

Policy, Research, and External Affairs

WORKING PAPERS

Socialist Economies

WPS0501

Country Economics Department
The World Bank
September 1990
WPS 501

Tax Systems in the Reforming Socialist Economies of Europe

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As socialist countries move toward market systems, tax policy is an important part of the reform agenda.

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This paper — a product of the Socialist Economies Division, Country Economics Department — is part of a larger effort in PRE to study the process of transition in reforming socialist economies. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Lois Lockyear, room N6-040, extension 36969 (29 pages).

This paper lays out some of the broad trends and issues now emerging as socialist economies attempt to reform their systems of taxation. Particular attention is paid to Hungary and Poland, the most advanced in the reform process, but short discussions of Czechoslovakia, Yugoslavia, and the U.S.S.R. are also included.

Although the fiscal system of every socialist country has its unique characteristics, there appears to be a distinct series of stages through which these systems have passed or will pass on the road from full central planning to a largely free market economy. The first stage, *classical socialism*, prevailed in the first two to three decades after World War II and was characterized by central control of many economic variables — including input and output mix, pricing, and income distribution. Tax systems tended to be very rudimentary tools to capture economic surplus and transfer revenues to the state. Taxes consisted primarily of a mixture of turnover taxes and taxes on factors of production. They were paid almost exclusively by firms in the socialized sector.

The second stage, *reform socialism*, began in the 1960s and early 1970s in many socialist economies and remains until today in some. It has typically coincided with expanded decentralization of economic decisionmaking and greater autonomy for enterprise managers — and been characterized by the emergence of a fledgling independent role for the tax system in directing economic activity. In this stage the

traditional sources of revenues — the turnover, company profits, and payroll taxes — remain the most important taxes, but they become more fine-tuned. They are often joined by new and unique taxes that attempt to mimic market forces, such as a levy on fixed assets, an excess wage tax, and a tax to extract rents from CMEA trade. The incentive effects of taxes in this stage tend to be muted by the very ad hoc, discretionary, individually negotiated nature of tax liabilities.

Several countries of Eastern Europe are now moving into the third stage, *post-socialist transition*. The tax changes needed to adapt to a market economy are fundamental and systemic. But three sets of problems — related to macroeconomic concerns, enterprise ownership and structure, and institutional weakness — impose constraints on the design of tax policy during the transition. Maintaining revenues to insure budget balance is crucial for macroeconomic stabilization. However, institutional weakness combined with the demands of rapid privatization threaten to erode the traditional revenue base (based as it has been on high rate and often ad hoc and discretionary taxes that are incompatible with private sector development). These constraints are well-illustrated in the current fiscal situation in Hungary and Poland, and they are likely to arise in other countries — including Czechoslovakia, Yugoslavia, and the U.S.S.R. — as they move toward fundamental fiscal reform.

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As socialist countries move toward market systems, fiscal policy is an important part of their reform agenda. First, they need to reorient public spending to focus more on the provision of "public" goods. Second, they need to adopt more selective, predictable, and nondiscretionary means to finance such spending. Although many developed and developing countries have faced challenges of the same general type in the last decade, the reforming socialist economies are fundamentally different because of the enormous magnitude of the transformation--in both policies and institutions--that is required. Uncertainties and tradeoffs are magnified manyfold in such an environment.

The goal of this paper is to lay out some of the broad trends and issues now emerging as socialist economies attempt to reform their systems of taxation.¹ The primary focus is on Eastern Europe, although many of the same trends and issues arise in the reforming socialized countries of Asia and Africa. Particular attention is paid to Hungary and Poland, which are most advanced in the tax reform process. The experiences they have had and the problems they are facing provide valuable lessons for those countries just starting on the reform process.

Historical Trends: The Changing Role for Tax Policy

Although the fiscal system of every socialist country has its unique characteristics, there appears to be a distinct series of stages through which

¹ This paper is concerned only with explicit taxes that are part of the formal tax system. It does not consider quasi- or implicit "taxes"--such as those arising from inflation, overvalued exchange rates, or negative real interest rates--that also impose significant financial burdens in many socialist economies.

these systems have passed or will pass on the road from full central planning to a largely free market economy. Both the goals and the patterns of taxation differ markedly in each stage. These stages mirror closely the stages of economic reform more generally. For simplicity, this discussion follows a tripartite division suggested by Prof. Janos Kornai--classical socialism, reform socialism, and post-socialist transition.²

Classical socialism: traditional central planning

The countries of Eastern Europe (except Yugoslavia) practiced traditional central planning for the first two to three decades after World War II. In these economies, central authorities tried to control most major economic variables--including input and output mix, pricing, and income and wealth distribution--through the plan. Tax systems tended to be very rudimentary tools to capture economic surplus and transfer revenues to the state.³ Virtually all tax revenues were paid by firms in the socialized sector. They consisted primarily of a mixture of turnover taxes⁴ and taxes on factors of production--generally on labor (payroll taxes and social insurance fees) and capital (company "profits" taxes). Of these, the turnover tax was the most important in revenue terms. These major

² Professor Kornai discussed these three regimes in a recent presentation to the World Bank's Executive Directors.

³ In the theory of classical socialism, enterprises do not exist as independent economic agents; they are in effect subdepartments of the state. Consequently, all profits should accrue to the state and all losses should be covered by the state, with taxes having no incentive function at all. In practice, however, high administrative and information costs prevent perfect control of economic variables and enterprise behavior by the center.

⁴ Strictly speaking, levies on turnover can be either positive (taxes) or negative (subsidies). Although the discussion in this paper focuses only on taxes, the reader should keep in mind that revenues from turnover taxes are typically offset to some extent in socialist systems by consumer and producer subsidies.

taxes were at times supplemented with taxes on agricultural land (usually crop rather than cash payments), urban property, non-wage personal income, and "excess" wages or profits, although the latter two in particular were typically very small sources of revenue.

Although rudimentary by Western standards, these tax systems could be quite complex because of the fine differentiations within them, in effect an extension of the fine differentiations in the economic plan. Turnover taxes were intertwined with other types of controls as tools to capture revenue and determine prices and subsidies. Usually there were hundreds of rates, and they were set and changed in an ad hoc manner. Company taxes were also highly variable from enterprise to enterprise and from year to year. Company profit taxes were designed generally to transfer the great bulk (if not all) of net enterprise income to the state budget. Because the state was the owner of most productive assets and had many other tools at its disposal to steer economic activity, discretionary and ad hoc changes in the tax regime were neither unexpected nor highly disruptive to production. In fact, the role of the state as tax collector was hardly distinguishable from its role as owner, and many of the levies called "taxes" (particularly those on company profits) could in fact be seen as returns derived from capital ownership.

The scope for independent analysis of fiscal policy would obviously be limited in such a setting. Tax policy analysts in western market economies are accustomed to thinking of taxes as tools to accomplish certain social and economic goals. Some analysts focus on the incentive effects of taxation--such as their impact on investment, employment, and prices. Others concentrate on the ability of tax systems to redistribute income from richer to poorer. Still others are concerned primarily with the ability of a tax system to raise revenues

to finance government spending, thereby avoiding fiscal deficits and macroeconomic instability. In a traditional centrally planned economy, "taxes" by themselves (as distinct from other controls, such as central plan directives for enterprises, price controls, labor regulations, and so on) have little independent role to play in raising revenue, providing incentives, or improving equity.

Reform socialism

The second stage in the transition, reform socialism, is characterized by the emergence of a fledgling independent role for the tax system in directing economic activity. This stage began in the 1960s and early 1970s in many socialist economies and remains until today in some, including the U.S.S.R. and China. The stage typically coincided with expanded decentralization of economic decision making and greater autonomy for enterprise managers. Given this new managerial autonomy, authorities found that they needed indirect levers for the first time to influence economic variables and capture economic surplus.

While still somewhat rudimentary by Western standards, tax systems in reform socialist economies have generally been more sophisticated than those in classical centrally planned systems. The traditional sources of revenue, the turnover, company profits, and payroll taxes, remain the most important taxes, but their roles change somewhat. Turnover tax rates tend to become even more differentiated, as their price-regulating function becomes even more predominant. At the same time, profits tax rate structures may become somewhat more uniform across sectors (at least on paper) in an attempt to spur efficiency in the use

of resources.⁵ The incentive effects tend to be muted, however, by the very ad hoc, discretionary, individually negotiated nature of tax liabilities. The enormous discretion of authorities to change tax rules will--often after profits have been made--is both a major cause of the soft budget constraints of firms and an important disincentive to improved efficiency.⁶

In addition, new and unique taxes have often been introduced in reforming socialist countries in an attempt to mimic market forces. One example is the levy on fixed assets, widely introduced in socialist countries in the 1960s to stimulate more efficient use of capital.⁷ Such levy mandates the payment to the state of a preset rate of return on assets regardless of actual profits. In 1965, for example, the U.S.S.R. instituted a tax ("profit payment") on the balance sheet value of fixed assets and the value of working capital

⁵ In Hungary, for example, the enterprise profits tax took on greater importance in the 1960s, surpassing the turnover tax as the major source of budgetary revenues. The 1968 reform program stressed the need for uniformity in enterprise taxation across sectors, in order to provide equal incentives to enterprises. "Hungarian People's Republic," in International Bureau of Fiscal Documentation, p. 21.

⁶ This process of changing the rules in an ad hoc fashion after profits have been made is often called "leveling." It results in part from asymmetries in information between the firm and the government. The government wants to capture and redistribute surplus but only the firms know what that potential surplus is. So tax rules are set before the fact that encourage production and efficiency, but they are changed after the fact to capture more of the resulting surplus. The process of leveling erodes the confidence of managers and ultimately creates strong incentives against increased work effort or improvements in efficiency (Litwack, 1989). Several studies have documented the extent to which socialist tax and subsidy schemes redistribute incomes--in part through this leveling process--from more profitable to less profitable firms (Kornai, 1984; Schaffer, 1989; Vodopivec, 1990). The analysis of Yugoslav firms carried out by Vodopivec was extended to include not only explicit taxes and subsidies but also quasi-taxes and subsidies (through forced investments at negative real interest rates) as well as the inflation tax.

⁷ As with the company profits tax under classical socialism, this levy on fixed assets--sometimes called a dividend--derives more from the government's role as owner than from its role as tax collector.

("circulating means"). The rate was generally 6%, although lower rates could apply in certain circumstances. Similarly, Hungary levied a 5% charge on assets between 1964 and 1978, and Poland introduced such an "interest charge" on fixed assets as early as 1959.⁸

Another example of a "reform socialist" tax is the excess wage tax, used as a means of regulating enterprise wage determination in the absence of labor market discipline. Hungary first introduced a tax on excessive wage increases (above a prespecified norm) after its major 1968 economic reform. Several overhauls were introduced in the 1970s and 1980s in an attempt to liberalize and reform the system of wage determination. Poland has enforced a similar type of tax on excessive wage increases since the early 1980s. However, these schemes have generally not been successful at limiting wage increases because of the many systemic and ad hoc exemptions that have been granted along the way.⁹

Finally, another unique type of tax typical in the reform socialist systems of Eastern Europe is the tax used to extract rents from CMEA trade.¹⁰ This trade (mostly comprised of bilateral deals with the Soviet Union) has traditionally been at terms that favor the countries of Eastern Europe. They have been able to import raw materials at a low price and export manufactured goods at a premium

⁸ Poland has reintroduced this form of tax in its current reform, as described below.

⁹ Poland is currently attempting to implement a very strict excess wage tax as part of its 1990 reform package, as described in greater detail below.

¹⁰ Such a tax also has a role in post-socialist transitional economies as long as the terms of CMEA trade diverge from world market prices. Revenues from such a tax are of course offset by certain export and import subsidies also needed to correct for distorted CMEA prices and exchange rates.

relative to what they might draw on the world market.¹¹ Governments have used the tax system to capture the rents of importers and exporters. The revenues from such taxes can be enormous; for example, Hungary's Special Commodity Tax accounted for almost as much revenue as the VAT in 1988.

Post-socialist transition

The third stage of reform is the post-socialist transitional economy. The endpoint of the transition is presumably a mature market economy similar to those in Western Europe. While virtually all the countries of Eastern Europe profess a desire to move towards this model, Hungary, Poland, and Yugoslavia are the most advanced in the transitional stage. They are in the process of adopting the major systemic reforms needed to take them there--for example, reforms in ownership, industrial structure, pricing, trade policy, financial markets, and social safety nets.

The important and independent role of taxes in a mature market economy is familiar. Several concerns must always be balanced in designing tax policy, including the adequacy of revenue to finance government operations and transfers, efficiency in the use of factors of production, equity in the distribution of income and wealth, ease of administration, and interaction with foreign tax systems. Yet the balancing process is eased by the relative stability of the underlying economic and institutional structure in these countries; analysis can be done assuming that most changes will be marginal.

In post-socialist transition economies, the underlying economic and institutional structure is much less stable, and needed changes are not marginal

¹¹ These diversions from world market prices have not necessarily been intentional but have resulted from the complexities of CMEA pricing and exchange rate rules.

but fundamental and systemic. Although the end goal may be familiar, the process of transition is fraught with difficulties, not only for the economy in general, but also for a fiscal system in particular. In particular, three sets of problems impose constraints on the design of tax policy during the transition.

Macroeconomic Concerns.

First, the need to ensure macroeconomic stability imposes strict constraints on tax policy. Budget deficits are a root cause of instability and inflation, as evidenced again and again in reforming socialist economies such as Poland, Hungary, Yugoslavia, the U.S.S.R., and China. Stabilization programs, such as the current Poland program, require tight fiscal policies to control budget deficits. A tight fiscal stance generally leaves little room for revenues to fall. Therefore, it is difficult to eliminate old and reliable sources of revenue even if they do not support the goals of a market economy.

Maintaining revenues to meet balanced budget targets during the transition is even more difficult given the unemployment and the slowdown in growth that tend to accompany the process. In Poland, for example, output fell substantially in the first few months of the stabilization program,¹² as public and private demand fell and firms were subjected to changing price structures, harder budget constraints, and world market competition. When output and employment fall, the tax base falls as well. Furthermore, unemployment leads to increased demands for unemployment compensation and thus for increased revenues to finance it. Revenue needs clash with the reality of the downturn and the need to reform (and

¹² Official estimates of the fall in output in the first three months of 1990 range from 20% to 30%, although some observers think these numbers--based on poor statistics and failing to include the benefits of eliminating queues--overstate the economic hardship somewhat.

lower) taxes to spur investment and restructuring.

Enterprise Ownership and Structure.

When virtually all enterprises are owned and controlled by the state, collecting revenues is relatively easy. As noted earlier, ad hoc changes in tax rules can be made as needed to meet budget targets (although such changes clearly disrupt the credibility and thus the long-term incentive effects of the system). Such constant ad hoc changes have been the norm in all socialist countries. However, as state ownership is diminished through privatization and as new (often small) private activities are allowed to emerge spontaneously, the tax system needs to become more predictable and less discretionary. The introduction of more democratic processes in the political sphere also puts limits on the number of changes in tax policy that are feasible in a given period. The state thus loses a large degree of flexibility in raising revenues as needed to close budget deficits. The entire process of privatization, so critical to long-term economic reform, could in this way be jeopardized by fiscal concerns.

Furthermore, privatization and the accompanying loosening of direct controls over productive activity heightens the influence of tax rules over economic behavior. All of the tradeoffs facing tax policy in mature market economies--generally balancing revenue, efficiency, and equity concerns--begin to come into play. For example, the potential deadweight loss from high marginal effective tax rates increases significantly. The need to support increased investment and efficiency in resource use further limits the flexibility of the revenue system.

Finally, expanded private ownership creates pockets of vested interest independent from the state. The fact that these interests can assert heavy

pressures to block change later on argues for getting tax policy right early in the process. This lesson is well illustrated in Hungary, where earlier personal income tax reforms gave generous exemptions to individuals and earlier company tax reforms put very generous incentives in place for foreign investors (see below). These are now quite difficult to remove because of the vested interests that have arisen to preserve them.

Institutional Weakness.

Most socialist or post-socialist countries are very poorly equipped for the modern, relatively impersonal tax administration called for in a market economy. In traditional or reform socialism, tax administrators are part of the ownership and control structure of government, and they have unrestricted access to enterprise books and records. State enterprises tend to be quite large, and therefore the number of registered taxpayers tends to be relatively small given the size of the economy.

Tax administration in a market economy with many independent firms (both small and large) and thus many taxpayers calls for a different set of skills--skills that tend to be lacking in socialist economies. For example, techniques of selective auditing and tax enforcement need to be developed; so do accounting practices and a reliable and objective legal framework for dispute resolution. Furthermore, the public needs to be well-versed in principles of tax policy and methods of tax compliance. Not only do all of these countries need a major effort to develop the institutional capacity for tax administration, but they should carefully consider the administrative dimension when designing the substance of tax reform.

Institutional development takes time, and thus true tax reform will take

tion. Yet this does not necessarily mean that the process of substantive tax reform should be delayed. As noted above, putting well-designed, clear, and simple tax laws in place early in the reform process may prevent the future blocking of reforms once private interest groups take hold.

Illustrations: Tax Systems in Various Reforming Countries

Hungary

Hungary has gone farthest down the road of tax reform of any socialist country. From 1949 to 1967 its tax system approximated that of a traditional socialist economy, dominated by a production turnover tax and a tax on enterprise profits (amounting to all of the enterprises' planned profits and a portion of surplus profits). These were later supplemented by the payroll tax (in 1958), the social insurance fee (in 1958), and the 5% charge on firm assets (in 1964).

The major reforms in the economic management system enacted in 1968 were accompanied by important tax reforms, as the tax system took on more of a regulatory role in addition to its basic revenue-raising role. Profits taxes increased in importance and were designed to give more incentive for efficiency in input use. The regulatory role of turnover taxes in controlling consumer prices and insulating the domestic economy from international price developments became more important as compared to their budgetary role. Authorities increasingly used the payroll tax, social insurance contribution, and tax on incremental wages as means of regulating enterprise wage determinations and policies. The tax system became more and more complex with the introduction of new taxes, the proliferation of tax rates, and the granting of tax preferences. The tax regime was highly differentiated by sector and often individually negotiated by enterprise.

Finally, the Hungarians implemented a major tax reform in 1988 with the introduction of a VAT and a personal income tax, followed in 1989 with a reform of the company income tax. These modern taxes set the stage for the transition from a reform socialist economy to a post-socialist economy in transition. The reform was intended to move away from a complex and discretionary system of taxation to one based more on the objectives of neutrality, stability and transparency. The new taxes do indeed--for the first time--look quite a lot like the taxes in mature western economies. However, the problems of transition noted earlier have clearly imposed constraints on the achievement of these objectives.

Macroeconomic Concerns.

A major problem in the transition has been macroeconomic stability. Although the budget had been in surplus in 1984, it eroded significantly in the following two years. The budget deficit exceeded 3% of GDP in 1986 and 1987. There was no room for revenue shortfall when tax reform began in 1988.

The need to maintain budget balance (combined with a penchant for "fine-tuning" as discussed later) forced general tax rates to remain high in the new system. The maximum personal income tax rate was 60% when the tax came into force in 1988, and VAT rates were relatively high at 25% (the normal rate) and 15% (mostly applicable to services).¹³ The company tax rate after the 1989 reform was 50%, with a one-time additional 4% charged in 1989 for budgetary purposes. While these rates may not seem particularly excessive in mature market

¹³ Furthermore, for fear of revenue loss the creditability of taxes paid on investment goods is being phased in over a five-year period. Only 40% of the tax was creditable in 1989. One-hundred percent will be creditable beginning in 1992.

economies, they are hardly conducive to new investment or higher work effort. Furthermore, high marginal rates put a strain on any tax administration because of the heightened benefits taxpayers can gain through evasion. For these reasons, macroeconomic constraints and the urgent need to maintain revenue yield clashed with other goals--investment, efficiency, and institutional development--in the Hungarian reform.

The 1988 reforms did in fact succeed in maintaining revenues. Yields on the new VAT and personal income tax were close to anticipated, with the VAT bringing in much more than the previous turnover tax. Because of a concurrent increase in profit tax revenues (under the old system), total revenues rose by 3 percentage points of GDP from 1987 to 1988. Total expenditures rose only slightly, and the budget deficit fell from just over 3% in 1987 to just under 1% in 1988.¹⁴ However, revenues fell significantly in 1989 with the introduction of the new profits tax (with its many exemptions) and general stagnation in the economy.¹⁵ Only through expenditure cuts did the Hungarians manage to keep the overall budget deficit close to the 1988 figure.

Enterprise Reform.

Hungary must weigh its desire to promote changes in enterprise structure, ownership, and efficiency against these macroeconomic concerns. Increasing privatization of the economy and increasing exposure to market forces need to be accompanied by less distortionary, more predictable tax regimes. The reforms of 1988 and 1989 went a long way in this direction. Furthermore, as part of its

¹⁴ IMF staff estimates, calculated using Government Finance Statistics conventions.

¹⁵ Virtually no growth occurred in 1988 or 1989.

post-socialist transition, Hungary is now moving further to reduce the role of the state by cutting expenditures (particularly subsidies) and allowing revenues to fall concurrently. Maximum tax rates for personal and company income taxes were reduced in January 1990 to 50% and 40%, respectively.¹⁶

However, in the view of most observers, Hungary made one mistake in its initial tax reform process that now makes change more difficult. In a desire to promote growth and equity--combined with a confidence in the ability to "fine-tune" the economy through central directives, perhaps a holdover from previous days--it loaded all of its new taxes with a myriad of exemptions and exceptions. For example, the personal income tax exempts an estimated two-thirds of all personal income, including not only a generous tax-exempt amount (slightly over one-half average earnings), but also social security and other transfers, pensions, and most income from farming. The VAT exempts all financial, health, education, sports, and cultural services; it "zero-rates" many goods, including processed foods, medicines and medical equipment, books and periodicals, transportation services, and many sources of energy. The profits tax specifies reduced rates for certain activities, including public utility and health services, cultural and sports activities, agriculture, food processing, and food retailing. It is particularly generous to foreigners investing in a wide range of activities of "special importance".¹⁷ Joint ventures with foreigners (with a very modest limit--20% or 5 million forints--on required foreign participation) are eligible not only for a five-year tax holiday, but also for a 60% tax

¹⁶ State-owned enterprises must also pay a "dividend" of 18% of after-tax profits, making the effective profits tax rate 50.8%. The personal income tax rate was reduced in 1989 from 62% to 56%, before being again reduced in 1990.

¹⁷ These include tourism, telecommunications, and a wide range of manufacturing operations.

reduction after the five-year period and a rebate of any taxes of the foreign partner reinvested in Hungary. Under such a generous regime, it would be surprising if such joint ventures ever paid taxes in Hungary.

The fine-tuning incorporated into the reformed Hungarian tax laws will be difficult to change given the vested interests that have formed around it. The new government has expressed a desire to reduce the generous exemptions given to foreign investment, but some fear that this might create uncertainty and suspicion in the foreign community. The government has also expressed the desire to lower VAT rates and narrow the range of goods subject to the 0% rate. However, bringing previously exempt income into the personal income tax or the VAT will be difficult, although many of these items are fully taxed in other countries and could legitimately have been included in the tax net from the beginning. Any increase in the personal income tax coverage is particularly problematic. Hungary's government suffered great political cost in introducing a high-rate personal income tax early in the game.¹⁸

Administrative Concerns.

Although Hungary has had more experience with tax policy formulation and tax administration than other reforming socialist economies, it will still need time and technical assistance to improve auditing and enforcement capabilities. According to Hungarian observers, the tax administration is not yet capable of enforcing taxes on "hard-to-tax" groups. For example, most income from self-employment (including "moonlighting", a major source of income for many) is de facto tax exempt due to difficulties in collection. This can lead to great

¹⁸ This is true even though wages and salaries in the socialized sector were grossed up to cover the additional tax burden.

inequities in the system; doctors in state-owned clinics, for example, are said to earn well over one-half of their income from extra payments and moonlighting.

Fine-tuning a tax system with many exemptions and exceptions adds to the complexity of administration. Hungary could benefit from extensive tax simplification, broadening tax bases and lowering tax rates. Although inflation is significant (about 20% in 1989) and may be rising, indexing the tax system for inflation could put additional administrative strains on an already overly-complex system. Many hope that the economic program now in place will lower inflation and thus reduce the need for indexing.

Poland

Poland is taking the "big bang" approach to economic reform, adopting many far-reaching changes simultaneously. While it has not gone far down the road of tax reform yet, plans are underway to make major changes in the next couple of years.

Post-war Poland adopted the classical socialist system of central planning. All major economic variables were controlled through the plan, and taxes did not have an independent role in influencing economic decision making at the firm level. The turnover tax--the main tax instrument--joined with subsidies (their mirror image) to fulfill the traditional function of providing government revenues and constraining demand to fit planned supply through the use of thousands of specific rates.

Poland's early moves away from classical socialism toward reform socialism can be dated from the early 1970s, when the Polish authorities introduced an experiment in decentralized economic management. The turnover tax was simplified into a system based on ad valorem rates, and was used for the first time to

indirectly influence output mix by charging lower rates of tax on favored goods.

Payroll taxes were introduced to influence wage-setting, and an "interest" charge on fixed assets, first introduced in 1959, was incorporated into the new system.

The reform program of 1981-82 represented the most far-ranging effort at reform since the adoption of central planning. It was based on the desire to use economic instruments, including fiscal policy, to guide enterprise behavior and increase enterprise efficiency indirectly. The turnover tax continued to be a major tax instrument. It remained highly differentiated by product, having hundreds of rates and subject to ad hoc change at any time. The payroll tax was supplemented in 1982 with a tax on excess wages in an attempt to alleviate the rise in the wage bill. A progressive company profits tax was introduced in 1982. It was changed to a flat 60% tax in 1984 (raised to 65% in 1985) in an attempt to encourage increases in production. A growing number of systemic and ad hoc tax exemptions and reliefs in the 1980s led to ever increasing complexity and fine differentiations in tax burden among sectors and individual firms.¹⁹ By 1987, the turnover tax had about 400 rates, about one-third of enterprise income was effectively exempt from tax through negotiated reliefs, and the entire system was heavily burdened by the efforts of the authorities to direct the "reformed socialist" economy to desired ends. These major taxes were supplemented by numerous less important (but nonetheless complex) ones, including a salary tax (on income from activity in the nonsocialized sector), a highly progressive "equalization tax" on individual wages (from any activity) above a certain

¹⁹ These included, for example, tax rate reductions for exporting firms (to counteract an overvalued exchange rate), three-year tax holidays for high-technology enterprises, and lower tax rates for social organizations engaged in education, health, or cultural activities, not to mention numerous tax reductions negotiated on an individualized basis with ailing firms.

amount, an urban property tax, an agricultural tax, and numerous lump-sum taxes intended to substitute for turnover and income taxes on small taxpayers.

In late 1989 and early 1990, Poland introduced a non-communist government and radical steps toward economic reform. This reflected a fundamental change in goals away from reform socialism toward post-socialist transition to a free market economy. Concurrently, initial steps were made to move toward a more neutral and transparent tax system conducive to market behavior and privatization. For the first time, the turnover and income tax regimes were made almost the same for socialized and nonsocialized firms.²⁰ The number of turnover tax rates was reduced to only about 14 (11 general rates plus special rates on alcohol, petroleum, and cigarettes) in January 1990. Company income tax rates were reduced (earlier in 1989) to 40%, and most special incentives (including those for export and investment) were eliminated. The "dividend" required of state enterprises was strengthened to offset the revenue loss from the reduced company tax rate, to force the efficient use of assets, and to identify both viable firms and firms that are nonviable and should be liquidated.²¹ Finally,

²⁰ The main remaining differences in tax treatment by owner or sector are that foreign joint ventures are eligible for 3-year tax holidays, and domestic firms in some sectors--such as pharmaceuticals, housing, and food processing are eligible for tax holidays of 3-10 years.

²¹ As noted earlier, this dividend derives from the government's role as owner rather than its role as tax collector, and thus it is not a "tax" in the traditional meaning of the term. The Polish authorities estimate that the dividend will amount to about 5-10 percent of enterprise asset value on average per year. By law, the required dividend for 1990 is set at 32% of the value of the firms "founding fund". The founding fund is a share of the firms assets calculated as the net book value at the end of 1983, increased by subsequent capital transfers from the government and the capitalization of any previous dividend requirements not paid by the firm. Any increments resulting from revaluation of assets or retained earnings from 1983 to 1989 are added to the "enterprise fund" and not included in the founding fund. In January 1990 firms were instructed to revalue assets, with different revaluation coefficients depending on the type of assets, but the average coefficient being about 14, with the incremental value to be allocated proportionately between the two funds.

a very steep excess wage tax was imposed on enterprises to control wage increases during the stabilization period.²²

Polish authorities are preparing the ground for a major tax reform effort in 1991 and 1992. They plan to introduce a modern, global income tax in January 1991,²³ and a VAT in 1991 or 1992. In making these reforms the Poles face many of the same constraints as the Hungarians. First, insuring adequate revenues to maintain budget balance is critical during the stabilization period. The budget deficit soared to about 8 percent in 1989, and the 1990 budget projects a much tighter fiscal stance, with a deficit of only about one percent of GDP. While the easing of inflation through the stabilization program will boost revenues considerably in real terms (by eliminating the real cost of lags in collection), the downturn in economic activity accompanying the stabilization program reduces the tax base for many revenue items. For example, the 1990 budget predicts a 42% real rise in company income tax revenues (equivalent to a jump of over 3 percentage points of GDP); one wonders if this is feasible given the reported downturn of at least 20% in industrial production. Revenues from the turnover and wage taxes are projected to fall in real terms; this would seem more consistent with expected economic trends. In any case, macroeconomic concerns make it unlikely that the Poles can lower tax rates significantly in

On average about one-third of a firm's capital is allocated to the founding fund, while two-thirds are allocated to the enterprise fund.

²² Specifically, the increment in the total wage bill is to be taxed at a very progressive rate (from 200% up to 500%) if it increases faster than a certain proportion of the monthly inflation rate. That proportion was set at 0.3 in January, 0.2 in February, March, and April, and 0.6 from May on.

²³ The tax would replace five current taxes and would apply four progressive rates up to 50%, with a maximum average rate of 40%, the same as the company income tax rate. The only exemptions proposed are on agricultural income (separately taxed under the agricultural tax) and possibly interest income and capital gains on the sale of shares and bonds.

the near future.

In addition, administrative concerns pose a significant constraint on tax reform. Because of the relative newness of its major reform efforts, Poland has not had the experience that even Hungary has had with modern tax administration. Until the tax administration is trained in modern auditing and collection techniques, it could be risky to move quickly on major changes to redefine the tax system and expand the tax net. On the other hand, there is merit to moving quickly to reform the tax system before vested interests are created through expanded private ownership.

Fiscal concerns could also complicate the debate on privatization. Widespread private ownership would mean the disappearance of a significant revenue source, the "dividend" required from public enterprises. Projected dividend revenues account for almost 9% of total revenues in the 1990 budget, and their budgetary importance is increasing rather than decreasing, as the Poles move to impose stricter profit expectations on state enterprises. The cost of foreign dividends could in theory be offset by revenues from the sale of state assets. This would require that those assets be properly valued and carefully sold to the highest bidder, a process that could slow down privatization considerably at a time when many are insisting that it must go forward rapidly.

In addition, the tax administration is likely to have more difficulty collecting taxes from privatized firms (especially if they are granted tax incentives) than from public enterprises. Auditing financial statements and enforcing tax requirements on independent firms and individuals are very different and more complex tasks than collecting rudimentary taxes from state-owned and state-controlled firms.

Finally, the government will find it more difficult to introduce ad hoc

revenue measures at will to close a budget gap, as has often been the practice in the past. A tax system needs to be relatively stable, transparent, and nondiscretionary to attract and support productive private investment, whether domestic or foreign.

Other Reforming European Socialist Countries

None of the other reforming socialist countries has yet made the moves taken or contemplated by Hungary and Poland to radically reform their tax systems in line with a move toward post-socialist transition. Some of them--most notably Czechoslovakia and Yugoslavia--are preparing to move in that direction, however.

CZECHOSLOVAKIA.

Czechoslovakia's main sources of revenues until 1967 were those traditionally found in classical socialist economies--including the turnover tax, public enterprise profit taxes (including "output" and "performance" taxes, levies on assets, and dividends), a wage tax, and a tax on agricultural activities, and some other minor taxes on specific activities. From 1967 to the early 1970s, subsequent to the "New Economic System Directive" in January 1967, a series of changes were made (similar to those in Poland and Hungary) to increase the independent regulatory role of the tax system. The ingredients are familiar--complex, differentiated, and generally high-rate²⁴ levies on manufacturers' turnover, profits, capital, payroll (including social security

²⁴ For example, profit levy has generally been assessed at a rate of 75%, and social security contributions are generally set at 50% of payroll. As in other socialist countries, the convention under the turnover tax has been to quote the rate as a percentage of the tax-inclusive price, rather than the tax-exclusive price as used in the West. Thus, a tax of 50% represents a 100% addition to the base (or tax-exclusive) price. "Czechoslovak Socialist Republic", in International Bureau of Fiscal Documentation.

contributions), and incremental wages.

A similar system remains today, although the general payroll tax was abolished in 1978 and replaced with an individualized wage tax and company social security contributions (based on payroll). The largest sources of revenue remain profits and turnover taxes paid by state enterprises (together about two-thirds of total tax revenue). Because Czechoslovakia has a federal system, revenue sources are divided between the federal budget, the republics' (Czech and Slovak) budgets, and the budgets of the "national committees" (local government entities). The Federal budget receives all foreign trade tax revenues as well as profit taxes from federally controlled state enterprises; the republic's budgets receive taxes from republic-controlled state enterprises; the national committees receive wage tax revenues from individuals. Turnover tax revenues, which previously went to the federal government, are to be divided equally between the federal government and the republics from 1990 on.

As Czechoslovakia enters the stage of post-socialist transition, it plans to reform the tax system to bring it more in line with the needs of a private market economy and to harmonize it with the tax systems of other European countries. The Czechs plan to introduce a value-added tax, a unified company profits tax, and a global personal income tax in 1993.²⁵ In doing so they will face many of the constraints--related to macroeconomic policy,²⁶ enterprise reform, and administrative capacity--now facing Hungary and Poland.

²⁵ They are taking small intermediate steps now. Transitional laws recently passed by Parliament extended turnover and profits taxes to newly-legitimized private businesses, and another new law imposes a personal income tax on private non-wage income.

²⁶ However, to date Czechoslovakia has managed to avoid the large budget deficits and accompanying inflation that have plagued Poland and to some extent Hungary.

YUGOSLAVIA.

Although the types of taxes that exist in Yugoslavia are similar to those in other reform socialist countries, the country is a very unique case because of its highly decentralized federalist structure. Enterprise and turnover taxes (the latter generally charged at the retail level) are highly variable across sectors and republics/provinces,²⁷ with varying rates and many systemic and ad hoc exemptions. Turnover taxes are relatively less important than in most other socialist countries, accounting for about 20% of total public sector revenues, compared with about 65% for assessments on enterprises. In addition to enterprise income and payroll taxes, large "contributions" are required of Yugoslav firms for various social funds. Each fund is in essence a separate taxing authority with earmarked revenues; thus, the administrative system for revenue and budget administration is highly fragmented and costly.

Individuals are subject in principle to ten complex and convoluted schedular taxes plus a highly progressive tax on total earnings over a certain level. Taxes on wages are collected through withholding; other taxes on individual activities (for example, on property and property income, private sector income, and agricultural activities) are probably not widely collected in practice due to the almost impossible administrative challenge they present.

Yugoslavia is interested in undertaking major reforms in its tax system, including the adoption of a VAT and modern company and personal income taxes. However, the political and economic tensions between the provinces--not to mention the country's very tight macroeconomic constraints and the decentralized and inefficient tax administration apparatus--will make the process extremely

²⁷ Yugoslavia has six "republics" and two "autonomous provinces".

difficult in the near term.

U.S.S.R.

Unlike the other countries discussed above, the U.S.S.R. is still clearly in the reform socialist stage, although some Soviet reformers are beginning to express a desire to move toward a market economy based on private ownership. The current tax system fits the reform socialist model--complex, dedicated to "fine-tuning", and constantly subject to discretionary change.²⁸ As in other socialist economies, the great bulk of revenues (over 90%) comes from state-owned productive units, in particular from turnover taxes and profit payments paid by large state enterprises. Although there are numerous tax laws that pertain to individuals,²⁹ in sum they impose a very low direct tax burden on the population, because of both low rates and many exemptions (not to mention lax enforcement).

The evolution of tax policy in the U.S.S.R. has been similar to that in the other countries discussed earlier, except that the commitment to post-socialist transition is yet to be made. Turnover and profit taxes in the U.S.S.R. date from 1930, when they replaced dozens of separate types of payments to the treasury. A move to greater enterprise autonomy in the mid-1960s under the "new conditions of economic management" was accompanied by changes in the

²⁸ Keeping up with the constant stream of recent changes in the Soviet tax system is virtually impossible for Western observers. According to Litwack (1989, pg. 24), "In 1989, significant discretionary changes in taxes and incentives for state enterprises ... occurred almost on a monthly basis." For an overview of the development of the Soviet tax system until the mid-1980s, see "Union of Soviet Socialist Republics," in International Bureau of Fiscal Documentation.

²⁹ These include the tax on wages of factory and office workers, tax on author's fees, tax on outside earnings, social insurance contributions, the agricultural tax, and even a tax on bachelors and married women with no children.

tax system intended to stimulate greater productivity and efficiency. The system provided for three types of payments out of enterprise profits that still existed into the 1980s. These include charges on fixed production assets and working capital (generally at a 6% rate), fixed rental payments (primarily in oil and gas and mining), and residual profit payments (individually negotiated based on plan norms). These have been supplemented over time with specialized tax rules covering certain types of cooperative and individual activity, as well as income earned by foreigners and joint ventures. Recent changes include the introduction, in October, 1989, of a heavy tax on the growth of wage funds over a 3% limit.

The Soviets are increasingly facing the macroeconomic instability and deterioration in enterprise efficiency that have plagued other countries in the stage of socialist reform. The 1989 budget deficit is estimated to have been over 13% of GDP, and repressed inflation combined with widespread shortages of goods are driving more and more economic activity to the underground economy. The complex and discretionary tax system is a reflection of much larger economic and political problems beyond the scope of this paper. Significant tax reform may be impossible unless and until the Soviet Union abandons its commitment to reform socialism.

Options for the Future

As the countries of Eastern Europe move into the stage of post-socialist transition, they face both constraints and opportunities in setting up new fiscal systems to underlie their reform efforts. Some of the constraints have been discussed in detail above. But they also have significant opportunities to avoid the previous mistakes of many developed and developing countries and put in place

from the beginning tax systems that encourage efficiency, equity and growth while assuring adequate revenues for the central functions of government.

The most obvious recommendation for the medium term is to adopt a fairly traditional yet relatively simple, low rate tax system along the lines of those in some Western market economies. Such a system would presumably include a standard company income tax (with a maximum rate in the range of 30-50%), a global personal income tax (with a maximum rate no higher than 50% and preferably lower), and a comprehensive retail VAT of the standard European type with as few rates as possible (preferably only one). While the design of each type of tax requires decisions on many detailed issues, the public finance literature is replete with analyses of the various tradeoffs involved in each. This option has many advantages; not only can it lessen tax-induced economic distortions prevalent in more complex systems, but it is familiar to potential investors and trading partners and harmonizes well with the tax systems of other countries.

The second option is to adopt a fairly traditional tax system--with company and personal income taxes and a VAT--but to load each tax with numerous exemptions and exceptions and to tax the remaining base at relatively high and complex structure of rates. This has been the course taken so far in Hungary. It may also be the course that other countries are most likely to drift into, because of both political and social concerns for equity and the legacy of fine-tuning left over from central planning. Many believe it would be a more costly choice than the first option because of the unnecessary administrative burdens and the distorted incentives it would create.

A third option is to consider adopting a new type of tax system not necessarily similar to those in Western market economies. For example, public finance literature makes a strong case for replacing an income tax with a direct

"consumption" or "expenditure" tax.³⁰ Some variants of such a tax are levied only on consumption, while others exempt the returns to savings and investment.³¹ Each attempts to eliminate the income tax's inherent bias against savings (i.e. future consumption) in favor of present consumption. A tax of this type would thus spur enhanced savings, investment, and growth. Furthermore, such a tax can be easier to administer than an income tax if it allows immediate writeoff of investment expenditures and thus eliminates the need for depreciation, inflation indexing, or the calculation of capital gains. The fact that no country has yet adopted such a tax is attributable in part to the difficulty of fundamental change once a traditional system is in place; given that the countries of Eastern Europe (other than Hungary) have no such system yet in place, they might be ideal testing grounds for new, innovative ideas that many consider superior to current practice in the West. They would have to be careful, however, to work out the international implications of any such experiment, given their common desire to further integrate their economies with other mature market economies (the EEC in particular).

The next step for post-socialist economies in transition should be to work out the implications of different courses of action for tax reform. Taking into account the goals and constraints in each particular case, what are the pros and cons of various options? What do they imply for revenues, for the distribution of the tax burden, for savings and investment (both foreign and domestic), for tax administration, even perhaps for the environment? What major problems would be likely to arise during the transition to each? Such analysis is of some

³⁰ See, for example, Andrews (1974), Bradford (1980), Mieszkowski (1980), and Zodrow and McLure (1988). Charles McLure (1990) has perceptively noted the potential benefits of this approach for Eastern Europe.

³¹ Under certain circumstances the two types are equivalent.

urgency; given the speed of transition, irrevocable decisions--whether good or bad--are likely to be made sooner rather than later.

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