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THE POLITICAL ECONOMY OF TAXATION AND TAX REFORMS IN NEW EU MEMBERS COUNTRIES

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THE POLITICAL ECONOMY OF TAXATION AND TAX REFORMS IN NEW EU MEMBERS COUNTRIES

Paola Profeta

University of Pavia, Italy

Abstract

This paper is part of a wider research program on taxation in New EU members coordinated at the University of Pavia by L. Bernardi, M. Chandler and L. Gandullia, under the supervision of V. Tanzi. The paper analyzes the political economy determinants of several issues in taxation and tax reforms in new UE Members countries. The definition of the role of government and the relations among different levels of government, as well as the definition of a new fiscal institution, including tax administration, depend on the political process and on the political will of policymakers, which in turn is based on the political support they can enjoy. In transition countries, this support is often based on interest groups, rent seeking, economically and politically powerful, rather than on the majority of voters. These interest groups, together with other political constraints faced by policymakers, have a strong impact on tax reforms in new EU Members countries.

JEL Classification numbers: H20, H24, H25

Key words: role of government, tax administration, fiscal institutions, political constraints, interest groups.

E-mail Address: paola.profeta@unipv.it

Department of Public and Environmental Economics

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1. Introduction

Political economy arguments are at the centre of the debate on the transition process from communist to market economies that took place in most EU New members. They have been used to explain or justify many aspects of the transition, to characterize the different performances across transition countries, and to discuss the strategies of the economic reforms.

In this paper, I will focus on the main political economy arguments related to the issue of taxation in New EU Members countries. I will analyze how political economy arguments can explain and justify many aspects of tax systems and tax reforms in New EU Members (as described by the w.p. Siep February 2004 on tax policy in new EU Members), how they can explain some differences across transition countries, and what is their role in shaping tax reforms.

From a tax policy perspective, new and more efficient instruments of taxation were introduced with the transition (for instance, VAT) while the major existing problems concern how to raise revenues, the definition of the role of government and the relation between levels of government, tax administration and taxation of small enterprises, a closer harmonization with EU tax systems. A general problem concerns the definition of a fiscal institution, including tax administration, which represents an endogenous outcome, since institutions are a product of the transition process. I will focus on these issues and provide a political economy perspective.

Political economy arguments are at the centre of both the positive and the normative side of the analysis of political economy of transition reforms. The normative side focuses on the political constraints faced by the reformers. There exist ex ante constraints related to the conditions for a reform to be feasible and accepted – and ex post ones, related to the conditions for a reform to be maintained and not reversed after its implementation and after the outcome is observed. The positive side focuses on the action of special interest rent seeking groups, which, depending on the economic, social and political initial conditions of reforms, have a different impact on the reform process. There is also a wide debate about the political economy desirability of big bang/ shocking reforms *versus* gradualist reforms. I will analyze these issues in the context of tax reforms.

This line of analysis belongs to the *political economics* literature, a more general and fundamental field of economic research, based on the interplay between economic problems and their political determinants (see Persson and Tabellini 2000). The political economy of transition has been largely studied by Roland (2001, 2002). The political economy of taxation has been previously studied by Hettich and Winer (1999) and Profeta (2003). While many suggestions can be derived from studies of various authors especially at the World Bank and the IMF, there is no a comprehensive analysis of the political economy of taxation focusing on New EU Members countries.

This paper is organized as follows: the next section examines issues on the political economy of tax systems in new members countries. Section three analyzes tax reforms in new members countries, from both a positive and a normative side. Section four concludes.

2. Issues on the political economy of tax systems in New EU Members countries

This section starts with some information on the politics of the New EU members, analyzed in this paper. Then, it addresses from a political economy view some of the main problems faced by these countries: how to raise revenues, to redefine the role of government and of different levels of government, to build a new fiscal institution, to administer taxes and to tax small enterprises.

2.1 Some facts

It is useful to start with some information on the political systems in the new EU Members. This section shows that these countries are characterized by a general political instability, measured at different levels.

All these countries have opted for a parliamentary regime, the main form of government in Western Europe. Roland (2002) shows that Hungary and Slovenia have been very stable, with an average time between elections respectively of 48 and 47 months, while this time has been 32 months in Czech Republic, 36 in Estonia and 36.5

in Poland. Average government duration has, however, been low (18,2 in Czech, 12,9 in Estonia, 17,9 in Poland, 23,3 in Slovenia) with the exception of Hungary (48). Government duration between the two most recent elections has in general been longer (24 in Poland and Slovenia, 48 in Hungary) with the exception of Czech (12) and Estonia (12), reflecting political tensions or instability. The average number of parties in government ranges from 2.2 in Estonia to 2.7 in Hungary, 3 in Slovenia, 3.2 in Czech Republic and 3.4 in Poland, with a high percentage of right wing parties in government. There is a huge variation in the re-election of incumbents: 50 and 100 percent of re-elected governments respectively in Czech Republic and Slovenia, while zero in the other three considered countries.

2.2 How to raise revenues

Pre-transition countries were characterized by three major sources of taxation: turnover taxes, enterprise taxes and payroll taxes. The taxation of resources and indirect subsidies were implicit in the state allocation of under-priced resources. During the transition, corporate income taxes fall, due to the loss of revenues from profits of publicly owned enterprises under the price liberalization, the diffusion of tax exemptions and tax arrears, and the use of harder budget constraints. This led to a decrease of the importance of income taxes, though personal income taxes increased, and a general decrease of tax revenue as percentage of GDP. At the same time indirect taxes (VAT, sales, turnover taxes and excises) increased in their importance. As a general trend, the evolution of the share of tax revenue to GDP and the share of major taxes on GDP in transition countries appears to be U-shaped, reflecting both the loss of traditional profit, turnover and payroll tax revenues and the difficulties in tax administration (Mitra and Stern 2003).

The transition implies a movement from a system where the government decided first, before citizens had access to the resources of the economy, to one with a reduced role of the public sector, where the government needs to collect revenues before spending. This means that New EU Members countries need to build a fiscal system based on new and more efficient instruments of taxation, for instance by increasing the share of direct taxes, personal income taxes, with respect to the share of revenue from domestic indirect taxes. However, the way in which revenues can be raised represents a major problem. This is an issue where political factors interplay with economics arguments to design the current status of the fiscal systems. To raise revenues, i.e., to collect taxes, a political will is necessary, which is based on the support of citizens as voters (Burgess and Stern, 1993). However, to agree on policy decisions aimed at changing the composition of revenues, people need to believe and trust the efficacy and the fairness of the system. In absence of this belief, people may choose not to support the policy, or not to pay. Thus, an adequate tax administration is necessary to guarantee an efficient extraction of resources. How the political system affects the ability to extract resources is a crucial issue. These countries risk to be stuck between the need of increasing revenues, the weakness of tax administration and the political difficulties of changing the status of tax policy in absence of public positive beliefs in the system.

2.3 The role of government

A related issue concerns the new role of government in new EU Members countries.

Data from Gupta et al (2001) show that on average government spending as percentage of GDP in new EU Members countries has declined since the early 1990s. As a consequence, these governments are smaller than those in Western European countries (Tanzi and Schuknecht, 2000). However, this reduction in government spending does not necessarily imply a reduction of the role of government, but it rather represents the answer of the government to its limited revenue-raising capacity and a shift of resources across different uses and functions. As explained before, in the new system, the government needs to collect revenues before spending. This revenue constraint is affected by the economic development of the country and the level of its tax administration. After taken, the decisions over spending plans are difficult to be changed, especially if they concern expenditures involving long-term commitment and a large number of beneficiaries (such as pensions, health, public unemployment). Since new members countries have in some cases economic conditions (per capita income and economic structure) closer to developing countries than to industrial countries (see Tanzi and Tsibouris 2000), we expect that in these countries taxes cannot stay as high as their current levels and they will start to fall. As a consequence, governments need to be realistic when committing to expenditure programs, by accordingly reducing their programmed levels. However, Gupta et al. (2001) find that this reduction of government spending has not been sufficient in many new EU Members countries, where the level of government spending still remains quite high, due to rising indebtedness, a heavy regulatory burden and prevalence of non cash transaction. At the same time, this reduction of government spending has not been appropriate: governments in many new EU Members have now to provide services, such as kindergartens, health care centres and housing, that were previously responsibility of the state-owned enterprises, and they have to provide subsidies to meet social needs for groups negatively affected by economic reforms. As a consequence, an appropriate definition of the role of the new governments is still needed. To this respect, political economy determinants should be taken into account (Alesina and Perotti, 1995): political economy constraints to reform, vested interests, preferences of regional groups, a strong tax administration and control are all elements that may affect the size and scope of governments (see also section 2.5 and 3.2) .

Moreover, the role of government depends on the relations between the executive and the legislative branches of government. The political process that generates the legislature and creates the executive branch of government has an impact on this outcome. It is essential that the executive and the legislative branches have close views and that they are working under common, clear and well-defined rules, strategies and objectives, to contrast possible pressures by powerful political groups or figures in the legislative or the executive branch, aimed at reducing tax liabilities of specific taxpayers or protecting tax arrears.

These difficulties may explain why some governments are more effective than others in the transition process. According to the EBRD Transition Report (1998) among our countries, central and eastern European countries, such as Hungary, Poland, the Czech Republic and Slovenia, have been more successful in the transition, followed by Estonia and the Baltics.

The success of the transition process in the fiscal area depends also on both the allocation of fiscal responsibilities among the different levels of government and on the creation of well-working fiscal institutions. Both these issues have a political economy component, as I will comment in the next two sections.

2.4 Levels of government

The definition of the role of government in fiscal issues implies the definition of the fiscal responsibilities of the subnational and national governments. This has to be done through clear and precise rules. In absence of these rules, political interests can intervene, on top of economic considerations. The assignment of revenue is related to the assignment of expenditures: a part from the transfers they receive from the central government, subnational governments need adequate resources to pay the expenditures under their pertinence, and they have to be forced to respect their budget. In new members countries it is often the case that fiscal arrangements between national and subnational governments are vague and local governments can act without control.

During the transition, several expenditure responsibilities (education, health and social welfare) have been assigned to sub-national governments, but without a clear definition of the basis for expenditure and revenue assignments. Revenue assignments and taxing powers were often maintained at national levels, with an inadequate system of intergovernmental transfers. This has led to intergovernmental fiscal imbalances, low efficiency of public services, and has limited the potential benefits from decentralization. Moreover, this has left large space for discretionary fiscal behaviour including bargaining among the different levels of government and between the budget entities and their suppliers (such as utility companies) at the subnational level.

The main challenge for the leading reform countries, such as Czech Republic and Hungary, is the definition of government responsibilities at the local level, including details over revenue and expenditure assignments. In these countries the role of intermediate levels of government is now relatively clear, but the role of the local governments is still problematic, with problems of fragmented or inefficient service delivery. Local governments need greater accountability, to collect their own sources of revenue and decide with greater autonomy over them.

A second challenge is represented by establishing clear, transparent and stable rules for transfer systems, which would avoid the process of negotiation based on political interests.

Finally, local governments should be monitored and their borrowing should be limited. Information and a capacity of sub-national governments in public expenditure and debt management are necessary.

2.5 Fiscal institutions and tax administration

Fiscal institutions were necessary to have a successful transition of the fiscal system.

In the pre-transition period taxes were mainly collected on the basis of negotiations between the enterprises and the government. There were no precise rules, codified tax law, well-defined tax bases and tax rates. As there were not explicit taxes, most individuals had no direct contacts with the tax authorities and they did not even know how much they were actually paying.

The transition made it necessary to radically change the tax system. The elimination of the planned economies implied that the government could not directly control quantities and prices to be taxed, and had to rely on tax declarations, which were not always correct due to large tax evasion. The main sources of revenues, such as tax on state enterprises, disappeared, while the number of new potential taxpayers largely increased due to the birth of private sector activities. Also, corruption and bribes increased.

All these changes called for a radical reform of the tax system (Tanzi and Tsibouris 2000). A totally new, transparent tax system was necessary and new fiscal institutions were required. These new fiscal institutions, such as the tax administration, were essential to allow a correct functioning of the new tax system. Radical reform means that not only the new fiscal institutions have to introduce new instruments of taxation, a transparent fiscal system, and a well-working tax administration, but also that they have to correct attitudes, incentives and relations. In particular, the new fiscal institutions have to strengthen enforcement and at the same time develop the taxpayer education and improve compliance. This means that taxpayers have to be informed about the need to pay taxes, to be assisted in paying them, also through the simplification of procedures.

However, these institutions had numerous difficulties. They were created under lack of financial resources, specialized skills and technical knowledge and a clear definition of strategies and objectives under a defined legal system. Moreover, it has to be stressed that political economy issues played a twofold important role to this respect. In fact, on one side political interference by powerful groups in politics and economics posed an additional constraint to the activities of the new born fiscal institutions, especially for the tax administration. On the other side, these institutions were created arbitrarily, rather than through a structured political process, and thus, due to their lack of authority, they were even more exposed to these political interferences.

Tax administration in transition countries is highly politicized. Widespread tax exemptions, deferrals and arrears indicate that the tax system is politicized, firms bargain with the state to obtain tax concessions and so on. As a result, tax compliance is low and tax avoidance is high. An interesting study by Schaffer and Turely (2000) measures the effective tax administration in transition economies, by calculating the ratio between effective and statutory tax rates for 25 transition countries. This ratio is calculated for three taxes paid by the firm: corporate income tax (CIT), value-added tax (VAT) and social security tax (SST). Huge differences between effective and statutory tax rates indicate tax compliance and collection problems. The authors find that, due to the greater politicization of the tax system, the shortfalls in effective tax yields in transition economies (calculated on 1997 data) are larger than a benchmark for mature economies (the 1996 average of the EU-15 countries) where tax systems are well established, the administrative capacity is stronger and tax arrears are tolerated less frequently. However, the leading transition countries (Poland, Hungary, Slovenia, Czech Republic and the Baltic States) have effective/statutory tax rates ratios similar to the EU average. Focusing on the countries analyzed in this paper, for VAT, Czech Republic and Hungary have an effective/statutory tax ratio of 0.40, Poland of 0.46 and Estonia of 0.68, while the EU-15 mean is 0.45. For SST, Poland shows a value of 0.76 followed by Hungary with 0.80, Estonia with 0.83, Czech Republic and Slovenia with 0.94, while the EU-15 mean is 0.88. Finally, for CIT, Slovenia shows a value of 0.15, Poland of 0.20, Estonia of 0.22, Czech Republic of 0.23, Hungary of 0.26, while the EU-15 mean is 0.24. This result contrasts with the values obtained for other transition countries largely behind in the transition process, which show lower values of the ratio effective/statutory rates. In fact, the authors find that progress in transition, measured by an EBRD transition indicator, is positively correlated with effective tax administration. The authors also find that countries with larger bribes have less effective tax administration, due to a highly politicized tax administration. In transition economies, it is not uncommon for firms to pay bribes to government officials in return for tax concessions and various favours. Obviously, the amount of these payments does not appear in government fiscal accounts. Interestingly, the EBRD (1999) and the World Bank construct a measure of the extent to which firms pay bribes to government officials: the average bribe tax in our analyzed transition countries ranges from 2.5 in Poland, to 2.8 in Estonia, 3.4 in Slovenia, 3.5 in Hungary and 4.5 in the Czech Republic. Again, these leading transition countries perform better than the other transition countries.

As stressed by Mitra and Stern (2003), this politicization of the tax administration should be avoided. Political will plays an essential role in the administration of tax policy at two different levels: (i) to support the hardening budget constraints and (ii) as a commitment to simplify procedures and tax regimes and to create an attractive investment climate. However, this does not imply that tax administration should be used for political ends, such as enforcing tax discipline on large taxpayers.

2.6 Taxation of small enterprises

A crucial issue in tax systems of new EU Members countries is the treatment of small enterprises. In this specific field we find many issues already discussed about the weakness of tax administration, and its political determinants.

Small enterprises are a key sector to promote growth and employment in transition countries. Mitra and Stern (2003) find a positive correlation between the number of small firms and the level of development of the country. A major challenge for governments of new EU members is to create an attractive and competitive investment climate, which would give incentives to the activities of restructured and new enterprises This challenge requires a clear political strategy. This strategy includes reducing excessively high tax rates for small firms, simplifying regulatory procedures and tax administration for small firms and eliminating tax exemptions that benefit powerful special interests. All these measures would encourage compliance by small firms. A study by the EBRD (1999) finds that taxes and regulations are among the more important obstacles to the development of new enterprises in transition countries. Among the new EU Members, Poland and Hungary have the less complex system of tax on business. However, tax incentives for new enterprises are currently almost zero in all countries, because of harmonization with the EU systems.

3. Issues on the political economy of tax reforms in New EU Members countries

This section addresses general issues of the political economy of transition reforms, from a normative and a positive side.

3.1 The normative side: political constraints

The normative side focuses on the political constraints faced by the reformers.
Following Roland (2002), these political constraints can be of two types: (i) feasibility constraints, also called ex ante political constraints, that can block decision making and prevent reforms from being accepted, and (ii) ex post political constraints, that can reverse a reform after its implementation. These two types of constraints are not the same in the presence of uncertainty and reversal costs. In reforming transition countries, aggregate (concerning the economic effects of reform programs) and individual (concerning the identity of the winners and losers of the reforms) uncertainty and reversal costs play a crucial role. The final output of the transition process is uncertain and the political constraints are different if this outcome will be a positive result, or at least an improvement with respect to the status quo, or if it will be a negative result, since in that last case people may want to reverse a reform. Uncertainty may imply that a majority will oppose a reform even though ex post it could have benefited from the reforms (see Fernandez and Rodrik 1991). Reversal costs make it more difficult to start a reform. A sequence of politically feasible reform is more difficult in presence of uncertainty. In this case, gradualist reform packages have higher ex ante feasibility and higher ex post irreversibility of enacted reform than big-bang strategies which involve high reversal costs (Dewatripont and Roland, 1995). In fact, countries such as the ones analyzed in this paper, which have followed a gradual reform process, by starting transition early, growing and then facing the prospect of entry in the European Union, have been more successful in the transition process (see the previous section).

To relax the ex ante political constraints and start a reform under the status quo, it is necessary either to design a reform, which compensates the losers, and credibly commit to this design, or to make only a partial reform. Focusing on tax reforms, the design of a reform package, which includes compensating transfers, seems quite difficult. Compensation by redistributive transfers would be feasible only if distortionary costs of collecting revenues were not very high and enforcement of tax collection were guaranteed, both conditions being quite far from the picture of the tax systems in new EU members countries described in the previous section. Such kind of compensations also need commitment of decision makers, whereas it is unlikely in these countries that the coalition in power today could commit over continuation of these policies by future coalitions. These difficulties may explain why partial reforms are more easily implemented, although they have the risk of creating rents for given groups that will be threatened by further reforms (see next subsection), and thus create opposition to further reforms. The sequence of reforms is also important, since more popular reforms at the beginning may build support for further, initially less popular, reforms.

Reforms supported by broader coalitions are more likely to be ex ante politically feasible. These reforms are also more likely to be ex post politically feasible, since if they are accepted by broader coalitions, they will be reversed more difficulty. However, there may exists a trade-off between political constraints and graduality of reforms: if ex ante political constraints are less important, a less gradual reform may ensure more irreversibility. Again, starting with more popular reforms is preferred, to avoid support for reform reversal.

Roland (2001) argues that the political constraints to reform have been less strong in Central Europe than in other transition countries, such as the former Soviet Union. He argues that geopolitical factors play an important role: transition represents an opportunity for many countries, among which the ones analyzed in this paper, to shift from being a satellite country of the Soviet empire to being anchored to the European Union, adopting its political and economic system. People do not see this event as a traumatic experience, as for instance in Russia, but rather as a liberation. Governments like Czech, Hungarian and Polish entered a “transition tournament”, trying to show to be the most advanced transition country in order to attract investments. This created favourable political support to reforms, especially in the field of taxation, essential for the development of foreign investments and new enterprises.

3.2 The positive side: the role of interest groups

In New EU Members, politically powerful special interest groups and rent seeking play an important role in tax reforms (Roland 2002, Burgess and Stern, 1993). The support of powerful lobbies may be essential to implement specific reforms, which would never be approved by the majority of people. In particular, owners of privatized enterprises, who represent a minority and are thus not likely to be pivotal in election, may have incentives to organize as a lobby and exert their economic and political power to obtain tax advantages for their firms, as it happened in many cases (see the previous section).

New rich individuals benefit from many tax advantages and tax exemptions. Corruption is strictly related to the action of these groups.

It can be noticed that the action of powerful social networks, such as the Catholic Church and the Solidarity Trade Union in Poland, have been important in contrasting the Communist Party and in creating social support for the transition. In other countries, where these social networks did not exist, oligarchs and insiders emerged as a more powerful political and economic force.

The question of rent seeking is also related to the distribution of wealth and power. The transition process increased inequality with political and economic consequences. The increase in inequality affected the political decisions making through different political channels, which go beyond the median voter theory, including the relative role of electoral politics and special interest politics, and the policy and political coalition formation process. A vicious circle emerges when few rich individuals are politically powerful: they can influence reforms in their favour, which in turn creates persistence for their economic and political power.

4. Conclusions

New EU Members are experiencing fundamental changes. Tax systems and tax reforms represent one of the major challenges that these countries have to face. In these countries, politics and economics strictly interplay in all sectors of the society, including taxation. Many problematic issues of taxation and tax reforms in transition countries are related to political determinants, such as the definition of the role of government and the relation between levels of government, the definition of a fiscal institution, including tax administration and taxation of enterprises. In particular, tax policy improvements have been substantial, while tax administration remains weak and fragmented, hence representing a crucial constraint to revenue collection and to the general working of the tax system. Political economy factors stay behind this lack of efficacy of the tax administration.

Political constraints are fundamental both to start and implement tax reforms (ex ante political constraints) and to maintain such reforms (ex post political constraint). Majority voting models do not capture essential elements of the political process to determine tax reforms in these countries, such as the action of rent seeking interest groups and of economically and politically powerful lobbies which emerged from the transition process. A natural extension of this paper would be to compare more appropriate political economy models to analyze specific economic reforms in transition *versus* developed countries. I would expect that lobbying models perform better in case of transition countries than the more common median voter models, especially in sectors like taxation characterized by a strong influence of powerful interest groups.

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