Tax Reform in Newly Emerging Market Economies

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Unlike the American Revolution, which started with cries of "no taxation without representation," the overthrow of political and economic systems in Central and Eastern Europe did not have taxes at its forefront. Under socialism, taxes had been invisible to much of the population. They were part of an elaborate framework of central planning, rather than a separate, distinguishable element in the lives of typical citizens.

This article examines how tax structures have fared in the context of broader changes in Central and Eastern Europe. It investigates the extent to which these tax systems continue to reflect a legacy of socialism, as opposed to resembling those in the United States and other market economies.

Section I outlines the fundamental differences between taxation in a socialist and a market-oriented economy. Recent worldwide themes in tax reform heightened these distinctions and are summarized in Section II. Section III describes the very sizable tax changes that have occurred in Hungary and Poland, and provides a brief overview of reform efforts in other formerly socialist countries in Central and Eastern Europe. Section IV presents the article's conclusions. Tax reform appears to be an evolutionary process, largely mimicking broader economic reforms. Even where changes have taken place in economic and tax policies, however, reform of tax administration remains a significant challenge. The formerly socialist countries must address how to monitor tax collections from a greatly expanded number of entities that are covered under the reformed tax laws. The tax authorities must find the right balance between acknowledging the expanded economic freedom arising from capitalism on the one hand, and enforcing the private sector's responsibility to pay the taxes it owes on the other.

Table 1
Government Revenues as a Percent of Gross Domestic Product, 1988 or 1989

<table>
<tr><th></th><th>Total Revenues</th><th>Total Tax Revenues</th><th>Profit or Corporate Income Tax</th><th>Personal Income Tax</th><th>Taxes on Goods and Services</th><th>Social Security Contributions</th><th>All Other Taxes</th></tr>
<tr><td>Albania</td><td>n.a.</td><td>44</td><td colspan="2">11</td><td>23</td><td>5</td><td>6</td></tr>
<tr><td>Bulgaria</td><td>57</td><td>49</td><td>23</td><td>4</td><td>11</td><td>10</td><td>1</td></tr>
<tr><td>Czech and Slovak Federal Republic</td><td>60</td><td>55</td><td>15</td><td>6</td><td>18</td><td>15</td><td>1</td></tr>
<tr><td>Hungary</td><td>61</td><td>49</td><td>7</td><td>6</td><td>18</td><td>14</td><td>5</td></tr>
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<tr><td>USSR</td><td>46</td><td>39</td><td>12</td><td>5</td><td>12</td><td>4</td><td>6</td></tr>
<tr><td>Yugoslavia</td><td>41</td><td>35</td><td>6</td><td>10</td><td>5</td><td>9</td><td>5</td></tr>
<tr><td>Averages</td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Socialist countries[a]</td><td>52</td><td>44</td><td>12</td><td>6</td><td>14</td><td>9</td><td>4</td></tr>
<tr><td>OECD</td><td>n.a.</td><td>38</td><td>3</td><td>12</td><td>12</td><td>10</td><td>2</td></tr>
<tr><td>European Community</td><td>44</td><td>41</td><td>3</td><td>11</td><td>13</td><td>12</td><td>2</td></tr>
</table>

[a]Excluding Albania in cases of missing data.
n.a. indicates data are not available from the sources used.
Source: Total revenues from Kopits (1991). Tax revenues from Blejer and others (1992), OECD (1990, 1991a, 1992), and author's calculations.

I. The Legacy of Socialism

In both market-oriented and socialist economies, the primary goal of taxation is to raise enough revenue to fund government expenditures. But in a socialist economy, the tax system also reflects the government's role as the setter of prices and the predominant owner of capital. The administration of the tax system takes advantage of the concentration of economic activity. To the extent that private enterprise exists, it is taxed under separate rules. Outside of socialist countries, by contrast, market forces rather than taxes are the primary determinant of the allocation of resources among sectors of the economy. If governments apply different tax rates to different activities, they are under some obligation to justify these choices by indicating how the market fails to achieve a socially desirable outcome. Finally, in a market-based economy, the tax authorities rely on "self-assessment" by taxpayers—that is, calculation of their obligations without direct supervision, and only selective audits, by government.

Central Planning

Government plays a more interventionist role in socialist than in market-oriented economies. Not surprisingly, then, at the outset of their transition to a market economy, the socialist countries of Europe generally allocated a higher share of national income to government than was the case in market-oriented developed nations. Government revenues averaged 52 percent of GDP in Bulgaria, Czechoslovakia, Hungary, Poland, Romania, the Soviet Union, and Yugoslavia in the late 1980s (Table 1). This compared with 44 percent in the European Community at that time.

But the degree of government intervention is not adequately captured by such a simple ratio.[1] For one thing, the average share of taxes in the socialist countries understates the role of the state because of "off budget" activities. State-owned enterprises provided basic health care, recreational facilities, and in

[1] In addition to the points raised in the text about the measurement of government's role, it should be noted that Table 1 is derived from countries' own estimates of taxes and GDP. Countries may differ as to whether social security contributions and customs duties are considered taxes. Some functions may be assigned to local authorities financed by a mix of government taxes and independent nontax revenues. The measurement of GDP is subject to considerable uncertainty in socialist countries. Traditionally, these countries concentrated their data collection on the tabulation of net material product, a concept that does not take into account many of the services included in GDP. Also, the market values of a variety of goods and services were masked by price controls and quantity restrictions.

some cases housing to their workers. In addition, they often financed the construction of infrastructure for public utilities. Nor does it appear from the data in Table 1 that "bigger" governments necessarily claimed a larger share of national income. Hungary, for example, began a gradual retreat from central planning in the late 1960s, yet its ratio of government revenues to GDP (61 percent) is the highest among the countries shown. By contrast, the Soviet Union, where socialism was the most entrenched, comes out with the second lowest ratio of government to GDP (46 percent).

In addition to raising revenue, the tax system in a socialist economy reflected the government's role as the setter of prices and the predominant owner of capital.

Intervention is also indicated by the degree to which government sets revenue burdens and subsidies that vary by type of economic activity. Under socialism, industry-specific turnover taxes were used to control profit margins.[2] For example, suppose a manufacturer purchased inputs at 100 currency units and was allowed to sell output at 200. If the planning authorities decided to limit the manufacturer's gross margin to 40, they would impose a turnover tax of 60. The turnover tax rate (in this case, 30 percent—60 divided by 200) would be determined as the outcome of planners' calculations of the target profit margin for the business. This margin, in turn, would determine the enterprise's budget for remunerating workers, buying capital goods, and undertaking other business expenditures. In other words, it would affect the resources channeled to each type of production.

Socialist countries in Central and Eastern Europe had hundreds or even thousands of turnover tax rates. In market-based economies, by contrast, tax rates are set independently and reflect overall revenue requirements. To the extent possible, the framers of the latter systems seek neutrality, in the sense of not taxing sales of different goods and services, or profits of different types of companies, at different rates. Tax rates are just one of the factors influencing profit margins for individual companies. As noted in section III below, one measure of Hungary's progress toward a market economy is that it had drastically reduced the number of turnover tax rates by the mid 1980s.

Public Ownership

In an economic system where a considerable amount of property is publicly owned, the government has a variety of options for collecting revenues. In addition to imposing taxes, it may charge "rents" or "interest" for the use of state-owned property, or it may collect "dividends" from state-owned enterprises. The socialist countries of Central and Eastern Europe, on average, were collecting 8 percent of GDP in nontax revenues, more than double the share for market-oriented countries. (Compare "total revenues" and "total tax revenues" columns in Table 1.)

Furthermore, because under socialism both business taxpayers and the tax administration answered to the government, taxes and nontax levies could be more arbitrary than in a market economy. If central planners decided that greater revenues were needed, they could raise taxes or fees retroactively by issuing the necessary instructions to tax administrators. State-owned enterprises were unlikely to complain (as private companies might) that the government had violated a social contract—or that they had based their business decisions on the wrong signals. In fact, tax policy changed very frequently, and tax payments often were negotiated between state-owned enterprises and the tax authorities. As a result, payments were not well predicted by what appeared in formal tax laws.

It was not important for taxpayers in socialist countries to understand the tax system. Tax payments typically were based not on the taxpayer's own assessment of tax liability given a set of rules, but on the judgment of the tax collector. Simplicity was not needed, either in the design of tax policy or in the design of tax forms.

Concentration of Production

The relative importance of business and personal income taxes differed considerably between the socialist and the market-oriented countries. On average, the Central and Eastern European socialist coun-

[2] Turnover taxes are a form of sales tax. Usually they are levied at intermediate stages of production, such as manufacturing and wholesaling.

tries were four times as reliant on taxes from business enterprise profits as the OECD or Western European countries, and only half as dependent on personal income taxes (Table 1). Moreover, in most socialist countries, many individuals were totally unaware of income taxes, as these taxes were paid by their employers. Workers were quoted a wage rate that was net of taxes. Government authorities did not receive documentation of which workers' wages were taxed, as they do in market-oriented countries that use payroll taxes to finance social insurance programs. In Poland, for example, only an estimated 1 to 2 percent of government revenues consisted of taxes collected directly from individuals (Bolkowiak and Relewicz 1991).

Socialist countries had many fewer taxpayers than comparably sized market-oriented countries. Not only were many individuals not responsible for making tax payments, but also most production was carried out by large state-owned enterprises. For example, prior to the recent reforms, two-thirds of industrial workers in Hungary were employed in enterprises with over 240 workers; in capitalist industrialized countries, the share is typically well under 10 percent. Poland's employment was even more concentrated than Hungary's, as two-thirds of its industrial work force was employed at enterprises with over 1,000 workers (OECD 1992).

The existence of relatively few taxpayers meant that tax administrators could readily use manual procedures to record tax collections. Also, the government was able to check up on the overwhelming share of total tax payments as part of its annual audits of the economic performance of state-owned enterprises.

Separate Rules Governing Private Sector Activity

To the extent that private activity existed, socialist countries tended to discourage it actively by imposing very high income tax rates. The more objectionable the activity, the higher the tax rate. For example, Bulgaria had a general personal income tax rate of 14 percent, a 50 percent tax rate for artists and scholars, and an 85 percent tax rate for private entrepreneurs. By contrast, income tax schedules in OECD countries do not distinguish between occupations or between employment in the private versus the public sector. Also, as discussed in the next section, top marginal rates are generally lower than those that existed under socialism.

Finally, some types of private ownership of capital were (practically) nonexistent in socialist countries, so the tax laws were silent on certain forms of income. For example, citizens did not accumulate financial wealth by owning stocks and bonds of private corporations (or, for that matter, of government or state-owned enterprises). Therefore tax codes did not have to address issues related to dividends, interest, and capital gains from such sources. Individuals could accumulate wealth in savings accounts at state-owned financial institutions, but the revenue requirements of the government were addressed through implicit taxation—that is, control of interest rates.[3]

II. Tax Reform in Market-Oriented Countries

In order to assess how closely tax systems in Central and Eastern Europe now resemble those in other countries, it is necessary to take account of the worldwide tax reform movement of the 1980s. Throughout the capitalist industrialized world, countries explicitly sought to lower the influence of taxation on economic decisions. By lowering marginal income tax rates, they permitted workers and businesses to earn a wage or rate of return that was closer to the true economic value of their production. By introducing greater similarity of tax rates across different goods and services, they allowed consumers' buying decisions to be based on less distorted market prices. This visible attempt to achieve greater tax neutrality served to heighten the distinction between socialist and capitalist tax frameworks at the time that Central and Eastern European countries started their reforms.

The dominant theme in worldwide income tax reform was lower personal and corporate tax rates, combined with a broader tax base. During the 1980s, almost all countries in the OECD lowered their top rates of individual income tax (Table 2). In over half of the OECD countries, the new top rate was at least 10 points lower than had existed prior to the reforms. The majority of countries also lowered their rates of corporate income tax. Top personal income tax rates now typically lie in the range of 30 to 50 percent, and top corporate rates between 35 and 45 percent.

Despite the lowering of tax rates, income tax revenues remained roughly constant as a fraction of

[3] Implicit taxation is another reason why the data in Table 1 do not capture the full extent of government intervention in the economy.

Table 2
Top Central Government Marginal Income Tax Rates in OECD Member Countries, 1990

	Personal Income		Corporate Income	
Country	Top Tax Rate after Reform (Percent)	Reduction from Reform[a] (Percentage Points)	Top Tax Rate after Reform (Percent)	Reduction from Reform[b] (Percentage Points)
Australia	47	10	39	10
Austria	50	12	30	n.a.
Belgium	55	17	41	2
Canada	29	5	25	21
Denmark	40	5	40	10
Finland	43	8	33	0
France	57	8	37	13
Germany	53	3	50	6
Greece	50	13	46	n.a.
Iceland	33	5	50	n.a.
Ireland	53	5	43	7
Italy	50	12	36	10
Japan	50	20	37.5	5.5
Luxembourg	56	1	34	2
Netherlands	60	12	35	7
New Zealand	33	24	28	20
Norway	20	20	27.8	0
Portugal	[c]	[c]	36.5	1.5
Spain	56	10	35	0
Sweden	20[d]	30	40	12
Switzerland	13	0	3.6–9.8	0
Turkey	50	0	46	0
United Kingdom	40	20	35	15
United States	28[e]	22[e]	34	12

[a]Based on comparison with 1986 top tax rate.
[b]Based on comparison with 1984 top tax rate; Australia, Belgium, Denmark, Finland, Ireland, Luxembourg, New Zealand, Norway, Portugal, Spain, Switzerland, Turkey compared with 1988.
[c]Comparison not possible because of a reform in the structure of personal income taxation.
[d]1991 data.
[e]The top rate in 1980 was 70 percent, for a 1980–90 reduction of 42 points. Since 1990, the top rate has been increased to 39.6 percent.
Note: n.a. = no information available in sources used.
Source: Personal income tax rates, OECD (1991a). Corporate income tax rates, OECD (1991a), Pechman (1987), Price Waterhouse (1988).

GDP. Income tax bases were broadened and tax credits were scaled back to compensate for the lower rates. For example, the U.S. tax reform in 1986 eliminated the partial exemption of capital gains income, disallowed the deductibility of some state and local taxes, ended the investment tax credit, slowed depreciation of buildings, and introduced a host of other provisions designed to keep total personal plus corporate income tax revenues unchanged as rates were reduced.

Lower income tax rates and a broader base were introduced in order to make the tax system more neutral with respect to economic decisions. Greater neutrality was thought to promote higher output in the long run, as compared with a system in which certain activities are taxed preferentially. For example, if some businesses qualify for lower taxation as a result of eligibility for higher depreciation deductions, they will tend to expand at the expense of other businesses that might be more productive, but that are at a financial disadvantage as a result of ineligibility for tax preferences. If, on the other hand, the tax system is neutral, businesses with higher productivity will have greater relative possibilities for expansion. In some countries, an unindexed income tax code had interacted with high inflation to result in disparate taxation of different types of business activity and general discouragement of work and saving. Also, the availability of tax preferences for certain activities and not others had led to a perception of

Table 3
Value-Added Tax Rates in OECD Member Countries

Country	Standard Rate	Number of Rates[a]	Date of Introduction of VAT
Australia	No VAT		
Austria	20	3	1973
Belgium	19	6	1971
Canada	7	1	1991
Denmark	22	1	1967
Finland	17	1	1990
France	18.6	5	1968
Germany	14	2	1968
Greece	18	4	1987
Iceland	24.5	2	1990
Ireland	21	4	1972
Italy	19	4	1976
Japan	3	2	1989
Luxembourg	12	3	1970
Netherlands	18.5	2	1969
New Zealand	12.5	1	1986
Norway	20	2	1970
Portugal	17	3	1986
Spain	12	3	1986
Sweden	25	1	1969
Switzerland	No VAT		
Turkey	12	5	1985
United Kingdom	17.5	1	1973
United States	No VAT		

[a]Excluding zero rate.
Note: Data reflect most recent information available to the International Monetary Fund at the time the report was prepared.
Source: Tait (1991).

unfairness, as well as potential distortions in the allocation of resources among activities.

With regard to indirect taxation, the most prevalent theme was the substitution of a value-added tax (VAT) for pre-existing turnover or sales taxes. Twelve countries in the OECD already had a VAT at the beginning of the 1980s (Table 3). But VATs have since been introduced in nine others—Canada, Finland, Greece, Iceland, Japan, New Zealand, Portugal, Spain, and Turkey. This leaves only three OECD countries—including the United States—without a value-added tax.

As with income tax reforms, one reason for introducing a value-added tax has been to promote neutrality. For example, if turnover or sales taxes are imposed at several levels of production, final products may effectively be taxed quite differently, depending upon how many companies are involved in their manufacture and distribution.[4] This problem does not arise under a value-added tax, since each company receives a credit for the tax paid by suppliers. Also, many traditional consumption taxes applied only to goods but not to services, or were levied at different rates for different sectors of the economy. The shift from a turnover or sales tax to a value-added tax has sometimes been a convenient point for broadening the tax base and imposing more uniform rates.[5]

Another reason for introducing a value-added tax was that it provides neutral treatment for domestically produced and imported goods. Exporters pay a zero rate on their production, while a VAT is paid upon importation of goods or services. The result of this policy is that taxes depend on where goods are consumed, not where they are produced.[6]

In an effort to harmonize tax structures as part of a move toward greater economic unity, the European Community has recommended that its members have no more than two or three rates of value-added tax, with lower rates limited to basic necessities. The standard rate is to be not less than 15 percent and the reduced rate(s) not less than 5 percent. Seven of the twelve members of the European Community cur-

[4] For example, suppose manufacturers and wholesalers are subject to sales taxes. If a product is sold by a manufacturer to a wholesaler, and then by the wholesaler to a retailer, the price charged to the retail customer is likely to reflect the two levels of tax. On the other hand, if the manufacturer and the wholesaler merged, the sales tax would be charged only once, resulting in some potential price reduction for the ultimate consumer.

[5] For example, consider Canada and Japan, two countries that recently adopted a VAT. In Canada, the preexisting manufacturers' sales tax was collected on a base that included only about one-third of total consumption. Rates varied across products. Capital was taxed heavily, as capital goods were included in the tax base and the value added by capital was captured in the tax base of using industries. Now Canada has a single-rate VAT applying to a broad range of goods and services. Japan used to levy a retail sales tax on some goods (10 percent for carpets and 15 percent for all other goods subject to the retail tax) and a wholesale tax on other goods (at rates ranging from 5 percent for coffee to 30 percent for certain luxuries). Now Japan has two rates of value-added tax. See Pechman (1987), Boskin and McLure (1990), and Table 3.

[6] For example, suppose country A imports raw materials valued at 100 currency units from country B. The importing company would be liable for value-added tax at country A's rate, say 10 percent. Suppose the company processed the raw materials further and sold the finished product for 300. It would pay a VAT of 30, but would receive a credit of 10. The total value-added tax paid upon importation and upon final sale, 30, would be identical to what would be paid if the company had purchased the raw materials domestically (assuming identical prices). In that case, the domestic supplier would pay a VAT of 10, and the processing company would still pay a VAT of 30 but receive a credit of 10. This example assumes that country B in effect levies no value-added or other sales tax on exports that might be incorporated into its selling price to country A.

Table 4
Basic Features of Taxation in Hungary and Poland

	Hungary	Poland
Personal Income Tax	Tax brackets of 25, 35, and 40 percent. Zero bracket covers income up to 100,000 forints (approximately $1,050 at current exchange rate). Top bracket starts at 500,000 forints (approximately $5,250). Flat tax rate of 20 percent on interest, 10 percent on dividends.	Tax brackets of 20, 30, and 40 percent. Personal exemption of 864,000 złoty (approximately $45 at current exchange rate). Top bracket starts at 129.6 million złoty (approximately $7,200). Flat tax rate of 20 percent on interest and dividends.
Enterprise Income Tax	Tax rate of 40 percent; 35 percent for small enterprises. Five-year carryforward of net operating losses. Straight-line depreciation.	Tax rate of 40 percent. Three-year carryforward of net operating losses. Straight-line depreciation; periodic revaluation of basis.
Value-Added Tax	Zero tax rate for pharmaceuticals. 10-percent rate for basic foods, some agricultural inputs, household energy, health care products, and books. 25-percent rate for most other goods and services. Some products also subject to excises.	7-percent rate for agricultural products (except certain meat, egg, and milk products, which are exempt from tax), agricultural machinery, pharmaceuticals and health care products, newspapers, basic transportation services, and hotel services (except luxury hotels). 23-percent rate for most other goods and services. Rate for building materials, fuels, and energy temporarily reduced to 7 percent. Some products also subject to excises.

Source: Andersson (1992); "Capitalism Already? A Variety of Hungarian Taxes" (1992); Dziennik Ustaw (1993); Kozłowska and Radzewicz (1991); Lukács (1991); OECD (1991a); Ożóg (1992); and country sources.

rently have three or fewer VAT rates.[7] Foods, pharmaceuticals, and books and newspapers are the items most often receiving preferential tax treatment (OECD 1991a).

III. Tax Reform in Central and Eastern Europe

The timing of tax reform in Central and Eastern Europe has reflected the pace of economic reforms. Countries where privatization is taking place need to develop tax structures that are conducive to growth of private sector activity. Unless their tax structures expand to encompass private activity, however, revenues will fall sharply as the state-owned business sector shrinks—both as a direct result of privatization and because of the declining profitability of state-owned enterprises in the face of competition.

Among the countries in this region, Hungary and Poland have made the most progress toward both tax and economic reforms. According to researchers at the Polish Institute of Finance, by the late 1980s "the tax system, introduced in the framework of a centrally planned economy, and characteristic of socialist realities, had already turned into a very tight 'corset'" in both Hungary and Poland (Bolkowiak and Relewicz 1991). The Czech and Slovak Republics have recently caught up in terms of tax policy changes, after being delayed by discussions of their political relationship.[8] This section describes tax reform efforts in Hungary and Poland (with their current tax structures summarized in Table 4). It then reports briefly on the status of tax reform in the remaining countries of the region.

Hungary

Hungary first started to retreat from central planning in 1968 by providing more autonomy for individual enterprises. Economic reforms took place gradually, so that in the early 1980s the economy was still dominated by about 6,000 large enterprises and quasi-state agricultural cooperatives (Kornai 1992). Hungary took a series of steps in the 1980s to relax

[7] The exceptions are Belgium, France, Greece, Ireland, and Italy (Table 3).

[8] On January 1, 1993, Czechoslovakia split into two independent countries, the Czech Republic and Slovakia.

restrictions on private business activity. In 1989–90, the Communist Party monopoly came to an end, and free elections were held, thereby ushering in further liberalization of the economy. By 1991, the tax authorities were aware of over 100,000 economic entities (Kornai 1992).

Hungary has gone through a maturation process with respect to tax policy. Early attempts to attract foreign investors emphasized tax breaks. More recently, the tax system has evolved to become more similar to what OECD residents might find in their home countries—thereby signaling Hungary's desire to become an integral part of the economically advanced world.

Enterprise profits taxes. Hungary is well known among the other countries in Central and Eastern Europe for its policy of allowing generous tax breaks to encourage joint ventures with foreign companies.[9] Hungary began to allow joint ventures with foreigners in 1972. At that time, taxation of domestic businesses—primarily state-owned enterprises—was complex and arbitrary. The overall tax burden on businesses was estimated to be considerably higher than in capitalist countries. The Hungarian authorities decided explicitly to grant preferential tax treatment to foreign direct investments as a means of encouraging economic development. In order to provide foreign companies with a clear indication of their tax obligations, legislation was passed to bar the practice, commonly applied to domestic companies, of introducing new levies during the course of a tax year.

Over time, tax concessions for foreign joint ventures became increasingly generous and the rules were formalized rather than being applied ad hoc. By the late 1980s, three tiers of tax treatment had developed. All foreign ventures enjoyed at least a 20 percent reduction in their effective tax rate, compared with what the law specified for domestic companies. Manufacturing ventures of a certain size and degree of foreign participation were allowed a 60 percent tax reduction over the first five years of their existence, followed by a 40 percent tax reduction in each subsequent year. Companies in industries considered to be of special importance enjoyed a tax holiday for five years, followed by a 60 percent tax reduction from what domestic tax laws specified.

With the acceleration of economic and political changes in the late 1980s, Hungary began to create new opportunities for domestic investment. In 1989, the enterprise income tax was overhauled, and the top rate reduced to 50 percent. The following year, the tax rate was reduced further, to 40 percent. The Budapest stock market was re-established in 1989. The State Property Agency was established in 1990 to oversee privatization. It organized weekly auctions of small businesses and individual offerings of larger businesses. Consistent with the policy of encouraging indigenous capitalism, the government cut back preferences for foreign direct investment. As of 1990, the general 20 percent tax break was eliminated, and remaining tax reliefs were restricted to a period not to exceed 10 years. The special provisions for foreign investment are due to disappear entirely for ventures established after 1993.

With the gradual reductions in the top statutory tax rate, along with the scaling back of tax preferences for foreign-owned ventures, Hungary's system of taxing business income has become quite similar to tax systems in other industrialized countries. Some analysts continue to regard the effective taxation of business profits as high, however, especially given stringent provisions for depreciation allowances (Andersson 1992).[10]

Taxation of goods and services. Reform of taxes on goods and services began in 1968, but according to the account of an official of the Hungarian Ministry of Finance, "it took more than 15 years to transform the original turnover tax system using about three thousand rates into a four-rate system, with similar and substitute products classified under the same respective rates" (Lukács 1991, p. 221).

In 1988, Hungary replaced its turnover tax with a value-added tax. Most basic goods, including food, were zero-rated under the VAT, while other products were taxed at a 25 percent rate. Services were either tax-exempt or taxed at a 15 percent rate. (A producer of an item that is zero-rated pays no tax on sales, but is allowed the standard credit for value-added tax paid by suppliers of inputs. By contrast, a tax exemption means that the business has neither tax liabilities nor tax credits.[11])

[9] For an especially good overview of the historical influences on Hungary's policy toward foreign direct investment, see Répássy (1991).

[10] Andersson also noted that Hungary has a relatively restrictive policy regarding loss carryforwards. However, losses may now generally be carried forward five years, which is not unlike OECD rules. More liberal rules exist for start-up companies.

[11] Governments choose zero rating when they wish to provide favorable tax treatment for particular goods or services. By contrast, they choose tax exemptions largely for administrative reasons—to limit the overall number of taxpayers or to exclude taxpayers from whom it is deemed difficult to collect the tax. For example, VATs typically have an exemption for businesses below a specified size. Tax-exempt businesses may still bear some tax burden, however, to the extent they purchase inputs whose price reflects the VAT.

The overall coverage of the zero tax rate was unusually high—over 40 percent of total measured consumption. Necessities form a large fraction of the budget of Hungarian consumers. In addition, the policy of not taxing food is rare. Among OECD countries, only the United Kingdom, Ireland, and Portugal specify a zero rate for all or most food products.

In order to increase revenues, the Hungarian government recently eliminated the zero tax rate, except for pharmaceuticals (and exports, as is standard under the VAT). Domestically consumed goods and services are taxed at 10 percent or 25 percent. This new structure still leaves Hungary's top tax rate high by European standards (see Table 3). Thus, further reform might be called for before Hungary obtains full membership in the European Community.[12]

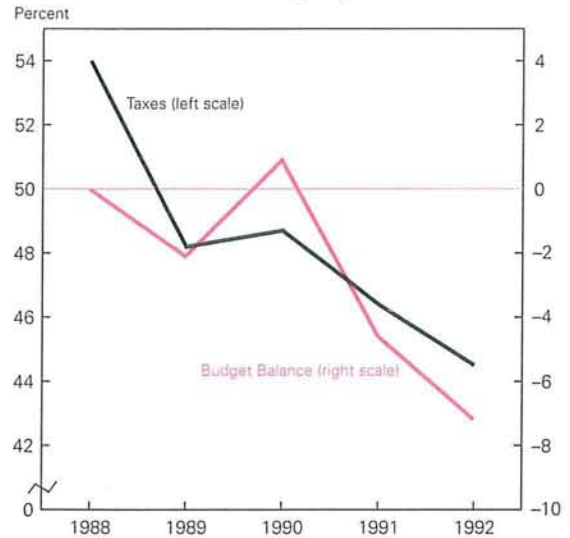
Personal income and wage taxes. A broad-based personal income tax was introduced in Hungary in 1988. The rate structure is progressive, but over time, marginal income tax rates have been lowered. The top rate was 60 percent at inception, 56 percent in 1989, 50 percent in 1990 and 1991, and is now 40 percent—in the middle of the range for the OECD countries. Faced with budgetary problems, however, the government is considering raising the marginal tax rate somewhat.

Taxes to fund social insurance benefits are quite high. The combined employer-employee tax for funding retirement and disability payments is 54 percent of gross wages. An additional 6 percent payroll tax was introduced in 1991 to finance unemployment benefits. These high tax rates largely reflect the fact that average wages are not as high relative to minimum acceptable incomes as they are in wealthier countries. Also, retirees have not accumulated much private savings; therefore, virtually all of their consumption must be supported by public pensions.

Tax revenues and tax administration. During the transition to a market economy, tax revenues in Hungary have fallen as a fraction of GDP—by about 9 percentage points since 1988. This result appears to be largely unintentional, as it has contributed to a rising government budget deficit (Figure 1). According to the International Monetary Fund (1993), a substantial part of the drop-off in tax revenues is due to the inability of the tax administration to collect profits taxes from the growing private sector, at the same time that profits of traditional taxpayers—state-owned enterprises—have plummeted. Also, each round of tax reform appears to have been accompanied by temporary problems in implementation. All in all, it appears that tax policy has been able to change more rapidly than tax administration.

Figure 1

Taxes and Government Budget Balance as a Percentage of GDP in Hungary



Source: Tax revenues from the International Monetary Fund (1993). Budget balances from the Bank for International Settlements (1993).

Poland

Economic and tax reform started in earnest in Poland in 1989, after the selection of a Prime Minister from the Solidarity coalition. The famous "shock therapy" program included decontrol of many prices, liberalization of foreign trade, and the creation of a legal framework for privatization. It is estimated that only 4 percent of industrial production was private immediately prior to the reform. By the end of 1992, this figure was over 40 percent (Information Center, Ministry of Ownership Changes, 1993). Most of the transformation of ownership of industrial firms has taken place by so-called capital privatization—that is, either the sale of a state-owned enterprise to another corporation or an initial public offering of its shares. A plan for mass privatization, in which shares of several hundred state-owned enterprises will be of-

[12] Hungary, Poland, and the Czech Republic are associate members of the European Community.

fered to Polish citizens at a nominal cost, was approved in May 1993 and has yet to be implemented in full.[13] Retailing is now over 90 percent private; this transition was accomplished mostly by sales of establishments to employees. Even under socialism, Polish agriculture was predominantly private; the share has grown recently to over 90 percent.

Enterprise profits taxes. As in Hungary, an early step in tax reform was to overhaul the rules for taxing business enterprises. The pre-existing enterprise income tax rate was 65 percent for socialized businesses and 85 percent for the private sector. As noted in an economic survey by the OECD (1992, p. 167), however, "given the system of subsidies, charges, etc., it was not strictly correct to talk about a tax system for state firms." In 1989, the tax rate was lowered to 40 percent, and the law specified that private and state-owned enterprises would be subject to the same rules. In the following year, various special-purpose tax exemptions were introduced, but they have since largely disappeared, except for a provision to allow rapid depreciation for companies investing in areas of the country with very high unemployment. A further reform in 1992 allowed for a three-year carryforward of operating losses and taxation of dividends.

Despite the fact that income of all businesses is taxed under the same rules, special additional taxes continue to exist for the socialized sector in Poland.

Despite the fact that income of all businesses is taxed under the same rules, special additional taxes continue to exist for the socialized sector. First, state-owned enterprises must pay the "dywidenda" tax on their capital.[14] In effect, the *dywidenda* is a payment demanded by the state as the owner of the enterprise. It is somewhat analogous to the dividends paid by private companies, but it has been criticized for not taking into account the profitability of the enterprise. Second, state-owned enterprises pay the "popiwek" if wages increase in excess of specified norms.[15] Until 1991, this tax also applied to private domestic enterprises. (Hungary has employed a similar tax-based incomes policy.) In the absence of effective control by either market forces or regulations, the *dywidenda* and *popiwek* were intended to prevent managers from stripping the assets of state-owned enterprises through unusually large payoffs to themselves or to workers. The rules have changed frequently, but the recent trend generally has been toward lower tax rates.

Poland has taken steps to encourage foreign direct investment, but never adopted tax rules as generous as those in Hungary. For a while, joint ventures were allowed a three-year tax holiday. More recently, investments made prior to the end of 1993 have been eligible for a tax exemption up to the amount of the investment, but only if the company meets guidelines specified by the Minister of Finance for employment, productivity, and possibly other social objectives.

Taxation of goods and services. As part of the economic reforms since 1989, Poland undertook to reduce the number of turnover tax rates from about four hundred to just a handful. In 1992, turnover taxes were extended to several items including processed foods that were expected to be included in the base of a value-added tax. Aside from increasing revenues, this policy was intended to minimize the risk of a price shock from introducing the VAT, which would have made the tax unpopular with the public. In July 1993 turnover taxes indeed were replaced by a value-added tax, with rates of 7 percent and 22 percent. Although a VAT had been discussed for several years, the timetable for actually implementing it was extremely tight—six months from the enactment of legislation. Typically, the International Monetary Fund recommends a 12- to 18-month implementation period in order to lay the groundwork for administration of the tax, including registration and education of taxpayers. As of this writing, it is too soon to judge the success of the VAT.

Personal income and wage taxation. Poland implemented a general personal income tax in 1992. As in

[13] Interestingly, Hungary has no plans to implement mass privatization, despite being the first of the formerly socialist countries to introduce laws allowing privatization of state-owned enterprises. Czechoslovakia conducted a mass privatization program involving over 2,000 enterprises in late 1991 and early 1992; the Russian Federation followed suit starting in late 1992. For a discussion of privatization methods and their tax consequences, see Kodrzycki and Zolt (1994).

[14] The base for this tax is the initial fund ("capital transferred to the enterprise in the past in the form of the assets needed for engaging in economic activity"), indexed for inflation. See OECD (1992, Chapters III and IV).

[15] The term *popiwek* is derived from the Polish abbreviation for tax on wage increases.

market-oriented economies, the tax generally depends on overall income rather than the particular activity that generated the income. The new personal income tax has brackets of 20, 30, and 40 percent. It replaced a 20 percent wage tax paid by state-owned enterprises and four separate income taxes paid by individuals with income from outside the socialized sector or with high income regardless of the source. For example, nonagricultural private economic activity had been taxed at marginal rates up to 75 percent as of 1989 (reduced to 50 percent in 1990). Although the new personal income tax law called for indexing brackets for inflation, the government elected not to implement indexing in 1993 because of budgetary pressures.

The tax is neutral with respect to most sources of earnings, as its base includes non-wage income such as pensions and various forms of social assistance, as well as non-monetary compensation provided by employers (which is often significant in the socialized sector).[16] Almost everyone is covered by the personal income tax because the minimum threshold is quite low (considerably lower, for example, than in Hungary).[17]

Two aspects of the personal income tax law apparently were designed to promote its acceptability. First, upon introduction of the tax, wages and pensions were grossed up by an amount reflecting the basic 20 percent tax rate, leaving net income unchanged for much of the population.[18] Second, as in Hungary, generous allowances are given for housing expenditures. Polish taxpayers purchasing new housing or renovating existing housing are able to deduct the full expenditure (up to certain limits) from taxable income. These housing deductions are of considerable popular value in a country where the government previously had limited the amount of residential space per person.

Interest income from savings and, through 1993, capital gains on the sale of securities, are exempt from the income tax. These exemptions were deemed necessary to provide support for the early stages of a capitalist economy. Also, the policy recognizes that many savings vehicles continue to earn negative rates of return after adjusting for inflation.

So far, the greatest surprise about the Polish personal income tax to its designers is how many individuals filed a tax return. Individuals with income from only a single source who did not wish to take advantage of itemized deductions did not have to file a tax return. Instead, they could request their employer or pension agency to calculate the difference between income taxes withheld and income taxes owed for the year, and make the appropriate payment (which would be deducted from their pay or pension).[19] An early projection indicated that three million individuals would file returns (Białobrzeski 1991); the actual number appears to be three times higher. The cause of these high individual filings is not yet known.

As in Hungary, wage taxes to finance pensions are very high in Poland—45 percent. The number of early retirements has risen during the reform period. Some of this trend reflects persons who elect to retire in order to head off the possibility of unemployment (which provides lower benefits). In other cases, people with opportunities in the private sector have been able to take up new jobs while collecting a pension from their former employer.[20]

Tax administration.[21] As a result of the recent tax reforms, many more individuals have become liable

[16] As examples of non-monetary compensation, employees of public utilities typically receive discounts on their utility bills and employees of state-owned banks are eligible for below-market rates of interest on loans. The value of such subsidies must now be included in taxable income. The Hungarian personal income tax base also includes in-kind benefits, except for education and medical services.

[17] See Table 4. However, farmers do not pay income tax. They are subject to a separate agricultural tax.

[18] For example, under the old wage tax, an employer would have paid a tax of 400,000 złoty for an employee earning a monthly wage of 2 million złoty. With the new personal income tax, the employee's wage would be increased to 2.5 million złoty. A 20 percent income tax (500,000 złoty) would be withheld monthly, leaving net earnings at 2 million złoty.

[19] The tax treatment of married couples may have added inadvertently to the number of filers. Many married couples would be taxed the same amount, whether they chose to be taxed as two unrelated individuals or jointly. This is because in the case of joint filing, the couple computes the tax owed on half of their joint income. Their total liability is twice this amount. In other words, their average income is the basis for taxation. However, given progressive tax rates, married persons with dissimilar incomes (say, with one member in the 20 percent bracket and the other in the 40 percent bracket) would owe less tax if they filed jointly than if they were taxed individually. On the other hand, the tax system does not offer any special encouragement for couples with children to file jointly. Children's allowances are paid directly to their mother, rather than taking the form of a tax deduction. Hungary does grant tax allowances for dependent children, as is common in other European countries.

[20] As of 1992, the law requires pensions to be decreased for individuals who earn above a certain amount, but significant opportunities for "double dipping" continue to exist. For an excellent discussion of these trends, see Maret and Schwartz (1993).

[21] This section is not intended to convey the impression that either progress or problems in tax administration are more notable in Poland than in the other countries of the region. It simply reflects the author's greater familiarity with Poland, and the fact that relatively little information is available publicly about the status of tax administration in the formerly socialist countries.

for payment of income taxes. The Polish government has conducted a public awareness campaign to inform taxpayers of their responsibilities and to provide specific information on how to comply with new laws. The new political framework for taxpayers and the tax authority is evident in the introduction to a pamphlet distributed to payers of the personal income tax: "Only he who pays the tax gains the moral authority to ask how his money will be spent. We will try to spend it sensibly."

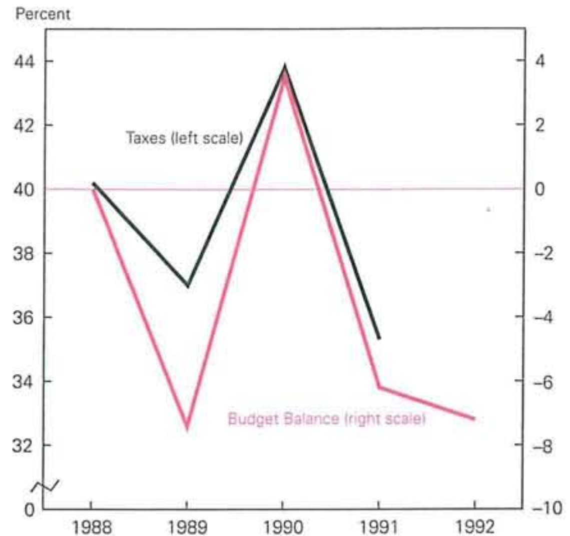
In administering the new taxes, the government has tried to impose greater uniformity in the procedures used by local tax offices. It has become evident, however, that significant progress cannot be made until a nationwide computer system for recording tax collections is implemented.[22] Until that time, different offices will continue to keep somewhat different information on transactions with taxpayers.

As noted in Section I, auditing under socialism was concerned mostly with verification of transactions by a limited number of state-owned enterprises. Since beginning its reforms, Poland has established new fiscal inspection offices to deal with tax evasion that inevitably occurs in a system with many more taxpayers who are less controlled by the state. The effectiveness of these offices has been somewhat limited by start-up problems, such as the time required to recruit and train audit personnel. Furthermore, Poland is quite unusual in having separate agencies for tax collection and tax audits. This institutional arrangement has caused considerable uncertainty about the respective responsibilities of the two groups, as well as difficulties of coordination of their activities. For example, the findings of the auditors are not binding; tax collectors may decide whether or not to to pursue taxpayers with added liability. Finally, the activities of the tax inspectors also have been hampered by a lack of power. Except in very limited cases, the law does not allow inspectors to investigate bank account records of taxpayers under suspicion of tax evasion. Although the fiscal inspectorate has sought expanded audit powers, the majority in Parliament appear unwilling to restrict what they view as taxpayers' essential economic freedom.[23]

Tax revenues. With the temporary hyperinflation that accompanied Poland's deregulation of prices in 1990, tax revenues soared. More recently, tax revenues have been on a downward path as a share of GDP and a sizable budget deficit has developed (Figure 2). As in Hungary, officials express particular disappointment with collections of enterprise income taxes.

Figure 2

Taxes and Government Budget Balance as a Percentage of GDP in Poland



Source: Tax revenues from the International Monetary Fund (1993). Budget balances from the Bank for International Settlements (1993).

Status of Tax Reform in the Other Soviet Bloc Countries

Other countries in Central and Eastern Europe have been slower to reform their tax structures than Hungary or Poland, but most have adopted a value-added tax. In the case of the new nations of the former Soviet Union, however, tax laws are sometimes sketchy and unstable.

The former Czechoslovakia. By early 1992, the Czechoslovak Federal Ministry of Finance had developed a comprehensive tax reform proposal. The plan featured the following: a comprehensive enterprise income tax with a federal rate of 45 percent but the possibility of a 5 point increase or decrease enacted by the republics; a new personal income tax with a top

[22] Considerable progress has been made to develop such a system, but the project has proved to be considerably more complex than its architects had envisioned.

[23] Interestingly, the Polish law on fiscal inspection has been criticized for allowing inspectors to reward citizens who provide information on tax evasion. Even though such authority is not unusual in the international context, it was seen in Poland as a throwback to the Stalinist era, when neighbors were encouraged to spy on each other.

rate of 47 percent and a base that would include income from interest, dividends and other forms of capital ownership; and a value-added tax levied at a 23 percent rate on most goods and a 5 percent rate for food, newspapers, and many services.

While the basic tax rules would apply equally to residents of the Czech and the Slovak Republics, the Federal Ministry of Finance acknowledged their desire for greater autonomy by allowing each republic to be responsible for administering taxes in its jurisdiction. Such a bifurcated structure would allow the possibility of different tax forms and administrative procedures, which would lower the effectiveness of tax audits of businesses operating in both republics.

In the wake of the federal reform proposal, tax officials in the Czech and Slovak Republics continued to debate whether it would be feasible and economically desirable for the two republics to adopt different tax rates. They also explored alternative formulas for revenue sharing between the national government and the governments of the republics, especially in light of the relative weakness of the Slovak economy and the calls by Slovaks for a greater share of total revenues.

These discussions of tax reform reinforced the long-standing separatist tendencies of the two republics, and Czechoslovakia split into two nations at the beginning of 1993. However, the Czech Republic and Slovakia each adopted a value-added tax and reformed income taxes. They reached an informal agreement to maintain similarity in key tax rates, in order to prevent the tax system from encouraging resources to flow from one country to the other.

Romania and Bulgaria. Romania and Bulgaria are less far along on the path of economic reform than Hungary, Poland, or the former Czechoslovakia. Nevertheless each country recently enacted a value-added tax. Romania's tax took effect in the summer of 1993, and Bulgaria's is due to be in place in the spring of 1994. In both cases, an 18 percent tax rate applies to a broad range of goods and services. The enactment of single-rate VATs signals the intention of these countries to promote tax neutrality with respect to different consumption items. Also, the simplicity of such a structure will make the new VATs easier to comply with and administer, especially in light of the lack of experience with such a tax and unsophisticated systems for tax administration.

Albania. Albania's tax reform focus has been different from those of other countries emerging from socialism. It has had to concentrate on property and excise taxes, as its economy (and therefore national income and consumption) has been in a deep depression.

The former Soviet Union. The experience of the countries of the former Soviet Union illustrates that comprehensive tax reform entails not just adopting new taxes—which they have done—but also a new attitude toward policymaking—which often is missing. For example, Russia introduced a value-added tax in January 1992. The text of the law was only a few paragraphs—apparently leaving many of the details to tax administrators. The original tax rate was quite high, 28 percent. Only a month after implementation, the tax rate applicable to many types of food was lowered to 15 percent. Within a few months, several other former republics adopted very similar tax legislation, although each nation specified a somewhat different list of exemptions. Some observers have noted that tax administrators and taxpayers in these countries are somewhat confused about the operation of a VAT—notably the distinction between zero rating and exemption.

Another unusual tax feature in much of the former Soviet Union is that businesses are not allowed to deduct wages or interest payments in calculating their income tax base. It is thought that allowing any deduction (or in some cases, wage deductions in excess of an amount based on a fixed multiple of the minimum wage) would provide incentives for excess payments. This policy is much more extreme than the Polish *popiwek*.

IV. Conclusions

This article addresses tax reform efforts in the formerly socialist countries of Central and Eastern Europe. These efforts have been influenced by recent tax reform efforts in other industrialized countries, as well as their own legacy of socialism. On the whole, what emerges is a picture of gradualism. That is, tax reform is an ongoing process.

The first steps involve removal of the grossest obstacles to the development of a market economy—widely disparate tax rates on different types of economic activity and frequent, seemingly arbitrary changes in tax rules. These measures create an environment in which market forces become more important than decisions by government, and they echo the theme of neutrality that dominated the worldwide tax reform movement of the 1980s. During the transition in Central and Eastern Europe, however, some special rules tend to be established that are not found in

advanced economies with a long history of capitalism. For example, foreign direct investment receives tax concessions, and socialized industry bears extra taxes to monitor its behavior. The tax system may be used to provide generous incentives for improving housing conditions, which were a source of dissatisfaction under the former political system.

Already, however, the broad outlines, and many of the specific details, of taxation in Hungary, Poland, and—more recently—the former Czechoslovakia are compatible with tax structures in existence in OECD countries. For example, the top rates of personal and enterprise income tax are comparable to tax rates in the OECD. Tax rates no longer vary between workers in the private and state-owned sectors, and returns to many forms of personal capital ownership are included in the income tax base. Especially after this year's reform in Hungary, value-added taxes cover a wide range of goods and services. Almost all the remaining formerly socialist countries also have indicated a desire to head in the direction of tax systems in the OECD countries by adopting a value-added tax. In the long term, it appears that if economic and political reforms continue, policymakers will be inclined to shed features that have made their tax systems distinct.

If the transition to a new tax structure is to be successful, however, tax administration must be overhauled. Even in Hungary and Poland, one often hears that private businesses' tax payments are not rising as a share of total taxes, even though these economies are increasingly private. To the degree that this phenomenon is due to tax concessions designed to promote business development, the result represents an explicit policy decision. But to the degree that it reflects poor compliance with tax laws or leads to unintended budget deficits, improved tax administration might enhance total revenues as well as the perceived fairness of the tax system.

Creation of an effective mechanism of ensuring compliance with tax laws in Central and Eastern Europe must overcome several legacies of socialism. First, tax administrations must develop procedures enabling them to keep track of tax payments by a much larger number of taxpayers and to choose a subset of taxpayers for audit. This generally requires more personnel, the help of computer systems, and appropriate organizational development. Second, members of the public must stop viewing taxes as penalties designed to discourage certain forms of economic activity or as part of a government planning process. Rather, taxes must be considered a universal responsibility—as is the intent of the new tax laws. Finally, lawmakers must drop their belief that a strong tax inspectorate is antithetical to economic freedom. Overcoming these obstacles is taking longer than designing new tax policies.

Note: The author is grateful to numerous government officials in Central and Eastern European countries for discussions that laid the groundwork for this article. Gerd Schwartz, Jean Tesche, Charles Vehorn, and James Wooster provided valuable comments on an earlier draft as a result of their experiences in the region. Finally, colleagues at the Federal Reserve Bank of Boston offered useful queries and suggestions, and Karen Therien provided research assistance.

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