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Tax system development trends in the OECD countries; lessons learnt

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The study examines whether or not the Euro-Atlantic region is characterised by specific taxation features, and if yes, what lessons they may provide for Hungary. The paper presents the tax systems and the development trends thereof, and evaluates the tax reforms based on international and Hungarian statistics. The author presents the arising problems and his own relevant opinion, as well as the conclusions that can be drawn.

DATA CHARACTERISING THE DEVELOPMENT TRENDS

The tax burden (tax rate)

The past

The past has been studied by many authors (László Szabó, 2004 and Zoltán Pitti Zoltán, 2004), wherefore I present data only about the period under review (*See Table 1*, OECD Revenue Statistics 2005).

In 1965, the *tax rate* [total taxes and social security contributions (hereinafter: SS contributions) as a percentage of the GDP] equalled 25.8% in the entire OECD, which grew to 36.3% by 2003. The growth rate was 4.3% in the period between 1965 and 1975, 3.2% between 1976 and 1985, 2.2% in the period between 1986 and 1995, and has been 1.1% since 1995. Contentwise, the first period reflected the expansion of the welfare policy, the second one showed the impacts of the supply economics and those of the budgetary deficit. Since 1995, changes in the tax burden have been influenced both by the status of the economy and the intention to curb taxes.

Within the general trend, we must make a sharp distinction between the EU-15 countries, the so called off-shoot countries, as well as Japan and the US. *(See Table 2)*

What conclusions can be drawn about the tax burden?

- since 1965, the tax burden in Europe has grown, albeit at a slackening pace, while it has remained at a constant low level in the US and Japan.
- A slight growth could be observed in Western European countries with a great tax burden even after 1980, while the increase was significant in the Mediterranean countries.
- in 5 of the 20 Western European OECD countries the tax burden decreased between 1990 and 2004.
- Growth was a typical trend until 2000, after which the EU-15 countries experienced a total fall of 1.2 percentage point. In the period

Table 1

THE TAX BURDEN IN THE OECD COUNTRIES

(as a percentage of the GDP)

Country	Tax and SS contributions 1990	Tax and SS contributions 2003	Taxes without SS contribution 2003
OECD	34.8	36.3	26.8
EU 19	39.3	39.4	27.4
EU 15	39.3	40.5	28.9
Hungary	–	38.8	26.8
Austria	39.6	43.1	28.6
Slovakia		31.1	18.7
Spain	32.1	34.9	22.5
Portugal	29.2	37.1	25.3
Greece	29.3	35.7	22.8
Denmark	47.7	48.3	47.1
France	42.2	43.4	27.0
US	27.3	25.6	18.8
Canada	35.9	33.8	28.6

Selection criteria: Austria, Slovakia – small neighbouring countries; Portugal, Greece – Mediterranean countries of a similar size; Spain – large Mediterranean country; Denmark – "innovator", small, developed country; France – Rhenish, non federal country; Canada – Anglo-Saxon off-shoot country influenced by European culture, US; EU-19: EU-15 + 4 Visegrád countries.

between 2000 and 2004, from among the 25 countries that provided data, the tax burden increased by over 1% in four countries, and decreased in 13 countries in four years.

▪ It is known from other sources that the tax burden has also decreased in the Visegrád countries since the change of the regime (since 1990 by nearly 7% in Hungary).

▪ It cannot be stated definitely to what extent the decrease Western Europe experienced after 2000 can be attributed to a deliberate tax policy, and to what extent it is the consequence of an economic slump. According to an article published in *The Economist*, in 2005 the negative GDP gap was still over 2% in the euro zone. (August 29, 2005)

What can we expect? In relation to the tax processes expected to take place in the EU we can rely on the convergence programs submitted by the individual countries *(See Table 3)*.

Table 2

TAX BURDENS IN THE DIFFERENT GROUPS OF COUNTRIES

(as a percentage of the GDP)

Country	1965	1995	2003
EU 15	27.9	40.1	40.5
Off-shoot countries (Canada, New Zealand, Australia)	23.8	34.1	33.3
US	24.7	27.9	25.6
Japan	27.4	26.7	25.3
Mediterranean countries (Portugal, Spain)	16.8	32.6	35.9

Note: unweighted averages

Table 3

TAX RATE PROJECTIONS IN THE STABILITY AND CONVERGENCE PROGRAMS

(as a percentage of the GDP)

Country	Date of the document	Common charges					
		2003	2004	2005	2007	2008	2010
Hungary	December 2005	39.1		39.0	36.5	35.5	
Austria	November 2004		44.3			41.2	
Slovakia	November 2004	32.1			30.7		
Denmark	November 2004	48.9	48.9				47.3
France	latest			43.7		43.7	
Germany	December 2005	45.0				42.5	
Greece	March 2005	39.5			42.0		
Portugal	January 2005			37.2		39.7	
Spain	latest		36.3			36.6	
Sweden	November 2004	50.5			48.7		
Finland	latest				44.1		44.3

As it can be seen, some countries envisage slightly decreasing, while others plan stagnant tax burdens, however, the Mediterranean countries would further increase the tax rate.

THE TAX STRUCTURE

Changes in the shares of income, turnover and SS contributions in Europe

In 2003, income taxes accounted for 31% of the total tax revenue in the EU-19, however, the extreme values are 23 and 60%. Only four countries fall in the 26 to 36% range. A 40% plus value is typical for Denmark, and below 26% values are typical for seven countries.

Variance is significant in the case of product taxes, too. In the EU-19 such taxes account for 31% of the revenues on average. The extreme values in Europe are 24 and 50%, respectively. The statistics of 9 countries of the 23 deviate from the average by more than 5%.

The average SS contribution rate in the EU-19 countries equals 31%. The statistics of 11 countries of the 23 deviate from the average by over 5%.

If we look at the time series – of which no table is provided -, we find that in the EU-19 the 31% income tax ratio in 2003 was identical with the ratio of 1965. SS contributions have been on the rise ever since. Taxes on labour [personal income tax (hereinafter: PIT) + SS contribution] grew from 16% to 22% of the GDP in the EU in the period between 1970 and 2003. This means that three quarters of the total tax burden growth in this period were attributed to this tax type. In the US and Japan the tax burden growth was only 14 to 15% (*Martinez-Mongay*, 2003). Product taxes have shown a stable ratio since 1975. *(See Table 4)*

The *picture compared to the GDP* is slightly different, but this difference is only due to changes in the weight of the total tax burden, and no new quality statement can be made. However, it is worth examining whether there are perceptible differences in the tax structures of countries with different cultural background. This is shown in the following *Table 5.*

Table 4

THE STRUCTURE OF TAX REVENUES, 2003*

(as a percentage of all taxes)

Description	Income taxes	Product taxes	SS contribution**
EU 19	31.0	31.4	30.9
EU 15	33.2	30.4	28.8
Scandinavian countries (Sweden, Norway, Finland))	39.4	29.8	26.2
Rhenish countries (France, Germany, Austria)	26.8	27.7	37.3
Mediterranean (Greece, Spain, Portugal)	25.3	33.6	34.4
Visegrád countries (3) (Hungary, Czech Republic, Slovakia)	21.9	33.9	41.5
Off-shoot countries (3)	53.6	30.3	5.1
USA	43.3	18.2	26.4
Hungary	24.8	39.4	30.5
Slovakia	22.3	36.2	39.6
Austria	29.7	28.2	33.7

* *Unweighted averages*
** *Including wage taxes*
Note: we have not focused on other tax types, wherefore the sum of the three columns is not 100%.

There are perceptible differences in the different groups of countries. The high level of turnover taxes in Hungary is influenced by the turnover type local business tax and the customs duty, i.e. it includes not only the consumption tax. Without these taxes the figure would resemble that of the Mediterranean countries. Due to this similarity it is worth taking a look at the dynamism of the tax structure of the Mediterranean countries. *(See Table 6)*

It can be seen that in the three Mediterranean countries the growth of the tax burden was basically triggered by taxes on labour (and the SS contribution).

Table 5

TAX LEVEL AND TAX STRUCTURE IN THE DIFFERENT GROUPS OF COUNTRIES, 2003*

(as a percentage of the GDP)

Description	Total	Income	Product tax	SS contribution**
EU 19	37.4	12.5	12.2	12.4
EU 15	40.5	13.7	12.2	12.0
Scandinavian countries	46.3	18.1	13.7	13.1
Rhenish countries	40.7	10.9	11.2	16.4
Mediterranean countries	35.9	9.1	12.1	12.3
Visegrád countries 3	34.3	7.6	11.5	14.3
Off-shoot countries	33.3	17.9	10.2	1.7
US	25.6	11.1	4.6	6.7
Hungary	38.5	9.5	15.2***	12.7

* *Unweighted averages*
** *Including wage taxes*
*** *Hungary without the local business tax and customs duty: around 12.6%*

Table 6

THE TAX STUCTURE OF THE MEDITERRANEAN COINTRIS
(as a percentage)

Description	1965	1990	2003
Income	16.3	25.4	25.3
SS contribution	27.3	29.9	34.4
VAT	44.6	38.9	33.6
Total	88.2	94.2	93.3

THE ECONOMIC EVALUATION OF THE TAX BURDENS

Functional tax burden

For the efficient allocation of resources it is not indifferent what direct taxes are directly imposed on the employees, the capital (the employers) and consumption, since this may influence employment, the willingness to invest capital, as well as changes in consumption and accumulation. Naturally, the tax payment obligation and the burden thereof due to the tax shift are far from being identical. The relevant calculations performed in the EU (EU-15) raise a lot of methodological questions, (the different tax revenues must be divided for the three groups),[1] and the computation methodology is often modified, which heavily affects, first of all, the tax burden on capital.

According *to an EU analysis of year 2002,* around half of the total tax burden is made up of direct taxes levied on the employees' earnings (including the SS contribution). The tax burden on *employee income* in relation to the total labour costs accounts to 36%, however variance is considerable. The indicators of six countries are below the average, the indicators of another six countries fall in the 37 to 43% range, while three countries have an even greater burden. This value has been more or less constant since 1995. According to my computations performed for Hungary, this ratio was 41%, two thirds of which was made up by SS contributions. (With this value we occupy the 11th place among the 15+1 countries.)

Two things must be taken into account when calculating the tax burden on capital:

- the so called mixed (entrepreneurial) income is regarded as capital gain,
- the indicator is calculated for capital gain from business activities, but also separately for capital gain plus property.

The total tax burden on *capital* equals 29%. This value ranges from 18 to 37% in the EU. Without the taxes levied on wealth and property, and the distribution thereof, i.e. taxes levied on *operational income* are of course smaller than the above value: 16% and 23% in 1995 and 2002, respectively. Data for Hungary could not be calculated, but according to a rough estimate, the tax burden on capital is smaller than the average burden in the EU-15. The corporate income tax is lower, and self-employed people indicate lower incomes on their tax returns. Taxes imposed on physical property are also of a lesser scale.

The tax burden on consumption (VAT and consumption taxes amount to 23% in the EU-15) has only slightly grown since 1995. The Hungarian figure is 22 or 26%, depending on whether or not the VAT on services provided by public institutions is taken into account or not, or if the local business tax listed under the turnover taxes, and the customs duty are not regarded as consumption taxes.

Tax wedge

Tax wedge is a tax burden expressed as a percentage of employee labour costs (wages, benefits, SS contribution). Since the value of the tax wedge differs depending on one's life con-

ditions, the OECD gives various calculations for the tax wedge. Hence, it is calculated for the industrial average wage, single employees and families with two children. In addition, calculations are presented for values other than the average wage for 2002. The following table demonstrates how the differences in common public charges arising from the different life conditions affect the tax wedge. *(See Table 7)*

Summary:

- In the developed countries the tax structure calculated on the basis of the tax types is very much different, there exists no such thing as "normal" tax structure tied to the level of development.
- The differences in the tax structure reflect constitutional and social traditions, and are not adjusted to tax theory statements.
- The rise in employment related taxes has been a general, long-term tendency.
- In Hungary the total tax burden on labour is not strikingly high compared to the GDP, however, due to the low level of employment and the significant tax exemption granted to low income citizens, the employment of people on average wage goes with an extremely high burden, mainly SS contribution. Tax allowances to families with children significantly reduced the burden on the employees.

> *It must be noted though that in Hungary the typical wage is not the "average" wage. According to the personal income tax returns for 2004, the average PIT base of private individuals was over HUF 1.3, but the medium tax base remained under HUF 900,000.*

All in all, it is worth citing the conclusions of a newer OECD study on European competitiveness:

"Empirical research on the relationship between the overall tax ratio (total tax to GDP) and GDP growth has not yielded conclusive results. *Barro* (1991) analyses the relation between the growth rate of GDP per capita and the tax ratio. His findings suggest that the tax burden has a negative impact on a country's growth performance. This result has been contested by subsequent studies that show a slight-

Table 7

THE TAX WEDGE IN 2002

(as a percentage of the total labour cost)

Description	Single on average wage	Single 167%	Family with 2 children 100%	Family with 2 children 100+67%
		wage level		
EU 15 (unweighted average)	41	49	29	37
– lowest	24	34	9	15
– highest	55	61	40	49
Hungary	46	55	30	35
Austria	45	50	30	34
Slovakia	41	45	30	36
Denmark	43	51	31	38
Spain	38	42	31	35
Portugal	33	38	23	27
Greece	35	40	35	35
France	48	51	39	40
US	30	35	18	25

ly positive or insignificant correlation (e.g. *Easterly* and *Rebelo*, 1993).

Not only the overall tax burden, but also the composition of the tax mix is considered as relevant for the growth performance, as the size of the incentive effects varies from one type of tax to another. Easterly and Rebelo (1993) suggest that there is a relationship between the level of national income and the composition of overall taxes. *Kneller, Bleaney* and *Gemmell* (1999) find a growth-reducing impact of distortionary taxes. In contrast, *Mendoza, Milesi-Ferretti* and *Asea* (1997) show that the growth effects of changes in the tax structure (implicit tax rates on capital, labour and consumption) are negligible. [OECD, 2004 a) page 27]"

Hence, the global figures are of limited value, but the issue will be studied below from another aspect, too.

TAX SYSTEM AND COMPETITIVENESS

As an introduction it must be noted that we are not talking about the relationship between public finance and competitiveness. We will not evaluate the expenditure policy of public finance, although according to the literature, this is what mostly affects competitiveness.

The IMD (International Institute for Management Development, Lausanne) Report

Let us assume that the essence of the IMD methodology is well known: it evaluates the indicators of 51 countries plus 9 regions (over 300 indicators for each!), and ranks the countries based on the summary of these indicators. There are many references to this rank, although you will see from the details that several of the indicators and the weighting method applied are rather subjective.

The following *Table 8* demonstrates the overall ranking, the qualification of government activities and the major tax indicators within that framework. The lower the tax the higher a country ranks.

It can be seen that the assessment of taxation and the overall rank are often very far from each other (Canada, US, Austria, Denmark), which indicates that taxation does not have a major role in a country's competitiveness. Here we can note what important role the general conditions of the economy and the so called metaeconomic conditions (e.g. law abidance, legal security) may play in the decisions of investors, and especially in the international capital flow. It is striking that countries (Scandinavian countries) with a high tax burden – countries that spend tax revenues in a sensible way, enjoying the trust of the voters – may rank high among the competitive economies,

If we focus on the Hungarian indicators we may state that:

- The overall indicator, the evaluation of the government as a whole and the ranks by the tax level or tax avoidance are close to one another. In Austria, Denmark and Canada these indicators strongly differ in favour of the indicators of general evaluation (civilised character?).
- The tax burden on the business sector is relatively favourable in Hungary (tax on profit, tax on property). This indicator would presumably worsen if the local business tax was included here, but some advantage would remain.
- Social security contribution on the whole receives poorer scores, but if we do not count with the favourable qualification of Denmark and Canada, we are in the pack.
- The effective personal income tax burden ranks very low. However, it must be known that this indicator is measured at the level of per capita GDP, i.e. at incomes much higher than the average income. In 2002 this meant an income of HUF 1.65 million/year, while

Table 8

COMPETITIVENESS RANKING

(according to IMD's World Competitiveness Yearbook 2005)

Description of criteria	Hungary	Austria	Slovakia	Spain	France	Denmark	Portugal	Greece	Canada	US
Overall ranking	37	17	40	38	30	7	45	50	5	1
Same without regions*	32	17	35	33	28	7	37	42	5	1
Total governance	38	20	17	30	45	4	41	52	9	16
Total tax burden	45	50	34	38	54	59	36	40	35	21
PIT/GDP % (not including regions)	35	43	18	30	34	55	26	23	49	40
Effective PIT**	58	53	22	20	44	56	30	32	35	26
Tax burden on profit (companies)	3	41	7	47	43	24	17	47	57	47
Corporate tax/GDP	16	11	26	36	22	28	41	45	44	10
SS contr./GDP										
• employer's	45	37	40	42	50	9	38	32	21	26
• employee's	30	48	33	25	42	20	39	45	27	36
Capital & property taxes/GDP	17	8	9	43	55	38	29	6	56	51
Indirect tax/GDP	57	44	39	26	33	58	54	53	20	7
Tax avoidance	39	10	15	26	23	11	53	46	14	24

Note:

* *IMD ranks 51 countries and 9 regions (mostly developed regions) within the countries collectively.*

** *Effective: percentage of an income equal to per capita GDP.*

In addition it must be noted that the countries under survey are beyond the countries of Southeast Asia and Oceania in terms of the tax burden. In relation to the global tax burden/PIT indicator Ireland is the number one country in Europe, yet it ranks only the 19th globally.

according to the PIT statistics, the average tax base of those who filed tax returns was HUF 1.1 million, while the average income was only HUF 777,000. More than 80% of the taxpayers have less than HUF 1.65 million in income.

■ Hungary's low ranking in the field of indirect taxes can partially be attributed to the local business tax, which is included in the category being discussed. (Otherwise, in terms of competitiveness the high ratio of indirect taxes to direct taxes is a beneficial feature.).

Tax burden, wage quota, wage wedge

In relation to competitiveness, experts often argue with the above categories simplifying the correlations, without analysing the relationship between them. Let us see these values for the countries under review, and one more indicator, i.e. that of the personal income tax + social security contribution, since they represent the major direct tax burdens on employment.

I am aware of the fact that the absolute values of the indicators have no economic content. Yet, I present the *Table 9*, because politicians tend to argue with such figures (if they makers perform calculations at all), and assume that there is great coherence between these indicators in people's minds. However, the difference of the deviations highlights that drawing a close relationship between them would be an erroneous simplification. For instance, in the US and Japan, where the tax burden is low, the wage/output ratio is similar to that in Sweden, and higher than in Finland (59, 55, as well as 57 and 49% in 2001). However, the wage/output ratio is much lower in Greece (33%), although the tax burden is higher there than in Canada or the US. It seems that the indicator is more influenced by the employment structure correlating with the level of economic development.

If the indicators of the individual countries are categorised as *low – medium – high,* the matching of the indicators will partially yield the logically calculated, and partially a different

Table 9

TAX BURDENS AND WAGE/OUTPUT RATIOS IN 2001

(per cent)

Country	1 Tax/GD	2 PIT+SSc/GDP	3 Wages	4 Wage/ output*	5 Employed population	6 4–1	7 4–2	8 4–3
Austria	44.6	24.8	44.8	52.1	35.8	7.5	27.3	7.3
Canada	34.9	18.3	30.8	54.1	50.1	19.2	35.8	23.3
Denmark	49.1	27.9	43.4	54.3	38.4	5.2	26.4	10.9
Greece	36.6	16.8	34.7	33.3	36.4	–3.3	16.5	–1.4
Finland	46.1	26.9	45.4	48.9	46.1	2.8	22.1	3.5
France	44.1	24.1	47.9	52.5	40.2	8.4	28.4	4.6
Hungary	39.1	18.2	46.3	45.6	38.7	6.5	27.4	–0.7
Ireland	30.1	13.1	24.5	40.9	44.6	10.8	27.8	16.4
Japan	26.8	21.9	24.2	55.4	49.5	28.6	33.5	31.2
Portugal	35.7	17.1	32.5	49.6	49.2	13.9	32.5	17.1
Slovakia	32.9	17.5	41.1	41.1	40.2	8.2	23.6	–0.3
Spain	34.4	18.9	38.2	50.1	40.8	16.7	31.2	11.9
Sweden	51.0	31.5	47.5	57.6	48.6	6.5	26.1	11.1
US	28.8	19.2	29.6	58.7	46.9	29.9	39.5	29.1

** Compensation of employees/GDP!*

result. Thus, for instance in 9 of the 14 countries high tax burden goes together with a high wage wedge, and the situation is similar in the case of high personal income tax + social security contribution and high wage/output ratio. However, high *wage tax wedge* and *low employment* (or vice versa) go together in only 7 of the 14 countries, while *low tax rate – high employment* (and vice versa) goes together in only 5 countries.

The tax rate and the tax burden

Tax rates, if studied by themselves, can be rather misleading, because the calculation of the tax base differs from country to country. (In France, for instance, the marginal tax rate of PIT is currently 48%, and it is planned to be reduced to 40% from 2007. At the same time, however, the French would repeal the rule according to which 20% of the wage is not considered as part of the tax base. Therefore, the reduction of the marginal tax rate would affect high income people neutrally "in the worst scenario". Otherwise, the tax rate is 5.5% up to EUR 5,500, and the 40% tax rate would be introduced at an income of EUR 65.6 thousand. There are of course other taxes and dues, wherefore the upper limit of the total tax burden is 60% of the income. (Economist, September 29, 2005.)

The corporate tax rate does not tell much about the effective tax burden either. This is indicated by *Table 10*, which contains figures for medium-sized and large companies for 2005.

CENTRAL AND LOCAL TAXES

Data pertaining to local tax revenues may reflect two approaches:

- local tax is a tax the base and/or rate of which is determined by the local government,
- local tax revenues come form local taxes and assigned (split) taxes collectively.

Although in theory the EU prefers the first approach, the tax statistics of the OECD applies the second one (except for Hungary[2]), wherefore regular data supply is only available about the latter. We may reach different conclusions depending on whether the provincial (state) taxes of the federal states are included or not in the local taxes. Evidently, the trends of non federal states are of primary importance for Hungary.[3] I hereby enclose a *Table 11* to demonstrate the above written.

As it can be seen, the picture is rather mixed in terms of both the levels and dynamism.

Table 10

THE TAX RATE AND THE TAX BURDEN

Country	Legal tax rate	Effective tax burden
US	39	38
Canada	34	39
Japan	42	34
United Kingdom	30	21
Germany	38	37
Sweden	28	12 (!)
China	24	46 (!)

Source: Economist September 24, 2005. in reference to C. D. Howe Institute (The concrete method of calculations is not included in the article.) China imposes VAT on investments, but the 46% rate can be reduced to as low as 18% with the allowances. In other countries local taxes add to the tax burden.

Table 11

TAX REVENUES BROKEN DOWN BY GOVERNANCE LEVELS IN OECD COUNTRIES

(total public finance tax revenues = 100)

Description	Local revenues	
	1975	2003
Federal states (unweighted average)		
• local	10.6	8.1
• provincial + local	28.4	27.3
Non federal states unweighted average	12.3	13.7
• lowest value	0.0	2.1
• highest value	29.2	35.7
Hungary	.	5.8 *
Slovakia	.	5.1
Denmark	29.8	35.7
France	7.6	10.3
Portugal	0.0	5.8
Greece	3.4	0.9
Spain	4.3	28.2

* *According to the IMF GFS statistics it exceeds 10%, because in Hungary the OECD lists the split PIT not under this category, but under subsidies. However IMF does not pursue this practice.*

Sources: OECD Revenue Statistics 2005

Relying primarily on 1999 figures, OECD prepared a special analysis, too (OECD, 2002). This analysis concludes that

- the strengthening of regional governments is a general tendency (by local governments or without them);
- in the new EU member states fiscal decentralisation is of a smaller scale than in the EU-15;
- Decentralisation is relatively stronger in Hungary than in the other new member states (especially in comparison to countries with a single decentralised level) despite the fact that most local governments are very small; the level of decentralisation in Hungary is comparable to that in several Western European countries;
- the role of taxes levied locally is negligible in all new member states but Hungary, but even Hungarian local taxes lag behind the local taxes of the seven, similarly structured Western European countries;
- as far as the future is concerned, it is worth remembering that according to the rule of thumb, the local government of a settlement with fewer than 6,000 to 8,000 residents cannot efficiently perform institution maintenance tasks. (In 2000, 91% of the Hungarian settlements had a population of less than 5,000, and 31% of the country's population lived in such settlements);
- the structure of local governmental taxes largely differs from country to country; from among all local taxes (including assigned taxes, too)
  - in Sweden and Denmark income taxes account for over 90%, while this ratio is 0 in France and the United Kingdom,
  - property taxes range from 0% (Sweden) to 100% (United Kingdom),
  - “other” taxes are usually negligible, but are very significant in Hungary and Italy (local business tax).

TAX REFORMS

According to *Ivanova*, permanent tax reforms can be attributed to three causes: the voters require them, the former reforms failed, or the social and economic conditions are changing. (Ivanova, 2005) I do not challenge these statements, however I believe that they need to be supplemented. In relation to the permanent requirement of the voters I would add that the requirement is induced by the politicians whose election programs always lure people with nicer and better conditions. The demands are rarely satisfied due to the conflicts of interest, since it is also true that reforms are usually required only as long as they are actually launched…

The biggest mistakes of the former reforms were that there were many unexpected (unrecognised or ignored) side effects, and that politicians tend to overestimate the significance of their reforms. Finally, it is also true that the circumstances change. Such reform was, for instance, the Hungarian tax reform of 1988, and a similar effect is triggered today by globalisation and possibly the need for decentralisation.

The most significant, clear trends of new age tax reforms until the end of the 20th century:

- introduction of the VAT (in 1954),
- expansion of the social security system,
- reduction of the marginal rates of the personal income tax and the corporate tax rate in the last one or two decades,
- reduction of the progressive tax brackets,
- strengthening of the pay-as-you-earn system,
- counterbalancing the reduction of the income rate by the frequent broadening of the tax base and by increasing the tax burden on consumption,[4]
- another frequent characteristic feature is that measures aimed at tax reduction are not linked to radical cuts in expenditures.

All this is typical for Hungary, too.

Tax reforms have also been accompanied by ups and downs and failures. Let me show a few examples for the latter:

- the impact of tax cuts on growth and savings falls short of the expectations (US 1980s, Japan 1990s),
- unemployment in Europe has rather grown than decreased,
- the tax systems have not simplified, actually they have become more complicated,
- the tax systems have been only partially adjusted to globalisation; the need to combat the "harmful tax competition" has appeared as a new problem and challenge, just like the "European Company" form, which limits the governments' possibilities to act.

There are fluctuations in subjecting the various capital gains to taxation.

There are many reasons behind the frequent and only partially successful reforms:

- often the reforms intend to assume too many tasks, which include trade-offs,
- although taxation theory has become sophisticated, its operationabilty is deficient, it is not really able to apply the general theses to the concrete conditions. The very specific "laws" are rather assailable (for example the Phillips curve), because they are linked to specific situations and the taxpayers' behaviours tend to change,
- the reforms must be harmonised with the revenue conditions, therefore the reforms are often lopsided and their economic impacts are overestimated,
- in the political bargains the reform proposals often lose their internal coherence.

During the tax reforms it is always greatly emphasised that it is inevitable to reduce the benefits built into the tax system. We have problems with evaluating the benefits: there are no long time series and internationally comparable data. The concept of benefit is not

defined. Certain benefits may not be benefits at all, but the attributes of the system. For instance the "discounted" VAT rate, the personal income tax credit in Hungary, or deductions aimed at the avoidance of double taxation. A major part of the differentiations is linked to the calculation of the tax base. For instance, the calculation of tax exempt pensions or non-realised income …

My general impression is that there is no tendentious reduction of benefits in countries where the tax rates have reached a reasonable level (10 to 40%).

Today in Europe the high wage wedge is sought to be reduced and the tax system is sought to be made more neutral (reduction of sectoral differentiations, influencing accumulated consumption), in which competitiveness and employment come to the forefront. The "growth and jobs" view is dominant, while the redistribution and stabilisation objectives are put on the back burner. On one hand, they have lost priority, and on the other these functions are thought to be more efficiently performed through budgetary expenditures.

A new feature is the strengthening of international regulation. For instance, the EU is currently most involved in the following tax issues:

- VAT harmonisation, electronic commerce, tax issues of downloads and taxation according to the country of origin,
- energy tax,
- avoidance of the double taxation of pensions,
- harmonisation of the tax base of multinational companies,
- approximation of the different tax burdens on capital gains,
- possible introduction of EU level taxation (air traffic?),
- tax measures in favour of employment,
- driving back the harmful tax competition.

PROBLEMS AND CHOICES

Social changes – frameworks for the tax policy

It is usually taken for granted that the frameworks of the tax policy are determined by the social and economic changes. Eventually, there is no doubt about that. In the 1930s, Lóránt Hegedűs wrote the following while explaining society and taxation: "Taxes are never the brainchild of an abstract notion, but are always and everywhere the mysterious indicators of the strange movements of the society."

The most important word in this quote is "mysterious". It means that social movements become clear often after a long time, and that due to the conflicts of interests there is no mechanical concurrence between the social processes and the changes of the tax system within the same period. This means that we can outline a theory, but it will not be implemented clearly, because the taxation policy is more likely to be influenced by the interest and power relations, as well as the traditions.[5]

As a model it is customary to cite the model of the liberal and social market economy[6] and that of the welfare state (I will not discuss the Eastern Asian conditions.) However, this traditional break-down says less about the new ecological challenges, it does not count with the "treatment" of globalisation, and competitiveness, an issue becoming a major point of state responsibility.

What can all this mean for tax policy? We may risk concluding that the tax system should undertake a smaller share from the three main functions of public finance, since those may be provided for more efficiently through the expenditure policy. Let's take a closer look at the issue:

- It is a well-know fact that sustained economic booms can be best ensured by high tax rates and strong progression. However,

these elements can be criticised form the aspect of competitiveness. Lower tax rates and prolonged progression weaken the stabilisation effect. However, unemployment benefits, other more flexible social measures, i.e. those that keep the need for such benefits in mind, may counterbalance these factors, all the more because such benefits are provided for those layers of the society that are ready to increase their consumption.

- Redistribution can be better served with subsidies targeted at low income people. Naturally, this would require greater self-support from middle-class people, wherefore it does not really suit pre-election tax politicking.
- Allocations can be somewhat cut back by slightly reducing the scope of tasks and by the gradual introduction of fees for services that mostly and directly serve the welfare of the individual (exemptions from payment must be ensured for those in need). At the same time, a specific egalitarianism must be maintained.

Tax reform trends

"Forecasts are always uncertain, especially if they pertain to the future." This wisdom holds true even today. Theoretical statements have weakened. From among the growth factors increasing value is attributed to the institutional factors, in contrast with the flow regulation measures.

Finally, it has become more and more evident that the general practice, i.e. the separation of tax reduction from the restructuring of expenditures, cannot be continued.

I have already referred to the trends of the coming years in the first chapter. It can bee seen from the convergence programs that the different countries generally do not rush headlong to the radical reduction of the tax burden.

This conclusion is contradicted by the major tax reduction tendency that has recently unfolded in the US. How can this impact the EU member states? Is it possible that they will need to reconsider their modest tax cut policies earmarked in the current convergence programs? It is possible, but I find it rather improbable, since the strengthening of the fiscal discipline is a general task today.

> *Although we have all rights to consider social security contribution as a type of tax, I will not discuss that here, since the problems of the social security system must be discussed separately due to the fact that it originates certain rights.*

Tax burden and competitiveness

Since the 1990s, the tax reforms have primarily emphasised the enhancement of efficiency. This approach gives preference to the reduction of the tax burden and the alleviation of distorted allocations.

Direction of the tax burden reduction:

- Reduction of the tax burden on capital gains and operational income. The main argument is that guarantee must be provided for capital, which has become very mobile due to the sweeping globalisation, since capital tries to escape from the large tax burden. The theory projects the "racing to the bottom" vision.
- In the EU unemployment and lower employment than in the US have reinforced intentions to reduce the wage burdens, primarily in the case of unskilled workforce.

However, many more in-depth studies (*Caterano*, 2003; Martinez-Mongay, 2003) indicate that the destructive tax competition and high taxes have not been fought off, and the correlation between the tax burden and the

growth rate has become rather uncertain. Until 2003, tax rate cuts did not really result in the reduction of the tax burden.

Is their any national convergence in the tax burdens? There is some convergence within Europe. One of the clear signs of this is the progress of the Mediterranean countries that formerly had lower tax rates, and the other is the convergence of the tax burden on labour in the period between 1980 and 1995. However, the researchers are not sure whether this is the concomitant of the tax competition, or other structural changes that influence taxes. (Martinez-Mongay, 2003)

Tax harmonisation, tax coordination?

Let us confine the topic of discussion to the EU. It is a well known fact that there is no tax harmonisation between the EU and the US. However, harmonisation of turnover taxes within the EU is well known. But in the case of direct taxes that account for two thirds of the revenues there is no conscious harmonisation, except for in the case of the corporate tax, the volume of which is not very significant. It may crop up as part of the Lisbon process with the help of the so called "open coordination", which is still a soft tool.

More significant measures than that of open coordination can be expected (for example after the introduction of the "European Company" form of enterprise) if the corporate tax bases are standardised and the systems of benefits are approximated. The need for standardisation will strengthen in the case of other forms of capital gains.

> *In compliance with the single market concept (the four freedoms and competition under equal terms), the European Union has been the engine of tax harmonisation since the beginnings, which has primarily aimed at the customs union and the regulation of price taxes, and was then extended to cross-border operations (parent companies and subsidiaries, sites, affiliated enterprises, acquisitions). This includes the handling of transfer prices, royalties and interests. The benefits from this harmonisation may include greater transparency, smaller performance costs, and the improvement of allocations within the EU. The concept of tax competition has been promoted recently. The advocates of tax competition believe that a competitive edge can be achieved by reducing the tax rates, by strengthening the financial discipline, and by maintaining the "equilibrium" between the tax burden and the state services. (These advocates basically oppose the harmonisation of direct taxes, because they believe that the bargaining of Leviathan governments does not serve the citizens' interests.)*

Governmental levels in taxation – local governmental taxes

We could see that the system and level of local governmental tax revenues (including transferred taxes) is rather varied. This is mainly due to the fact that the local governmental system is different in each OECD country. The difference is due to the fact that

- there are federal and non federal states, (the latter either have medium level administration or not),
- the size and functions of the local governments are historically different, and
- due to the centralisation philosophies of the central power.

It is obvious that fractured and centralised local governmental structures require different tasks. The more fractured the structure, the greater the differences are between settlements of the same size and functions. This reinforces the trend that in a tax system inseparated from the tax force, the taxes will become of subordinate significance in the case of 3,100 settle-

ments. With such a structure a higher ratio could only be reached if the tasks of the local governments would be significantly restricted (centralisation), i.e. the denominator would reduce.

Despite all these things, certain types of local funding can be observed. *Iván Illés* (2005) writes:

- "we will hardly be able to take over the traditional economic system of the Anglo-Saxon countries and their neighbours (Great Britain, Ireland, the Netherlands), which are almost entirely based on property taxes;
- the strongly centralised systems of the southern Mediterranean countries (Greece, Portugal) that provide minimum competencies and resources for the local governments are probably not exemplary for Hungary, either;
- for the time being we cannot follow the example of the Scandinavian countries, where the implementation of developed welfare policies is mostly the task of the local governments, which binds the overwhelming majority of the otherwise abundant local governmental resources;
- Austria, Switzerland and Germany – countries located not far from Hungary – are federally structured countries. Such a structure cannot be implemented in Hungary in the foreseeable future, and it might not even be reasonable to implement."

The author supplements these statements with the fact that Hungary may learn the most from the situation of the Visegrád countries. But the lessons to be learnt are not plentiful. Our system of local taxes is undeveloped in the sense that there are only a few taxes imposed by the local governments – as far as I know. Most of the tax revenues of local governments (as shown by the OECD) come from assigned personal income tax.

In the following we take the broadening of institution maintenance in the small regions and the emergence of the regions as a fact. However, here we must consider other assumptions, too.

- Will the system based on associations be transformed into a real, more concentrated local governmental system? This would be required by a sensible tax policy.
- Will the current local governmental concept sustain, which regards assigned taxes too much separated from local taxes? Yes, if the current practice of tax assignment will remain in effect. But we believe that a more sensible system can be developed, if the local governments are granted constitutional guarantee for an entire election, or an entire EU budgetary cycle against the arbitrary annual changes, and if the rule of assignment can be harmonised with the principle of service supply desirable to be applied to local governmental taxes.
- What financing can be expected at the level of the regions? In theory there could be regular local governments that impose taxes independently, by themselves. But this is not likely to happen until 2015. In Hungary no link has been formed in the people's minds to the regions. Under such circumstances, assigned taxes, as well as the above mentioned constitutional guarantees can serve as "own resources".

The constitutional regulation could be two-directional:

- before local governmental elections, the system and rate of assignment for the entire cycle (or the EU planning period) could be determined in a law requiring two thirds of the votes,
- the institutional and decision-making systems aimed at the reduction of differences in development could be reinforced.

In the case of local governmental taxes the governing principle is that service related taxation should be given preference. Local govern-

mental budgets can be associated neither with a growth stabilising function, nor with a basically independent redistribution policy. For this reason it is not advisable to use taxes that heavily depend on economic growth, because current local governmental expenses are incurred on a regular basis. Another principle: the use of petty taxes shall be avoided as much as possible, because they are financially unreasonable and the proliferation thereof will make finances more obscure.

Tax assignment, tax splitting

At small regional level the personal income tax is suitable for tax assignment, if the rate of the global share is fixed for several years, and if the assignment is adjusted to a service scope, (for instance weighting linked to staff depending on the age structure, or possibly to different functions). If the entrepreneurs or companies pay significant tax on property, such tax could function as split tax or tax assigned to the regions – occasionally in order to dampen unjustified differences.

Income tax

For the time being tax assignment seems to be more feasible than levying taxes independently. A system of supplements can be considered, however prudential behaviour is justified in this respect. On one hand, it would possibly lead to increased taxes, on the other it requires complicated administration. The introduction of local personal income tax is possible in theory only in the case of a more concentrated local governmental system, but only in the longer run.

Taxes on property

Local taxes on residential real property could become general, but only in a very gradual manner. The duty payable for the sale and purchase of real property could be fully assigned. It is inevitable to analyse the structure of very different property taxes: taxes on real property are significant in the Anglo-Saxon countries among the developed countries. In other countries considerable revenues are yielded from turnover (non-recurrent tax). Therefore the two taxes – and the inheritance tax – can only be examined together.

A few other challenges

In the following I will discuss a few specific issues of the European tax policy:

The flat rate personal income tax

Flat rate personal income taxes were introduced in the past years, primarily in Eastern Europe. Occasionally such ideas emerge in the west, too (recently in the United Kingdom), but have no colossal success. The introduction of a single rate tax is not on the agenda in the US. The pioneers of the flat rate tax are the Baltic states, which introduced 26 to 33% tax rates. Certain Eastern and Central European and the post Soviet states have recently introduced 13 to 19% rates. This may greatly influence the tax policy of Hungary.

The problems of the flat rate income tax – from the Hungarian perspective – are the following:

- a low rate would lead to a great loss of tax revenues, while a high rate would heavily penalise the middle classes,[7]
- so that it would really bring about simplification, the complicated system of tax credits should be abandoned in favour of the introduction of a tax free income bracket. If that bracket is low (lower than the minimum wage), it penalises low income people, if high, a high tax rate is required. (By the way, according to the statistics for 2004, 4.3 million people filed tax returns, but only 2.9 million paid personal income tax.),

- the burden of introducing a single rate may be eased if the payment of subsidies would be more linked to employment and the principle of indigence,
- all in all, the introduction of the single tax rate would also affect broad middle class layers and/or would go with a great loss of tax revenues. In the latter case consumption taxes would need to be raised.

> *In 2001, Russia introduced a flat rate (13%) personal income tax (applying 30% for certain capital gains) instead of the former 0, 10, 20 and 30%. The 13% rate is payable above the tax exempt income, which is 20% of the average wage. At the same time, the social security contribution was reduced from 38.5% to an average contribution of 30%, with declining degression from 35% to 5%. Tax revenues have significantly increased, although revenues from personal income tax equalled only 3.4% of the GDP. However, according to the IMF's analysis, it cannot be determined whether this is the result of the reform, or not. The supply effect was not strong. Tax-paying discipline has improved, however it is not clear, how the tax reform and the new measures improving tax administration contributed to this improvement. According to a panel survey, the 30% marginal tax rate affected only 0.5% of taxpayers and the 20% tax rate affects only 7%. (Ivanova, 2005)*

Ecotax

Can we expect a break-through in the significance of this type of tax? The ecological tax burden relative to the GDP was either stagnant, or somewhat reduced in the EU between 1995 and 2002. A change of paradigm may take place here, but because the imposition of special taxes on energy and transport may become a factor of competitiveness – this is only possible through international harmonisation, which is very time consuming. (See the debate on interest taxation in the EU.)

Corporate taxation and international direct investments

The tax burden on companies evidently influences international direct investments generated by multinational companies. (Individual investments are of smaller scale.) However, this impact cannot be simply attributed to the differences in the profit tax rates, because:

- other taxes, benefits and externalities (e.g. risks) also play a role,
- the computation of the tax base is different (amortisation rules, accounting of R+D),
- the achievable profit may significantly vary among the different countries,
- the system for the taxation of foreign income is rather distinct in the individual capital exporting countries (possibility and rules of accounting),
- the possibilities and conditions for investment funding are different (including the accounting of interests and royalties),
- transfer prices allow for the relocation of profit.

According to the surveys, the taxation rules play a greater role in the reinvestment of the profit than in new investments. This means that impacts exists, although the joint impact of the multiple factors can be clearly understood only in the case of the concrete decisions of the individual companies. (*Hines*, 1996)

CONCLUSIONS

> *"The virtue of our ancestors was that they did neither less, nor more than needed in anything."*
>
> *G. E. Lessing: Laocoon*

The conclusions are based not only on the study, but also on a range of experiences.

The tax policies of the OECD countries have been undoubtedly strongly influenced by the development of the tax theory, which has

revealed the impact of increased taxes on incomes, deviation and the GDP. However, it is typical for all countries that the intensity of this impact depends on several accompanying conditions, wherefore it provides little help for the development of tax policies and tax planning. In addition, the new theory of community decisions throws new light upon the driving forces behind the decisions, highlighting the major role of the enforcement of interests in business and politics.

Despite this fact several general tendencies can be mentioned.

- In the past decades the tax rate has increased everywhere but in a few non European Anglo-Saxon countries and Japan, but this growth has recently slowed down or has become stagnant.
- The latter was also due to reforms the objectives of which included tax reduction. This move was triggered by increasing tax evasion and tax avoidance, globalisation and liberal views.
- The most general trend is the reduction of the number of tax brackets and the marginal tax rate in the personal income tax, the harmonisation of the corporate income tax with the personal income tax and the application of the VAT system.
- The reforms have lately placed a great emphasis on the improvement of competitiveness, however the connection between taxation and competitiveness is not as direct as many people think. It seems that labour market behaviours and the regulation thereof – which includes taxation, of course – may have a much greater role.
- Changes of the tax burden and that of the tax structure are dominantly influenced by the changes in the state's role, and other traditions that judge the relationship between the individual and the state differently.
- The timing of the tax reforms largely depends on the election cycles. The programs are usually disconnected from the expenditure policy, and are typically characterised by extremely great intentions, however, the concrete measures and impacts fall short of the original expectations.
- The tax reforms wish to achieve their goals by changing the proportions of taxes, and by reaching a more neutral tax impact. These proportions have led to a greater tax burden on employment (which is a less mobile factor); increased employment has recently become a direct objective, and so has the reduction of the related taxes. Since the introduction of higher taxes on capital gains is hardly possible, it is a key issue to adjust expenditures. In addition, there is a theoretical possibility to increase service related taxes and fees, consumption taxes as well as ecological taxes.
- The concept of ecotaxation has been introduced to the tax policy, but it has not reached a grand scale in practice.
- The standardisation of the tax burden on capital gains aims at the improvement of capital allocation, however this has been hindered by the different lobbies for a long time.
- Having realised the negative impact of consistent income taxes on savings, the different consumption taxes are often increased, however, the overall tax burden on consumption has not grown much.
- In the EU nearly one third of the tax burden is made up by social security contributions. (In the non European Anglo-Saxon countries this ratio is significantly lower.) Therefore, the general aim is to place these systems partially outside the system of public finances and to promote self-support. This issue is becoming even more topical due to the aging population.
- The taxation policy is seldom based on long-term awareness that keeps in mind the interactions of the different taxes, as well as the equilibrium between tax reduction and expenditure cuts.

■ The international impacts of the recent major tax cuts introduced in the US cannot be assessed yet, partly because the European countries cannot allow themselves to finance enormous budget deficits from external sources, even though the Maastrich criteria are interpreted in a more flexible manner.

■ The use of a flat personal income tax rate is a relatively new phenomenon. Following the Eastern European practice, such ideas have come up, for instance, in the United Kingdom and Germany, but only with little success so far. The introduction of such a flat rate is not on the agenda in the US. In countries where a low rate was applied, the reform was accompanied by a VAT rise.

Conclusions for Hungary

The Hungarian tax system – including the changes announced for the coming years – more or less fits into the picture formed about the Rhenish and Mediterranean countries. Compared to these countries, the appropriate level of consumption taxes can be judged favourably, while the high tax wedge imposed on employees with low or medium incomes can be judged unfavourably. Local governmental taxation and funding must be radically re-evaluated. The future of the taxation systems of the countries taken as a basis for comparison largely depends on how the traditional values will change under the influence of neoliberal tendencies. One can expect:

- the slight reduction of the tax burden, the expansion of privatisation, corporatisation and fee-paying,
- the decline in social policy involvement in taxation, the partial transfer thereof to the expenditure policy (smaller tax progression – increasingly targeted welfare policy),
- the reinforcement of the neutrality of taxation, the reduction of allowances and exemptions – but it is not clear, which of those may remain (for instance: US: charity, home owners; Europe: family), the introduction of a more uniform tax on capital gains,
- the promotion of employment as a top priority, in which factors other than taxation also play an important role,
- the radical transformation of local governmental funding. In the medium run the role of tax assignment is more likely to grow than that of independently leviable taxes.

All this will have an impact on the taxation policy of Hungary, too. As soon as a social and economic model – or the alternatives thereof – reflecting the Hungarian conditions takes shape as the research progresses, more detailed concepts can be developed.[8]

NOTES

[1] The break-down is not simple. It turns out, for example that in the EU-15 only 55 to 70% of the personal income tax is paid after employment. There may be methodological uncertainties in the grouping of taxes. This is indicated by the fact that the EU analyses are often corrected, especially when calculating the tax burden on capital. (For example: profit on share option undoubtedly constitutes capital gain - which is not reflected in the GDP - but the taxation system considers it as part of employee income.)

[2] In the case of assigned or split taxes the central government assigns a fixed portion of the collected tax to a subnational unit. Therefore, the central and the local governments are together “through thick and thin”. The assignment of personal income tax in Hungary is not accepted as local governmental tax, because only a fraction of it is linked to the place of origin.

[3] In non-federal states only regions with specific historic features have taxation tasks (e.g. in Spain and recently and partially in the UK).

[4] Tax rate cut in Australia: in 1955 29 brackets, a marginal tax rate of 67%, tax free bracket up to

12% of the average wage. The marginal tax rate was payable on incomes equalling at least 18 times the average income. In contrast with this, in 1985: 5 brackets, a marginal tax rate of 60%, tax free bracket up to 22% of the average income, and the marginal tax rate was payable on incomes equalling at least 1.7 times the average income. (In 1989: the marginal tax rate was 49%, but was introduced for incomes equalling at least 1.3 times the average income.) United Kingdom 1985-1995: the marginal tax rate decreased from 60% to 40%, but only 4% of the tax-payers fell into the 40% plus bracket even before the reform. On the other hand however, the VAT rate grew from 15% to 17.5%.

[5] One of the best course books on public finance closes the chapter on taxation theory with the following: "considering the complexity of the subject, the Reader has all rights to doubt whether these problems are raised at all during the decision-making process." *Cullis*, 2003)

[6] Today the social market economy is most frequently misinterpreted and is seen as a sort of a welfare state. Its original meaning – to which it would be better to adhere to – is a liberal concept supplemented with social guarantees, which is against the Keynesist system and supports agreement (participation).

[7] According to a survey carried out in the UK, a 30% flat rate tax would increase the burden on those falling into the fourth to seventh income bracket.

[8] I expressed my thoughts in a former study. (*Hetényi*, 2004)

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