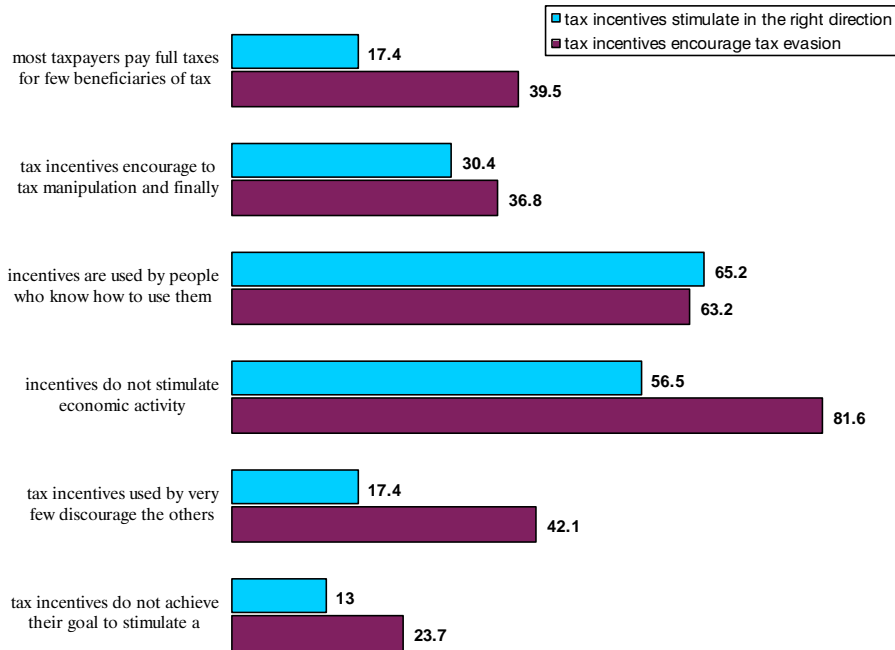
**Express your opinion about the present practice of tax reduction exemptions and incentives:**

Opinion:	Percentage
they encourage more effective activity in selected branches	23.2
they sometimes stimulate development but sometimes they give undesirable effects	38.4

they encourage tax manipulations to avoid payments	38.4
--	------

Source: Survey

The correlations provided below show to what extent the answer “they encourage tax manipulations to avoid payments” falls within the general attitude toward tax exemptions and reliefs.



Source: Survey

The idea that tax incentives encourage tax evasion is repeated in the other indicators of negative attitude towards tax exemptions and reliefs. There can be recognized a consistent, though not big (30-35 %) group of entrepreneurs who understand the negative impact of tax incentives. The most significant correlation here is between the negative answer to the key question and the perception that tax incentives do not stimulate economic activity. Also, a remarkable relation is found in connection with the statements:

- most taxpayers pay full taxes for the few beneficiaries of tax incentives;
- tax incentives used by very few discourage the others;
- tax incentives do not stimulate the desired behavior.

Compared to the idea of single-rate taxation, the attitudes against tax incentives are even more consistent and correlated. The backbone of the negative perception of tax exemptions and reliefs is their economic inefficiency and general unfairness for the “non-preferential” market agents.

### 3. Simplicity of tax procedures, tax incentive and flat taxation

Answers used to identify relevant connections:

#### Single rate:

PIT dispersion 1:1.66

All social groups to be taxed by the same PIT rate

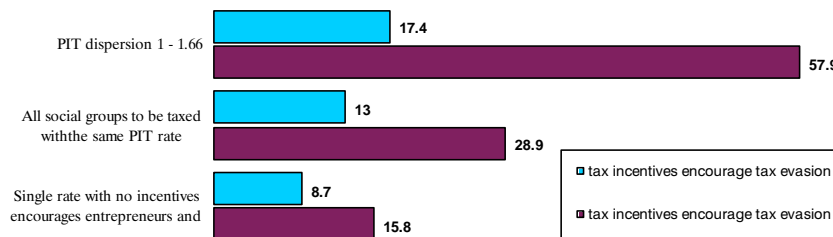
Single rate with no incentives stimulates entrepreneurs and employees

### No incentives:

Tax incentives encourage tax evasion

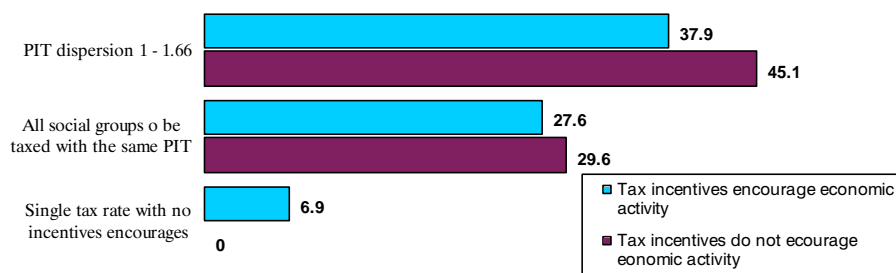
Tax incentives do not encourage economic activity

Correlation between the idea of flat tax and “Tax incentives encourage tax evasion”



Source: Survey

Correlation between the idea of flat tax and “Tax incentives do not encourage economic activity”



Source: Survey

As a whole the negative assessment of tax incentives as a tool of tax evasion significantly correlates with the idea of “flat tax.”

It is most clearly distinguished in the idea of flat PIT (or dispersion 1:1.66), as well as the negative attitude toward differentiated treatment for certain social groups.

The correlation between the idea that single-rate taxation encourages entrepreneurs and employees and the understanding that tax incentives stimulate tax evasion is not so sound. It is obvious that the idea of the single tax rate does not correspond with the destimulating role of tax exemptions and reliefs.

In general, there exists a certain potential for the understanding that the abolishment of tax incentives and the introduction of a flat tax rate would encourage economic activity. However, this potential is still vague and reversible.

As for the correlation between the negative attitudes toward tax incentives and the idea of a single rate, and those who opted for simplification of tax procedures, no significant statistical correlation was detected. Obviously, the number of tax rates and the existing tax incentives are not understood as a factor that increases the confusion and complexity of taxation procedures.

### 3.2.7. Proposals for Tax Deregulation

Table 52

**What is in your opinion about the acceptable frequency of changes and improvements to tax changes by the Government?**

Acceptable frequency:	Percentage
once every year	12.2
once every two years	14.3
once every three years	12.2
once every four years	5.1
once every five years	56.1

Source: Survey

The frequent changes in tax legislation in the last couple of years explains the result in the table above. The business community needs stability and predictability.

**Table 53**

**In your opinion, is the tax system is neutral / indifferent concerning politics?**

The tax system is neutral?	Percentage
Yes	60.4
No	39.6

Source: Survey

**Table 54**

**Are the present criteria for setting up tax rates fair?**

Answers:	Percentage
Yes	57.0
No, they express the political interests (electoral programs) of governing powers	43.0

Source: Survey

Most respondents consider the tax system to be politically independent — almost 60 %. This means that the political parties are still not identified with certain business and social interests.

**Table 55**

**How do you assess the reporting obligations of companies as far as the problem of income taxes is concerned?**

Reporting obligations are:	Percentage
too difficult	28.7
not too difficult, but could be simpler	61.4
they do not cause problems	9.9

Source: Survey

The hypothesis that the complexity of tax declarations and procedures create unbearable problems for taxpayers did not hold grounds. Only 28.7 % think that they are too time-consuming, while the others feel they can comply.

**Table 56**

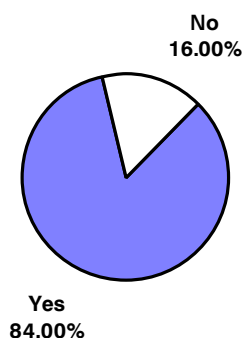
**Do you think that companies should be taxed:**

Companies should be taxed:	Percentage
by a proportional rate	24
big companies more, small business less	61
as at present	15

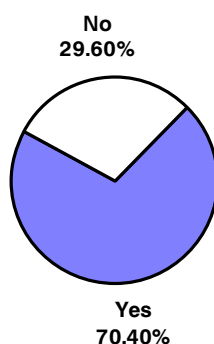
Source: Survey

The answers should be interpreted in the context of the common belief that tax rates must be used as a tool for social policy, and of the political campaigns directed at stimulating small companies through tax reliefs. Also, a leftist egalitarian attitude toward income inequalities still affects the business community.

**Should tax offices be obliged to inform taxpayers about changes in tax duties?**



**Do you think that this will increase collectibility?**



The low level of tax collection is not due to the low level of informedness of taxpayers about their obligations. Hence the above data probably shows that entrepreneurs tend to perceive the tax administration as an “alien,” as an opponent. Any sign of “friendly behavior” on behalf of the administration is expected to be treated as an invitation for a partnership dialogue which indirectly could change the situation with tax evaders.

**Table 57**

**In your opinion, what fiscal policies of tax collection are most convenient?**

Solutions:	Percentage
fast collection with lower rates	71
at higher tax rates, but with delayed collection	7
as at present	22

Source: Survey

The answers to the question above prove that the level of the tax rates is still the major problem that entrepreneurs face. The results also demonstrate low-inflation expectations among the entrepreneurs.

**Table 58**

**Which is closer to your opinion?**



Opinion:	Percentage
Taxes are an effective instrument of social policy.	56.6
The social system should be independent of the tax system.	43.4

Source: Survey

As mentioned earlier, the results reflect the general leftist orientation of the business community. The same conclusion applies to the next issue:

**Table 59**

**In your opinion, tax declarations should be required for period of:**

Declaration:	Preferred frequency (%)			
	Monthly	Quarterly	Semiannually	Annually
PIT	19	20	6	55
CIT	6.1	28.6	16.3	49
VAT	33	39.2	8.2	19.6

Source: Survey

Given the current tax rates the general preference in the case of PIT and CIT is toward rare payments — annually, if possible. At the same time, the trend regarding VAT is just the opposite. The explanation lies in the fact that most small companies export, or underdeclare incomes and produce negative value added, thus creating conditions for VAT refunds. Of course, the more frequent the refund is, the better for the company. On the contrary, CIT and PIT regulations demand advance payments and do not provide for tax refunds. Generalizing from the results above, there is a clear sign that Bulgarian entrepreneurs still interpret tax problems in the context of their own short-term survival.

### Concluding remarks

A natural preference prevails for greater tax regulation stability. More than 56 % think that any changes should be valid for at least five years.

60.4 % believe that the tax system does not favor specific political views. Nevertheless, this should be interpreted in connection with the expectations regarding tax regulation stability. On the other hand, the tax system's "political neutrality" implies that small and medium business is not politically or parliamentary represented. 57 % of those interviewed consider tax definition criteria to be objective and not favoring any specific political force's interests. This fact confirms the observation that small and medium business do not identify political forces as behind tax regulations.

Other expectations about the PIT payment procedures being difficult for business were not confirmed. 61.4 % would be satisfied if they were simplified, though as a whole, they do not realize the emerged chance for reducing expenses if PIT procedures are simplified.

61 % of those interviewed think that the bigger companies should pay at higher tax rates. The results confirm opinions on greater tax differentiation. The distribution of answers by company size and registration does not suggest considerable differences, which shows data homogeneity and standpoint unanimity regarding greater differentiation. By these results it becomes clear that this differentiation is understood as a way to create opportunities for lower rates.

Over 70 % of those interviewed approve of paying taxes more frequently, if this is necessary in order to pay at lower rates. This fact is a key to understanding the total research results. It confirms observations that procedures are not so important, but tax size as such is a decisive factor in entrepreneurs' opinion. It gives a sense of expectations, therefore, for greater tax system differentiation and comparatively better acceptance for advance tax payment.

Preferences for more differentiation and a desperate search for lower rates have some economic logic, and are not only the result of a low management culture. Maybe these

suggestions are adequate to the current economic environment, in which the motivation for expense reduction prevails over the motivation to increase income. It could be assumed that, with the progress of economic reform, the alternative cost of dealing with tax administration will increase and entrepreneurs will start to bother for simplified procedures.

The greater part of companies (53 %) believe that property declarations can help in calculating tax obligations. It is quite curious that sole proprietors and limited liability companies expect by the same degree (about 50 %), that property declarations would be efficient. The present research's general data shows that property declarations are accepted as commonly valid and as presenting a more realistic measure of real profits, than PIT.

### 3.2.8. *Expected effects of tax reform*

At the end, entrepreneurs were suggested a hypothetical tax reform designed as follows:

- reduction of individual tax to 30%;
- reduction of corporate income tax to 30 %;
- introduction of single-rate (14 %) VAT without possibility of exemptions and breaks;
- simplification the tax system and tax accounting to the maximum extent possible;

According to the business people, the implementation of such reform would, in two years, lead to the following consequences

**Table 60**

**If the measures described above are taken, what do you expect for your company in the next two years?**

Effects	Yes	No	If yes, to what extent?	Not answered
Increased production and sales	90.1	5.9	26.27	4.0
Increased investment	70.3	18.8	19.63	10.9
Increased employment	64.4	22.8	24.89	12.9
Increased entrepreneurs consumption	49.5	33.7	17.41	16.8
Reduced administration costs	34.7	51.5	14.31	13.9
Increased company property	68.3	18.8	16.21	12.9
Reduced time consumption in accountancy	57.4	28.7	18.71	13.9
Increased financial liquidity	49.5	32.7	18.38	17.8
Increased profitability	70.3	17.8	18.21	11.9
Better concentration on operational activity	51.5	31.7	24.69	16.8

Source: Survey

**Table 61**

**What effects do you expect for the country as a whole?**

Effects	Yes	No	If yes, to what extent?	Not answered
Increased production and sales	93.1	5.0	21.15	2.0
Increased investment	85.1	9.9	21.31	5.0
Increased employment	80.2	10.9	16.84	8.9
Increased entrepreneurs consumption	74.3	13.9	13.72	11.9
Reduced administration costs	62.4	27.7	24.23	9.9
Increased company property	57.4	28.7	15.45	13.9

Reduced time consumption in accountancy	79.2	9.9	18.38	10.9
Increased financial liquidity	53.5	32.7	15.36	13.9
Increased profitability	67.3	17.8	16.08	14.9
Better concentration on operational activity	50.5	34.7	17.26	14.9

Source: Survey

On the whole, entrepreneurs' expectations are toward production and sales increases, and diminished informal economy.

The majority of expected effects on companies' activity, are connected with production and sales increases (average of 26.3 %), increasing number of employees (24.8 %), and improving executive management (24.7 %). The other parameters have a comparatively weaker influence, but can be considered potential consequences of the above-mentioned three. A smaller influence is expected on the curtailment of administrative expenses (reduced by 14.3 %). This fact is particularly illustrative regarding entrepreneurs' considerations of reforms as a prospect for decreasing nominal tax value, rather than as a chance to limit bureaucracy.

Greater effect for the country as a whole are seen in the informal economy decrease (average of 24.3 %), and increased investment (21.3 %), production and sales (21.2 %), and consumption (18.4 %).

Generally, entrepreneurs identify tax reform with improvement in the current situation. The contradiction between the data on the specific items on tax exemptions and tax rate dispersion, and the positive expectations expressed in the table above, might be explained by two major reasons: first, the proposed reform significantly decreases the level of tax rates *ceteris paribus* (there are no exemptions to be abolished; i.e., for investment purchases); and second, the answers are a mirror image of what politicians claim a successful tax reform should achieve.

### 3.2.9. Survey of Business Organizations

The questionnaire was distributed among:

1. Bulgarian Industrial Association
2. Bulgarian Trade and Industrial Chamber
3. Federation of Bread Producers and Confectioners in Bulgaria
4. CNIKA Technology and Innovation Center

The first two are universal business associations, while the latter are two of the most influential branch unions. The results showed that Bulgarian business associations interpret the problem of taxation in almost the same manner. However, the number of organizations that were interviewed does not allow for deriving representative conclusions. We can just mention the main differences in their attitudes, as well as the consensus issues.

Parallels:

1. The percentage of tax evaders estimated by the organizations coincides with that in the survey of companies;
2. They are equivocal as to whether a private enterprise can not produce loss permanently;
3. They are for lump sum taxation for small firms;
4. The major problem with PIT they see is that high rates are applied to low incomes;
5. Surprisingly, they think that profit transfers for tax avoidance are rare;
6. They are against double taxation by PIT and CIT, and also consider the different levels of PIT and CIT rates undesirable;

7. Like the entrepreneurs, they think the acceptable VAT rate is about 15%. The major problem they encounter with VAT regulations is with the VAT refund process;
8. They are sure that the tax system is politically neutral;
9. They prefer fast tax collection at rates lower than the present ones;
10. Their expectations about the possible effects of the described reform are quite modest; the average positive effect in terms of increased investment, sales, productivity, etc., is estimated at 10-15%.

Differences:

1. The preferred levels of PIT range from 10-40% to 20-33;
2. They conflict regarding fixed advance payments for small taxpayers;
3. They also diverge on the issue of tax differentiation according to sources of personal income and types of taxpayers;
4. They differ on the effects of tax exemptions and reliefs, with a slight preference on behalf of tax incentives;
5. Regarding VAT differentiation, the argument is whether there should be different rates for dealing with different goods and services;
6. They differ when asked on the tax reporting periods;
7. The most significant difference is on the issue of flat vs. progressive taxation. On the one side, all respondents prefer linear taxation with few or no exemptions, at a rate of 30-32%. On the other side, they state that bigger companies should be taxed at higher rates. The explanation might be that the current levels of CIT for companies with annual profit above DEM 50,000 is 37%, while at the same time there are no exemptions (for investment purchases, etc.) anyway. The same conclusion applies to the overall results of the survey.

### **3.2.10. Summary**

#### **1. Tax Scales, Preferences and Rates**

On the whole, the problem of tax system simplification and the business incentives of easier taxation procedures are not a priority in the Bulgarian small and medium businessman's consciousness. At the present stage, the tax level, not its form, is seen above all else as the problem confronting entrepreneurial development. The tax burden is obviously too heavy in nominal terms, to be compensated for solely by less bureaucracy, deregulation of procedures, etc.

Small and medium business still do view tax preferences as a serious obstacle facing individual development. Should there be negative opinions about preferences, they can be summarized mostly as the imperfection and unfairness of existing regulations, but not by the negative consequences for the total economic environment.

The tax scale composition, also, is not of a particular importance regarding daily company activities. There is no clearly expressed preference toward "linear," "small progression" or "big progression" scales. As a matter of fact, these forms could be a factor only along with tax rates' nominal reduction.

Expectations about tax reduction are realistic. It might be that the tax attitude could be changed, if rates are reduced to the level of a maximum of 30% for PIT and 15% for VAT. At these levels companies could expect general economic revival.

On the whole, if the tax reform remains only in the procedure of deregulation or abolishment of preferences, without any significant tax rate reduction, it can be hardly assumed that considerable changes in tax behavior will occur, and respectively in tax collectibility itself.

## **2. Tax Behavior and Tax Efficiency**

Companies' assessment on tax collectibility shows that an average of 70% of taxpayers who owe taxes at the maximum rate, by different means avoid paying their whole amount due. Over 70 % of companies think that taxpayers at the maximum tax rate pay less than half of tax due. At the same time, 89.9 % believe the present tax system is not giving enough incentives for "fair play."

From a tax administration point of view, PIT does not look very efficient. A considerable portion of limited liability companies prefer paying PIT and CIT simultaneously, which means that PIT does not correspondingly register the real revenues of entrepreneurs. At the same time, if tax regulations give a more adequate and flexible form for registering expenses, entrepreneurs would be less motivated to evade tax payment.

Therefore, from an administrative point of view, introducing ownership declarations could prove efficient. There is a common opinion that this form has the potential to register real income.

On the whole, VAT is viewed positively by companies. The registration threshold of BGL 75 million is comparatively close to the expectations (BGL 83.7 million). However, if the registration minimum is reduced, an increase in production and export activity can be expected from small business. The desired changes in VAT are related to the introduction of more flexible forms for reporting tax credit and an accelerated process of processing the data by the tax administration.

In spite of the understanding of advance payment as "drawing off fresh assets from companies," advance installments are not considered to be a big problem, even for small business. In general entrepreneurs prefer to pay taxes less frequently.

Nevertheless, if more frequent payments are accompanied by lower rates, more than 71 % of companies would chose exactly this scheme.

The general results of the present study show preferences for the tax stimulation of manufacturing, sales and investment. The tax reform expectations relate to hopes for lower rates, combined with procedure simplification.

## **3.3. Preferences of Polish Entrepreneurs on Tax System Reform**

### **Introduction**

The entrepreneurs' survey on preferences regarding how to deregulate the Polish tax system took place in 1997. The survey interviewed 102 entrepreneurs, selected mostly from the member lists of regional Chambers of Commerce. The idea was to select more active and credible companies. Chamber members could be considered to be both active and honest. This method of selection (3/4 of respondents) was supplemented by the selection of respondents from the clients' group of the Polish American Small Business Advisory Foundation (1/4 of respondents).

As a result 102 questionnaires were distributed amongst companies. The most dominant industry group represented was service (40%). The other major groups were commercial companies (35%), manufacturing (16%) and multi-branch (6%). Most of the respondents could be described as small- and medium-size enterprises. Thirty % of the respondents' firms had fewer than six employees, 39 % had 6-50, 16 % had 51-250, and 15 % had more than 250 employees. The legal forms of companies represented were: limited liability companies (32%), joint stock companies (30%), civil partnerships (23%) and proprietorships (15%). Responses were made by company owners and directors (3/5); however, in larger companies financial controllers (accountants) were the most important answering group.

### 3.3.1. Personal Income Tax (PIT)

#### Number of PIT Rates and Dispersion Range

In the research the entrepreneurs were asked whether they would prefer an increase or decrease in the number of PIT rates, or whether they should remain unchanged. The replies are included in Table 62.

**Table 62**

#### Entrepreneurs' Preferences on the Number of PIT Rates

Preferred Solution	Percentage of respondents
Increase number of tax rates to 5	11.8
<b>Maintain present 3 rates</b>	37.3
Reduce number of tax rates to 2 (basic rate and increased rate for very high incomes)	34.3
Introduce flat rate	16.6

#### Source: Survey

According to the data received in the survey, about half of entrepreneurs would prefer a reduction in the number of PIT rates. Within this group about 16 % preferred a single flat rate. Quite big group of entrepreneurs considers the present system of three rates to be acceptable. The general conclusion is that a majority of entrepreneurs opposes the idea of an increase in the number of tax rates.

In the opinion of business people the present number of PIT rates hardly allows the equalization of income differences within society. Only 6.9 % of the respondents opposed the above opinion. More than half of the entrepreneurs surveyed (54.9 %) consider that the present system of PIT rates creates reluctance to engage in entrepreneurship. The entrepreneurs indicated that the system creates troubles in tax income calculation (16.7 %) and paying tax advances (18.6 %).

Apart from the problem of the number of PIT rates, their dispersion range seems to be a very important issue. Experts dealing with tax systems modeling maintain that a level of dispersion between the lowest and highest rate greater than 2.0 does not promote fiscal honesty. The preferences of the businessmen surveyed on the optimum range of tax dispersion are presented in the following table.

**Table 63**

#### Optimum Dispersion between the Lowest and Highest PIT Rates

Dispersion Range	Percentage of entrepreneurs
2.56 (left Labor Union proposal; refused)	16
2.14 (as in 1996)	14
<b>2.0 (as until the end of 1993)</b>	45
1.66 (as in the UK)	13
1.0 (as in Estonia)	12

## Source: Survey

The data included in the table above show that about 1/3 of those surveyed are for keeping the present dispersion range or even an increase of the range. However, a majority (2/3) would prefer a reduction in the difference between the highest and lowest PIT rates. It is important to underline that nearly half of those surveyed consider a dispersion of 2.0 as optimal. The average preferred PIT rate dispersion was 1.95 (found by multiplying percentages of respondents by preferred dispersion). This result is very close to the state of the system in 1993.

### Maximum PIT Rates

The surveyed entrepreneurs proposed a significant increase in the income level taxed at the maximum rate. Above 2/3 of those surveyed maintain that the marginal rate should start from a level of 5-10 average incomes. The entrepreneurs' opinions are presented in the following table.

**Table 64**

### Preferred Start Level of the Marginal Tax Rate

Preferred Start Level of the Marginal PIT Rate	Percentage of respondents
2 x average income	8.4
<b>3 x average income</b>	21.1
5 x average income	37.9
7 x average income	17.9
10 x average income	14.7

## Source: Survey

Using the rule described in the preceding paragraph, the average preferred start level of the marginal PIT rate was estimated. It amounts to 5.42. This result shows that the marginal PIT rate should start at 5.4 average incomes. (At present it starts at 4.00). The entrepreneurs were also invited to indicate their preferred minimum and maximum PIT rates. On the average they stated:

**for the minimum PIT rate: 13.7%**

**for the maximum PIT rate: 30.4%**

In comparison to the existing maximum (43%) and minimum (20%) rates (1997), the differences seem quite large. The most of those surveyed consider that the present marginal PIT rates discourage tax honesty. According to the results of the research, about 60 % of entrepreneurs takes steps to decrease the amount of reported income. Thanks to these efforts they pay significantly lower taxes. The entrepreneurs surveyed were asked to estimate their "savings on taxes." The results of the research are presented in the table below.

**Table 65**

### Estimations on Tax Avoidance by Marginal Taxpayers

Marginal Tax payers avoid to pay ...	Percentage of respondents
80-100% of PIT due	6.9
50-80% of PIT due	30.7
30-50% of PIT due	48.5
10-30% of PIT due	10.9

10% of PIT due	3.0
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## Source: Survey

To estimate the average tax avoidance range, the percentages of respondents were multiplied by the averages of the range brackets. The result was 47.9 %. This means that in the opinion of the entrepreneurs, marginal taxpayers avoid paying on the average 47.9 % of their due taxes. The results show that using maximum PIT rate for taxpayers with an equivalent of four average incomes does not produce satisfactory tax inflows. Of course these results may be considered as estimations only. It's also important to underline that Polish entrepreneurs tend to present their opinions in a more negative light than it is in reality. However, these data show that high rates don't lead to high PIT inflows.

### Differentiation of PIT according to Different Income Sources

Most of the entrepreneurs surveyed would prefer to maintain the present differentiation of income taxation according to different income sources. More than 60 % would opt to keep different tax rates for capital gains, personal incomes and agricultural incomes. The results show that the opinions of entrepreneurs on whether or not to introduce uniform taxation is significantly divided. In the majority is a group who sees benefits from the present regulations and accepts a more complicated tax payment procedure. At the same time, about 40 % of those surveyed believe it is better to simplify the regulations and introduce uniform taxation for incomes coming from different sources.

### PIT in Small Firms

The dominant group of enterprises in Poland consists of private proprietorships. These firms pay income taxes according to PIT rates. It is striking that small private firms' owners have less money for development than corporate entities. It was one of the main purposes of the research to state whether money spent for a firm's development should be taxed according to ordinary PIT rates. About 72 % of those surveyed maintain that taxation of income spent on capital goods should be lower than on divided incomes. Entrepreneurs consider that the tax on invested income should be lowered by about 24 %, which means that invested income should be taxed at a rate of about 20%.

Most of the entrepreneurs surveyed (74 %) felt that very small firms with low sales should be taxed by lump sum taxes. In relation to very low incomes (not exceeding minimum wage), the entrepreneurs proposed that an annual PIT declaration not be required (46 % of respondents). These entrepreneurs considered that people with very low incomes should not pay tax advance payments. Most of the entrepreneurs thought that annual tax declarations should be shortened and limited to a maximum of two pages (64 %)

### Losses and Price Transfers to Firms with Tax Exemptions and Incentives

It is an interesting observation that a lot of firms submitting tax declarations to Tax Offices report permanent losses. They do this through different price and cost transfers. Entrepreneurs consider that a situation of producing permanent losses is rather impossible in the long run (51 %), and about 30% thought that this situation was absolutely impossible. These answers are proof of entrepreneurs' declining acceptance for permanently hiding incomes.

The entrepreneurs surveyed were also asked what would be the frequency and range of income transferring to firms with tax exemptions or incentives. The results of the research are presented in the table below.

### Table 66



## Frequency and Range of Income Transfer to Firms with Tax Exemptions and Reliefs

Frequency and Range of Income Transferring to Firms with Tax Exemptions or Reliefs is ...	Percentage of respondents
Common (80-100% of firms with tax exemptions or reliefs)	7.2
Very frequent (50-80% of firms with tax exemptions or reliefs)	17.5
Quite frequent (30-50% of firms with tax exemptions or reliefs)	41.2
Moderate (10-30% of firms with tax exemptions or reliefs)	21.6
Rare (10% or less of firms with tax exemptions or reliefs)	12.5

### Source: Survey

The results show that nearly every second firm with tax exemptions becomes a target for transfer pricing. More precise estimations show that transfer pricing touches 39.3 % of firms with tax exemptions and reliefs. This means that the tax exempt sector destroys fiscal honesty, significantly reducing tax inflows.

### 3.3.2. Corporate Income Tax (CIT)

At the beginning it is important to underline that the majority of entrepreneurs' opinions on CIT involved the least disagreement. This was caused by the fact that this tax has been very stable since its inception in the early 1980s. The rate of CIT was established at the level of 40% at that time. In 1997 this tax was reduced to 38%, and a program for gradual reduction to 32% by the year 2000 was also introduced. This situation causes entrepreneurs to evaluate PIT in a very positive way. Despite this, entrepreneurs were asked to indicate their preferences concerning this tax.

#### Differentiation between Personal and Corporate Income Taxation

The entrepreneurs surveyed were asked whether the present differentiation between the marginal PIT rate (43%) and CIT rate (38%) discriminates against PIT payers (mostly small firms). More than 78.2 % of the entrepreneurs surveyed said "YES, IT IS". At the same time, 73.2 % of respondents stated that partners in limited liability companies should have the possibility to be taxed by PIT (as in the United States, for the so-called S-corporations). Entrepreneurs were also asked to indicate their preferences toward the detailed structure of CIT. The results are presented in the following table.

**Table 67**

#### Preferences Toward CIT Model

CIT should be ...	Percentage of respondents
<b>Flat rate of 30% (without tax exemptions and reliefs)</b>	33.7
Flat rate of 32% (with slight tax exemptions and reliefs)	41.6
Flat rate of 40% (with large tax exemptions and reliefs; present situation)	8.9
Progressive (similar to PIT)	15.8

### Source: Survey

The results of the research show that business people prefer low rates without significant tax exemptions and reliefs. This means that the business sector would prefer a neutral tax system without strong influence from the state.

### 3.3.2. Tax Exemptions and Relief

Tax exemptions and reliefs are some of the most important elements of the Polish tax system. According to the intention of the legislature, tax exemptions and reliefs are intended to stimulate strictly defined businessmen's and taxpayers' activities. These activities are defined in the economic policy of the government. Opponents of exemptions and reliefs say they destroy the logic of the tax system, change the initial and basic economic intentions of taxpayers and direct business activities toward inefficient targets. Also, they maintain that tax exemptions and reliefs change the structure of supply and demand, leading to a situation in which the portion of GNP distributed by the government is higher than the official amount written into the budget. A question which arises is the following:

*What is the relationship of entrepreneurs to tax exemptions and reliefs?*

The tables below contain the entrepreneurs' responses to these questions. They deal with problems such as: evaluation of the present system of tax exemptions and reliefs, evaluation of the economic meaning of tax exemptions and reliefs, preferences on how to shape the system of reliefs, and possibilities for the elimination of some tax reliefs.

**Table 68**

#### **Evaluation of the Present System of Tax Exemptions and Reliefs**

	Percentage of respondents
Meaning of tax exemptions and reliefs:	
They stimulate taxpayers to avoid tax payment	49.0
They sometimes stimulate business development but sometimes give undesirable effects	38.7
They encourage more effective business activity	12.3

#### **Source: Survey**

According to the results it is possible to admit that half of the entrepreneurs have a negative opinion of tax exemptions and reliefs. One-third see both positive and negative effects, and only one-eighth see only positive results from such tax instruments. The general conclusion on entrepreneurs' opinion of tax exemptions and reliefs is that it varies greatly; however, the critical attitude to tax reliefs prevails.

The next question was focused on the evaluation of the macroeconomic meaning of tax exemptions and reliefs. The respondents were presented with several qualitative statements on this meaning and could choose as many as they wished. The results of the research are presented in the table below.

**Table 69**

#### **Evaluation of the Macroeconomic Meaning of Tax Reliefs and Exemptions**

Opinions - Statements	Percentage of respondents
-----------------------	---------------------------

<b>Tax exemptions and reliefs are used by persons who are more familiarized with the tax system rather than by those who need them</b>	66.7
Tax exemptions and reliefs stimulate tax manipulations and cause serious tax inflow reduction	50.0
Tax reliefs are received by only a few but everybody pays for them	43.1
Tax reliefs which are commonly used have no effect	26.5
Tax reliefs and exemptions received by a few are a disincentive to honest activity for the rest	19.6
Tax reliefs reduce consumption and increase investment	20.6
Tax exemptions and reliefs stimulate desired business activities	16.7

**Source: Survey**

According to the results, the majority of entrepreneurs see negative macroeconomic effects from tax reliefs. Only one-sixth to one-fifth find an economic stimulation mechanism in tax reliefs. In connection to the above question the entrepreneurs surveyed were asked to indicate their preferences for the practical use of tax reliefs and exemptions. The results of the research are presented in the table below.

**Table 70**

**Preferences Towards Practical Use of Tax Reliefs and Exemptions**

<b>The best solution is ...</b>	Percentage of respondents
Grant tax reliefs and exemptions to those who can demonstrate that benefits gained can be used for new workplaces, new investment. However, everybody pays for the activities of a few.	45.0
Grant tax reliefs and exemptions to the maximum number of entities, so that nearly all feel stimulated. Nearly everybody receives and uses tax reliefs	35.0
No tax reliefs nor any tax privileges	20.0

**Source: Survey**

The results presented in the table above show that nearly 2/3 of those surveyed either do not accept tax reliefs and exemptions or would limit the use of tax reliefs to those who can demonstrate benefits to society. Slightly more than 1/3 of the entrepreneurs accepts a broad use of tax reliefs. It seems that entrepreneurs belonging to the second group benefit or benefited themselves from tax reliefs.

The entrepreneurs surveyed were also asked which tax reliefs should be eliminated. Paradoxical results were received for this question. Apart from tax reliefs on the purchase of treasury bonds (53.9 % accepted their abolishment), the other types of tax reliefs received very low indications for abolishment. For example, only 24.5 % accepted the abolishment of reliefs for the purchase of educational materials, 17.6 % would eliminate those for education, and only 10.6 % would eliminate those for new capital investment.

The conclusion from the above research is the following: generally, entrepreneurs are against tax reliefs but they do not accept their abolishment without suitable compensation. According to this conclusion, the entrepreneurs surveyed were asked to what extent the abolishment of tax reliefs should be accompanied by a reduction in the rates of PIT or CIT. The results received are presented below.

**Table 71****Reduction of Income Tax Rates with Regard to Tax Relief Abolishment**

Range of Income Tax Rate Reduction	Percentage of respondents
<b>2 percentage points</b>	13.8
5 percentage points	36.8
10 percentage points	34.5
X percentage points (average 18.85)	14.9

**Source: Survey**

The results presented above indicate a preferred reduction in income tax rates of 5 to 10 percentage points. The average result was 8.4 % (using the methodology described in the earlier part of the text). This means that the entrepreneurs surveyed would expect an average reduction in income tax rates of 8.4 percentage points, in exchange for tax relief abolishment. At the same time, 57.8 % of those surveyed agreed that some groups of taxpayers, especially the very poor, should be exempted from taxation.

The conclusion which arises from analysis of the above questions shows that the common level of acceptance for the present system of tax reliefs is very low. The most of those surveyed maintain that tax reliefs encourage dishonest activities, causing a reduction in tax inflows. Only a small portion of the entrepreneurs indicate the positive impacts of tax reliefs. Despite this, those surveyed do not accept the liquidation of tax reliefs without suitable compensation. This compensation should be the reduction of income tax rates by some 8.4 percentage points.

*3.3.4. Value Added Tax (VAT)*

In Poland the Value Added Tax is considered to cause the most problems, the highest level of time-consuming work and large possibilities for errors and mistakes. The explanation of this situation vary. The first main reason is that the procedures for computing, paying and refunding VAT are very complicated. Secondly, the present regulations are quite unclear, lead to controversies and cause a high level of “taxpayer’ s stress”. Taxpayers are unsure as to whether they are paying VAT in the proper way. In light of the aforementioned problems, a set of questions touching on VAT structure and procedures was asked.

**Number of VAT Rates**

The present system in Poland comprises of five VAT rates: 0%, 7%, 17%, 22% and goods or services exempt from VAT. This inspired the researchers to ask entrepreneurs whether the present number of VAT rates should be increased or decreased. The results of the research are presented in the table below.

**Table 72****Preferred Number of VAT Rates**

The proper solution is ...	Percentage of respondents
Decrease the number of VAT rates to one domestic (e.g. 14%) and one for export (0%)	54.1
Decrease the present number of VAT rates from five to four (without the intermediary rate of 17%)	20.5
Maintain the present system	22.5

Increase number of rates to six	2.9
---------------------------------	-----

### Source: Survey

The indications of the entrepreneurs show that in order to simplify VAT, a reduction in the number of rates to one (domestic) would be necessary. This reform would simplify tax settlements, and in the opinion of over 68 % of those surveyed it would make it impossible to qualify goods and services for VAT rates lower than the due rate.

#### VAT Coverage

The problem of VAT coverage is quite controversial. Generally, small service people and tradesmen oppose full VAT coverage. Most of the companies interviewed in this study were covered by VAT, and this influenced the results received. Thus, in reply to the question of whether all firms should be covered by VAT, 79 % answered that they should. However, if VAT would not be applicable to all companies, they indicated that the starting level of VAT should be sales of PLN 72,000 per year (about US \$27,000 at the beginning of 1997).

#### Size of the Preferred VAT Rate

As indicated in the previous paragraphs, most of the entrepreneurs prefer a single uniform VAT rate. Following this opinion a question concerning the VAT rate level was asked. The average answer received was 12.8%. This means that the entrepreneurs surveyed would accept a VAT rate higher than 7% (the lowest of the current rates) and significantly lower than the present maximum of 22%. If a single VAT rate was introduced it would simplify the system and normalize the demand structure.

#### Preferences regarding the Simplification of VAT Procedures

To learn the opinion of entrepreneurs concerning the simplification of VAT procedures, they were asked how they evaluate the complexity of VAT regulations. The results of the research are presented below.

**Table 73**

#### Complexity of VAT Regulations

Regulations concerning VAT are ...	Percentage of respondents
Complicated, unclear and imprecise	45.1
Require excellent orientation and knowledge not possessed by the average entrepreneur	36.3
Relatively complicated	34.3
Relatively easy to use for every accountant	7.8
Simple and easy to use	1.9

**NB: more than one answer allowed**

### Source: Survey

The results included in Table 73 are proof of the very critical opinion of entrepreneurs toward VAT regulations. VAT regulations cause the most taxpayers' troubles. This is why the entrepreneurs surveyed were asked to indicate their preferences regarding the simplification of the VAT regulations. The entrepreneurs underlined a necessity to simplify the procedures for

qualifying goods for different VAT rates (65.7 %) and the procedures for VAT refunds to the taxpayers (50 %), and stressed a need for accepting some slight errors in invoicing (such as lack of a postal code etc.) (50.9 %). The latter problem also raised the question of responsibility for invoice errors. At present both the seller and the buyer are responsible for errors made in invoicing. The majority of the entrepreneurs surveyed opted for only the seller being held responsible (60.8 %). Moreover, the entrepreneurs suggested a lot of detailed proposals for the simplification of the VAT structure.

### 3.3.5. Preferences with regard to System-wide Solutions

The entrepreneurs surveyed were also asked to indicate their opinions on the whole tax system. Below are presented the research results concerning different issues important to the whole system.

#### Frequency of Tax Regulations Changes

Very frequent changes in tax regulations causes difficulties with proper understanding of the system. Very few businessmen can afford to be constantly informed about neverending amendments in legislation. As a result entrepreneurs often make errors and get penalized. The entrepreneurs were asked what they considered to be an acceptable frequency of changes to tax regulations. The results are indicated below.

**Table 74**

#### Acceptable Frequency of Changes to Tax Regulations

Acceptable Frequency	Percentage of respondents
Every five years	66
Every four years	14
Every three years	17
Every two years	1
Every year	2

#### Source: Survey

Results show a significant trend. Entrepreneurs desire the stabilization of the system. At present the tax system is changed every year, and in some cases even during the fiscal year (e.g. in June).

#### Political Transparency of the System

According to 82.8 % of the entrepreneurs surveyed, the tax system is not politically neutral. This means that the basic regulation and redistribution system of the economy is under pressure from the current political situation. More than 88 % of the entrepreneurs maintained that the criteria for the setting up of tax rates are not transparent and are based on the current political interests of the governing parties. According to 51 % of those surveyed, the present system does not encourage honesty, and 45 % believe that it stimulates dishonesty. Only 4% of the entrepreneurs surveyed in Poland thought that the present tax system encourages honest tax practices. This means that in the opinion of the majority of entrepreneurs, the present system is a source of demoralization.

#### Basic Systematic Principles

The basic principles of the system's operation seem to be one of the most important issues deciding entrepreneurs' opinion on the efficiency the tax system. Two important issues in this area are: the pace of tax collection and the level of taxes due. The attitudes of entrepreneurs to balancing these issues are presented in the table below.

**Table 75**

**Preferred Tax Collection Procedure and Height of Due Taxes**

The best solution is ...	Percentage of respondents
Collect fast, but in reduced amount (at reduced rates)	44
Collect at present rates, but prolong payment terms	26
Prolong the payment procedure and also reduce rates	30

**Source: Survey**

What is striking in the above results is the fact that nearly half of the entrepreneurs surveyed would prefer the tax collection procedure to be faster than in the present situation. Of course the reduction of rates is considered to be a necessary compensation for a faster procedure. When asked what the tax burdens should be for firms of different sizes, entrepreneurs indicated that they should be more proportional (62 %). Only 18 % of those surveyed maintained that big firms should be taxed at higher rate than small firms. 20% of the entrepreneurs accepted the present situation.

It seems to be a very important task to measure entrepreneurs' preferences with regard to using the tax system to further the social policy of the state. According to the research results, more than 72 % of the entrepreneurs surveyed preferred the tax system to be independent from the social system. This means a high preference for a neutral tax system.

The group examined in the study was also asked to indicate their preferences concerning levels of tax progression and reliefs. The results are presented below.

**Table 76**

**Preferences with Regard to Balancing Tax Progression and Reliefs**

The situation which would best stimulate both entrepreneurs and employers activity is ...	Percentage of respondents
Highly progressive taxes and huge tax reliefs stimulate desired activities	34.9
Low progression and small reliefs	33.0
No progression and no reliefs	32.1

**Source: Survey**

The results show that the entrepreneurs' group is divided into three nearly equal parts. However, if we combine the last two groups it is possible to state that there is a significant majority in favor of little or no progression and few or no reliefs. This group accounts for nearly 2/3 of those surveyed.

**Reporting Obligations**

Reporting obligations seem to be one of the most important difficulties imposed by the present tax system. The entrepreneurs' opinion on different aspects of the reporting requirements are presented below:

- Difficulties in reporting obligations in income taxes:

According to 45.1 % of the entrepreneurs, the tax reporting obligations are too burdensome. 49 % of those surveyed say that they are difficult and could be easier. Only 5.9 % maintain that they don't create any troubles.

- Lack of information about changes in tax obligations:  
More than 82.4 % of the entrepreneurs proposed that tax offices should be obliged to inform tax payers about changes in their tax obligations. Reliance solely on the published law is not sufficient.
- On the introduction of property declarations:  
As many as 92.9 % of those surveyed maintained that the introduction of property declarations would increase difficulties in tax settlements.
- Frequency of submitting tax declarations:  
The majority of the entrepreneurs were in favor of submitting tax declarations quarterly (61.8 %). 43.1 % of those surveyed maintained that the obligation to submit tax declarations should be abolished while a company is liquidated, bankrupt or has temporarily ceased operation.
- Definitions of tax deductible costs:  
68.3 % of the entrepreneurs considered that the regulations concerning deductible costs should precisely define which costs are deductible and which are not.

### *3.3.6. Attitudes of Business Organizations toward Tax System Deregulation*

At the end of 1997 the survey results were enriched by interviews with the major businessmen's organizations in Poland. The interviews included the following organizations:

1. Union of Polish Crafts (UPC)
2. Warsaw Chamber of Commerce (WCC)
3. Chamber of Crafts and Small Business (CCSB)
4. Head Council of Commerce and Service Associations (HCCSA)
5. Polish Chamber of Commerce (PCC)

It is important to underline that the aforementioned businessmen's organizations are member-oriented and for this reason they lobby for solutions comfortable to their members. In some cases their approach is different from that of entrepreneurs in general. This is why we decided to list the major similar and different attitudes between the entrepreneurs and the organizations representing entrepreneurs.

#### Similar attitudes

1. Business organizations are for keeping simplified taxation (lump sum) for small companies. Similarly to entrepreneurs, they propose expansion of this opportunity over new categories of small firms.
2. If tax reliefs should be eliminated, the business organizations propose reducing income taxes to a maximum of 30% (however, the majority of business organizations are for the maintenance of tax reliefs)
3. VAT regulations should be simplified. There is too much bureaucracy in this tax.
4. The frequency of tax changes should be reduced. Stabilization of the tax system is required.
5. The discretionary approach to taxpayers should be eliminated. Tax regulations should define precisely what is required, and when. The position of taxpayers in dispute procedures with tax authorities should be strengthened.
6. Reporting obligations should be reduced, for most firms to quarterly obligations. Tax forms should be shortened and simplified. There was a proposal to construct a simpler declaration form for SMEs.
7. The tax system should be politically neutral, not dependent on political changes.

#### Different or Conflicting Approaches



It is important to underline that there are many business organizations, and their approaches can vary significantly. This is why we decided to present different standpoints.

1. Some organizations, like the Union of Polish Crafts, proposed an increase in the number of rates for PIT and introduction of a tax deductible amount equal to the minimum wage. These solutions are similar to the German system, to a certain extent. However, at present Germans are very critical about their tax system, which is considered to be too socially-oriented.

2. Crafts organizations proposed building social mechanisms into the tax system. They proposed the introduction of a tax deductible amount for every child, amounting to PLN 1,800 per year (Dec. 1997 - about US \$500). This is entirely opposite to the opinion of the surveyed group.

3. Both chambers and crafts organizations were, in general, against abolishing tax reliefs. Their opinion was to some extent contradictory. They proposed both reducing tax rates and maintaining tax reliefs. However, this standpoint can be explained by tactical reasons. It would be uncomfortable for them to propose the abolishment of tax reliefs while some of their members benefit from them. In the opinion of our Institute, they preferred to have some room for negotiation with the government. It is important to underline that chambers presented a higher level of willingness to give up tax reliefs in exchange for reduced rates than did crafts organizations.

4. The Warsaw Chamber of Commerce proposed introduction of law imposing full bookkeeping for enterprises with sales over PLN 1.8 million, while the present regulations require this from a level of about PLN 1.6 million (ECU 400,000), so the difference is slight. This means that some business organizations are not well-familiarized with the present tax legislation.

5. The lobbying policies of different business organizations are not coordinated. This is why single organizations are relatively weak. They are easy for the government to handle with different proposals and as a result they do nothing.

The general conclusion from the interviews with business organizations is the following: first, business organizations propose similar solutions to entrepreneurs, but in some cases they are quite different. The differences between organizations and businessmen to some extent have a tactical character, and they are closely related to intra-organizational relations. Business organizations must take into consideration the opinions of their members. To some extent the interests of business organization members and the rest of entrepreneurs differ. Something striking in the interviews is the fact that crafts organizations are for introduction of social elements into the tax system. However, if we take into consideration that the 1990s were difficult for craftsmen this defensive approach is more comprehensible. The final conclusion is that business organizations should now better recognize entrepreneurs' needs and preferences.

### *3.3.7. Simulation of the Effects of Deregulation on Enterprises*

Entrepreneurs are a group of people who have good skills in evaluating the efficiency of economic policy instruments. This is obvious, because leading a private firm requires the ability to make different decisions and choices concerning such issues as employment, taxes, sales and many others. The ability to predict future results of today's actions is characteristic for private entrepreneurs. Therefore, the entrepreneurs surveyed were presented with the following deregulation hypothesis:

*Please imagine that the government has introduced a Program of Tax Deregulation Reforms. As a consequence the maximum rate of PIT was reduced to 30%, and CIT was lowered to the same rate. VAT was set up at level of 14%. Every possibility for tax reliefs and exemptions was eliminated. The tax system*

*has been simplified to the maximum extent possible, as well as tax accounting and reporting duties.*

After this presentation the entrepreneurs were asked what results such deregulation of the tax system would cause for their firms. On the basis of 102 answers the following research output was received.

**Table 77**

**Effect on Enterprises of Deregulation of the Tax System (after 2 years) - Opinion of Entrepreneurs**

Possible Effect	YES	NO	If YES please indicate what (average result) by %	Average result (no answer also taken into consideration)
Increased investment	78%	22%	15.5%	12.1%
Increased sales	67%	33%	16.2%	10.9%
Increased employment	48%	52%	9.9%	4.8%
Increased consumption by business owners	43%	57%	11.1%	4.8%
Reduction of administrative costs	55%	45%	10.9%	6.0%
Increased capital assets	78%	22%	14.7%	11.5%
Reduction of time consumption for accountancy	89%	11%	14.7%	13.1%
Increased profitability	79%	21%	11.4%	9.0%
Improved financial liquidity	69%	31%	11.2%	7.7%
Concentration on business instead on bureaucracy (time)	81%	19%	16.6%	13.3%

**Source: Survey**

The results show that a majority of the entrepreneurs surveyed think that such deregulation would lead to positive results for their enterprises. It is very interesting that apart from a reduction in time consumption for work on tax issues, the greatest expected effect is on companies' capital assets and investment. Deregulation and limiting the nominal tax burden can create incentive for entrepreneurship, building wealth and active investment. It could lead to positive effects for the whole national economy.

*3.3.8. Simulation of the Effects of Deregulation on the National Economy*

The influence of deregulation on the national economy is also an important issue. This is why the Institute decided to ask the entrepreneurs what they imagined the results of deregulation would be for the national economy. The researchers' intention was to translate a microeconomic approach into a macroeconomic simulation. The results of the survey are presented in the table below.

**Table 78**

**Effects on the National Economy of Tax System Deregulation (after 2 years) - Opinion of Entrepreneurs**

Expected Effect	YES	NO	If YES please indicate what (average result) by %	Average result (no answer also included)
Increased production	85%	15%	17.5%	14%
Increased investment	85%	15%	12.1%	10.3%
Increased employment	69%	18%	19.2%	8.4%
Increased profitability of enterprises	67%	33%	14.9%	9.9%
Reduction in shadow economy	74%	26%	9.2%	6.8%
Decreased production costs	74%	26%	9.2%	6.8%
Increased consumption	80%	20%	9.9%	7.9%
Increased preference for saving	73%	27%	9.2%	6.7%
Increased accumulation of capital	70%	30%	8.9%	6.2%
Decreased employment in fiscal service	80%	20%	12.7%	10.2%

**Source: Survey**

The results presented in the table above are impressive. Entrepreneurs consider that the impact of tax system deregulation on the national economy would be even stronger than on their own enterprises. This is shocking. Usually entrepreneurs think in a way such as: “what is good for me is not good for the state,” and “what is good for the government is not good for me.” This research shows that the natural conflict between private and public purposes can be eliminated. According to the opinion of the entrepreneurs it is possible to admit that deregulation could unify public and private purposes and all could benefit.

## **4. Lessons From Tax Reforms In Developed Countries**

### **4.1. Introduction**

One of the prerequisites for successful completion of the transition in Central and Eastern Europe is the ability to learn from both the achievements and failures of previous efforts to reform the tax systems of the most developed countries.

The selected six countries represent a variety of alternative approaches to tax systems: the United States and Great Britain are traditionally countries with relatively lower tax and social contribution burdens, compared to continental European countries such as Germany, Italy and (most of all) Sweden, with their heavy redistribution processes. In this context Switzerland is an exception, and almost a textbook example of fiscal decentralization and successfully-introduced competition.

Regardless of these differences, all major industrial nations suffer from the expansion of tax-financed social programs, higher public spending and redistribution. High tax and contribution burdens and complicated tax systems do not contribute to new job creation, new investments or economic growth. The tax reforms of 1980s and 1990s represent efforts to increase efficiency and productivity and to regain international competitiveness.

However, the reform efforts face important economic and political barriers. As a consequence of this, the results of tax reform have been rather disappointing in some cases (e.g., tax reform is stalled in Germany). Despite this, generally positive trends continue: striving for tax neutrality by lowering tax rates and broadening the tax base, simplification of tax systems by removing some of the numerous preferential treatments, etc.; these are objectives all countries trying to reform their tax systems have in common.

The transition countries of Central and Eastern Europe need to follow these processes very closely. New reform strategies can be developed based on knowledge derived from the reform efforts in the developed countries — by learning from their success and avoiding their mistakes.

#### **4.2. The United States of America**

U.S. public finance is not what it used to be. On February 2, 1998, President Clinton unveiled the first balanced budget proposal in many years. The last several decades have seen record-high budget deficits as high as 5.4 % of GDP, as late as 1985. Persistent budget deficits have produced a national debt of about \$5 trillion — a numbing figure, even for a \$7 trillion economy.

Recently things have changed, as the table below illustrates:

<b>Year</b>	<b>Tax receipts (% of GDP)</b>	<b>Spending (% of GDP)</b>
<b>1997</b>	<b>19.8</b>	<b>20.1</b>
<b>1999*</b>	<b>20.1</b>	<b>20.0</b>
<b>2003*</b>	<b>19.6</b>	<b>18.8</b>

\* = projections

Forecasts of the cumulative budget surplus over the next decade lie between \$600 billion and \$1.1 trillion.

The balanced budget was born of a unique blend of three factors. First, there were tax increases under the Bush (1990) and Clinton (1993) administrations. Second, a booming economy has been generating record tax revenues. Third, there was a serendipitous and frustrating political dialogue, which involved a defeated balanced-budget constitutional amendment and a partial federal government shutdown in late 1995. It finally produced a bipartisan agreement to balance the budget and curtail spending.

However, the most recent fundamental piece of tax reform and deregulation remains Reagan's Tax Reform Act of 1986. Since then the U.S. tax system has been reverting to the pre-1986 status quo. The simplicity gained by the 1986 reform has been sacrificed for more (and higher) marginal tax rates and for more (and more cumbersome) bureaucratic complications. The greater neutrality produced by the 1986 reform has been sacrificed for ever more preferential treatment.

Here we explore issues of reform and deregulation in three major areas: personal income tax, corporation tax, and taxes on consumption and wealth. In all three areas there will be ample illustrations of the breadth and scope of the 1986 reform, and the subsequent partial reversal of it, or attempts at its reversal. These remarks will include discussion of failed ideas for reform and deregulation, and will conclude with speculation as to why tax reform is so difficult to implement.

## *Personal Income Tax (PIT)*

In 1993, 110 million tax returns were filed. They generated a total revenue of \$510 billion, which equaled 44 % of total federal tax receipts.

When personal income tax was introduced in 1913 by means of a constitutional amendment, tax rates ranged from 1% to 7% of taxable income. In 1939, most taxpayers still faced marginal tax rates below 4%. PIT marginal rates dramatically increased during World War II, and in 1945 they ranged between 23% and 94%. PIT rates fell after the war, but in the mid-1980s there were a total of 14 tax brackets, with rates ranging between 11% and 50%. The Tax Reform Act of 1986 reduced the number of marginal tax rates to two (15% and 28%). The Bush administration added a 31% bracket and the Clinton administration added two additional ones, of 36% and 39.6%. Obviously, there has been movement backward, in the direction of the pre-1986 multiplicity of marginal tax rates.

Progressive as it undoubtedly is, the U.S. personal income tax system has been further expanded in order to shift the tax burden from the poorest to the richest social strata.

The **Earned Income Tax Credit** (EITC) is in effect a subsidy for low-income families, and since its expansion in 1993 it has become the single largest federal program of cash transfers to the poor. In 1996, for example, a family with two or more children was entitled to a tax credit equal to 40 % of all wage and salary income, up to \$9,740. If the credit exceeded the family's tax liability, the difference was refunded. The EITC was devised as a way to provide low-income individuals with an incentive to work by relieving their tax burden. However, several studies argue that its effect has been often the opposite; by increasing the disposable income of low-income households it has created a disincentive to work.

The **Alternative Minimum Tax** (AMT) is an ad hoc method for increasing the tax burden on upper-income individuals. Its rationale is rooted in the fact that certain types of income, such as local and state bonds, are not considered taxable income. Thus, it is possible for some households to have high income yet pay little or no income tax. The AMT is designed to make sure such households do in fact pay some amount of tax on their income. The need for an AMT proves the general lack of consistency in the U.S. personal income tax system.

A basic target for reform has been the so-called **marriage tax**. In 1969, Congress created a new tax schedule for unmarried people. Its purpose was to decrease the relative tax burden on singles, who until that time paid higher taxes than married couples. The policy was ill-calibrated, and produced an overkill effect: it became quite possible for a person's tax liabilities to increase when he or she married. This is known as the "marriage tax." A substantial penalty for married people still exists, despite several attempts to remedy this distortion and create a more "marriage-neutral" PIT system. Abolishing the "marriage tax" is among the most popular ideas for tax reform.

A basis for understanding how the U.S. personal tax system works is the famous Haig-Simons definition of income as: "the money value of a net increase to an individual's power to consume during a period." Interestingly, the U.S. tax code even includes proceeds from embezzlement in its definition of income, in addition to more conventional items such as wages, dividends, rents, royalties and prizes.

Certain important exceptions are made from the Haig-Simons definition.

First, interest earned on state and local bonds is not subject to federal tax. Initially, the rationale for this exception was found in the federalist constitutional principle that one level of government should not tax another's securities. Now, this important exception is more often viewed as a subsidy for local and state governments, and as a missed tax revenue by the federal government. Obviously, the subsidy helps local and state governments raise revenue more easily by allowing them to borrow funds at rates lower than the market ones. This measure has obvious distortionary effects on capital markets and leads to misallocation of capital.

Capital gains are also subject to preferential treatment. Assets are not taxed continuously as they appreciate in value, but only upon the sale of the asset when the capital gain is realized.

Thus, in effect asset holders get an interest-free loan on their capital gains taxes due. This is an illustration of the popular principle that "taxes postponed are taxes saved." The preferential treatment of capital gains results in what is known as the lock-in effect. Asset holders generally refrain from selling their assets and from restructuring their asset portfolios, since that would generate immediate tax liabilities. Again, that obviously has distortionary effects on capital markets.

Finally, unsold assets are not taxed at death, but only when the heir decides to sell the inherited asset. Even then, only the increase in value of the asset since it was inherited is subject to tax. Any previous appreciation is never taxed.

The preferential treatment of capital gains is motivated by the need to encourage saving and investment, which are thought to be vital for economic growth.

Employers' contributions to retirement plans are not taxed until they are paid out to the retired employee. When the Clinton administration considered taxing them in 1993, the idea met such public outcry that it was immediately abandoned.

Employee savings for retirement (the so-called IRA, 401(k), and Keogh plans) is also subject to preferential tax treatment.

Taxpayers can further subtract exemptions and deductions from their income before it is subject to tax.

Taxpayers are allowed to choose between a standard deduction and certain itemized deductions. Unreimbursed medical expenses that exceed 7.5 % of adjusted gross income are an important tax-deductible item. The same applies to state and local income and property taxes. Finally, some interest payments are deductible, a most important example being home mortgage interest payments.

The total adjusted income (the tax base) in 1992 was \$3.25 trillion. After making all deductions from the tax, taxable income was only \$2.1 trillion, a reduction of 35 %. Obviously, deductions and exemptions are quite large relative to the size of the tax base. Thus, the tax expenditure (the revenue lost from the exclusion of income from the tax base) is also very substantial.

### *Corporate Tax*

Corporate tax provided 27.9 % of total tax receipts in the federal budget in 1950. In 1993 it provided only 10.3 % of federal tax receipts. Obviously, its share in the revenue structure of the federal budget has been declining steadily. Before the Tax Reform Act of 1986, most corporate taxable income was taxed at a rate of 46%. The 1986 act reduced the rate to 35%. There is a lower rate of 15%, but it applies only to corporate income below \$10 million. For all practical purposes, the 35% rate is the universal one. Corporations are allowed to deduct wages, interest, and depreciation expenses from their incomes.

Dividends are subject to special treatment. They are not deductible, and are thus subject to double taxation, both as corporate income and as personal income to the shareholders to whom they are paid out. One would expect that such a severe disincentive would force corporations to virtually refrain from paying out dividends. However, according to statistical evidence, a whopping 60 % of corporate after-tax profits are paid out in the form of dividends to shareholders. The only way to explain this paradox is by the special role dividends play in the American economy, as a signal to capital markets of the vitality and strength of the particular corporation. It is still argued that the double taxation of dividends causes misallocation of resources and excessive retained earnings, as well as a bias toward debt finance over equity finance, which increases the risk of bankruptcy.

Two possible remedies have been suggested. One is the dividend relief approach, which would allow for dividends to be deducted from corporate income. Another more radical approach is the so-called partnership/integration method, which would in essence treat the corporation as a partnership and attribute all of its earnings (whether paid out as dividends or not) to its shareholders, and tax them accordingly. The investment tax credit was eliminated by the Tax Reform Act of 1986.

### ***Taxes on Consumption and Wealth***

Consumption is taxed primarily at the state level. Most states impose a sales tax on consumption, which varies from 3% to 8%. Half of the states exempt food from sales tax, and virtually all exempt prescription drugs. This can be viewed as an example of how social policy is run via the tax code. Furthermore, there exist both federal and state excise taxes on certain commodities: luxuries, tobacco, alcohol and gasoline. Taxing those items is often rationalized by the need to internalize externalities (tobacco smoke) or to impose user fees for public goods (consumption of gasoline is clearly correlated with the consumption of roads). Sometimes some of these are viewed simply as taxes on "sin."

Sales taxes have been defended as easier to implement than income taxes, because income taxes require good record-keeping on the part of taxpayers and efficient administration on the part of tax authorities.

There have been ideas to replace sales taxes with a European-style value-added tax, or with a personal consumption tax. Currently, neither seems to be high on tax reformers' agenda, as both seem to imply daunting administrative and transitional problems.

Wealth is defined as accumulated savings — as the cumulative difference between potential and actual consumption. Taxes on wealth are primarily motivated by concerns about the excessive concentration of wealth. According to a 1989 study, the richest 1% of Americans holds 37 % of total wealth.

### ***Further Ideas for Tax Reform***

Ideas for tax reform of varying degrees of controversy and common sense have been at the center of political debates and election campaigns. Republicans seem focused on abolishing the Internal Revenue Service and on repealing the Internal Revenue Code entirely. Some have argued that tax collection should be privatized (using private tax collectors under the oversight of a federal agency). Tax reform radicals have been speaking of abolishing income taxes altogether and replacing them with a 15% federal sales tax. An alternative and less radical proposition is to replace the current complicated progressive rate schedule with a flat 17% PIT rate. A simple relatively low rate would, it is argued, decrease the excess burden of taxation (the welfare lost in excess of and beyond the revenue collected) and reduce tax evasion.

There are two major forces in the United States pressing for radical tax reform and deregulation. One is the "graying" of the so-called Baby Boom Generation. As more and more of the baby-boomers start to retire in the coming decade, their entitlement claims will strain the Social Security system and Medicare (the federal health insurance program for the elderly) to the limit. When the Social Security system was established half a century ago, 16 workers supported one retiree. Now the ratio is 2 to 1, and expected to worsen. By most accounts, both programs will go bankrupt by 2010 if no major reforms are implemented.

The second force pushing for tax reform and deregulation is the ascent of the information age and the Internet. Many surmise that it will lead to the fall of the corporate Leviathans of American business and to the rise of small firms and entrepreneurs. What is still primarily an economy of workers will be transformed by the Internet into an economy of entrepreneurs, who will undoubtedly demand lower and simpler taxes.

### ***The Issue of Simplicity***

The U.S. tax system is not exemplary in terms of simplicity and neutrality. The current U.S. Internal Revenue Code contains over seven million words and continues to expand every year. Back in 1942, President Franklin Roosevelt did not even bother to read a major piece of his administration's tax legislation, the Revenue Act. He defended himself by observing that it "might as well have been written in a foreign language" (quoted in Rosen 379). The generic Form 1040 that has to be filed by everybody by April 15 each year contained 48 pages and 28 possible supplementary schedules to fill out before Reagan's Tax Reform Act of 1986. Things

have improved only marginally since then, as far as simplicity is concerned. For average Americans, filing their tax returns is still a major hassle and many hire qualified tax accountants to help them fill out their forms.

### *Why Is Reform So Hard?*

Tax reform has turned out to be so infeasible because it is a political process. Taxation is essentially a redistributive activity, and while tax reform ideas benefit some individuals and communities, they will inevitably hurt others, who will in turn lobby ferociously against any changes. In a political system which is by design extremely responsive to public, change has proved to be difficult.

As the Tax Reform Act of 1986 has illustrated, the one effective way to reform and deregulate the tax system is by broad measures rather than by narrow piecemeal steps. When everybody is affected in some way, it is less clear who the winners and losers are.

A further reason why tax reform is difficult to implement is that designing any tax system involves a fair number of arbitrary decisions. And while the arbitrary decisions already built into the current tax system are often legitimated by time and use, the arbitrary decisions contained in reform propositions often seem unacceptable and even ludicrous.

Tax reform is difficult to implement because people make their long-term commitments and decisions based on the existing tax system. These are generally hard to reverse. One example might be the mortgage interest deduction, which was introduced to encourage home ownership. Repealing it would substantially hurt people who have already bought housing for their families. That is why the mortgage interest deduction seems to be politically unassailable.

A final cynical view on the feasibility of tax reform and deregulation concludes pessimistically that "a simple, stable tax system is not in the self-interest of politicians. Granting and modifying tax breaks is a basic source of power" (quoted in Rosen 396).

But to conclude on a more optimistic note, it is appropriate to quote Winston Churchill, perhaps the greatest cynic of all, who once said: "The American people always do the right thing — after exhausting all other possibilities."

### **4.3. Great Britain**

#### *UK Taxes*

The most important taxes in Great Britain are as follows:

- . *Personal income tax (with capital gains tax);*
- . *Company taxes;*
- . *Social Insurance contributions (SICs);*
- . *Taxes on expenditure (VAT and excise duties);*
- . *Taxes on capital;*
- . *Rates;*
- . *The community charge.*

Personal income tax is levied on all types of regular income – wages, dividends, interest, rent, self-employment profits – and on some forms of in-kind income, such as the use of a company car. Tax payable varies with income. Capital gains tax (SGT) is included in this category, although in the UK National Accounts it is listed under taxes on capital.



Company tax and petroleum revenue tax (PRT) represent the two categories of direct taxes paid by companies on their profits (companies also pay employers' SICs and business rates). Corporation tax is levied on taxable profits, which are revenues less costs. PRT is levied in addition to corporation tax, on profits earned from oil and gas extraction, because the profit potential of these activities is so large. The royalties and license fees paid by North Sea oil companies are not included here, because they are required payments for permission to exploit the North Sea. It is arguable, however, that they could be regarded as taxes.

National Insurance contributions, or SICs, are payable by employers, employees and the self-employed. They are administered not by the Inland Revenue Board, but by a "contributions agency" responsible to the Department of Social Security. They may be regarded as a second income tax. For a large number of taxpayers the marginal rate of tax is not the basic income tax rate (25%) but the income tax plus SICs at a rate of 9% — a total of 34%. Taxpayers with high incomes whose marginal rate of income tax is 40% do not face a marginal rate of 49%. This is because there is a ceiling to SICs, which is reached before the 40% income tax rate is reached. The Labour Party's proposed tax reforms include the abolition of this ceiling. SICs entitle contributors to claim various non-means-tested benefits (such as unemployment and sickness benefits and retirement pensions). However, although separately administered and going into the national insurance 'fund' from which National Insurance benefits are paid, SICs may be regarded in practice as another large contributor of tax revenue to the government.

Taxes on expenditure go under a variety of names: expenditure taxes, indirect taxes, sales taxes and consumption taxes. For the UK they consist of VAT, which is a general tax, and specific duties which are imposed on a limited number of goods and services.

VAT and excise duties are levied on sellers of output and are the most important indirect taxes. In working out their liability, sellers may deduct any VAT which has been charged on their inputs. The ultimate consumer faces a price, which is 17.5% (the VAT rate) higher than it would have been if the tax did not exist. Excise duties are payable on petrol, tobacco, alcohol and betting. They are levied mainly as a fixed amount per liter, packet, bottle or pint (a unit tax), though tobacco duty has a part which is proportional to price (an *ad valorem* tax). VAT is added to the post-duty price. As well as raising revenue, these duties are intended to discourage the consumption of some goods.

In the UK all suppliers with a turnover above £25,400 (1990-91 and £35,000 in 1991-92) must register and account for VAT. It is a general tax, in that it is imposed on all goods and services, though some are zero-rated, which frees them from tax, and some are exempt, which reduces the tax paid. In the UK about 40% of goods and services incur no VAT, so it is sometimes argued that the tax can hardly be regarded as general. It is an *ad valorem* tax in that the amount payable is calculated as a percentage of the price, not as a fixed sum per unit. It is multistage, because it is collected as a proportion of the value added at each stage of the production process. Some goods are zero-rated and no tax is paid on them. Zero-rating applies to food, fuel for heat and light, domestic water services, children's clothing, public transport, residential construction, books, newspapers and magazines, and prescription medicines. The consequence of zero-rating is that in the UK only about 60% of consumer spending incurs VAT. Other goods, or rather services, are exempt from VAT. Exempt traders do not have to charge VAT when they sell their services. Such exemption applies to financial services, insurance, betting, postal services, education and health services, funeral services, land and rent.

Tax on capital: inheritance tax and stamp duty are a category of tax which plays a very small part in the British system. Since the abolition of domestic rates, business rates represent the only recurrent tax on wealth or property. "Inheritance" tax and stamp duty do not have to be paid regularly, but only when capital is transferred. Inheritance tax is an estate duty: a tax on bequests, not on inheritances. In 1986 it replaced both estate (or death) duty and capital transfer tax (CTT). Like death duty, it is a voluntary tax paid only by "fools or patriots," because it can

be avoided by transferring capital before death. CTT was introduced in 1975 to close this loophole, then applying to death duty. Lifetime gifts became taxable, and a little more revenue was raised. The 1986 Budget, however, abolished tax on lifetime gifts, and CTT was replaced by the avoidable inheritance tax, which also absorbed death duty. Stamp duty, also a tax on the transfer of capital, is levied on new capital issued by companies and on the transfer of property, shares and other assets.

Rates: during the temporary operation of the community charge, the only recurrent tax on property in the UK is the uniform business rate (UBR), which firms will try to shift forward on to the price of their products, or which may be capitalized into the price of the property (high rates make the price of a property lower). Domestic rates, when they existed, were also a recurrent tax on property paid by householders. Until 1990 (1989 in Scotland) local government raised just over 40 % of its revenue from domestic and business rates. They were a tax on dwelling or business property. The amount payable depended on the ratable value of the property, equal to its estimated annual rental value in the year of valuation, and on the rate poundage, pence in the pound. The rates bill was the ratable value multiplied by the rate poundage. With the reform of local government taxation, domestic rates were abolished and replaced by the community charge, soon itself to be replaced. The collection of business rates was taken over by central government and set at a uniform national rate.

The community charge (poll tax) is a per capita tax levied on every person. Such a tax is also called a head (or poll) tax; hence its alternative name. The same amount is levied on everyone in a local authority area, apart from those on income support and students, who pay 20 % of the tax. People with very low incomes may receive a community charge benefit. The sum shown in Table 1 represents revenue collected in Scotland, where the tax was introduced in April 1989.

The table below shows the principal UK taxes, their contribution to total revenue and the amount of GDP they absorbed in 1989.

Table 1  
UK Tax Receipts, 1989

<b>Taxes</b>	<b>% of Revenue</b>	<b>% GDP at factor costs</b>
<b>Personal income, etc., tax</b>	<b>26.7</b>	<b>11.4</b>
<b>Company taxes, including North Sea oil</b>	<b>12.0</b>	<b>5.1</b>
<b>SICs:</b>		
<b>employers</b>	<b>9.5</b>	4.1
<b>employees, etc.</b>	<b>8.0</b>	3.4
<b>total</b>	<b>17.5</b>	7.5
<b>VAT</b>	<b>17.0</b>	<b>7.3</b>
<b>Excise duties, etc.</b>	<b>14.1</b>	<b>6.1</b>

<b>Taxes on capital</b>	<b>1.8</b>	<b>0.8</b>
<b>Rates</b>	<b>10.6</b>	<b>4.6</b>
<b>Community charge (Scotland)</b>	<b>0.3</b>	<b>0.1</b>
<b>Total tax revenue</b>	<b>100.0</b>	<b>42.9</b>

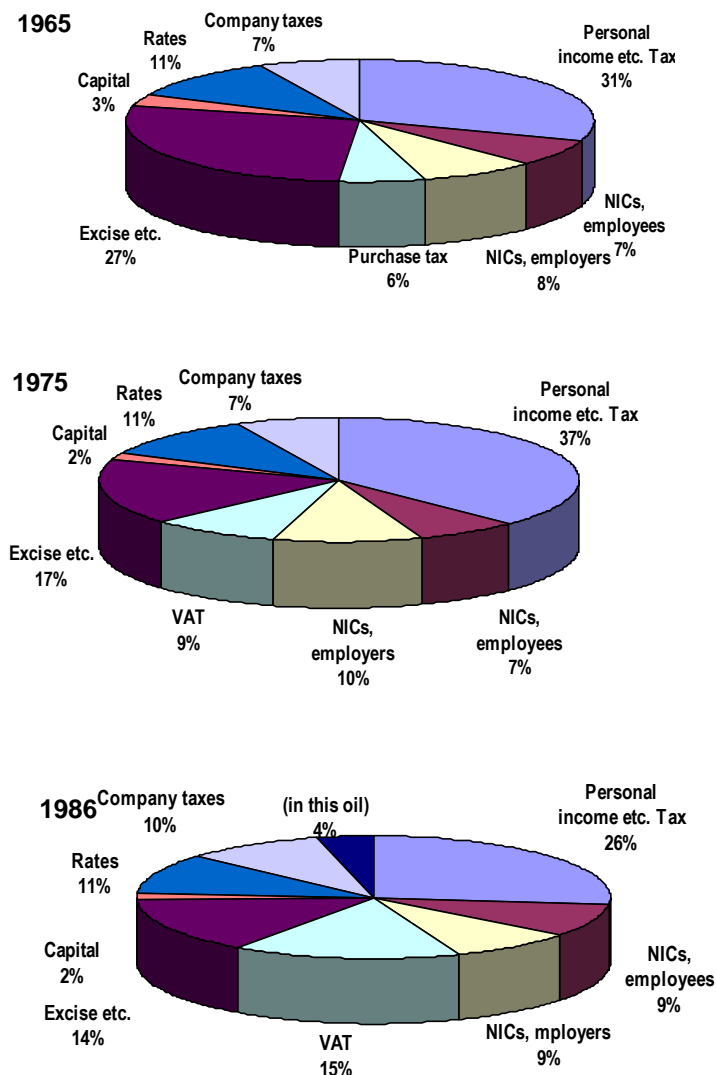
Note: total tax revenue = L188.124 billion. GDP at factor cost = L438.774 billion. GDP at market prices = L513.242 billion. Tax revenue is 42.9% of GDP at factor cost and 36.7% of GDP at market prices.

Source: UK National Accounts (1990) by M. Wilkinson, Taxation (1992).

The following three graphs show the pattern of British taxes in the middle 1960s, 1970s and 1980s.

Graph 1

Principal Tax Revenues as proportions of Total Tax Revenue, UK, 1965, 1975, and 1986



Note: SICs, employees and employers are social security contributions; in 1965 it was 15%, 17% in 1975 and 18% in 1986.

Source: Calculated from OECD (1988), Table 59 by M. Wilkinson, Taxation (1992).

One can see that personal income taxes represent the largest source of revenue in each of the years shown, at their highest, proportionately, in 1975. By 1986, following the Conservative policy switch from direct to indirect taxes — in particular to VAT — they had fallen considerably as a proportion of the total, and this was even before the 1988 budget, which cut the top rate of tax from 60% to 40%. Employees' social security contributions (SICs) are placed next to personal income tax in the pie charts so that the proportion of total taxes paid directly by individuals may be seen. Employees' and employers' (together) SICs as a proportion of total revenue grew, very slowly, over the twenty years shown.

VAT did not exist in 1965. Purchase tax, VAT's predecessor, raised 6% of total revenue. In 1975, when the VAT was 8%, with a "luxury" rate of 25% introduced in that year and soon abolished, VAT raised 9% of total revenue. In 1986, when the rate was 15%, 16% of total revenue was from VAT. Revenues from the other main tax on goods and services, excise duty — principally on tobacco, alcohol and petrol — shrank in proportionate terms over the twenty years.

Company taxes vary with company profits, and show some variability over the trade cycle. They were swollen in 1986 by oil revenues. Capital taxes, excluding rates, were very small and shrinking. Finally, the most constant source of revenue over the twenty years was from business and (now abolished) domestic rates, which provided a constant 11% of total revenue in each of the years shown.

### ***Tax Reform***

Tax reform may be characterized as "set the lowest possible rate with the fewest possible reliefs;" that is, for efficiency governments should aim at a low tax rate on a wide tax base. If exemptions are ended, this removes the distortions which happen when people and companies attempt to make the sources and uses of their income fit into the exempt categories. Moreover, if the tax rate or rates are low, then people have less incentive to change their behavior in order to avoid tax.

In Britain, as in other countries, in the 1980s this kind of tax reform took place. The personal income tax base was widened by the withdrawal of relief for life insurance premiums in 1984, by the maintenance of the £30,000 ceiling for mortgages qualifying for relief on interest payments, and by mortgage relief being confined to the basic rate of tax (1991). These are welcome inroads on fiscal privilege, which increase the efficiency of the system. However, most reliefs remain in place and some new ones have been added. The 1984 reform of company taxation reduced investment allowances and so made company taxation less distortionary. Some of the disincentives caused by jumps in the SIC schedule have been ironed out, and there has been a very slight widening of the VAT tax base — for example, by the inclusion of confectionery and take-away foods — but most zero-rated items remain zero-rated.

What most people regard as the principal reform of the 1980s, however, was the reduction in the rates of personal income tax. The top rate of tax on earned income, 83% in 1979, was down to 40% by 1988. The basic rate was reduced over the same period from 33% to 25%. Lower rates may be regarded as reform because they make the system more neutral: they minimize the incentive to reduce the tax bill by working less. However, there is a cost: personal income tax is more progressive than the other taxes (VAT, SICs) from which revenue lost from income tax has been recouped, so that judged by the ability to pay the system has become less fair. True reform would have meant paying for lower tax rates by eliminating (gradually) tax reliefs and exemptions, which also distort people's decisions.

### ***Personal Income Tax***

The 1978-79 was the last year of the 1974-79 Labour government, when very high top rates of income tax existed. A deregulation was included in the changes in the Conservatives' first budget in June 1979, when the basic rate was reduced from 33% to 30% and the top rate on earned income from 83% to 60%. VAT was raised from 8% to 15% to pay for the changes. In 1978-79 there were ten different rates at which earned income could be taxed, with the highest rate at 83%. In 1990-91 there were only two, and the top rate had been reduced to 40%. In 1978-79 there was an additional 15% tax on high unearned incomes (not shown in the figures and mostly avoided), but it was abolished in 1984. In 1978-79 women and single men started paying income tax when their incomes were 23 % of male average earnings; in 1990-91 they started paying tax when their incomes were 24 % of the male average.

With the reduction in average and marginal rates of tax, the British income tax system has become much less progressive. For example, people earning five times the average income in 1978 faced a 75% marginal rate of tax and paid nearly 40% of their earnings in tax. In 1990 they faced a marginal rate of 40% and one-third of their earnings went to the Inland Revenue. For people with eight times the average income the marginal rate fell from 83% to 40% and the average rate from 55% to below 36%.

Until April 1990, the British tax system discriminated between taxpayers on the basis of sex and marital status. Married men were treated more favorably than all other taxpayers, married women worse than all others, and single people occupied a middle position. This happened because of the aggregation of the incomes of husbands and wives, and because husbands had larger personal allowances than all other taxpayers. The tax treatment of married couples was therefore at the forefront of debate in the UK throughout the 1980s. This culminated in partial reform in April 1990. It abolished aggregation, so that husbands and wives are taxed separately on both earned and investment income. Wives can have complete privacy in their tax affairs, but the system still discriminates because the married man's allowance remains. It is now called a "married couple's allowance" and may be applied to the husband's or to the wife's income. However, it normally goes to the husband, and there has been no real change in this aspect of the old system. Married men still have higher allowances than all others, to support supposedly dependent wives. The existence of marriage allowances means that a married man receives help to support his wife whether or not she has children to look after. If he is taxed at the basic rate he pays £8.30 per week (1990-91) less tax than everyone else does. The 1990 reform applied separate taxation to unearned as well as to earned income. This increases the regressive nature of the system. If a wife has no earnings, then the transfer to her of assets providing investment income of £3,005 (equal to the untaxed personal allowance) means that tax (at 25% or 40%) no longer has to be paid on that income. The table below shows the tax rates in 1994-1995.

Table 2

UK Income Tax in 1994-1995

<b>Income in GBP</b>	<b>Tax rate in %</b>
<b>Up to 3,000</b>	<b>2</b>
<b>3,000 – 23,700</b>	<b>25</b>
<b>Over 23,700</b>	<b>40</b>

Source: A. Komar, Systemy podatkowe krajow Unii Europejskiej (The Tax Systems of EU Countries),PWE, Warszawa 1996.

Capital gains happen when the value of an asset increases. The asset may be real (perhaps an antique), or financial (for example, shares in a company). Gains can be nominal (in money terms) or real. Capital gains are taxed, however, not as they accrue but when they are realized. A gain is realized when an asset is disposed of (either sold or given away). Since 1982 only real gains have been taxable, and the first £5,000 (£5,500 from 1991) of real gains are tax free. The tax rate payable is 25% or 40%, depending on the taxpayer's other income, which determines the marginal rate. Capital losses can be used to offset capital gains. Capital gains on some assets are tax free, principally those which arise from a person's home (or main home), from most personal belongings and from national savings. If assets are given to charities, art galleries, the National Trust and so on, then they are exempt from CGT.

### *Business taxes*

Taxes on business are taxes on companies' profits, and their impact is on shareholders. In the 1980s, a reform of company taxes led to a lower tax rate on a wider base: investment allowances and relief were reduced. The debate about the right balance between neutrality and the encouragement of investment goes on.

A business can be incorporated or unincorporated. Incorporation bestows the benefits of limited liability on its owners (its shareholders), but the profits of corporations are liable to corporation tax. The owners of small unincorporated business pay personal income tax on the incomes they earn from their companies.

In the early 1980s the rate of corporation tax was 52%, and reliefs were large and generous. There was a high tax rate on a reduced tax base. Investment in plants and equipment received 100% allowances in the first year. If £1 million was spent, then £1 million of net profits was immediately exempt from tax. Capital allowances represent tax expenditures within the corporation tax system. Buildings were treated differently from industrial plants and machinery. Industrial buildings were entitled to a first-year allowance of 75% of their value, then 4% of the full value was allowed per year, until the remaining 25% had been depreciated. Commercial buildings (apart from hotels, which received a 20% initial allowance) were thought not to lose value over the years, and so no depreciation allowance was permitted for them. Thus there were biases in the treatment of different types of investment.

There was also stock relief, which was the tax relief on investment in stock, inventories of raw materials, intermediate and finished goods that was introduced in the 1974 emergency, when companies faced a liquidity crisis following the inflation and recession which resulted from the first oil price increase. Relief was permitted whether the increased value of stock arose from a volume increase or from inflation.

In 1984 widening the base and cutting the rate reformed company taxation. The tax base was widened by the reduction of allowances and reliefs. The 100% first-year allowances were abolished and replaced by more gradual depreciation allowances. After a phasing-in period, 25% of the outstanding balance of the initial cost of plants and equipment was to be set off annually against taxable profits. For industrial buildings 4% was to be written off annually. In addition, stock relief was abolished. These allowance reductions financed a staged cut in the corporation tax rate, from 52% to 35%. The first £300,000 are taxed at 25%, the next £1.5 million is taxed at 35%, and profit above £1.8 million is taxed at 33%. In 1997 corporation tax rates were: 23% for the first £300,000, 35.5% for the next £1.2 million, and 33% for surplus above £1.5 million. Company tax rates are set up annually by budget.

Corporation tax is not the only tax corporations pay. Like many other businesses and institutions, they pay employers' SICs and business rates. Corporations engaged in North Sea oil and gas extraction pay PRT in addition to corporation tax. They also pay royalties on the value of their oil and gas production.

### *Indirect taxes*

VAT was introduced in the UK in April 1973 as a part of the harmonization process on entry to the EEC. The standard VAT rate was 10%. It was reduced in 1974 to 8%, and increased in 1979 to 15% because of the personal income tax rate decrease. It remained at that rate until 1991, when it was raised to 17.5% to pay for a reduction in poll tax bills. VAT replaced the single-stage purchase tax, which was not a bad tax. It did not apply to services, but selective employment tax (SET) had been introduced to tax them. Purchase tax was not as broadly-based as VAT, and it was imposed at different rates on different groups of products, which was not good for neutrality, but it was cheap to collect, and as it was levied at the wholesaler level it imposed no compliance cost on small traders.

### *Conclusions*

Compared to the nineteenth century, Britain today bears a heavy tax burden. Compared with the United States and Japan British citizens appear heavily taxed. However, in comparison with its EC partners and European neighbors, to whom the UK is closer in social philosophy, the British burden is only moderate. In the opinion of the British public, their tax system is complex, inefficient and unfair, and a variety of reforms are recommended. Change should be made acceptable to taxpayers. This probably means that reform should be incremental or phased in. Sudden disruption of taxpayers' finances and expectations leads to resistance. To attain the goal of better taxes, plans have to be made about how to undertake reform, as well as what reforms to implement.

#### **4.4. Germany**

**Compared to other EU countries, Germany has a very complicated tax system. German taxpayers have to pay 35 different taxes, and it would be difficult to present all of them in a brief form. Therefore we will focus on those taxes which are crucial for conducting economic activity in Germany.**

#### *Corporate Tax*

**Corporate tax is imposed on the basis of the Corporation Tax Law of 1991 and the Corporation Tax Implementing Ordinance of 1984. Corporation tax directives have also been issued in the form of general administrative regulations to clarify uncertainties and points calling for interpretation. This applies in particular to incorporated businesses, such as AG and GmbH.**

**Corporate tax in Germany can be applied at different rates. The basic rate is 45% of taxable income. Corporations, associations of persons and holdings of property that are not covered by the imputation system pay a reduced rate of 42%. The computation system was designed to prevent double taxation of profit, first through the corporation tax payable by the distributing corporation, and second, through the income tax payable by shareholders. When a corporation distributes its profit, the standard corporation tax is adjusted by the imputation system:**

- On the level of the corporation, the standard tax (tax liability before the imputation) is first determined according to the Corporation Tax Law. When the corporation decides to distribute part of its profit, corporation tax is then adjusted to give a uniform rate of 30 percent of the profit before tax. If the*

*standard tax is less than 30%, the corporation tax is increased, and if it is more than 30%, the corporation tax is decreased. In order to provide the basis for the decrease or increase in standard tax, the corporation must maintain a current account, showing whether and if so to what extent its profits plus reserves available for distribution have borne corporation tax;*

- . On the level of the shareholders, tax paid by the corporation is compared with the tax due from the shareholder according to the Income Tax Law. Distributed profit is taxed only up to the amount of the shareholder's income tax liability. If it is nil, the shareholder may claim a refund of corporation tax.*

### *Income Tax*

**The basis for imposing income taxes in Germany is the Income Tax Law of 1990 and Income Tax Implementing Ordinance of 1992. Both regulations were amended in October 1995. According to the German system, income tax is collected from the profit obtained from the following sources:**

- . Agriculture and forestry;*
- . Trade or businesses;*
- . Personal services;*
- . Investment of capital;*
- . Rentals and royalties;*
- . Other income designated in the Income Tax Law (e.g., interest portion of a pension from statutory pension insurance, or speculative gains).*

**Profits are computed on the basis of the business receipts less business expenditures. Gross income is calculated by adding together the positive results from all sources and deducting the losses. Later tax relief and special expenses are deducted, and taxable income is determined. Tax is paid according to appropriate tax rate.**

- . A basic personal allowance of DM 12,365 for single persons and DM 24,731 for a married couple (in 1999 these amounts will be respectively DM 13,067 and 26,136) is granted on taxable income.*
- . In the first tax bracket, income in excess of the above-mentioned basic personal allowance rises from 29.5% up to 33.5% on taxable income up to DM 58,643 for singles and DM 117,284 for married couples (the amount is to be increased in 1999 to DM 66,365 and 132,731, respectively).*
- . In the second bracket tax is imposed at rates between 33.5% and 53% on taxable income of up to DM 120,041 for singles and DM 240,083 for married couples.*
- . Above DM 120,041 / 240,083, all income is taxed at the rate of 53%.*

### *Value Added Tax*

**Value added tax in Germany is paid on the basis of the Turnover Tax Law of 1993 and the Turnover Tax Implementing Ordinance of 1993. All entrepreneurs, who are defined as persons who independently carry out a business or professional activity, pay it.**

**Germany has two rates of VAT tax:**

- . General rate of 15%;*



*Reduced rate of 7%.*

Most goods and services are taxed at the general rate. The reduced rate applies in particular to the supply, non-business use and importation of almost all foods, with the exception of beverages and catering supplies. It also applies to local transport, the supply of books, newspapers and certain art objects.

German regulations include two categories of goods and services which are exempt from VAT taxation. The first category covers supplies for which input tax remains deductible (so-called zero rate) This rate is applied to export and intra-EU supplies. The second category covers supplies with respect to which no input tax may be deducted. These include the provision of credit, the renting of real estate, medical services provided by doctors, and the services of social insurance funds, private schools, theaters and museums.

Entrepreneurs fill out VAT reports and advance payment is made every quarter. Large-scale entrepreneurs are obliged to make the reports and payment every month. At the end of each calendar year entrepreneurs must file a tax return in which they again compute the VAT payable.

Entrepreneurs whose turnover did not exceed DM 32,500 in the previous calendar year and is not expected to exceed DM 100,000 in the current calendar year do not have to pay turnover tax. However, if this arrangement is unfavorable for them they may opt either for a special arrangement or for taxation in accordance with the general provision.

In agriculture and forestry the law allows for a blanket rate of input tax. It was estimated that keeping the necessary accounts would place too heavy a burden on the majority of farms and forestry establishments. The law provides that the tax rates applied to agriculture and forestry are fixed, so as to correspond to the average input tax borne by such organizations. In most cases the tax due and the input tax cancel each other out.

However, owners of the aforementioned establishments may opt to pay the taxes according to the general regulations.

### *Trade Tax*

The basis for this tax is the Trade Tax Act, published in 1991. It is paid by all business enterprises. Activities of forestry and agricultural establishments or provision of independent personal services are not subject to trade tax. The Trade Tax is a communal tax, and for local authorities it is the most important direct source of funds. Part of this tax (ca. 15%) is also transferred to the federal budget.

Trade tax is levied on business profits and business capital (except the capital of businesses in "new lands" in former East Germany). Profits are determined the same way as for income taxes. Taxable business capital is the assessed value of the business under the rules of the Valuation Law.

The computation of trade tax on business profits proceeds from the basic tax, obtained by multiplying the amount of business profit by a fixed percentage, usually 5%. Individuals and partnerships qualify for an allowance of DM 48,000. Reduced basic rates apply to business profits up to DM 144,000.

The computation of the trade tax on business capital is done by multiplying the amount of business capital by a fixed percentage, usually 0.2%.

### *Solidarity surcharge*

**A general surcharge on wages, income and corporation tax has been levied to finance the costs of German unification. The surcharge applies to the same extent to all income, without exceptions, and is imposed uniformly on all taxpayers. Presently the surcharge is 5.5%, scaled down from 7.5% in 1997.**

### *Tax Reform in Germany*

**In the middle of 1990s Germany realized that high taxation and a complicated tax system are a significant hindrance to competitiveness and economic development. The German government returned to the idea of low taxation in 1982-1990, when over three million new jobs were created. The existing system hampers the creation of the new jobs.**

**Chances for scaling down unemployment without scaling down the tax burden are very low. High taxation is a serious barrier to new investment and the creation of new jobs. As a result the cost of social benefits remain at a high level.**

The lower competitiveness of the German economy forced policy makers to propose the reform of the German tax system. The outline of the reform was based on the idea of the first minister of finance after the Second World War, Fritz Schaeffer. According to him the tax system should be changed keeping in mind two ideas:

- . *The taxation level for all income groups should be lowered; and*
- . *Tax incentives should be abolished.*

Over 40 years after the reform proposed by Fritz Schaeffer, German experts and politicians prepared a new scheme for the tax system. The reform was focused mostly on income taxes. During the discussion, four main models of income taxes were proposed:

- . *Model of Uldall, with three taxation levels: 8%, 18% and 28%. The top rate would be introduced for persons with the relatively low income of DM 30,000 for unmarried taxpayers. Such a significant reduction in taxes would have high impact on the income of the state budget. The budget revenue would be scaled down by DM 115 billion. Therefore most the existing tax incentives should be canceled.*
- . *Model Solms'a, with three taxation levels: 15%, 25% and 35%. The top level would start from income over DM 60,000. Due to the introduction of this model, state revenues would be reduced by DM 75 billion. The model would require a reduction in tax incentives and an increase in VAT.*
- . *Model CDA (Association of German Administration) is very similar to the Uldall model. It would only introduce an additional, fourth tax level of 35% for incomes over DM 120,000. This model proposed to abolish all tax incentives.*
- . *Model of the German taxpayers Association proposed a first tax level of 15% for income exceeding DM 12,000. The top rate would be 35% for income over DM 100,000. It is expected that this model would reduce state revenues by DM 100 billion. It would require a significant reduction of tax incentives.*

Based upon the described models, the final proposal for the reform was elaborated. The new tax model also proposed three taxation levels:

- . *15% on income above DM 12,000 and below DM 18,000*
- . *18% on income above DM 18,000 and below DM 90,000*
- . *39% on income above DM 90,000*

People with income lower than DM 12,000 would not pay any income taxes. Married persons would have doubled taxation levels per couple. Together with the significant reduction in taxes, some of the tax incentives would be canceled. The amount of tax-free income for all employees would be lowered from DM 2,000 to DM 1,300 per year. Additional income for work performed on Sundays and other holidays would be taxed (presently it is not taxed). Also work during the nights would be taxed. A steep reduction in tax incentives related to mileage was proposed. The flat rate of DM 0.70 per kilometers for the use of a personal car would be scaled down to DM 0.40. The deduction of the cost of the car would be possible only in cases where the taxpayer would have to travel over 15 kilometers to his or her workplace.

Despite the reduction in tax incentives, the total amount of taxes would be reduced by DM 30 billion. It was expected that a reduction in taxes would create conditions for economic growth and the creation of new jobs. According to Minister Theo Waigel, such a reduced tax burden and deregulation of the income tax system would increase GDP growth by 0.5%.

The reform of the German tax system was expected to be the “work of the 20th century.” It included the main ideas of deregulation: scaling down both taxes and tax incentives. It would also reduce paperwork. It was planned that the new system would be introduced starting from 1999. Presently there is no chance that the German system will be changed before year 2001. The outline of the reform was rejected in the autumn of 1997, despite the fact that most of society would benefit from the reform. However, there were some groups which probably would be affected by the changes. The first of these were a large portion of pensioners.

In Germany there are 14 million retired persons. Presently only 2.5 million of them pay taxes. After the reform this number would increase to 3.5 million. It was obvious that the majority of pensioners would be not affected by the reform. It was planned that retirement allowances up to DM 31,511 for single persons and up to DM 62,594 for married couples would not be taxed. However, one million of the retired persons who presently do not pay taxes would be obliged to pay taxes after the reform.

In addition, persons with income between DM 90,000 and 120,000 would not profit from the reform, as the top taxation level would start from DM 90,000 and the majority of tax reliefs would be canceled. Also workers who work on Sundays and during the nights and employees who live far away from their workplaces were not interested in the reform. It was also expected that reform of the income tax system would also require an increase in the VAT tax. This would probably increase inflation.

The group who would be negatively affected by the reform created a lobby against the changes, but it did not decide the rejection of the reform. The main reason for the postponing of the reform was the political controversy concerning the cost of the reform to the state budget. Despite the decrease in tax incentives, the reform would cost over DM 30 billion. Also, the German government promised to scale down the “Solidarity tax” in 1998, from 7.5% to 5.5%. The opposition emphasizes that the proposed decrease in revenues would inflict a budget deficit. Besides, the Social Democrats were afraid of the decrease in social spending which also would be necessary. As a result the reform was postponed, and deregulation of the German tax system will probably not be discussed before the parliamentary elections in autumn 1998. The German project for the deregulation of the tax system shows the difficulties in obtaining consensus among politicians on the decrease of taxes. In practice, such a reform can only be successful if it is also supported by the opposition. Also, proper political arguments and consensus among different groups of the society are necessary.

#### **4.5. Italy**

The Italian fiscal system doesn't differ substantially compared with the fiscal systems of the rest of the industrialized countries. All these countries tax roughly the same things (incomes,

property, consumption). The difference exists rather in the functioning of the bureaucratic fiscal machinery.<sup>8</sup> This means that, given a relatively homogeneous fiscal pressure (see Table 1, which represents the rate domestic revenue/GNP), there is a non-negligible difference between the quality of the services which the state provides to taxpayers and the ease and simplicity of the application of taxes.

**Table 1**

**The tax burden as percentage of GDP**

	Taxes (tax pressure)	Social contribution (contribution pressure)	Total
Great Britain	27.6	6.0	33.6
France	24.3	19.6	43.9
Germany	23.9	15.1	39.0
Spain	21.7	13.4	35.1
Holland	29.7	18.3	48.0
Italy	28.8	13.5	42.3
USA	21.0	8.7	29.7
Japan	19.3	9.8	29.1
Belgium	29.4	16.3	45.7
Sweden	36.1	13.8	49.9
Canada	29.7	5.9	35.6
Switzerland	20.8	12.4	33.2

Source: OECD Report, 1995.

Table 2 provides the structure of domestic revenue in Italy. The taxes are divided into government and local ones. It can be noted that an imbalance between what comes from income taxes, from property taxes and from consumption taxes doesn't exist. Therefore, the problem isn't in the imbalance between abstract typologies of taxes, but in the opportunity to evade payment unpunished.

Income taxes are the greatest category, and this fact is due to the observance of the principle: "it is better to leave the capital intact, withdrawing a part of the return."

**Table 2**

**The domestic revenue in billions of ITL**

<sup>8</sup> To closely examine the problems of the Italian fiscal machinery, we suggest "Le Illusioni Fiscali" by Raffaello Lupi, copyright 1996 by Mulino, Bologna.

	State taxes	Local taxes
Taxation of incomes and taxation of capital		
Irpef (individual income tax)		153,000
Ilor (local individual income tax)		18,500
Irpeg (corporate income tax)		29,500
Capital gains tax		40,000
Net property tax on the firm		6,000
Ici (municipal house tax)		14,000
<del>Taxation of consumption of goods and services</del>		
VAT		88,000
Insurance tax		4,892
Entertainment duty		578
Processing tax on gas and other mineral oils		39,000
Other processing taxes (spirits, beer)		1,700
Energy (electricity and gas meter)	5,500	700
Tobacco monopoly		9,000
<del>Transfer and legal acts taxes</del>		
Stamp		8,500
Register/mortgage and cadaster		6,760
Administrative license	4,000	700
Inheritance and gift taxes		1,100
Automobile	1,300	5,500
<del>Other</del>		
Disposal of solid refuse		6,000
Municipal advertising tax		500
RAI television fee		2,500

Lotto, lottery		7,000
Tosap (employment of public spaces and areas)		1,350

Source: 'Notiziario fiscale,' 1995

While the indirect taxes (those which relate to purchases and expenses; i.e., those which have a direct influence on supply and demand), tend to be multiplied and diversified according to the different types of goods and services exchanged on the market, income taxes maintain a certain organic unity. They are structured as follows:

1. Irpef (individual income tax): which is not levied on incomes taxed by substitutive taxes, nor on the ones which, by an explicit or implicit rule, are entirely excluded from taxation.
2. Irpeg (corporate income tax): it is levied at a rate of 37% on joint-stock companies, limited liability companies and legal persons, with a complex mechanism to avoid double taxation of the member and the company.
3. Ilor (local income tax): this is a further amount, at a rate of 16.2%, of income taxation which doesn't derive from work income; i.e., derived from capital and therefore earned with minor effort. The aim of this tax is to face as best as possible the conceptual inconvenience typical for this kind of taxation; i.e., the incapacity to equate taxation in relation to the different kinds of effort exerted for equal earnings.
4. Substitutive taxes: these kinds of taxes are applied at a wide range of rates, variable in relation to the type of income; they strike different portions of income such as interest on government securities and other bonds, capital gains etc.; for example, interest on bank deposits is subject to a 30% rate, the ones on liability and public bonds, to 12.5%, and so on.

The Irpef, inspired by the individual taxation typical for European Social Democracy, adopts the principle of progressiveness, according to which the greater the income, the greater proportion the taxpayer can do without, with the same level of sacrifice. The concept of progressive tax is based on the assumption that, for example, the first ITL 20 million of income goes for the indispensable things (food, clothes, etc.), whereas any additional earnings are less necessary, and therefore could be subject to a greater rate of taxation. Thus, in Irpef taxation there is a curve of rates (from 10% to 51% on incomes over ITL 300 million).

In Italy, the two major forms for the reporting of tax duties are the 740, which contains the declaration of individual persons' incomes (Irpef), and the 760, which contains the declaration of legal persons (Irpeg). The 740 has been the object of a lot of criticism, mainly about its complexity. Therefore, efforts are being made in this direction; i.e., simplification. Millions of individuals have to fill out this form, and not all of them are capable of comprehending the aims and, above all, the rules for carrying out this operation. In this way, the fiscal machinery loses the confidence of the taxpayers and stimulates fraud and evasion.

Legal persons, together with the form 760, must enclose their Working Balance and other documents. The Working Balance is composed of three parts: Asset and Liability Statement, Profit and Loss Account and Integrative Note.

The Working Balance represents a systematic, qualitative, periodic statement regarding costs and returns, whose aim is to provide the volume and composition of the periodical operating results and the quality-quantity structure of the invested capital at the end of a typical (administrative) period.

The Working Balance provides the operating result, but only for accounting purposes. For fiscal purposes a special operating result, called taxable base, is calculated. The two kinds of results never coincide. The operating result for accounting purposes could be set up in different ways, but the main condition is to be clear and truthful. This condition is not enough for fiscal

purposes. On the net operating result (positive or negative), which the Working Balance provides, different corrections are carried out (additions or reductions), as a result of the application of special fiscal norms provided by the fiscal law.

The principle is that the accounting operating result is the main one, whereas the fiscal operating result (taxable base) is derived from it. The aim of this principle is to avoid duplication in the estimation of the components of income and the components of capital.

The fiscal body of legislation regarding the determination of corporate income is a result of a long legislative effort having been continually modified:

1. Oct. 9, 1971 Law no. 825 - Legislative Delegation to the Government of the Republic of Italy for Tax Reform.
2. Sept. 29, 1973 Decree of the President of the Republic (D.P.R.) no. 597, 598, 600 - Legislative decrees on Irpef (individual income tax), Irpeg (corporate income tax) and common dispositions on the assessment of the incomes.
3. Dec. 22, 1986 D.P.R. no. 917 - Unique Text of the Income Taxes (Testo Unico delle Imposte sui Redditi - TUIR) - a reform of D.P.R. no. 577 and 598.

Law no. 825 of 1971 names income determined for civil purposes as the main one and thus the income for fiscal purposes must be adjusted from it, following different criteria. The predominance of incomes determined by the principles of *competenza economica* on the taxable incomes has been suggested by the need for efficiency, strengthening the rationalization of the national productive apparatus. Since then, the trend has been towards an inversion of the tendency — the fiscal aim gradually took priority as a source of information and the fiscal lexicon has prevailed in firms' accounting. Thus, to put into effect the IV Directive of the EEC,<sup>9</sup> the delegated legislator has had to refer to the current “lows” in fiscal matters.

The fiscal reform of 1973 made the mistake of putting big industries on the same base with small tradesmen, with regard to accounting duties. The tradesmen and the handicraftsmen have been constrained to an unnatural regime: accounting has been imposed on them which they didn't need, where before they could write what they wanted to. The regular conduction of the accounting prevented even the most sensible adjustments based on the characteristics of the enterprise. From this combination of accounting nuisance and formal guarantees has been born the figure of the “tax dodger” and a deep split between declared incomes and common sense. These errors are the root of the scarce fiscal credibility visible in the statistics on the incomes of tradesmen and handicraftsmen.

The excessive importance that has been attributed to the journal entries of tradesmen and handicraftsmen by the 1973 Reform was worsened by the fiscal apparatus, which left the offices without any guidelines. There was, on the contrary, a legislative frenzy; since 1982 the offices and the taxpayers have been dazed by a continuous normative emergency, with an alternation of ephemeral anti-evasion measures, which appeared and disappeared between one remission and another. In the summer of 1984 the law *Visentini ter* took effect, re-introducing inductive assessment based on the characteristics of the enterprise (surface, purchases, employees, means of production, etc.). The rule, however, was remained only on paper, because in December 1991, the last expiration date for the above-mentioned inductive assessments, came another big remission.

Meanwhile, presumed income coefficients were introduced (law no. 154 of 1989), determined by the fiscal registry office according to a generic “law manifesto” and based on a few elements given in the tax return (e.g., square meterage of the shop, employees' remuneration, purchasing

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<sup>9</sup> The IV Directive of the EEC is one of the directives posed before the members of the Community to harmonize their legislations, regarding accounting. It is not a matter of lows, but minimal requirements, which don't prevent single states from adopting stronger rules. “Harmonize” doesn't mean standardize, but choose among different alternatives based on common criteria.

of goods, etc.). Actually, it was matter of a cabal of random figures aiming for a vague computerized mass control, in which the officials would be replaced by the fiscal registry's computers. Until now nobody has had the courage to massively utilize such a rough tool, reminding one of a dead letter in the fictitious world of the "effects of the announcement."

The same logic of intervention inspired the minimum tax (1992), a procedure for the collection of personnel income tax (Irpef) based on a minimum presumed corporate tax, supposing that the tradesman or the handicraftsman earns almost as much as he would earn as an employee. The fact that retail trade and craftsmanship are the only alternative to unemployment was neglected. Many individuals with high incomes were favored by the minimum tax, having the opportunity to hide part of their earnings. The minimum tax was abolished. The same kind of improvisation inspired the huge controls limited to taxpayers of a few categories, which in 1994 caused the fiscal offices to waste a lot of time checking all the dentists and managers of the joint-ownership of buildings, even in the absence of special indications of evasion and in the presence of externally reasonable tax returns.

In Italy the structure of trade and services is so pulverized, that many retailers and handicraftsmen remain on the market only thanks to tax evasion: if they declared their incomes up to the last lira, there wouldn't be any more incentive to work, because they wouldn't be competitive and capable of paying taxes and supporting their families. On one hand, it is impossible for evasion forever to be the only factor determining the survival of tradesmen and handicraftsmen, but on the other hand, the rationalization has to be gradual and not a kind of "killer" of the activities which have more a social than an economic function. Thus transparent fiscal policies with incentives toward modernization are needed. Enterprises facing the problem of survival need special regimes, reserved for the weak, and not licenses to evade, from which the strong also benefit.

In Italy at present, the tendency of fiscal policy is toward decentralization. This fiscal federalism is going to bring higher efficiency and a smaller field for corruption. Moreover, a simplification of the mechanism is aimed at.

In 1998 Irap (local tax on the industrial activity) will come into force, which for the first time allows wide fiscal autonomy to regions, provinces and municipalities.

The state will determine the ceiling of the rate, whereas the local authority will determine the rate itself. The incomes thus gathered will flow to the local funds. During the initial stage the state fiscal administration will manage the mechanism of this tax through the local fiscal agencies.

Together with the introduction of the Irap will be the simplification and rationalization of taxpayers' tax duties, because a few taxes will be canceled:

- . Ilor.
- . Tax for the concession on VAT.
- . Tax on the liabilities of firms.
- . Medical service contributions etc.

It is a matter of a contribution of a real nature, which is due from anyone who practices an organized activity for the production of goods and services, from individual businessmen, companies, commercial and non-commercial bodies, from artists and other profession-practicing individuals, the state and other administrations.

Irap doesn't directly regard employees, who will benefit indirectly, since the financial system will be financed by employers' contributions. The starting-point for the determination of the taxable base will be the Balance Sheet.

The tax will be levied on the taxable base, based on the added value produced on the territory of the region and resulting from the Balance. For non-balance obligated firms, it will be levied on the global annual added value, produced on the territory of the region and resulting from the



tax return. In case of more activity, appropriate criteria will be provided as, for example, the distribution of the taxable base between regions as a proportion of the personnel costs, operating at the various factories and offices. The new tax won't be deductible under Irpeg and Irpef duties.

The fixing of rates will be within the competence of the regions, which will have the ability to determine an additional Irep within the range of 0.5-1%. Moreover, during the first two years the relative rates will be fixed by the state and Irep won't be increased by the regions.

The taxable mechanism will be realized at a rate which will vary between 3.5-4.5%, with the possibility for regions to differentiate for economic and redistribution policy reasons and to provide facilities which could benefit the subjects which undertake new activities.

At the same time an additional rate of Irpef ranging from 0.5 to 1% will be set up. Regions will have the power to regulate with a law the procedures for the application of the tax. A unique declaration will be presented, together with the ones for Irpef and Irpeg, integrated in an adequate manner.

For the temporary stage of the application of Irap, the state will retain a certain percentage for organizational expenses. On the contrary, the application, gathering, assessment and sanctions will be up to the financial administration; any eventual appeals will be under to the jurisdiction of the fiscal commissions.

At present, Italy aims at the achievement of the parameters which will allow it to take part in the common monetary system (the euro). The necessary public deficit/GNP rate of 3% has been achieved (2.7%). To continue on the way, a modern and efficient fiscal system is obligatory. This means radical modifications not just on taxation itself, but on the fiscal machinery. As part of the decentralization mentioned above, simplifications in payment procedures are going to be realized. Instead of the actual offices of the Financial Administration, all the payments must be made at:

- . Tax collection licensees in whose district the competent financial office is situated;
- . Banks;
- . Post offices.

For the taxpayers, these reforms mean a simplification in the procedures. The constraint of cash payment is eliminated.

For firms and production activities, the withdrawal will be more simplified and rational and in many cases slighter. The discrimination which gave advantages to capital gains incomes over business incomes has been modified. Numerous interventions are on course to render closer the relationship between the civil administration and the "Guardia di Finanza" (the financial police).

The Italian Stock Exchange (Borsa di Milano) suffers from a relatively small number of quoted national enterprises. The level of transactions is still less, but, on the other hand, all the economic agents need an efficient stock exchange: the state, to privatize the state enterprises and to lighten the deficit; the investors, to find different alternatives; the enterprises, to re-capitalize their activities; and the banks, to diversify the range of their services.

Enterprises, especially the middle-size ones, harbor a kind of "fear," being quoted, of loosening control. To encourage the enterprises, lots of short- and long-term measures and laws have been provided by the authorities. One of the main leverages is in the fiscal incentives. Regarding the government's policy in this direction, a significant break has been set up for the enterprises that intend to list themselves on the Borsa di Milano. It consists of a reduction of the corporate income tax (Irpeg) from 36% to 20% for three years.

#### 4.6. Sweden

The scope of the taxation in Sweden is determined by the fact that the public sector used to account for three-quarters of total GDP, and even today this share is higher than in any other OECD country. The growing financial requirements of an extensive welfare state with very generous social security schemes and benefits are the most important factor contributing to unprecedented public spending expansion from 50 to 65 percent of GDP between 1976 and 1981.

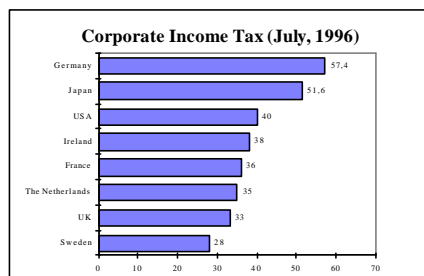
##### *Sweden's Tax Structure*

Sweden's tax structure includes the following principal taxes:

- . *Corporate Taxes*
  - Personal Income Taxes (Taxes on Wage Income, Taxes on Capital Income)*
- . *Personal Wealth Tax*
- . *Personal Property Tax*
- . *Real Estate Tax*
- . *VAT*
- . *Excise Taxes*

##### *Corporate Taxes*

As a result of a major tax reform in the early 1990s, Sweden's corporate tax rates are today the second lowest in Europe. They have been lowered to 28 percent.<sup>10</sup> Corporate income tax is levied on total net corporate profit.



Source: KPMG, OECD.

Tax regulations are generally the same for both corporations (aktiebolag) and unincorporated, individually-owned businesses. All profit is taxable, including income from capital belonging to a business.

##### *Social Insurance Contributions*

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<sup>10</sup> With an effective rate of approximately 26%.

Social insurance contributions are called “employers’ contributions” in Sweden. They are included in our analysis because they are considered to be taxes rather than insurance premiums, due to their weak actuarial connection.

These contributions exceed 30 percent of an employee’s annual wages or salary.<sup>11</sup> Employers’ social security contributions are deductible from taxable income. More detailed information on social security contributions is contained in following table:

Table 1

Social Insurance Contributions 1996 (as % of annual wage bill)

	<b>Workers</b>	<b>White-Collar Employees</b>
<b>STATUTORY</b>		
<b>Supplementary pension (ATP)</b>	<b>13.00</b>	<b>13.00</b>
<b>Health Insurance</b>	<b>5.28</b>	<b>5.28</b>
<b>Basic Pension</b>	<b>5.86</b>	<b>5.86</b>
<b>Partial Pension</b>	<b>0.20</b>	<b>0.20</b>
<b>Occupational Injury Insurance</b>	<b>1.38</b>	<b>1.38</b>
<b>Occupational Safety</b>	<b>0.17</b>	<b>0.17</b>
<b>Labor Market Contribution</b>	<b>5.42</b>	<b>5.42</b>
<b>Pay Guarantee</b>	<b>0.25</b>	<b>0.25</b>
<b>General Payroll Contribution</b>	<b>1.50</b>	<b>1.50</b>
<b>TOTAL STATUTORY</b>	<b>33.06</b>	<b>33.06</b>
<b>BY COLLECTIVE AGREEMENT</b>		
<b>Group Life Insurance (TGL)*</b>	<b>0.50</b>	<b>0.30</b>
<b>Collective Group Health Insurance (AGS)</b>	<b>0.95</b>	<b>-</b>
<b>Severance-Pay Grant (AGB)</b>	<b>0.15</b>	<b>-</b>
<b>Supplementary Pension (STP, ITP)*</b>	<b>3.15</b>	<b>6.70</b>

<sup>11</sup> They amount to about 33 percent of payroll.

<b>Labor Market No-Fault Liability (TFA)</b>	<b>0.50</b>	<b>0.05</b>
<b>Employment Security Fund/Council</b>	<b>-</b>	<b>0.035</b>
<b>Special Pension Payment</b>	<b>0.75</b>	<b>-</b>
<b>TOTAL BY COLLECTIVE AGREEMENT</b>	<b>6.00</b>	<b>7.40</b>
<b>Special Payroll Tax on Pension Costs*</b>	<b>0.80</b>	<b>1.40</b>
<b>TOTAL EMPLOYER CONTRIBUTION</b>	<b>39.90</b>	<b>41.90</b>
<b>STATUTORY EMPLOYEE CONTRIBUTIONS</b>		
<b>Health Insurance</b>	<b>3.95</b>	<b>3.95</b>
<b>Pension</b>	<b>1.00</b>	<b>1.00</b>
<b>TOTAL STATUTORY EMPLOYEE CONTRIBUTIONS</b>	<b>4.95</b>	<b>4.95</b>

\* = Approximate figures.

Source: Swedish Employers' Confederation

Sweden's comprehensive social insurance system covers old age pensions, health care, unemployment and disability benefits, maternity payments, and child and youth benefits. It is mainly financed through employer contributions: employers' statutory social insurance contributions amount to 33.06 percent of total remuneration (see details in Table 6 above).

In addition, employers contribute about 6-8 percent of an employee's pay to cover the cost of complementary pension schemes according to union agreements.

A special payroll tax on pension costs of 0.8% for blue-collar workers and 1.4% for white-collar workers is paid by employers as well, in order to cover special pension premiums for employees.

Employees themselves pay a health insurance fee of 3.95% and a pension fee of 1% on gross income, up to a ceiling of SEK 276,000.

### *Personal Income Taxes*

Sweden's personal tax rates have been lowered, as a result of a major tax reform in 1991, to levels that are more comparable to those in the rest of Europe, but they are still relatively very high.

After the tax reform personal income tax came to comprise the tax paid to the municipality, parish (church) and county council, 31% on average, and national income tax of 20% payable only on incomes above the breakpoint. Individuals must file tax returns each year for income on wages and capital.

### *Taxes on Wage Income*

Income on wages is taxed by municipalities, and the State. Municipal tax rates vary by municipality, ranging from 26 percent to 35 percent, and averaging around 30 percent. Most taxpayers pay only municipal income taxes and SEK 200 in a nominal state tax. High-income individuals also pay 25 percent in state taxes on taxable income exceeding SEK 203,900 (in 1996).

Marginal tax rates are as follows:

Table 2

Marginal Tax 1921-1996\* in percent (Single Wage-earners)

Income level in SEK	1921	1931	1941	1951	1961	1971	1981	1991	1996
150,000	13.7	14.7	28.5	37.0	40.8	49.5	52.6	34.3	38.0
250,000	16.1	15.1	36.8	42.5	49.9	60.6	74.6	51.2	58.8
400,000	17.6	17.9	40.2	46.1	53.3	60.5	80.0	51.2	56.7

\* Income in 1996 prices.

Source: Nils-Eric Sandberg: *What went wrong in Sweden?*, Timbro, Stockholm, 1997, p. 8.

Back in the 1920s the maximum rate of income tax was 17%. The first significant increase in marginal taxes can be identified between 1931 and 1951 (from 14.7% to 37.0%, from 15.1% to 42.5%, and from 17.9% to 46.1%). This can be explained by World War II going on during this period.

However, between 1961 and 1981 there is no evidence of an event such as a war contributing to increased public spending, and yet during that period marginal taxes rose even more steeply: by 11.8% for incomes up to SEK 150,000, 24.7% for incomes up to SEK 250,000, and 26.7% for incomes up to SEK 400,000.

Taxation in Sweden has risen steeply since 1970. The 1971 tax reform reduced taxes for the lower income levels but made taxation more progressive: that is, the scale of taxation became steeper. Marginal taxes increased. Even in low income brackets, most pay raises were eaten up by taxes.<sup>12</sup>

Wage income includes salaries, pensions, annuities, severance pay, sickness allowances, benefits or "perks" provided by employers, income from hobbies, etc. Pensioners are taxed

<sup>12</sup> Nils-Eric Sandberg: *What went wrong in Sweden?*, Timbro, Stockholm, 1997, p. 27. This problem is explained further on page 33: "The problem was that the taxation scales were not adjusted for inflation, so that if wages were increased in step with inflation, taxes rose in proportion to income. Income remained unaltered, in fixed money terms. But tax, in fixed money terms, increased."

according to the rules for ordinary income earners. However, some special deductions are allowed.

Deductions are very limited. There are no standard deductions. For example, 30 percent of interest payments on a home mortgage are deductible. Investment savings in pension schemes are deductible up to one half of a basic amount. The basic amount, which is adjusted annually to reflect the cost of living, was SEK 36,200 in 1996 and SEK 36,300 in 1997.

The few other deductions available include: costs of travel to and from work that exceed SEK 6,000, costs of materials and tools needed for a job, but only those that exceed SEK 1,000, and social insurance fees which are — as noted above — paid by employees (3.95% health insurance fee and 1% pension fee, in 1996). However, social insurance fees are paid only on income up to 7.5 times the basic amount, or SEK 276,000 in 1996.

### *Taxes on Capital Income*

Only private persons pay taxes on capital income. Income from capital includes interest income, stock dividends, capital gains and losses from the sale of stock, bonds, real estate, personal belongings and similar assets, and income from the rental of private residences.

Income from capital is taxed by the state at a flat rate of 30% regardless of any other income a taxpayer may have. Deductions are allowed for interest costs and other expenses connected with capital income.

Direct taxes in Sweden are compared to average levels of direct taxes in OECD countries in the following table:

Table 3

Direct taxes in Sweden and OECD countries

<b>Taxes on Direct Income</b>	<b>Sweden</b>	<b>OECD</b>
<b>An Average Industrial Worker</b>	<b>28%</b>	<b>16%</b>
<b>Employees with twice the gross earnings</b>	<b>39%</b>	<b>24%</b>

Source: Nils-Eric Sandberg: What went wrong in Sweden?, Timbro, Stockholm, 1997, p. 27.

However, direct income taxes account for less than 40 percent of total taxation. To direct taxes are added indirect taxes. Together with the above-mentioned “employers’ contributions” on gross earnings (in fact taxes on the wage bill) financing pensions, unemployment benefits, health insurance and other social security benefits, other indirect taxes — such as consumption taxes (especially the tax on energy) and general VAT — were increased significantly as well.

### *Personal Wealth and Property Tax*

Personal wealth with a total value exceeding SEK 800,000 (was to be increased to SEK 900,000 in 1997) is taxed at a rate of 1.5%. Wealth includes real estate, stocks and bonds, cash, jewelry, art, pleasure boats, cars, etc. The value of real estate is based on its tax-assessed value and the value of stocks and bonds is the full market value (as of 1996).

The entire profit on the sale of personal property, such as household goods, jewelry, art, etc., is taxable, regardless of how long it has been owned. But property is subject to capital gains tax only if the total gains during a year exceed SEK 50,000.

### *Real Estate Taxes*

Real estate is subject to a state tax, which was 1.7% of assessed value in 1996. There are no municipal real estate taxes.

Newly-built homes, with an assessment year of 1991 or later, are exempt from real estate tax for the first five years after the completion of construction. During the following five years, the real estate tax is half the normal tax.

### *Value Added Tax*

Swedish value added tax (VAT) regulations are harmonized with the VAT directives of the EU. Known in Swedish as “Moms” (short for Mervardeskatt), VAT is charged at a rate of 25% on sales of goods and services. As of 1996, a lower tax rate of 12% is applied to food products, hotel services, passenger transportation and the import of works of art. VAT is 6% on newspapers and admission tickets to cinemas.

The main items exempt from VAT are medical, dental and social care, the sale of ships and aircraft, the sale of real estate, education, banking and insurance services, concerts, aircraft fuel, and inventories and equipment in connection with the sale or transfer of an entire business.

### *Excise Taxes*

Sweden currently has 15 different excise taxes or duties on products and services, ranging from advertising to pesticides. The largest and most important are on fuels, electrical power, alcohol and tobacco.

The fuel tax is applied primarily to gasoline, oil, coal and liquefied petroleum gas. The taxes are based on amount of energy, carbon dioxide and sulfur. Alcohol taxes are traditionally very high in Sweden, the result of a strong historic temperance movement. The tax depends on alcohol content. For beer, it is SEK 1.21-2.38 per liter, for wine and liqueurs SEK 9.21-44.51 per liter, and for spirits SEK 485.04 per liter of pure alcohol.

Tobacco tax is SEK 0.52 per cigarette (or SEK 10.40 per pack), plus 15 percent of the retail price, and SEK 0.35 per cigar or cigarillo. Pipe tobacco is taxed at a rate of SEK 384 per kilogram, snuff at SEK 75 per kilogram, and chewing tobacco at SEK 123 per kilogram.

### *Tax Administration*

The National Tax Board (Riksskatteverket) supervises and has overall responsibility for the tax system. Sweden is divided into 24 administrative units, called counties. All of Sweden's 24 counties have a Tax Authority (Skattemyndighet), each of which handles taxation within its region. Each Authority has special sections to serve large business and provide legal and administrative assistance.

The National Tax Board issues regulations, provides advice and makes rulings that are applied by the county Tax Authorities. The National Tax Board is an administrative authority operating independently of the Government.<sup>13</sup>

The county Tax Authorities operate local Tax Offices, which provide a number of services: processing of all income tax, value-added tax and tax collection returns; making tax withholding assessments on wages, businesses and legal entities; handling questions about value added tax and employer contributions; carrying out real estate tax assessments; controlling and auditing tax returns; registering the local population and administering general elections.

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<sup>13</sup> Individual tax matters are resolved by the National Tax Board and the county Tax Authorities without the involvement of the Government.

## *Expenditure and Revenue Structure*

The public sector expenditure structure is roughly estimated in the following table:

Table 4

Composition of the public sector in 1993<sup>14</sup> (billion SEK)

<b>National government spending</b>	<b>115</b>
<b>Local government spending</b>	<b>280</b>
<b>Social expenditures/transfers</b>	<b>400</b>
<b>The debt state</b>	<b>170</b>

Source: Ingemar Stahl, Kurt Wickman: *Suedosclerosis: The Problems of Swedish Economy*. Excerpts, Timbro, Stockholm 1995, pp. 11-12.

National government spending includes: defense (40 billion), justice (25 billion) and research/education (25 billion).

The main local government spending items are: schools (80 billion), child supervision (30 billion), care of the elderly (35 billion) and infrastructure (20 billion).

Social expenditure/transfers include, among others: ATP supplementary pensions (100 billion), policies for the unemployed (100 billion), basic pensions (80 billion), medical care (40 billion), parental insurance (25 billion) and housing allowances (15 billion).

The term “debt state” includes: servicing of the national debt (100 billion), costs of the banking crisis (40 billion) and home mortgage interest charges (30 billion).

The primary sources of revenue for the Swedish State are:

- . *value added taxes (contributing 33 percent of the total state revenue in fiscal year 1993/94);*
- . *employers' social security contributions (17 percent);*
- . *excise duties (16 percent);*
- . *and income taxes (8 percent);*
- . *the remaining revenues are from various fees, charges, licenses, etc.*

The main source of revenue for Sweden's 288 municipalities is the income taxes paid by individuals. The tax rate averages about 30%. An important constitutional change has occurred in the municipal nexus: the government now pays municipalities a lump sum instead of earmarked grants. “This changes the terms on which municipalities decide to do things. In other words, municipal activities are being correctly priced.”<sup>15</sup>

### ***Tax Reform***

The capacity of the state to generate new tax revenues to finance all of the above-mentioned items lagged behind increases in all expenditures items. This can be clearly seen on the

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<sup>14</sup> Government Current Expenditure (total government expenditure, excluding capital expenditure) as a percentage of GDP was 66.4% in 1995.

<sup>15</sup> See: Ingemar Stahl, Kurt Wickman, *Suedosclerosis: The Problems of Swedish Economy*. Excerpts, Timbro, Stockholm 1995, p 14.



following table, summarizing Sweden's fiscal position in comparison to G-7, EU and OECD averages:

Table 5

General Government Fiscal Surplus (+) or Deficit (-) as a % of GDP

	1990	1991	1992	1993	1994	1995	1996
<b>Sweden</b>	<b>4.2</b>	<b>-1.1</b>	<b>-7.8</b>	<b>-12.3</b>	<b>-10.3</b>	<b>-7.7</b>	<b>-3.6</b>
<b>Total of G-7 countries</b>	<b>-2.1</b>	<b>-2.7</b>	<b>-4.0</b>	<b>-4.3</b>	<b>-3.5</b>	<b>-3.4</b>	<b>-3.1</b>
<b>Total of EU countries*</b>	<b>-3.8</b>	<b>-4.4</b>	<b>-5.6</b>	<b>-6.5</b>	<b>-5.8</b>	<b>-5.2</b>	<b>-4.5</b>
<b>Total of OECD countries*</b>	<b>-2.1</b>	<b>-2.7</b>	<b>-3.9</b>	<b>-4.3</b>	<b>-3.6</b>	<b>-3.3</b>	<b>-2.9</b>

\* Data not available for all Member countries.

Source: OECD Economics Department

As a result of fiscal consolidation efforts, the general government deficit declined from 12.3 percent of GDP in 1993 to 3.6 percent in 1996. However, because public spending rose regardless of taxation revenue for some time, the Swedish government was forced to rely more and more on borrowing from abroad. As a result the national debt has risen significantly:

Table 6

General Government Gross Financial Liabilities as a % of GDP

	1990	1991	1992	1993	1994	1995	1996
<b>Sweden</b>	<b>44.3</b>	<b>53.2</b>	<b>71.1</b>	<b>76.3</b>	<b>81.2</b>	<b>80.5</b>	<b>79.8</b>
<b>Total of G-7 countries</b>	<b>58.3</b>	<b>60.2</b>	<b>63.2</b>	<b>66.9</b>	<b>68.6</b>	<b>72.1</b>	<b>73.9</b>
<b>Total of EU countries*</b>	<b>59.6</b>	<b>60.7</b>	<b>64.9</b>	<b>71.3</b>	<b>72.5</b>	<b>76.8</b>	<b>78.0</b>
<b>Total of OECD countries*</b>	<b>58.5</b>	<b>60.3</b>	<b>63.5</b>	<b>67.6</b>	<b>69.3</b>	<b>72.5</b>	<b>74.0</b>

\* Data not available for all Member countries.

Source: OECD Economics Department

The national debt almost doubled in a relatively short period of time, between 1990 and 1994, from 44.3 to 81.2 percent of GDP, when the long-term trend of growing public spending was combined with short-term cyclical factors in the beginning of the 1990s.

As a consequence of this development, average growth rates have declined steadily. Sweden in the 1960s had an average growth rate of 4.6 percent, in the 1970s it fell to 2 percent, and in the 1980s it declined a little further. Sweden was trapped in a vicious circle: companies were unable to bear their high tax and contribution burden, closed down their facilities, leading to growing unemployment, resulting in further increases in public spending.

The most important revenue sources (businesses' and households' direct taxes, indirect taxes, social security contributions) are summarized in the following table, covering the relatively long period of time between 1960 and 1995:

Table 7 Composition of government revenues 1960-1995

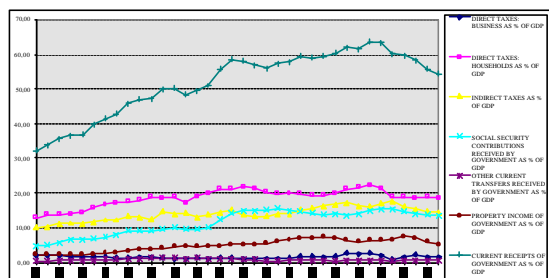
Sweden	1960		1970		1980		1995
	In SEK (billions)	In % of GDP	In SEK (billions)	In % of GDP	In SEK (billions)	In % of GDP	In SEK (billions)
Gross national/ domestic product	72,128	1100	172,226	1100	531,054	1100	1,359,976.75
Direct taxes: business	1,432	11.99	2,612	11.52	6,311	11.19	27,559
Direct taxes: households	9,350	112.96	32,398	118.81	107,614	220.26	291,053
Total direct taxes	10,782	114.95	35,010	220.33	113,925	221.45	318,612
Indirect taxes	7,206	99.99	21,754	112.63	71,446	113.45	233,362
Total direct and indirect taxes	17,988	224.94	56,764	332.96	185,371	334.91	551,974
Social security contributions	3,503	44.86	15,533	99.02	80,796	115.21	211,889
Taxes and contributions	21,491	229.80	93,788	441.98	266,167	550.12	763,863
Other current transfers	364.285	0.51	2,447	11.42	2,283	0.43	8,640
Property income of government	1,578	22.19	6,544	33.80	29,482	55.55	88,244
Current receipts of government	23,433.3	332.49	81,288	447.20	297,932	556.10	860,747

Source: OECD Statistics and own calculations based on OECD Statistics.

The same data were used to display shares of particular government revenue components as a % of GDP in a following chart:

Chart 2

Government Revenues Components as a % of GDP 1960 - 1995



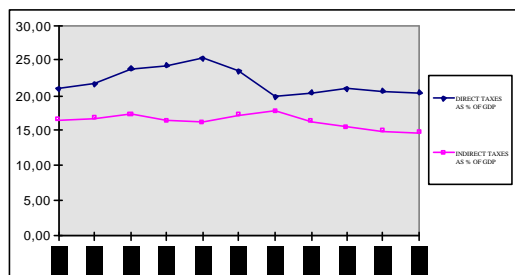
Both table and chart demonstrate a clearly visible trend of government revenues growing almost constantly from the 1960s to the beginning of the 1990s, at much faster rate in comparison to GDP growth, with a quite striking change in this trend at the beginning of the 1990s.

The tax reform at the beginning of the 1990s was aimed at a broadening of the tax base, lowering marginal tax rates, greater fiscal neutrality, improved efficiency and public finances. The other important objectives of the reform were to simplify taxation rules and to reduce direct taxes and simultaneously increase indirect taxes.

One way to see whether the reform has worked or not is, for example, to compare the share of direct and indirect taxes in GDP. From the following chart comparing direct and indirect taxes as a percentage of GDP during last decade in Sweden, it can be seen that the reform at least stopped the upward trends in both these categories:

Chart 3

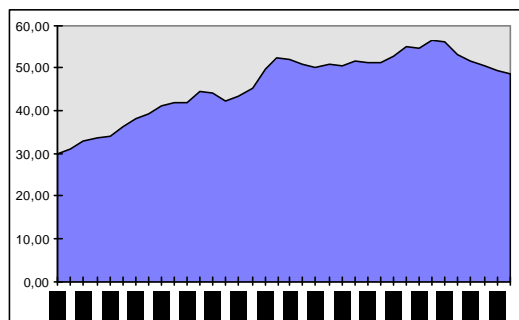
Direct and Indirect Taxes as a % of GDP 1985-1995



However, it is more important to see the overall effects of the reform: a decline in taxes and the contributions burden, measured as a share of GDP:

Chart 4

Taxes and Contributions in Sweden as a % of GDP 1960-1995



Today Swedish tax rates are at more comparable levels with those of other Western European countries, after a major tax reform. The main features of the Swedish tax system are as follows: corporate tax rates are the second lowest in Europe, and personal taxes are comparable to European levels.

#### **4.7. Switzerland**

##### *Tax Structure in Switzerland*

The Swiss tax system consists of the following principal taxes:

##### I. Income taxes:

1. Direct federal tax
2. Cantonal tax
3. Communal tax
4. Church or parish tax (in most cantons)
5. Withholding tax
6. Real estate gains tax.

##### II. Taxes on capital/net wealth:

1. Direct federal tax (corporations only)
2. Cantonal tax
3. Communal tax
4. Church tax (in most cantons)
5. Real estate tax (certain cantons only)

##### III. Taxes on transactions:

1. Federal tax (corporations only)
  - a. Turnover or sales tax, replaced by VAT in 1995
  - b. Stamp taxes
  - c. Customs duties
2. Cantonal taxes
  - a. Inheritance and gift taxes
  - b. Real estate transfer tax

##### IV. Other taxes:

Social security contributions

In Switzerland there are taxes which are:

- . *direct (on income and assets)*
- . *indirect (on consumption and property).*

##### ***Corporate Taxes***

Corporate income tax depends on the rate of return on investment (profit as a percentage of capital, including reserves), and is normally at a progressive rate. Companies are taxed at their place of business or the location actually linked to their economic activities. Depending on the canton, this tax (total for canton, commune and Confederation, as a percentage of net profit, 1995), the amounts are calculated as follows:

Table 1

Corporate Income Tax

<b>Return on investment</b>	<b>Tax as a % of net profit</b>
<b>4%</b>	<b>15% to 25%</b>
<b>20%</b>	<b>20% to 30%</b>

The direct federal income tax rate is 3.6% of the net profit in the case of a return of up to 4 percent, with a ceiling of 9.8 percent of the net profit. These taxes are comparatively lower than in the EU member countries, where they vary at between 30% and 45% of net profit. In addition to this, the taxes for the current year can be deducted from the net profit. This makes it possible to reduce the taxable profit and the effective tax burden will be less than indicated above.

The corporate tax on capital depends on the amount of capital, and is generally levied on a *pro rata* basis. As the federal capital tax rate is 0.08% of net profit, total for canton, commune and Confederation (as percentage of net profit, 1995), it amounts to less than 1% of the taxable capital (0.3 percent to 0.9 percent, depending on the canton).

### ***Personal Income Taxes***

Total income (including secondary activity income and investment income) is taxed at a progressive rate, without distinction between the different elements. Different rates are usually applied to single persons and married couples, favoring the latter.

Again, depending on the canton, the following personal income tax rates (total for canton, commune and Confederation, 1995) apply to a self-employed, married person without children:

Income of CHF 50,000	3.4% to 9.1%
Income of CHF 100,000	4.4% to 15.0%
Income of CHF 200,000	9.4% to 21.2%

### ***Social Security Contributions***

Social security contributions in Switzerland vary in accordance with the benefits covered, and are usually shared by employer and employee. The employer generally has to bear at least one-half of the cost.

The Swiss social security system is based on the so-called “three-pillar system” (compulsory federal insurance guaranteeing a basic minimum income, compulsory pension plans to maintain post-retirement living standards, and voluntary individual savings). Old-age, sickness and accident insurance are organized either privately or by public bodies. Unemployment insurance and compensation for military service are paid through a federal scheme. The amount of contribution depends on the age of the employee.

### ***Personal Wealth Taxes***

The wealth tax is generally a progressive one, based on the current market value. This tax amounts (total for canton, commune and Confederation, 1995) to less than 1 percent of net wealth. The Confederation levies no wealth tax.

Assets of:

CHF 50,000	generally tax free
CHF 100,000	taxable in half of the cantons

CHF 1,000,000            taxed at a rate between 0.2% and 0.8%, depending on the canton.

### ***Real Estate Taxes***

Most cantons and most of their communes levy annual real estate property taxes, based on the gross value of real estate. The taxable value is normally lower than current market value, and the rates of tax vary between 0.05% and 0.4%.

### ***Parish or Church Taxes***

In addition to cantonal and communal taxes, parish or church tax is levied by the Communal authorities. It is applicable to individuals indicating their religious denomination (Swiss Protestant, Roman Catholic, and Christian Catholic). If they are not members of any faith, the tax is not levied. The basis for calculation is the cantonal tax on income and wealth.

### ***VAT***

A turnover or sales tax (Warenumsatzsteuer), introduced in Switzerland during World War II as a temporal tool to raise funds for increased defense spending, was replaced by value added tax only in 1995.

Swiss VAT amounts to 6.5% (for certain commodities the rate is only 2%), making it much lower than that found in EU countries, where it varies between 15% and 21%.

### ***Tax Administration***

There are three levels of tax authority in Switzerland:

1.                    *the central government (Confederation);*
2.                    *26 sub-national governments (Cantons);*
3.                    *3,000 local governments (Communes).*

Switzerland's tax system is one of the most decentralized tax system in the world. The Federal Constitution reserves the exclusive right to levy taxes for the Confederation only in a very limited number of cases.

Each of the 26 cantons is generally free to levy taxes. Each has its own tax scale and sets its own taxation rate, as well as levels of tax exemption. Autonomous cantons have many responsibilities (e.g., education, health, road construction and maintenance, police, administration of justice, etc.), traditionally taken on by central governments in other countries. Efforts are made to harmonize withholding taxes, the time limits of tax liability, and the granting of alleviations.

Three thousand local authorities or "communes" (towns, villages) are only allowed to levy taxes within the limits set by the respective canton. Some of the above-mentioned responsibilities are either historically the duty of communes or they are delegated to them by the cantons. Since this design varies in different regions, so does the relative importance of communal taxes.

This design of the tax system in Switzerland allows the determination of taxation on a basis which takes individual circumstances into consideration.

In terms of the levying of their taxes, communes can:

1. *levy the tax based on a percentage (multipliers) of cantonal taxes;*
2. *receive a share of the total taxes collected by the canton; or*
3. *levy their own separate taxes.*

## *Referendum*

The system of public referendum is an important aspect of the Swiss tax system, protecting minorities and local interests. The federal government in Switzerland may neither introduce new taxes nor increase existing federal taxes without a constitutional amendment, subject to a compulsory popular referendum.

A new amendment to the Federal Constitution must be approved by a majority of the citizens eligible to vote and a majority of the cantons. Existing laws or the introduction of new federal laws may be subject to a popular referendum if at least 50,000 resident Swiss citizens or eight cantons request such a referendum.

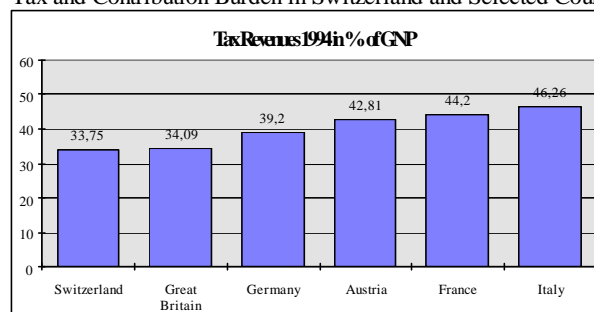
As a consequence of this constitutional limit, Swiss citizens are able to enjoy one of the lowest tax burdens of all developed countries.

## *Low Tax Burden*

Switzerland has one of the lowest rates of taxation and social security contributions of all the industrialized countries. These charges represent just 33.75 percent of GDP.

Chart 1

Tax and Contribution Burden in Switzerland and Selected Countries

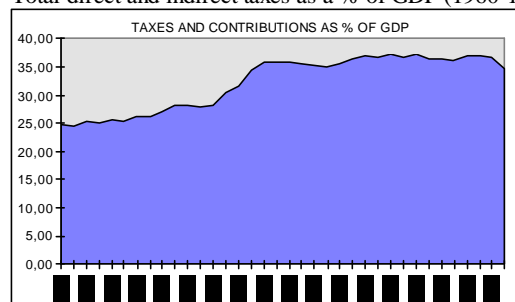


Source: The World Competitiveness Yearbook 1996

In addition to this, constitutional limits on taxation are the main factor behind its relatively stable level. Taxes and contributions as a share of GDP stayed steady for a long period of time, as shown in the following chart:

Chart 2

Total direct and indirect taxes as a % of GDP (1960-1995)



Source: Based on OECD Statistics.

If we take into account that the time period covered by chart is 35 years, keeping a steady tax and contribution burden growth within a 10% spread (less than 25% in 1960, compared to less than 35% in 1995), is a remarkable success.

## *Government Revenue Structure*



Government consumes a considerably lower proportion of GDP not only in comparison to Sweden, but in comparison to most other developed countries as well:

Table 2

Composition of government revenues 1960-1995

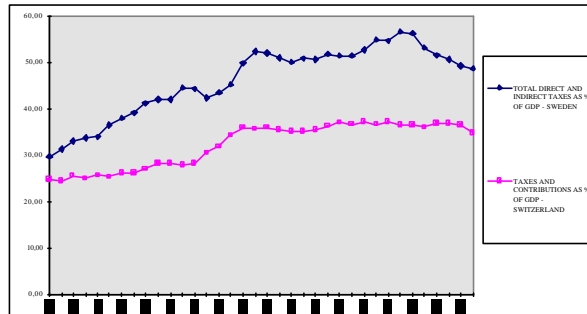
Switzerland	1960		1970		1980		1995
	In CHF (billions)	In % of GDP	In CHF (billions)	In % of GDP	In CHF (billions)	In % of GDP	In CHF (billions)
Gross National/Domestic Product	37,370	100	90,665	100	170,330	100	313,972
Direct Taxes: Business	640	11.71	2,175	22.40	3,870	22.27	8,265
Direct Taxes: Households	2,565	66.86	7,955	88.77	19,470	111.43	36,415
Total Direct Taxes	3,205	88.58	10,130	111.17	23,340	113.70	44,680
Indirect Taxes	2,710	77.25	6,375	77.03	11,910	66.99	20,685
Total Direct And Indirect Taxes	5,915	115.83	16,505	118.20	35,250	220.70	65,365
Social Security Contributions	3,320	88.88	8,985	99.91	24,650	114.47	49,000
Taxes And Contributions	9,235	224.71	25,490	228.11	59,900	335.17	114,365
Other Current Transfers	380	11.02	1,030	11.14	2,605	11.53	6,080
Property Income Of Government	1,145	33.06	2,775	33.06	6,060	33.56	13,765
Current Receipts Of Government	10,760	228.79	29,295	332.31	68,565	440.25	134,210

Source: OECD Statistics and own calculations based on OECD Statistics.

The following chart, comparing tax and contribution levels (as a percentage of GDP) in Switzerland and Sweden between 1990 and 1995, provides clear evidence of the difference between the two different approaches to tax system:

Chart 3

Tax and contribution levels in Switzerland and Sweden 1990 - 1995 (as a % of GDP)



The following table describes the current structure of intergovernmental revenue and the expenditure system in Switzerland, starting with central government operations (Table 11), general government operations, including social security insurance, completed accounts (Table 13) and debts (Table 14) for the Confederation, canton and commune levels:

Table 11

Fiscal Sector - Central Government Operations

Central Government Operations	1994		1995		1996	
	CHF billions	% of GDP	CHF billions	% of GDP	CHF billions	% of GDP
Nominal GDP	357.22	100	364.56	100	363.82	100
Balance, Deficit (-)/ Surplus (+)	-5.1	1.43	-3.3	0.91	-4.4	1.21
Revenue	36.2	10.13	37.3	10.23	39.5	10.86
Expenditure	41.3	11.56	40.5	11.11	43.8	12.04
Central Government Debt	75.71	21.20	82.15	22.53	88.42	24.30

Source: Swiss Statistics, Public Finance, Swiss Federal Statistical Office, 1997, own calculations.

Table 12

Fiscal Sector - General Government Operations

General Government Operations (Including Social Insurances)	1994		1995		1996	
	CHF billions	% of GDP	CHF billions	% of GDP	CHF billions	% of GDP
Balance, Deficit (-)/ Surplus (+)	-9.9	-2.8	-6.4	-1.8	-6.4	-1.8
Revenue	127.8	36.2	132.8	36.7	135.6	37.7
Expenditure	137.7	39.0	139.2	38.5	142.0	39.4
General Government Debt	160.9	45.6	170.1	47.0	179.0	49.7

Source: Swiss Statistics, Public Finance, Swiss Federal Statistical Office, 1997, own calculations.

Table 13

## Completed Accounts

Completed accounts in CHF billions	Revenue		Expenditure		Deficit	
	1995	1996*	1995	1996*	1995	1996*
Confederation	36.2	39.0	40.6	44.0	-4.5	-5.0
Cantons	50.1	52.6	52.1	55.2	-2.0	-2.6
Communes**	37.4	38.5	38.2	39.3	-0.8	-0.8
Total***	103.2	106.6	110.4	114.9	-7.2	-8.3

\* = Budget

\*\* = Without double accounting

\*\*\* = Estimates

Source: Swiss Statistics, Public Finance, Swiss Federal Statistical Office, 1997, own calculations.

Table 14

## Debts

Debts (in billions of CHF)	1970	1980	1990	1994	1995	1996*
Confederation	11.3	31.7	38.5	73.3	79.9	83.8
Cantons	10.0	22.4	30.5	51.7	53.4	56.0
Communes**	15.0	23.0	29.0	36.0	36.8	37.5
Total	36.3	77.1	98.0	160.9	170.1	177.3

\* = Budget

\*\* = Estimates

Source: Swiss Statistics, Public Finance, Swiss Federal Statistical Office, 1997, own calculations.

Public budgets have featured high deficits since the early 1990s. As a result, the level of debt has also risen. High government deficits required measures of budget consolidation, including spending restraints on all levels of government, in order to reduce these deficits. The structural deficit is estimated to be 1.5 percent of GDP in 1997, most of which is attributable to the Confederation.<sup>16</sup>

Government Current Expenditure<sup>17</sup> as a percentage of GDP reached 36.7 percent in 1995. Real GDP growth rates in 1994-1996 were as follows: 2.1%, 2.1% and -0.2%, respectively.

<sup>16</sup> Economic Survey of Switzerland, OECD, August 1997.

<sup>17</sup> Total government expenditure, excluding capital expenditure.<sup>18</sup> The most important issues have already been addressed in tax regulation amendments of late 1997; i.e., the equal treatment of all types of corporations (and some unincorporated or non-limited-liability enterprises). Here we deal with the remaining

## ***Tax System in Switzerland - Advantages and Disadvantages***

In order to create a favorable tax system it is necessary not only to design a low tax burden environment, but in addition to this it is important how tax powers are divided within the system. Answers to the following questions are particularly important:

*Who can levy taxes?*

*Which taxes are assigned to the central government and which to sub-national governments?*

*What is the revenue source structure (tax vs. non-tax; e.g., user charges)?*

*What is the level of local governments' dependence on transfers and shared taxes?*

*Which taxes are shared (in what proportion) with the central government?*

*What is the level of division of control over the tax rates or the tax base?*

Evaluating the Swiss tax system from this point of view, it can be said that this system demonstrates an important comparative advantage relative to the high tax and contributions environments of other countries, in terms of incentives to work, save and invest.

One of the weaknesses of the Swiss tax system is its complexity. In fact, 27 different (one federal, 26 cantonal), non-unified income tax laws exist in Switzerland. This weakness is recognized by the authorities. For example, a reform of business taxation is currently being considered in Parliament, with the following reform proposals:

- . *replacing the existing federal progressive taxation of business profits with a flat-rate tax of 8.5%;*
- . *abolition of the corporate capital tax.*

The other interesting aspect of the Swiss tax system is the general wording of Swiss tax laws. In other words, Swiss tax laws require much interpretation, and this creates a considerable scope for decisions at tax administrators' discretion.

All of the proposed steps aim to simplify business taxation and to make it more transparent. However, the excessively complex federal and cantonal corporate tax system remains more or less unchanged. This unfortunate feature of the Swiss tax system can be understood as the price paid for its decentralized design.

## **5. Needs For Tax Deregulation**

### ***5.1. Slovakia's Tax System: Recommendations***

General:

1. The key issue in the tax system of Slovakia is not the tax burden *per se*. Tax reforms are frequent and contribute to uncertainty and problems with taxation management. Both large businesses (over 500 employees) and small- and medium-size enterprises require less frequent and more predictable changes to tax legislation. They are against ambiguousness of tax laws which allows subjective interpretation and intransigence by

tax officers. The Tax Administration Act establishes inequality between tax officers and taxpayers.

2. However, some areas contribute more to the overall heavy tax burden than others, and this is considered unfair. The tax burden is estimated as high in conjunction with contributions to the social security system, with obligatory contributions (0.1 percent of exports and/or imports) to the export promotion fund. The latter is not declared as a tax, as is the case with employee support contributions such as travel expenses, meals, etc.
3. Serious problems are identified by the business community in connection with the amount eligible for deduction from the tax base; business people believe that the current system is based on discretion and, in fact, increases the tax burden.

## **Direct taxes**

The business community is against huge tax reliefs. Both large businesses and small- and medium-size enterprises consider reliefs to be based on discretion, and at the same time, not supporting capital accumulation and those by tax offices to support modernization to be insufficient.

## **Indirect taxes**

It is difficult, time consuming and costly to comply with the frequent amendments in the list of goods and services subject to specific VAT rates. Often, they seem irrelevant or illogical. A radical desire is expressed by the business community to shorten the period for VAT refunds, from 30 to 10 days. Under the present system, interest free-loans are in effect extended by businesses to the government. This significantly decreases the liquidity of enterprises and increases respective financial charges. However, the shorter period would require more frequent reports to the tax offices and would require harmonization with civic code procedures regulating contracts and relations with the administration.

In the point of view of small businesses it is necessary to introduce a single VAT rate of 17% , and to assign a 0% rate to food, children' s goods and convenience goods.

The rationale behind the above-mentioned requirements related to desired direct and indirect tax regulation amendments is that small- and medium-size businesses currently employ almost half of Slovakia' s labor force. Meanwhile, there is pure legislative recognition of the role of this sector in society.

## **Tax policy recommendations**

We believe that from the point of view of small- and medium-size enterprises (sole proprietorships with up to 20 employees, operating as physical persons), the following policy recommendations are relevant:

1. In order to support investment, they suggest to consider as taxable costs up to 30 percent of investments (i.e., 70 percent tax free).
2. A twofold increase in tax exempt income, from the current SK 21,000 to at least SK 40,000.
3. A twofold increase in tax brackets' thresholds
4. To increase the threshold for equipment purchase price required to recognize it as a tangible long-term asset, from SK 10,000 (a threshold established for more than 20 years) to at least SK 30,000.

5. To bring depreciation policy closer to real economic conditions by shortening periods of time and rethinking the categorization of individual types of equipment. The current depreciation methods hamper the introduction of modern technologies.
6. In order to support the real estate market — and indirectly, investment — a one-third reduction (at least 30%) in the real estate transfer and transition tax will be necessary.
7. In order to reduce the extreme financial burden on freight forwarders, rethinking the road-and-motorway taxes on trucks, trailers and extra units is necessary.

There are some changes in taxation which are also necessary for proper financial system functioning, as well as for its future transformation. In its recent form, taxation, as it affects the financial sector, favors certain types of subjects and products available on the financial market. There is no clear concept in these deviations, and they act as deformations, and not as a determined influence exerted by taxation.

## **5.2. Bulgaria: Reduction Of Tax Burden**

### **Areas**

Tax deregulation reforms deal with three broadly-defined areas of deregulation:

- 1) Income tax, personal and corporate: here we include property taxes, to the extent that they (may) generate income;
- 2) Consumption tax: all schemes of VAT, sales and turnover tax, excise and import/export duties;
- 3) Administrative reform which deals with the implementation of the above-mentioned taxes.

### **Objectives**

In general, the changes should aim at:

1. Reduction in nominal tax rates;
2. Introduction of refund schemes with regard to PIT and CIT;
3. Shorter VAT refund period;
4. Elimination of double taxation of corporations.

### **Income taxation**

#### **Personal Income Tax**

According to the economic theory and income redistribution function of taxes, all types of income should be included in the tax base. However, this requires more developed income accounting than that existing at present. Bearing this in mind, we suggest the following reform policies:

- 1) Consolidation of personal and corporate income tax legislation. Currently, Bulgaria recognizes three major types of income, in terms of their source of generation:
  - . from a labor contract (i.e., wage income);
  - . from private proprietorship;

- from certain activities, for which a single ‘patent fee’ is paid instead of income tax.

The system should be harmonized by the consolidation of personal income tax (PIT) with corporate income tax (CIT). A significant part of personal income comes from business, which should be taxed as corporate income. This allows for better accounting of transaction costs and separation of household and businesses.

- 2) Introduction of linear (flat) income tax scheme. Earmarked programs and transfer payments can achieve the same goal at a lower cost, and without tax system complications; it would remove the pro-inflationary impact of tax tables.
- 3) As an intermediary policy, a reduction in PIT rates to 20-32%. Such reduction is expected to improve tax performance and compliance.
- 4) Broaden the scope of lump-sum taxes (‘patent fees’) for sole proprietorships where applicable, provided simplification is achievable.

### Corporate Income Tax<sup>18</sup>

- 1) Dividend income and double taxation: the fact that many countries apply double taxation on dividend income does not mean that a country like Bulgaria, with the constraints of a currency board, export and competitiveness adjustments and an underdeveloped private sector, should have the adverse effects of double taxation on investment. Dividend income should be excluded from the tax base of personal income and be taxed at the corporate level.
- 2) Tax legislation adjustment to monetary and product inflation: high inflation is common in European emerging economies, and creates problems with the assets’ balance-sheet value of corporations through:
  - a) the creation of artificial profits for the company (it values inputs at historically lower prices and present output at higher prices);
  - b) low depreciation allowances (enterprise’s inability to fully account for its costs on fixed assets); and
  - c) rapid development in certain areas, which inflates the assets.
- 3) Advance payments: they should be based on current performance, rather than past profit. In Bulgaria, advance payments of one-twelfth of the previous year’s tax transfer do not reflect the development of the current year. However, advance payments allow for smoothing budget revenues throughout the year, which is important vis-a-vis debt payments and current expenditures. A flexible approach is to base payments on current performance (e.g., the last-quarter profit). Refunds of overpaid tax at the fiscal year’s end should be introduced. This should introduce equality in rights and duties, and eliminate zero-interest credit to the government.

Investment incentives. Preferences (e.g., exemptions on certain types of investment) were eliminated in 1996. The use of an accelerated depreciation scheme and a properly adjusted balance sheet value of fixed assets would create the proper incentives.

### Consumption Taxes

VAT will continue to be a major revenue source for the state budget in the future. The following improvements are necessary:

- Decrease (or eliminate) the registration barrier. The survey suggests that it prevents SMEs from claiming VAT refunds on inputs, thus depriving them of competitive advantages. It also decreases the export stimulus. The additional administrative burden should be tackled through introduction of a proper export refund threshold.



- Reduction of the VAT rate to 18%. In 1996 it was increased from 18% to 22%, in order to raise more revenues. The macroeconomic problems of 1996-1997 have been solved to a large extent, and it is time to reduce the VAT rate to its original 18% level. Entrepreneurs place the optimum VAT rate at 15.5%, but competitiveness adjustment under a currency board system would require further reduction in the near future.
- Faster VAT refund period. Currently, the VAT refund system provides for six *de jure* but seven *de facto* delays in favor of the government. This deprives businesses of their working capital. We suggest a three-month term for VAT refunds and a 30-day term for exporters.

## **Administration**

Bulgarian tax reforms and amendments under current regulations have had paid little attention to the role of administration. The survey indicated entrepreneurs' overall discontent with the costs of dealing with government. The Tax Administration Act was adopted in 1993 (and since then amended once), but implementation has been poor.

There is a need for special research on ways to enhance administration. However, two general recommendations seem appropriate:

- . reform should be directed toward enhancement of the administration's technological and management skills; and
- . public procurement regulations should provide for greater transparency and accountability.

### **5.3. Deregulation In Poland: Policy Recommendations**

The specific features of the Polish tax system presuppose certain aspirations of the business community, as well as expert recommendations. The major problems to be resolved seem to be the complexity of regulations (and implementation), discretionary action by tax officials, rate differentiation, and widely-spread allowances. The nominal level of taxes seems to be a significant issue as well. In the paragraphs below we mention the outlines of the necessary changes in tax regulations.

#### **Income taxes**

- . The proper functioning of the system requires an acceptable and bearable level of tax rates. The message of the entrepreneurs is quite explicit: PIT rates of 14%-30% and CIT rate of 30%-32% could be commonly assimilated. The proposed numbers also address the issue of rate dispersion and progression. The CIT should by all means remain linear, while a slight decrease in PIT dispersion is recommended.
- . The existence of various incentives and reliefs hinders growth-oriented activities. That was partially recognized by the business people. However, a reduction and further abolishment of tax exemptions would be accepted by the public only if accompanied by a simultaneous decrease in nominal tax rates. A reasonable reduction of about eight percentage points was estimated.

- . Unclear regulations on tax breaks provide room for discretionary action by the tax administration. This obviously discredits the very idea of tax incentives, and therefore either tax exemptions should be more precisely defined, or should be abandoned completely.

## **Indirect taxes**

- . Given the present number of VAT rates (five), the introduction of a uniform rate seems quite reasonable. However, it should be accompanied by a reduction in the basic rate. Assignment of goods and services to different rate groups creates too many problems.
- . Regarding VAT level, two approaches contradict: the business community opts for 12.8% while fiscal needs require a higher rate. Given the current differentiated system, however, it is quite difficult to estimate what level of VAT rate would fit budget needs.

## **Tax procedures**

- . The business community needs a stable environment. Obviously, amendments to tax laws should be made as rarely as possible. Moreover, these should not violate the principle *lex retro non agit*.
- . Tax laws should reflect long-term goals. Short-term, mainly political and interest group motives should be avoided completely. Otherwise, the system encourages fraud and non-compliance.
- . The taxation system should not be interpreted as a tool of the social system any more. The grounds for progressive taxation should not be income equalization, as broadly proclaimed. Rational thinking operates with inputs and benefits, not with justice and social welfare.
- . VAT declarations are too lengthy and complicated. They should be significantly shortened.
- . Reporting procedures are quite complicated and time-consuming. Therefore, all tax declarations should be significantly simplified and shortened (two-three pages).
- . The frequency of PIT and CIT reporting is unacceptable. A feasible measure would be the replacement of monthly declarations with quarterly ones.
- . A certain symmetry of relations between taxpayers and the administration should be introduced. This applies to the full extent to the right of tax officials to break bank confidentiality, which should be significantly reduced. Also, taxpayers should have the right to appeal to civil regulations procedures. Generally, tax conflicts should not be judged by the administration itself — one cannot be judge at his own trial.

- . More flexible schemes of tax payment should be elaborated. This includes the right to compensation of tax obligations with payments due by the government.
- . The obligatory three-year revision of accounting books should be applied only to bigger companies, with over 50 employees.
- . Representation of business interests in the legislature seems to be insufficient. Business organizations should have more influence on legislation regarding taxes.

All of the above might be summarized in one sentence: the ultimate goal of any government should be the achievement of a friendly business environment and incentives for hard work and innovation.

#### ***5.4. General Conclusions and Policy Recommendations***

Simultaneous surveys of business community attitudes toward current tax regulation conducted in three transition countries, Bulgaria, Poland and Slovakia, provide a foundation for some important policy conclusions and recommendations. Besides significant changes to current regulations, there is a challenge to reflect upon the common denominators of the tax policies required.

Tax reforms have passed their original stage — tax regulations already apply to different business categories and have introduced a majority of the instruments of contemporary tax systems. It seems that in all three countries deregulation and simplification are coming to the reform agenda.

It is obvious that there are three coinciding areas of policy recommendations:

- . First, nominal tax levels should be decreased;
- . Second, tax refund periods should be shortened;
- . Third, in the area of tax administration, there is a general mood in favor of simplifying reporting requirements, removing inequality and unfair (discretionary) practices.

It is likely that the public debate already involves the voice of the business community more and more strongly. We may assume that this will result in further tax reforms generally directed toward reduction of the tax burden, and, in the near future, toward linear or flat taxation.

Emerging European economies will pass through the same turning points of tax reform as other countries. The success of these reforms depends on many macroeconomic and political circumstances. From a macroeconomic point of view, the challenges come from the indebtedness of individual economies. From a political point of view, success would depend on the ability of individual governments to implement policies conducive to economic growth and prosperity.

As with other countries in the region, Bulgaria, Poland and Slovakia are involved in basically the same political pursuit — they have given priority to entering the EU. The survey indicated that some of the problems connected with tax reforms in the region are similar to those of the countries undertaking special efforts to comply with the EMU agenda. CEE countries have the unique opportunity to learn from the experiences of others.

The tax requirements of the business community are in harmony with general pro-growth and prosperity economic policy principles. At the same time, the macroeconomic and administrative feasibility of these requirements needs further consideration. There are three areas which require additional effort:

- . First, the fiscal and macroeconomic dimension of such reforms needs to be addressed, researched and quantified. The dynamic nature of transition economies, political changes and underdeveloped private sector statistics have been preventing such

activities, both on behalf of individual governments and entrepreneurs' communities. Our comparative survey indicates a need to further investigate the feasibility of tax reforms.

- . Second, there is a need for a public awareness campaign for the parties involved in any provisional tax reform. Our survey underlines a need for deregulation simplification and stability of tax systems. The fact that stability and fairness are missing proves that governments would benefit from such a campaign. Meanwhile, the private sector misses the general picture and is likely to gain additional arguments to support its position.
- . Third, in order to implement a fair tax system, special attention should be paid to administrative reform. A failure to proceed with comprehensive reform of the tax administration would mean that none of the otherwise reasonable suggestions and recommendations would become a reality.

<sup>1</sup> Income Tax Act No. 286/1992 Zb. with subsequent amendments.

<sup>1</sup> \_ A list of eight goods, such as bread, milk, water, medicaments, etc. are exempt from VAT until July 1, 2001. The level of VAT due on real estate deals is the difference between the 22% deduction and a local tax, defined in the Local Taxes and Fees Law.

<sup>1</sup> In 1998, the number of tax rates in Bulgaria was reduced from seven to four.

<sup>1</sup> The average preference of the PIT rates dispersion was obtained by multiplying percentages of respondents by preferred dispersion.

<sup>1</sup> There might exist a turnover threshold which distinguishes between those who are obliged to register for VAT taxation and those who can choose to do so, and also a threshold which distinguishes between those who should register and those who are not allowed to do so. The latter is the case with Bulgaria. Therefore, the conclusions derived further down are to certain extent misleading.

<sup>1</sup> When there is the possibility for a tax refund (VAT), there is a need to speed up declaration; when there is no tax refund (CIT and PIT), there is a need for less frequent declaration periods (which is quite rational).

<sup>1</sup> The "Other" included these complications/lack thereof:

- disastrous payment discipline;
- lack of transparency, leading to ample tax avoidance opportunities;
- no difficulties;
- the entire philosophy of individual income tax is too complicated;
- paying advances towards eventual tax liability slows down business in the subsequent year.

<sup>1</sup> To closely examine the problems of the Italian fiscal machinery, we suggest "Le Illusioni Fiscali" by Raffaello Lupi, copyright 1996 by Mulino, Bologna.

<sup>1</sup> The IV Directive of the EEC is one of the directives posed before the members of the Community to harmonize their legislations, regarding accounting. It is not a matter of lows, but minimal requirements, which don't prevent single states from adopting stronger rules. "Harmonize" doesn't mean standardize, but choose among different alternatives based on common criteria.

<sup>1</sup> With an effective rate of approximately 26%.

<sup>1</sup> They amount to about 33 percent of payroll.

<sup>1</sup> Nils-Eric Sandberg: What went wrong in Sweden?, Timbro, Stockholm, 1997, p. 27. This problem is explained further on page 33: "The problem was that the taxation scales were not adjusted for inflation, so that if wages were increased in step with inflation, taxes rose in proportion to income. Income remained unaltered, in fixed money terms. But tax, in fixed money terms, increased."

<sup>1</sup> Individual tax matters are resolved by the National Tax Board and the county Tax Authorities without the involvement of the Government.

<sup>1</sup> Government Current Expenditure (total government expenditure, excluding capital expenditure) as a percentage of GDP was 66.4% in 1995.

<sup>1</sup> See: Ingemar Stahl, Kurt Wickman, Suedosclerosis: The Problems of Swedish Economy. Excerpts, Timbro, Stockholm 1995, p 14.

<sup>1</sup> Economic Survey of Switzerland, OECD, August 1997.

<sup>1</sup> Total government expenditure, excluding capital expenditure.<sup>1</sup> The most important issues have already been addressed in tax regulation amendments of late 1997; i.e., the equal treatment of all types of corporations (and some unincorporated or non-limited-liability enterprises). Here we deal with the remaining problems.