What Do Good Taxes Look Like (in CEE)?

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Taxes come in different forms and shapes. Regardless, they all have certain consequences. The discussion about what is the optimal size of the state, and which public expenditures are justified and beneficial never tires. Some argue for minimal state focused only on protecting the lives and property of its citizens from external and internal aggression, while others dream of a huge welfare state. There are also many voices in-between arguing in favor of introducing public benefits for education or basic safety, while at the same time criticizing overblown social transfers. No matter the size of the government, it needs to be funded somehow, and it can be done in different ways, but nearly always taxes will be the main source of financing and different taxes will have different effects, as discussed by Tomasz Kasprowicz.

Well-designed taxes should fulfill several criteria, true, but most of all they should never cause unnecessary distortions in economy. The question of how to construct a tax system is not new – Adam Smith considered that problem many years ago. In *The Wealth of Nations* he pointed out that taxes should follow four principles:

- ***fairness*** – taxation should be compatible with taxpayers' conditions, including their ability to pay in line with personal and family needs;
- ***certainty*** – taxpayers should be clearly informed about why and how taxes are levied;
- ***convenience*** – the process of paying and collecting taxes should be as easy as possible;
- ***efficiency*** – the administration of tax collection should be so contrived as to take out of the pockets as little as possible, over and above that which it brings into the public treasury of the state[1].

These rules are still valid today, although they need to be further specified. We should remember that the starting point for the designing of a tax system is the desired amount of tax revenue and the level of redistribution built into the system. Typically, much more emphasis is currently put on efficiency - from the growth perspective, taxes should be designed in such a manner that harms economic activity as little as possible. The majority of economists would agree that in order to fulfill those criteria, taxes should be neutral, simple, and stable.

A neutral tax system is one that treats similar activities in similar ways. Such a design minimizes distortions – people choose among similar alternatives according to their preferences and not tax differences. It also limits the number of disputes between administration and taxpayers about which rate should be applied.

The examples from Ukraine and Poland discussed by Oksana Kuziakiv and me in the presented issue of *4liberty.eu Review* illustrate the risks of non-neutrality, when dif-

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[1] Smith, A. (1776) *The Wealth of Nations,* London: W. Strahan and T. Cadell. Available [online]: xxaxa

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ferences in tax regimes distort choices, creating preferences for some contracts over others. Of course, sometimes neutrality is not desirable – as the article by Radovan Durana of INESS on carbon taxes shows; here, taxes are purposefully designed in such way so that they dissuade people from certain activities or goods.

Intuitively, *simplicity* sounds like a desirable feature of a tax system, but it is much harder to achieve than it may seem. When it comes to the taxation of labor, the overall tax burden (tax wedge) is usually a mixture of different levies – including both taxes and different contributions. Sometimes those are just different in name, but in many cases social security systems are constructed in such a way so that future benefits are proportional to the paid contributions. Even in such systems, the things that have the biggest impact on the actions of both employers and employees is the overall burden, as we can see in the article by Admir Čavalić on Bosnia and Herzegovina.

Taxation of capital is not much easier – sometimes it is difficult to distinguish between capital and labor income – as, for example, is the case of the self-employed. The problem of coordination of taxes and social security contributions in such cases is described in the article by Latchezar Bogdanov, who discusses wider taxation trends in Bulgaria. Even in straightforward cases, where CIT applies, deciding what constitutes an eligible cost can be complicated, but so are modern economies. As discussed in Aleksy Przybylski's article, alternatives like the turnover tax only sound alluring, while in practice, they would create harmful distortions.

The stability of a tax system is desirable, as it limits uncertainty for citizens and encourages them to focus on long-term investment. Although the majority of policymakers and politicians agree with this approach, the temptation to introduce new taxes and levies is still rampant. The recent worrisome trend in CEE is an attempt to introduce sectoral taxes, usually targeted at the sectors with large international players present, like banking – such a case is presented in the article on the situation in the Czech Republic, written by Michael Fanta. But there are also brighter spots, as much more predictable excise taxes described by Šárka Prát. Although, as the author indicates, there is still some room for improvement, these

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taxes constitute a stable source of revenue for the Czech Republic.

The collection of the same amount of taxes from taxpayers can have varying impact on the economy. By sticking to the rules of neutrality, simplicity, and stability we can finance public expenditure, while minimizing the negative impact of taxation on economic activity.

Tax systems in CEE countries have their bright spots, like for example higher reliance on less distortive consumption taxes than income taxes, but there is still some room for improvement. Such reforms should be pursued, despite the enormous success of the last thirty years, our region is still poorer than its Western counterparts.

Furthermore, recent turmoil caused by the outbreak of the COVID-9 will most likely seriously hit CEE economies, leaving public finances with additional debts, and companies rethinking their supply chains. Therefore, after the pandemic is over, all ideas of how to restart and boost economic growth will be valuable. Still, all changes must be introduced with caution, after conducting a thorough analysis of any potential side effects.

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