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**Tax Reforms in Transition Economies
– a Mixed Record and Complex Future Agenda**

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Materials published here have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect Authors' point of view and not necessarily those of CASE.

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Abstract

The purpose of this paper is to demonstrate the diversified picture of the tax systems and tax reforms in the former communist countries after the first decade of their transition from a centrally planned to a market economy system.

While CEB countries are seriously advanced in synchronization of their tax systems with those of the EU, the countries of the Commonwealth of Independent States (CIS) suffer a lot of instability and distortions in this sphere (and Balkan countries staying in the middle between both groups). Thus, the CIS countries, including Russia and Ukraine, face a challenge of further substantial tax reforms related to list of existing taxes and quasi-tax obligations, construction of basic taxes, tax administration and procedures, issue of fiscal federalism (particularly in Russia), and many others.

The authors' intention is to give the overall characteristics of the tax systems in two broad groups of countries (i.e. the EU candidates, and the CIS+ countries) with a special emphasis devoted to principal shortcomings of tax regulations, and remaining challenges of tax reform.

Key words: taxation, tax system, tax reform

I. Introduction

Nobody likes to pay taxes but taxation is unavoidable as long as the institution of state exists. Because authors do not present anarchic ideas and do not want suggest elimination of the state they assume that certain tax obligations for citizens and enterprises must exist. The question is how big should be a tax burden and which concrete tax instruments are the least harmful for business activity and economic development. Answer for the first part of this question seems to be theoretically easy: the amount of the public goods, which government should provide determines the amount of budget revenue required. However, this leads us to a very controversial issue of the size of government and its function. Such a normative discussion is certainly beyond the agenda of this paper. However, numerous analyzes demonstrate that the scale of redistribution of GDP through the system of government finances is too large in most of transition economies, comparing to their level of development [see Barbone and Polackova, 1996; Dąbrowski, 1998]. Without any doubts this is true in relation to Central European countries [see Kosterna, 1998, Dąbrowski, 1999].

Trying to answer the second part of the question it will be useful to briefly recall principles of optimal taxation. According to Jurkovic [1991] countries in transition should develop a tax system that will be compatible with market economy principles and will meet the following requirements:

- (1) it should not interfere with rational allocation of resources, that is, it should be allocationally neutral as far as possible;
- (2) it should ensure a stable and optimal amount of public revenues for financing the supply of public goods;
- (3) it should ensure taxpayers certainty regarding their tax obligations;
- (4) tax burden should be fairly distributed;
- (5) it should be as simple as possible, understandable to taxpayers and cheap in application;
- (6) it should be flexible, that is, it should immediately react to changes in economic conditions.

The above list [see also: Gandhi and Mihaljek, 1992] can be uneasy in practical interpretation. This particularly concerns the issue of fairness, which is often understood in a very egalitarian way, leading to support for a progressive scale of direct taxation, or to preferential rate of indirect taxes on the so-called basic goods and services. However, this would stay in conflict with postulates of tax neutrality, simplicity, and its fiscal effectiveness.

Historical experience shows that the lump sum tax, i.e. fixed amount paid by each citizen independently of his/her income and wealth level is this kind of instrument, which guarantees the maximal allocative neutrality, the simplest and cheapest administration, and allows to solve the problem of tax avoidance. However, relying on this kind of taxation would be economically realistic only in the case of very low government spending to GDP ratio (probably not exceeding 10%). Additionally, this kind of taxation usually raises a lot of political resistance on the ground that it does not take into consideration any differences in taxpayers income and wealth status. It makes difficult to introduce such taxation even as one of many instruments, as Margaret Thatcher's experiment with local poll tax showed.

Broadly based indirect, multi-stage taxation (VAT) can be seen as the next best solution from the point of view of allocative neutrality and revenue collection capacity. This is probably a secret of its big career in the post-war period. However, VAT is not an easy instrument to be administered as the experience of transition countries perfectly demonstrates.

Direct taxation creates much more incentives problems because this is in fact a kind of penalty for getting profit or other sort of income. If such taxation is high and its scale is progressive, tax avoidance becomes prevailing and tax administration extremely complicated. The same can be said about payroll taxes traditionally financing public pension, unemployment and other social assistance schemes.

However, in the economic and political realities of the contemporary world direct taxation and social insurance contributions are hardly avoidable. The practical choice is limited to their size and simplicity. More rates, and more exemptions has the tax system, more distortive and more complicated is its administration, and taxpayers have more incentives to avoid tax obligations. This rule also relates to indirect taxation.

The presence of many tax exemptions gives usually an evidence of weak government position and intensive rent seeking of different lobbies. Additionally, in the case of transition economies they often reflect legacy of the previous economic regime where tax incentives played a role of substitute of market equilibrium prices and market competition.

Countries in transition did not have any great choice in designing general institutional frameworks of their tax system. They had to rely on the experience of developed Western countries, particularly those of the EU. It was determined by the necessity to have the basic institutions compatible with those existing in main trade and investment partners. In the case of Central European and Baltic (CEB) countries the strategic goal to join the EU played an additional, very important role.

However, this general choice have left enough room for deciding a general level of the tax burden (resulting, in first instance, from the level of government spending obligations), proportions between different tax instrument, a number and level of tax rates, number of tax exemptions, etc.

The purpose of this paper [1] is to demonstrate the diversified picture of the tax systems and tax reforms in the former communist countries after the first decade of their transition from a centrally planned to a market economy system. While CEB countries are seriously advanced in synchronization of their tax systems with those of the EU, the countries of the Commonwealth of Independent States (CIS) suffer a lot of instability and distortions in this sphere (and Balkan countries staying in the middle between both groups). Thus, the CIS countries, including Russia and Ukraine, face a challenge of further substantial tax reforms related to list of existing taxes and quasi-tax obligations, construction of basic taxes, tax administration and procedures, issue of fiscal federalism (particularly in Russia), and many others.

The paper will start with a short description of the starting point of tax reforms at the beginning of transition process, i.e. what was left after the previous political and economic regime in the sphere of collecting public revenues (section 2). It will be followed by a general overview of the progress in the tax reform sphere in transition countries in the decade of 1990s (section 3). Later on, we will give a comparative analysis of the indirect taxation (section 4), and direct taxation (section 5), basing on the tax systems of the Czech Republic, Estonia, Georgia, Hungary, Kyrgyzstan, Poland, Russia, and Ukraine in 1999. Section 6 will discuss the challenges facing tax policy and tax reforms in CEB countries, on the one hand, and in CIS countries, on the other. Section 7 will propose some final remarks and conclusions.

The authors are not going to carry out a detail analysis of the existing tax systems in individual countries with a complete list of taxes, tax rates, tax exemptions, and other important provisions of the tax laws. Instead, our intention is to give the overall characteristics of the tax systems in two broad groups of countries (i.e. the EU candidates, and the CIS countries) with a special emphasis devoted to principal shortcomings of tax regulations, and remaining challenges of tax reform. Thus, the concrete examples of tax rates and tax provisions will serve as an illustration of more

[1] The work on this paper started in 2000 when authors analyzed the subsequent versions of the draft Tax Code on a request of the Cabinet of Ministers and Ministry of Finance of Ukraine. Our expert comments included comparative analysis of tax systems and tax reforms in other transition countries. Our work was carried out under the USAID funded Ukraine Macroeconomic Policy Program (Award No. 121-A-00-98-00623-00). The first, very preliminary version of this paper was presented at the Leontief Annual Conference at Saint Petersburg, February 23–24, 2001. The current revised and updated version was completed on May 8, 2001. Authors want to express their gratitude to Mateusz Walewski for his helpful information and comments.

general trends and phenomena rather than a complete compendium of knowledge about the countries' tax regulations. In particular, we will not analyze a broad range of local taxes and fees and quasi-taxes providing revenues to numerous extra-budgetary funds.

2. Legacy of the past

Under the "classical" regime of central planning the overall system of public finances was fully subordinated to the production, investment and distribution targets set out by the planning authorities. Thus, collecting revenues for state needs differed significantly from any type of tax system known from the contemporary market economy. The following main characteristics could be attributed to the communist fiscal and tax system:

1. The boundaries of the public finance system could not be easily defined, because both state-owned enterprises and cooperatives were compulsory grouped in trusts, associations, and other kinds of branch organizations, which in turn were subordinated to sector ministries. Each level of management participated in redistribution of an enterprise profit. However, one can take a bit simplified assumption that all the levels of management over the state owned enterprise belonged to a "general government" sector and their redistribution activities had a fiscal or quasi-fiscal character.
2. Under the assumption taken in point 1, the level of redistribution of national income (calculated as the net material product) through the system of public finances was much higher than in most of developed countries even those burdened with the biggest welfare state commitments. Although fully comparative data are not available it well exceed half of the net material product (NMP).
3. Under the same assumption, state-owned enterprises' profit became the main source of financing general government expenditures. What is important, this profit was redistributed according the residual principle, i.e. all the enterprise profit exceeding approved investment programs and statutory bonus schemes (for management and employees) was automatically channeled to an account of the higher level of management. The same procedure was repeated on the branch and sector level. So, the state budget did not deal with individual enterprises and did not need a developed tax administration.
4. "Luxury" consumer goods were subject of highly differentiated (on the product-by-product basis) turnover taxes. On the other hand, most of basic goods and services were heavily subsidized. Turnover tax and subsidies played, in fact, the role of buffer

between the administratively determined prices and average branch costs of production and distribution. In practical terms, taxation of only few products such as alcohol beverages, tobacco products, cars, consumer electronics and sometimes oil products had bigger fiscal importance.

5. Personal income was mainly taxed using the "wage tax" collected by enterprises on behalf of employees. The same concerned the social insurance (pension) contribution. In Poland in 1970s, individual wage tax was formally replaced by the wage bill tax paid by enterprises and all wages and salaries started to be paid on the net basis. Extra income (additional employment or honoraria) was usually taxed using special tax scales.

6. Special income taxation was also used in relation to private business where such an activity was allowed at all (Poland, Hungary, Yugoslavia, and GDR). These taxes usually represented strongly progressive scales and tax rules were very unstable and arbitrary. In practice, tax decision played very often the role of instrument of expropriation of the private property and harassing these entrepreneurs who were considered as "political enemies". Unfortunately, this very bad tradition of the politically biased behavior is today followed by tax administration in many CIS countries.

7. Individual farmers where existed (Poland, Yugoslavia) paid the land tax and symbolic social insurance contributions. Additionally, in the earlier stage of communist regime (in Poland until 1971) they were obliged to deliver certain quotas of basic agriculture products at artificially low and administratively fixed prices to monopolistic procurement agencies.

8. Custom duties were paid by physical persons and private businesses (where allowed) only, in the case of goods imported and exported (!) for individual needs. Export control resulted from the administratively controlled domestic prices and subsidization of numerous consumer goods. State owned enterprises could export and import only through designated foreign trade companies (usually having the monopolistic character) under the export targets and import limits determined by the planning authorities. These foreign trade monopolists settled their profit accounts directly with the state budget.

Countries, which tried to reform their economic systems adopting some market mechanisms (Yugoslavia, Hungary, and Poland) had also to change at least some fiscal instruments. On the one hand, "market socialism" needed to implement the tax system looking more like the normal market one, in order to allow enterprises to have a certain room of operational and investment autonomy and provide them with the positive incentives. This was usually connected with replacing the individualized profit redistribution schemes (see above) with general profit (income) tax scales. On the other hand, however, tax system (particularly the enterprise income/profit taxes) was burdened with the task to provide several specific incentives substituting the non-existent market structure of prices

and market competition. Hence, the enormous number of tax exemptions existed in Hungary or Poland in late 1980s. These special incentives were provided both on general (sector or activity related) basis and individually, making tax system extremely non-transparent, fiscally ineffective and opened to intensive lobbying and rent-seeking.

The above short history of the pre-transition tax systems seems to be useful in understanding the significant part of the problems faced by the reformers in the decade of 1990s.

3. What was Achieved in the Decade of 1990s: a General Overview

At the beginning of transition process tax systems in the former communist countries reflected, to large extent, the legacy of a centrally planned economy in its either classical or "reformed" version (see above). In order to build the market system and carry out macroeconomic stabilization (almost all post-communist countries suffered huge fiscal and monetary imbalances) tax system had to be adjusted relatively quickly to the new needs. Most of countries took a strategic decision to follow an European type modern tax system based on VAT and excises as the main indirect taxes, and personal and corporate income taxes (PIT and CIT) as the main direct taxes. Additionally, significant pension and other type of social insurance contributions necessary to finance the extensive social programs had to be maintained. Foreign trade liberalization forced to adjust custom duties to the international standards although they do not play usually the important fiscal role.

Tax reform was a time consuming process and it usually lasted a number of years before being complete. Additionally, political liberalization and democratization made this process heavily politicized and vulnerable to various interest groups. Depending on the level of political consensus in favor of fast and consequent market transition, tax reforms were conducted with different speed, consistence and quality. Generally, one may risk the hypothesis that the outcome of tax reforms reflected the overall progress in economic and political transformation in individual countries.

The CEB countries considered as transition leaders adopted the new tax laws reflecting internationally accepted standards relatively quickly, usually in the course of 2–3 years (in Hungary this process took more time but started much earlier, already in 1986). Furthermore, changes currently implemented or planned in the nearest future are designed to harmonize their tax systems with laws prevailing in the European Union (as the part of their EU accession process).

The course of events in the CIS countries has been much more complicated. In the beginning of 1990s, the former Soviet Union did not have even this imperfect tax legislation and tax administration, which existed in the end of 1980s in Hungary, Poland or the former Yugoslavia. And the overall price and enterprise finance system was much more distorted in the former USSR than that in the Central Europe. In these circumstances the last Soviet government started to prepare in 1991 a general tax reform, involving introduction of the VAT, excise taxes, enterprise profit tax, and, to lesser extent, consolidated PIT. From the beginning of 1992, Russia, Ukraine and most of other former Soviet republics introduced this reform. It was the real systemic shock comparable to price liberalization carried out at the same time!

The revolutionary changes concerned particularly the indirect taxation where highly diversified turnover tax was replaced with unified VAT at very high rate of 28% and excises.

However, speed and radicalism of these changes was not supported by their quality and political will to sustain the new system. The new legislation determined only the main economic characteristics of individual taxes, leaving many important technicalities unanswered and old tax procedures and tax administration virtually unchanged. This led to a very distorted implementation of some taxes, particularly the VAT (details will be discussed in the next section). On the other hand, when the first "surprise" effect was over, sector and branch lobbies quickly learned the basic rule of new taxation and started to push for respecting their specific interests. The incomplete price (and exchange rate) liberalization made this pressure easier as some sectors had problems to pay so high taxes under the administratively controlled prices. Political instability and dominance of populist forces in parliaments helped these pressures to materialize.

As result, just after the introduction of the new tax system both legislative and executive branches of government in CIS countries started the never-ending process of its "corrections", mainly through accepting various kinds of exemptions. In spite of high basic tax rates, new taxes occurred to be fiscally ineffective giving very limited budget revenues. The parallel failure to cut sufficiently expenditure commitments (particularly in the social sphere) led to the chronic fiscal crisis and high inflation/hyperinflation, additionally devastating the system of public finances [see Gaidar, 1997].

Shortage of revenues pushed authorities on the central (federal), regional and local levels to search and invent the additional financial sources. This led to creating many additional taxes and quasi-taxes such as local sales taxes (cascading with the VAT), contributions to "extra-budgetary" funds, fees for conducting regulatory and inspection activities by "self-financing" government agencies, penalties for missing regulatory

standards, "voluntary" contributions to various funds and foundations created on initiative of regional and local authorities.

In some countries, (among others, in Kyrgyzstan), there has been a growing reliance on the so-called "special funds" revenues. Since special funds were guaranteed to remain, at least partially, within the collector's own budget, the collection effort was strong and revenue creation comparatively high. The ad hoc levying of fees at the sub-national level reduced the transparency of the tax system. Further, it added to equity (fairness) concerns as additional fees were levied according to easiest enforcement principle.

The overall tax system became so complicated, distorted and non-transparent that stopped to fulfil its basic functions and pushed a significant part of business activity into an informal sector. The weak legal infrastructure (including Soviet-type accounting principles incompatible with market-type taxation) together with unreformed tax procedures and tax administration contributed to fast growth of a shadow economy, on the one hand, and to high instability and massive "tax harassment" of these businesses, which continued their activity in the legal sphere, on the other.

From mid-1990s, the repeated attempts of the complex tax reforms, usually in the form of the consolidated Tax Code, have been undertaken. Contrary to experience of early 1990s, at that time the conceptual and preparatory legislation work has been supported by foreign experts. However, the results occurred to be ambiguous, for very political reasons. Even if government was fully committed to radical and complex tax reform and managed to get the support of parliament as it happened in Kyrgyzstan in 1995–1996, just after the gradual erosion of the new system started [2].

Table I illustrates the comparative assessment of the progress in tax reform (its formal dimension only) in Baltic and CIS countries since 1991, carried out by Ebrill, Havrylyshyn et al. [1999]. Although this ranking became a bit outdated at the beginning of 2001 (not reflecting, for example, recent Russian tax reforms) it gives a general orientation how much most of CIS countries stay behind the leading reformers, i.e. Baltic countries in this case. The main conclusions from this analysis are following:

- Georgia and Kazakhstan adopted comprehensive and generally appropriate new tax codes. However, in Georgia the positive net revenue effect of tax policy measures has been declining over time. The largest revenue increase happened in 1996, a year after the implementation of a number of tax policy improvements. More modest increase in the

[2] As result, the total tax revenues in Kyrgyzstan have shown almost continuous decline, from 15% of GDP in 1995 to less than 12.5% in 1999. Major distortions involve the agricultural sector exemption from VAT and income taxes, loopholes in customs, and the existence of free economic zones. The agricultural sector contribution to tax revenue remains marginal in spite of the fact that agriculture accounts for the largest share of GDP.

tax ratio in the following years reflected tax collection problems. In order to address these problems and broaden the tax base numerous fiscal measures were adopted in 1998 and 1999 [3].

- Armenia, Azerbaijan, Moldova, Kyrgyzstan, Tajikistan, Uzbekistan, and Ukraine have adopted new tax laws but their content reflects varying degree of reforms. Ukraine is discussing now a new complex Tax Code (not so radical as the Russian one) but chances and timetable of its approval by the Parliament are very unclear due to the current political crisis and forthcoming parliamentary elections. Also the Kyrgyz government is considering possibility of the "cleaning up" its Tax Code, heavily distorted by various amendments adopted in 1996–1999 [4].

Table I: Ranking of the Baltic and CIS countries with respect to their progress in tax reforms, 1992–1998

Country	Assessment of degree of tax reform 1992–1998
Armenia	2
Azerbaijan	3
Belarus	4
Estonia	1
Georgia	2
Kazakhstan	2
Kyrgyzstan	3
Latvia	1
Lithuania	1
Moldova	2
Russia	2
Tajikistan	3
Turkmenistan	5
Ukraine	3
Uzbekistan	4

Note: scale from 1 (high degree of appropriate market-oriented reforms) to 5 (very little, if any reform)

Source: Ebrill, Havrylyshyn et al. [1999]

[3] They concerned the elimination of VAT exemptions for agriculture, supply and import of natural gas and electricity; elimination of special treatment for imports and exports to the CIS countries; change in domestic tobacco products excises from an *ad valorem* to a specific tax formula, and introduction of mandatory excise stamps on all domestic and imported alcohol and tobacco products.

[4] First of all, changes concern a switch to the destination principle in trade with Russia, which would increase VAT revenue significantly, since Kyrgyzstan is a net importer from Russia. Over the medium term, there are proposals to impose VAT, both on agricultural commodities and processed goods, possibly granting exemptions for certain inputs (fertilizers and seeds).

- Russia, despite government's commitment to tax reform in 1997–1998, has made modest changes to the tax system until mid of 2000. However, the authorities defined the tax reform as the key structural measure in its complex program of economic reform approved in spring 2000. And in April 2000, the government submitted a comprehensive set of proposals relating to PIT, social fund contributions, VAT, and excises. Part of this package was accepted by Duma.

4. Indirect Taxation

Indirect taxation involves VAT, excises, additional sales taxes or quasi-taxes, and foreign trade taxes (custom duties).

4.1. VAT

Table 2 and Graph 1 show the VAT rates in selected transition economies. At first glance, CIS countries do not look so bad, comparing to the CEB countries in terms of the number of tax rates and their level. The latter do not exceed now 20%, less than in the Czech Republic, Hungary and Poland not saying about some EU countries such as Sweden, Denmark, or France [see Neneman, 1999]. Some of the CIS countries have one basic rate only while Central European countries and most of the current EU members have at least two.

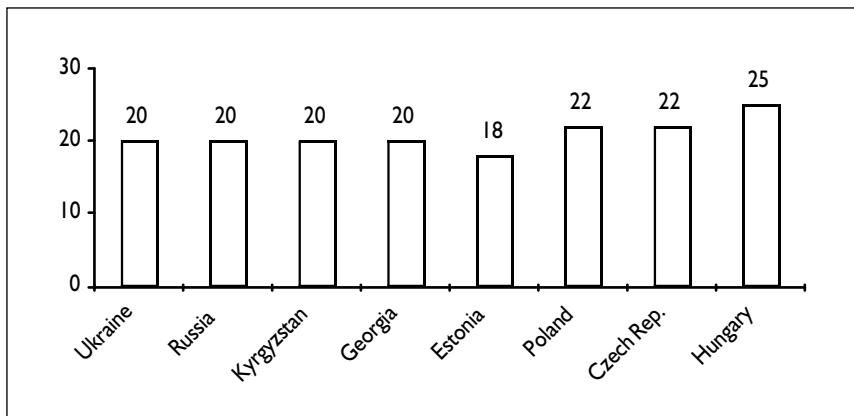
Table 2: VAT rates in selected transition economies, 1999

Country	General Rate	Reduced Rate
Czech Republic	22	5
Estonia	18	-
Georgia	20	-
Hungary	25	12
Kyrgyzstan	20	-
Poland	22	7
Russia	20	10
Ukraine	20	-

Source: KPMG Tax Facts

However, the revenue statistics illustrated in Table 3 demonstrates that the fiscal effectiveness of the VAT in CIS countries is limited, comparing to their CEB neighbors.

Graph I: General VAT rates in selected transition economies in 1999



Sources: KPMG Tax Facts

This can be attributed to the following shortcomings of the VAT legislation and administration in the CIS:

I / A large number of VAT exemptions including adoption of the zero rate not only to export (what is the standard solution) but also to some specific goods and services sold on domestic market what creates the evident distortion. One exemption in the production/distribution chain (especially in the primary sector such as an agriculture) complicates the situation of the VAT payers in the next stages of production (because they cannot get a VAT refund) and creates temptation to proliferate exemptions. At the same time, it decrease a general tax discipline in the economy as the potential VAT taxpayer lose their interest in obtaining inputs from a "legal" sector.

Table 3: VAT revenues in selected transition countries as % of GDP, 1996–1999

Country	1996	1997	1998	1999
Czech Republic	7.0	7.1	6.6	7.5
Estonia	10.1	10.4	8.7	8.5
Georgia	3.6	4.6	4.6	4.4
Hungary	7.7	7.9	7.9	8.2
Kyrgyzstan	5.3	5.6	5.8	4.1
Poland	7.3	7.9	7.8	8.2
Russia	5.7	4.7	4.4	4.8
Ukraine	7.7	8.1	7.1	6.6

Source: IMF Country Reports

2/ The VAT refund is often not effectively granted what creates the similar problems as described in point 1 (plus the cascading effect).

3/ CIS countries could not manage to complete a transition from the origin to destination principle in their trade relations yet. Russia has created the biggest obstacles in this transition.

4/ Under the pressure of inefficient enterprises, the cash basis of VAT collection (the same concerns the CIT) was adopted instead of accrual principle as in market economies. This effected not only in weak VAT collection but also in increased inter-enterprise arrears. Recently, most CIS countries have been doing effort to replace the cash principle with the accrual principle, but this process is far from being completed.

5/ In some countries, VAT has been divided between central and regional budgets what has created the additional distortions such as anti-export incentives.

6/ Fiscal effectiveness of custom administration is relatively low (particularly at the new borders between CIS countries) what influences negatively VAT (and excise) collection from imported goods.

7/ Countries representing lower level of economic development (Central Asia and Transcaucasus region) have the relatively high share of agriculture, small scale trade, production and services in GDP what naturally decrease a base of effective VAT collection.

8/ A general inability (political and administrative) to collect taxes is in many cases the biggest impediment to increase VAT revenue (rather than low tax rates or widespread formal tax exemptions). For example, Georgia has relatively modern tax system with tax rate, which is comparable with countries obtaining significantly higher tax yields. However, tax collections from broadly based VAT of 20% are estimated at around 43% of the potential only.

Some distortions in VAT legislation, such as adoption of the zero rate in relation to goods sold on domestic market (for example, books and newspapers or agriculture inputs in Poland) have also existed in CEB countries but they are gradually eliminated now, according to the EU harmonization requirements.

4.2. Excise Taxation

Table 4 below shows that level of excise tax collection in CIS countries is much lower than in CEB countries. This is connected both with the weak tax and custom administration, and many shortcomings of the excise taxation in the former group. Among the most controversial features of the excise taxation in the CIS one can mention:

Table 4: Excise tax revenues in selected countries as % of GDP, 1996–1999

Country	1996	1997	1998	1999
Czech Republic	3.9	3.8	3.8	4.0
Estonia	3.3	3.7	3.8	3.6
Georgia	0.7	1.2	0.8	2.1
Hungary	3.3	3.9	4.1	4.1
Kyrgyzstan *	1.9	2.3	3.2	3.3
Poland	4.0	3.8	3.8	4.1
Russia	n.a.	2.0	1.9	1.9
Ukraine	0.8	1.2	1.2	1.4

Source: IMF Country Reports

* Excise and customs

1/ Generally low excise rates, particularly in relation to oil products what seems to be both legacy of the old Soviet price structure and pressure of the agrarian lobby being a huge consumer of the oil products.

2/ So far *ad valorem* rates prevailed instead of specific rates what makes tax avoidance easier (although recently this weakness has been gradually corrected in several countries).

3/ Like in the case of other taxes many exemptions has been introduced reflecting an intensive rent seeking in most of parliaments and governments (sometimes so strange as exempting the import of oil products in Ukraine).

4/ Discriminatory practices against import (higher excise rates in relation to imported goods comparing to domestically produced) what contradicts the WTO principles and complicates accession to this organization.

5/ In some countries an excise taxation covers too many goods, going beyond the "classical" list of excise "sin" goods (oil, alcohol and tobacco products).

The last weakness concerns also some CEB countries, and it must be eliminated in order to adjust their excise taxation to the EU standards. Apart from eliminating excise duties in relation to non-sin goods, EU candidates should also increase tax rates for remaining excise goods, particularly for oil products [see: Neneman, 1999]. It will mean some additional supply shock in transportation, trade and service sectors. On the other hand, higher excise rates for alcohol and tobacco increase the already existing temptation for smuggling these goods from neighboring countries (particularly from those of CIS where rates are generally lower).

4.3. Additional Sales/Turnover Taxes

The effectiveness and transparency of the indirect taxation in the CIS is additionally worsened by the remaining (or even re-emerging) additional sales/turnover taxes. They create the cascading effect, i.e. multiple taxation of the same good (the same distorting effects may occur when the VAT paid in the earlier stage of production/distribution is not returned to purchaser or returned with a substantial delay).

Generally, one can distinguish two sources of the additional sales/turnover taxes. The **first** one is a product of the specific shape of the post-Soviet fiscal federalism (the case of the Russian Federation) or quasi-federalism (example of Kyrgyzstan). The regional or local government can introduce its own sales tax in addition to federal (central) VAT and excise duty and this opportunity constitutes one of the important sources of its budget revenue [5]. In theory, this kind of taxation relates to final product and services only and should not create the cascading effect. In practice, many taxed items have a double destination, both for consumption and as input in the further production/distribution process.

Secondly, there are quasi-taxes, concretely contributions to various extra-budgetary funds calculated as a percentage of the total enterprise turnover. So, they surely must create the cascading effect. Such funds exist both on a federal (central), regional and local level and are in charge of dealing with the special tasks such as, for example, natural disasters and other emergencies, maintaining roads, ecology, etc. By definition, these tasks are, in most cases, unrelated to the level of turnover (sales). This means that they have a strongly distorting character.

Extra-budgetary funds (and enterprise contributions being the source of their creation) can be seen as a legacy of the pre-transition system of public finances when sector ministries (and compulsory trusts and associations of state enterprises) played a crucial role in redistributing enterprise profit (see section 2). In spite of the decade of transition, many CIS governments continue to have a character of loose federation of sector ministries and the latter remain the autonomous sub-governmental bodies managing their own "extra-budgets", very often out of the effective control of the Ministry of Finance and parliament. The attempts to consolidate these funds into the single budget and eliminate distorting quasi-taxes are politically extremely difficult (as in the case of sector oriented tax exemptions). On the contrary, in some countries, for example in Ukraine, one may observe an almost unlimited proliferation of extra-

[5] Recently, the Constitutional Court of the Russian Federation questioned the existing legal basis of the sales taxes introduced by regions/republics.

budgetary funds, special budget accounts, etc., and attempts of almost each government agency to be "self-financed" in this way.

4.4. Foreign Trade Taxes (Custom Duties)

As we mentioned before, in the pre-transition time a custom system in the sense, which is known from a market economy either did not exist at all (most of communist countries) or had many distortions (this relates to the "socialist" market economies - Yugoslavia and Hungary). In the relatively short time most of transition economies built the market type tariffs system and the level of import tariffs, particularly in relation to industrial goods, has been relatively moderate comparing to some developing countries [6]. Additionally, the CEB countries had to carry out a significant trade liberalization program coming out from the free trade and association agreements with the EU, free trade agreements between themselves and, to lesser extent, from the WTO rules. In the end of 1990s, the first CIS countries, such as Kyrgyzstan [7], Georgia, Armenia, and Moldova joined the WTO and several others are just negotiating their membership in this organization. This means that also this group of countries will be constrained in manipulating their import tariffs and will have to adjust fully their custom rules to international standards [8].

Although trade related regulations have undergone significant modernization in many CIS countries, their customs codes still prove to be too detailed, complex, and difficult to understand. There are usually a wide variety of exemptions from customs duties and taxes available to importers. For example, in 1999 Kyrgyzstan's revenue foregone from such exemptions was estimated to be around 50% more than the revenue collected. Beside legislation adjustment, customs administration needs an organizational restructuring as the majority of its resources are devoted to controlling the legitimate traders who voluntarily report to the customs while insufficient resources are assigned to address major smuggling activities and revenue loss due to smuggling is reported to be sizable.

[6] One must remember, however, that apart from import tariffs some countries use also non-tariffs barriers, particularly in relation to agriculture trade. However, in this paper we discuss the fiscal importance of import protection only, instead of analyzing the whole issue of trade policy and protectionism.

[7] WTO membership may also impose some additional burdens on the customs administration. In Kyrgyzstan, the State Customs Inspectorate (SCI) is faced with complex verification responsibilities, particularly related to the WTO valuation agreement, rules of origin, and tariff classification.

[8] In 2000, Russia unilaterally decreased and simplified its import tariffs.

The fiscal role of import duties is rather limited and their share in GDP fluctuates around 1% of GDP in most countries (see Table 5).

Table 5: Foreign trade taxes revenue in selected transition countries as % of GDP, 1995–1999

Country	1995	1996	1997	1998	1999
Czech Republic	1.3	1.3	0.9	0.8	0.7
Estonia	0.6	0.1	0.8	0.8	1.0
Georgia	n.a.	0.5	1.4	1.4	0.6
Hungary	n.a.	n.a.	1.9	1.3	1.2
Poland	3.0	2.4	1.5	1.1	0.9
Russia	n.a.	n.a.	1.2	1.7	1.9
Ukraine	0.7	0.5	0.8	0.9	1.0

Source: IMF Country Reports

Export taxes (duties) are not subject to WTO constraints and usually reflect the desire to keep the internal price level for a specific good below the international level (contributing in this way to price distortions). In the beginning of transition it was the common practice of most of transition economies (even those considered as leading reformers) to keep some export barriers in relation to selected agriculture and energy products. Recently, this is mainly a case of CIS countries. Their direct fiscal role is even more limited than that of import tariffs. They serve mainly as an instrument of cross-subsidization in favor of domestic consumers or producers (the famous example of export tax on sunflower seeds in Ukraine aiming at supporting domestic producers of sunflower oil).

The export taxes on crude oil, oil products and natural gas in Russia are the only example of the fiscal importance of this kind of taxation although they also serve as an instrument of keeping the domestic energy and fuel prices on the low level. The improved position of the federal government since 1998 primarily reflects, to significant extent, changes in export taxes. Their reintroduction in early 1999, and their expansion since, has added over 2 percent of GDP to revenues of the federal budget (mostly it was contribution of energy exports) [IMF Country Report, 00/145].

Trying to assess the total fiscal impact of export taxes (and other export barriers) one must come to pessimistic conclusion. As they usually result in lower profitability of industries producing goods being subject of export taxation (most frequently, this relates to agriculture and energy producers) these industries need intensive state aid (or at least budget gets lower CIT revenues).

5. Direct Taxation

Direct taxation includes a personal income tax (PIT), corporate income tax (CIT) and social insurance contributions.

5.1. Personal Income Tax

Until very recently, big differences existed between the construction and fiscal effectiveness of the PIT in CEB and CIS countries. While the former introduced the consolidated taxation in relation to most of the sources of personal income, the latter continued, in fact, the traditional tax on wages and salaries only with a great number of costly exemptions. Thus, a dramatic difference in the level of PIT collection between both groups of countries cannot be surprising (see Table 6).

Most of transition countries introduced the progressive tax scales copying the experience of developed countries. The highest tax rates are usually on the level of 40% or even higher (Ukraine had the highest tax bracket on the level of 90% in 1993–1994) what does not help to stimulate compliance with tax obligations [9]. From the very beginning of transition, Estonia chose a different way, introducing the principle of proportional taxation at the rate of 26% (see Graph 2). As Table 6 demonstrates this construction has given the highest level of revenues among all analyzed countries. However, from 2001 the minimal income threshold for PIT was increased by 25%

Table 6: PIT revenues in selected transition countries as % of GDP, 1996–1999

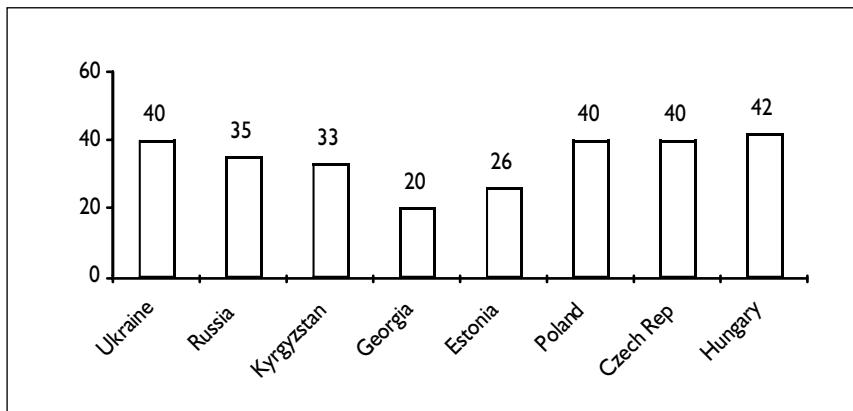
Country	1996	1997	1998	1999
Czech Republic	5.1	5.3	5.3	5.2
Estonia	8.3	8.1	8.5	8.7
Georgia	1.2	1.7	1.8	1.9
Hungary	5.8	6.6	6.5	6.7
Kyrgyzstan *	2.9	2.2	2.6	2.4
Poland	6.8	6.4	6.3	4.0
Russia	n.a.	0.1	0.2	0.4
Ukraine	3.2	3.5	3.5	3.5

Source: IMF Country Reports

*Total income taxes

[9] Among analyzed countries, Georgia is an exception with the progressive scale ending with the rate of 20% (12, 15, 17 and 20%).

Graph 2: Personal Income Tax top marginal rates in 1999



Sources: KPMG Tax Facts

(together with phasing out the CIT – see the next subsection) what should cause decreasing budget revenues from this source.

Recently, other countries of the region try to copy the Estonian experience [Aslund, 2001].

In Latvia, the Law on the Personal Income Tax together with the Law on the Corporate Income Tax forms a unified system of taxation on all types of income. Both PIT and CIT standard tax rates are set at 25%. The PIT is assessed on salary, income from self-employment, property income, as well as on all other kinds of remuneration. The system reflects, to very large degree, the principle of simplicity. It is characterized by a very limited number of transparently defined exemptions and deductions. The following are deducted from taxpayer income: (a) a nontaxable minimum, (b) a deduction for each dependent, (c) state social insurance contributions, (d) expenses for the education and health care, (e) donations to charity. Further, it precisely specifies short list of incomes on which tax is not assessed: agricultural income of individual farmers up to certain limit, interest income, social benefits, insurance compensation, and income from the sale of private property.

In summer 2000, the Russian Federal Assembly approved a radical reform of the PIT with the single tax rate of 13% from January 1, 2001. However, some sources of income are taxed at different rates, for example, dividends at the rate of 30% (also in Estonia dividends are taxed differently). In addition, several exemptions have been retained, so one cannot expect so high revenue effectiveness as in the Estonian case. Russian taxpayers can deduct from their taxable income some fixed quotas related to their social

and family status, housing investments, education and health expenditures. As the PIT revenues in Russia were extremely poor so far (see Table 6) the fiscal risk connected with this reform is not very high.

However, in countries where PIT revenues constitute a higher share of GDP the fiscal risk of flattening the tax scale seems to be much greater. In order to make such an operation fiscally neutral in the short run (in longer perspective a kind of Laffer type effect, i.e. stimulating a supply side or moving a part of the informal sector into the legal sphere can be expected), there is necessary to consider the following forms of compensation:

- removing the existing tax exemptions;
- increasing the lower rates of PIT;
- increasing indirect taxes (VAT and excise);
- decreasing budget expenditures.

None of these measures is politically easy (particularly the second one) as the opponents can accuse reformers of redistributing income in favor of groups with higher material status. The counter-arguments referring to the expected positive supply-side effects (higher rate of private savings, incentives to legal business, lower tax administration costs and higher transparency of tax system) are socially much less appealing than just a demagogic slogans about "helping poor" and "social justice".

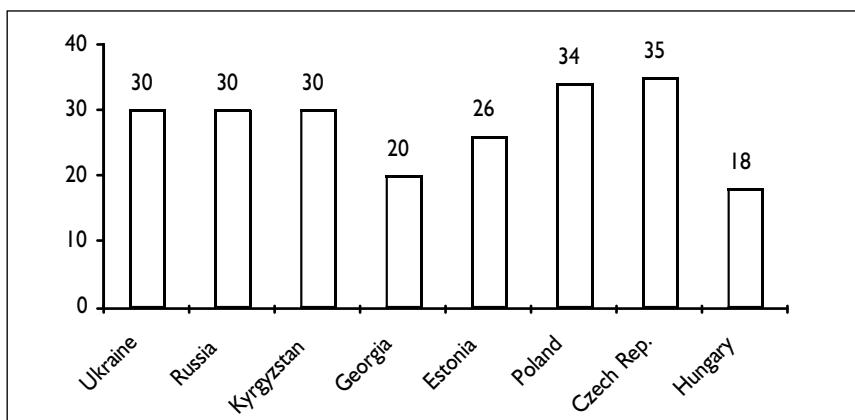
This was the main reason of political failure of the initiative to simplify the PIT scale in Poland advocated by the Deputy Prime Minister and Minister of Finance Leszek Balcerowicz in 1998–1999. The first, more radical, attempt in 1998 aimed at eliminating many preferential deductions, exemptions and credits in the PIT, CIT, and VAT, and introducing the flat taxation of individual income at the rate of 22% (equal to reduced CIT rate – see the next subsection). This proposal was simply blocked politically both by the left wing and right wing of the political spectrum. In mid-1999, the government reintroduced the tax reform proposal in the compromise form. The project considered gradual lowering of the marginal PIT rates from 19%, 30% and 40% brackets to 19%, 29% and 36% in 2000, 19%, 28%, and 35% in 2001, and 18% and 28 in 2002. After the long political debate this variant was approved by the parliament in November 1999 but vetoed by President Kwasniewski (on the basis of "social argumentation").

However, the increasing cross-border competition of the tax systems will probably force even the most "socially" oriented countries to decrease and flatten their PIT scales as it already has happened in the case of CIT.

5.2. Corporate Income Tax

Corporate income tax (named officially in most of the CIS countries as profit tax) has the proportional construction in all the transition economies. CIT rates were rather high in the beginning of transition (40% and more in the Central Europe, 30% in CIS). Gradually, several countries entered the way of decreasing CIT rates, taking into consideration both domestic policy considerations (stimulating economic growth, fighting tax avoidance and black economy), and increasing cross-border tax competition (see Graph 3).

Graph 3: Corporate Income Tax rates in 1999



Sources: KPMG Tax Facts

Hungary was the first country, which decided on the very radical step of decreasing the CIT rate to 18% in 1995 (from 40% in 1993 and 36% in 1994) [see Tomczynska, 1999]. The Czech Republic and Poland adopted the scenario of gradual CIT cuts, with the rate of 22% in year 2004 as the final goal of Polish reform [10].

Estonia, having a very moderate rate of 26%, abolished completely this tax, starting from 2001. So far, this is the most radical approach to CIT reform in the region. Higher excise tax collections [11] and improvements in tax administration are expected to fiscally balance this radical change. This decision was in line with the government's long-term objective of reducing the size of government in the economy.

[10] CIT rate amounts to 34% in 1999, 30% in 2000, 28% in 2001–2002, 24% in 2003 and 22% in 2004.

[11] On September 1, 2000 the excises on fuel components were introduced. On January 1, 2001 the introduction of excise for alcohol in warehouses took place.

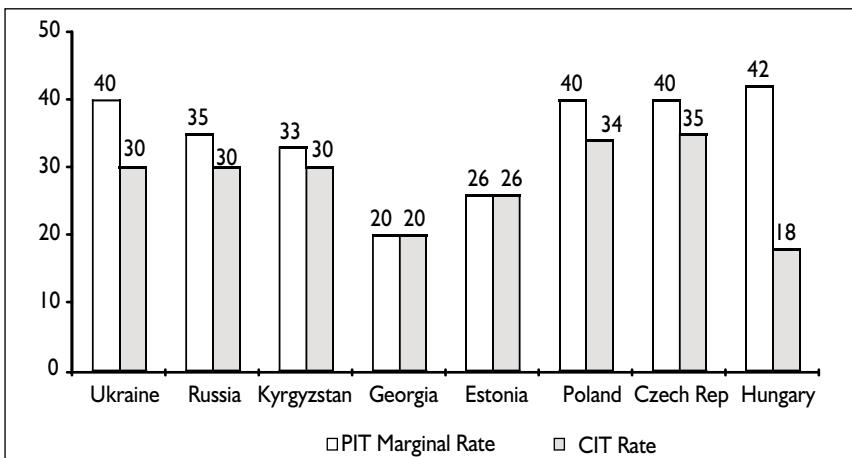
Table 7: CIT revenues in selected transition countries as % of GDP, 1996–1999

Country	1996	1997	1998	1999
Czech Republic	3.9	3.3	3.8	3.8
Estonia	1.7	1.9	2.6	2.2
Georgia	1.0	0.9	1.1	1.0
Hungary	1.7	1.9	2.2	2.3
Poland	2.8	2.8	2.7	2.4
Russia	n.a.	1.3	1.2	1.7
Ukraine	6.7	6.1	5.5	5.0

Source: IMF Country Reports

Probably, decreasing CIT rates will have to influence the similar trend in relation to PIT rates (particularly the top marginal ones), in order to keep some comparability of the taxation level in relation to small enterprises, which can have either the corporate form or be run directly by physical person (see Graph 4). Already now such a discrepancy seems to exist in the case of Hungary, Estonia, and Poland in favor of CIT (which is significantly lower than the top marginal rate of PIT), and in Russia in favor of recently reduced PIT [12].

Graph 4: Degree of unification between the levels of PIT and CIT rates in 1999



Sources: KPMG Tax Facts

[12] However, in order to make such a comparison really precise, one additional element should be taken into account, i.e. the tax on dividends, which varies in most countries in the range of 10–30%.

Assessing the CIT construction, it is worth to notice that in many CIS countries this tax does not meet the international standards yet, mainly because of too narrow definition of business costs and too low depreciation rates. The incompatibility of old Soviet type accounting rules with the International Accounting Standards creates serious problems to foreign investors. On the other hand, a lot of various exemptions decrease significantly its potential fiscal effectiveness.

Table 7 shows that fiscal importance of this tax is rather limited, apart from the Czech Republic and Ukraine. Paradoxically, this creates more room for reducing the CIT rate as other steps can relatively easily compensate the potential fiscal loss.

5.3. Payroll (Social) Quasi-Taxes

Public pensions, benefits for unemployed, sick leave benefits, and sometimes other social programs such as health expenditures, maternity leaves, child and family benefits, assistance to war veterans, etc.^[13] are financed out of special extra-budgetary funds. The revenue side of these funds is formed out of mandatory contributions of all wage earners, proportionally to their wage bill. In fact, these contributions have the quasi-tax character, do not differing from other taxes (particularly from the PIT).

Technically, contributions are paid either by employers on behalf of employees, or (partly) by employees themselves (but employer is usually in charge of deducting employees' contributions from their gross wages like in the case of PIT). The advantage of the second solution has an education character: people are more aware of the costs of social programs what can temper potential populist demands. Additionally, if the concrete social benefit is closely related with the individual contribution (for example, the defined contribution pension scheme) it can increase payment compliance. However, in both variants, contributions to social funds increase cost of labor, contributing to higher unemployment, tax avoidance and increase of informal sector.

Table 8 shows that the overall burden of payroll taxes in transition countries is substantial (apart from Georgia), close to that of Western European welfare state pattern, and much higher than in developing countries, representing the similar level of economic

[13] In Ukraine and Belarus there have also been special extra-budgetary funds supporting victims of the Chernobyl disaster. Until July 1997, the rate of mandatory contribution to the Chernobyl Fund in Ukraine amounted to 12% of the payroll. Later on, this quasi-tax has been gradually phased out. Between July 1997 and August 1998 it amounted to 10%. Since August 1998 it has been reduced to only 5%. Since 1999 contribution to the Chernobyl Fund has been completely eliminated and replaced by direct budget transfers. Simultaneously, the expenditure programs of this fund earlier involving a lot of waste and misdirected spending were substantially reduced.

Table 8: Revenues from payroll taxes in selected transition countries as % of GDP, 1995–1999

Country	1995	1996	1997	1998	1999
Czech Republic	15.9	14.1	14.8	14.6	14.7
Estonia	12.3	12.2	12.0	12.1	12.0
Georgia	1.6	2.4	2.3	2.5	2.4
Hungary	14.4	13.5	13.8	13.6	12.9
Poland	8.9	9.1	9.2	9.3	10.6
Russia	8.0	8.1	9.9	8.7	8.6
Ukraine	10.4	10.7	11.1	10.5	10.1

Source: IMF Country Reports

development. In most countries, this is not enough to finance all the existing entitlements. As result, either the state budget has to provide additional transfers to social funds (Central Europe, particularly Poland), or part of the government obligations remains under-financed leading to social arrears or even to ignoring the formally binding entitlements (most of CIS).

On the micro level, the above burden is translated into a very high summary rate of social contributions varied from 48% to 33% of the payroll in the analyzed countries in 1999. A comparison between revenues obtained from payroll taxes (Table 8) and their rates (Table 9) demonstrates that effectiveness of their collection is very differentiated. Georgia represents the worse performance in this respect. It may be connected with the total flattening of the pension benefits in this country – every pensioner receives the same pension (14 lari monthly, equivalent of 7 US\$) – what probably kills any incentives to pay contribution to the Pension Fund. In addition, important groups of population – farmers and self-employed – are totally exempted from paying this contribution.

Table 9: Rates of social insurance contribution in selected transition economies, 1999

Country	Rate
Czech Republic	47.5
Estonia	33
Georgia	33
Hungary	43
Kyrgyzstan	38
Poland	48
Russia	38.5
Ukraine	37

Source: KPMG Tax Facts

Awareness of the damaging microeconomic effects of the high payroll taxes has provoked an intellectual and political debate on their decreasing. As result, Ukraine gradually reduced the total level of payroll taxation from 51% in 1996 to 36.5% of the wage bill in 2001, canceling contributions to Chernobyl Fund, decreasing contributions to the Social Insurance Fund (from 4.4% to 2.5%) and Pension Fund (from 32.6% to 32%).

In 2000, Russia consolidated all social contribution into the Single Social Tax having a regressive character (i.e. with the lower rate for higher income). The similar solution was introduced since 1999 in Poland in relation to pension contributions. In Poland, contributions to the first and second pillar of the pension system are collected up to 240% of the average wage. Income exceeding this ceiling is free from this burden.

However, reforming the revenue side of the social funds only without touching their excessive expenditures does not give prospects for real decreasing of the tax burden. Decreasing contribution rates without reducing social entitlements must increase either the size of budget transfers (and, other things being equal, increasing other taxes), or the scale of violation of these entitlements and arrears.

Both effects can hardly be considered as desirable. The first variant leads to breaking the direct link between contribution and benefits, and undermining the insurance principle of public social schemes (if exists at all). The second one means increasing financial and regulatory chaos, provoking a chain of arrears, non-payments, netting-out operations, and downgrading the position of the state, which accepts obligations that cannot be fulfilled.

Revision of the social programs seems to be the only reasonable solution of this dilemma. Most of transition economies inherited too many badly targeted social obligations being the legacy of either the late communist era or the early democratic period, both having a strong populist characteristics. This relates, in first instance, to pension systems but also to unemployment programs (particularly in Central European countries) and the so-called social privileges, i.e. group entitlements to obtain certain goods and services for free or at highly subsidized price (*social'nye lgoty* in CIS countries).

Public pension systems in all transition countries are too generous offering low retirement age and a lot of opportunities for early retirement (both connected with the possibility to continue employment), and very easy eligibility criteria for disability pensions (Poland and Ukraine being outliers here). Private farmers pay very symbolic contributions (if any) what leads to cross-subsidization inside the pension system and putting even higher burden for other sectors. In addition, indexation formulas in Central Europe have been too generous bringing the replacement rate to the level above 60% in countries such as Poland and Slovenia. On the contrary, pension funds in CIS countries have been balanced mainly through the inflationary depreciation of pension benefits (due

to absence of regular and full indexation) as it happened in the beginning of 1990s and after the series of financial crises in 1998. As result, the replacement rate in CIS countries is very low amounting sometimes to the range of 20–30% [for example, in Russia in 1993 see: Goralska and Topinska, 2001].

Unfortunately, politicians in all the transition countries are very reluctant to start a serious "cleaning up" of pension and other social protection systems. They prefer to believe naively in self-compensating mechanism of unilateral tax cuts (Laffer-like effect). Domestic and foreign experts, sometimes even the international financial organizations, also do not like to push for radical revision of the social obligations. As result, only a couple of countries – Georgia, Kazakhstan, Armenia, Estonia, Latvia, the Czech Republic, and Kyrgyzstan – decided to increase officially the retirement age and only some of them (Georgia, the Czech Republic) to get rid of most of branch and professional privileges. The same has been done in more indirect way in Hungary during the implementation of three-pillar pension system in 1998. Also Poland's reform started in 1999 is expected to contribute to increasing the effective retirement age in longer term although the issue of branch and professional privileges has not been solved definitely yet.

6. Current and Future Challenges

The first decade of transition has resulted in differentiated results not only in relation to public finance sphere and tax systems.

After few years of output decline, the CEB countries managed to enter the road of sustainable economic growth. They have achieved general macroeconomic stability with annual inflation rate below 10%, and moderate fiscal deficits. They have made serious progress in building predominantly private market economies with Western-type financial sectors, liberal business and trade regimes, and basic market and democratic institutions in place. These economies can now be called capitalist and democratic middle-income countries.

On the other hand, until very recently, most of CIS countries were unable to achieve sustained economic growth, sustained price stability, and sustained fiscal balance. Their financial sectors are extremely fragile, and privatization, although formally advanced in many of these countries like in Russia, has failed to generate adequate microeconomic restructuring and establish good corporate governance structure. The basic market institutions are weak, and law enforcement is poor. The result is a regulatory environment that is very unfriendly both to domestic entrepreneurs and to foreign

investors. Most of the slow reformers can be characterized as lower-middle income countries with distorted capitalist and distorted democratic institutions.

Obviously, differentiated results of transition will influence its future agenda. The CEB countries are already advanced in the EU accession process and the necessity to harmonize their economic, legal, and institutional systems with the *acquis communautaire*, the detail body and EU laws and regulations will determine their transition agenda for the next decade (for good and bad). On the other hand, CIS countries will lack in this important geopolitical leveraging and will have to continue transition process on their own with the limited external support. If they want to avoid further marginalization in the world economy they should complete the basic structural and institutional reforms, including the comprehensive reform of the public finance sphere.

The process of the EU accession will affect at least partly the tax systems of CEB countries, particularly indirect taxation. The new EU members will have to give up the remaining sovereignty in custom policy and revenue from this source, in favor of the common EU trade policy and EU budget. They also must harmonize VAT and excise tax coverage and procedures. Excise tax for non-sin goods should be eliminated but excise rates for alcohol, tobacco and oil products will increase. Zero rate of VAT can be adopted to export only. VAT exemptions (mainly in agriculture and services sectors) must be reduced as well as using the preferential VAT rate. Part of VAT revenues will go to the EU budget. However, each country will have autonomy in setting the VAT rates.

Direct taxation and expenditure policies, particularly in the social sphere remain still the area of national responsibility in the EU. This means that the future EU members will retain a significant room of maneuver in the fiscal policy sphere and in determining their income and wealth taxes unless some harmonization steps within the EU will be initiated. Progressing globalization and further developing of the Single European Market will increase the role of cross-border tax competition what probably will push for further reduction of direct taxes' rates. Following this trend would be extremely important for the EU candidate countries where lower and simpler taxes can compensate investors for the weaknesses of institutional and infrastructure spheres. However, this desire will probably clash with the inherited tradition of a "premature post-communist welfare state" enhanced by the existing examples of excessive welfare state in the current EU. Ability to overcome this syndrome will be of crucial importance for the future growth prospects.

The challenges facing tax policy in CIS countries will differ from those of CEB region. Contrary to popular view, lowering basic rates of the main taxes does not seem to be so important as in the case of CEB or developed countries. They are moderate by international standards (see: sections 4 and 5). Certainly, lowering these rates if supported by the adequate compensating measures would be helpful for improving the

investment climate, fighting the black economy and stimulating economic growth. However, other steps are of much greater importance:

1/ Elimination of numerous additional taxes and quasi-taxes would help to eliminate cascading effect in indirect taxation and other distortions.

2/ Elimination of excessive number of tax exemptions would increase the fiscal effectiveness of the tax system, its transparency and fairness, guaranteeing a more equal treatment of all economic agents. It is worth to remember that constructing the well-targeted tax exemptions addressing exactly the declared economic or social problem is technically difficult in practice. Exemptions in direct taxes are used mainly by high- and middle-income groups and not by the poorest ones (this is, for example, with housing tax exemptions in Poland). What concerns similar preferences in indirect taxation the potential mistargeting and revenue losses may be even greater.

3/ Basic tax definitions and accounting rules are generally incompatible with the international standards.

4/ Instability and unpredictability of tax legislation seriously damages the business and investment climate stimulating the informal sector. This effect is additionally strengthened by incompetent, arbitrary and corrupted tax administration, very often serving as instrument of political pressure and interests of oligarch (or even criminal) groups.

The last problem seems to be the most fundamental one for achieving the real progress in tax policies in CIS countries. Even the best designed tax system and perfect tax legislation will not create a favorable business climate if law is regularly violated by government organs themselves, and enterprise or citizen does not have effective means of protecting his/her rights. However, this is strictly connected with reforming all the state institutions and methods of their operating, including the court system.

7. Summary and Conclusions

Trying to assess the overall progress in tax reforms, one can conclude that, only Baltic countries (particularly Estonia) managed to build the modern tax system, which is compatible with the EU/OECD standards, on the one hand, and relatively simple, with moderate and flat rates, on the other. Central European countries also adjusted their tax systems and tax administration to developed countries' standards but, unfortunately, they followed the high spending/high tax pattern of the Western European welfare state. Dismantling this premature welfare state and decreasing tax burden (especially in relation to PIT and payroll taxes) will be politically difficult.

Results of tax reforms in other countries (part of the Balkan group and CIS) are more ambiguous. Hence, they face much more complicated challenges in future. Although formally they have all major taxes typical for market economy (VAT, excises, PIT, CIT, payroll taxes) their construction differs sometimes significantly from the Western standards (with enormous number of various exemptions), and they are supplemented by several additional, highly distortive taxes and quasi-taxes (particularly on the local level). What is even more important, the weak tax administration and law enforcement makes tax systems in these countries fiscally ineffective, on the one hand, and unpredictable and repressive in relation to taxpayers, on the other.

However, CIS countries should not be advised to follow automatically the whole tax policy pattern of both the current EU members and the EU candidates from Central Europe (particularly their high tax rates and progressive scales of personal taxation) as the latter became, to significant extent, the victims of the excessive welfare state syndrome. Paradoxically, countries in the less advanced group, which managed to limit their social responsibilities (such as Bulgaria, Georgia, Armenia and Kazakhstan) get theoretically a chance to have more competitive tax systems comparing to their Central European neighbors. It will depend, however, on reforming not only the tax systems and tax administration themselves but building the solid foundations of the legal state what is a complicated and time-consuming task.

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