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Working Paper
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Diskussionsbeiträge: Serie II, Sonderforschungsbereich 178 "Internationalisierung der Wirtschaft", Universität Konstanz, No. 157

Provided in Cooperation with:
Department of Economics, University of Konstanz

Suggested Citation: Genser, Bernd; John, Christoph (1991) : Reform of the GDR tax system: A blueprint for east European economies?, Diskussionsbeiträge: Serie II, Sonderforschungsbereich 178 "Internationalisierung der Wirtschaft", Universität Konstanz, No. 157, Sonderforschungsbereich 178 "Internationalisierung der Wirtschaft", Universität Konstanz, Konstanz

This Version is available at:
http://hdl.handle.net/10419/101696

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Reform of the GDR Tax System: A Blueprint for East European Economies?
REFORM OF THE GDR TAX SYSTEM:
A BLUEPRINT FOR EAST EUROPEAN ECONOMIES?

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Serie II - Nr. 157

Oktober 1991
Abstract

The transformation of the GDR to a market economy is supported by the adoption of the West German tax system. There is evidence, however, that the adoption approach is a costly way of changing the tax structure of a country in transition. Nevertheless in the paper the implementation of the German tax system is regarded as the hypothetical benchmark, which allows to analyse amendments to and deviations from an adoption approach recommendable to countries in transition. With reference to the Hungarian and the Czech example emphasis is put on simplified VAT structures, trade taxation, cash-flow bases for income taxation and withholding devices.

1. Introduction

There is general consent among leading economic advisers that a well-designed tax system is a must for countries in transition (CITs) from socialism to a market economy. The former command economies of Eastern Europe must find a way to finance their public sector, which is not likely to shrink sharply in the short run, without generating dangerous inflationary processes. They must be careful that taxes do not distort resource allocation and create biased price signals. In particular, they must avoid discouraging foreign capital investment. This catalogue of requirements implies that the former command economies replace their traditional practices of fiscal and monetary control...
by a consistent system of well defined taxes for the financing of public expenditure.

In the face of the shortcomings of government finance that were common to all centrally planned economies, a comprehensive reform of their tax systems is unavoidable. The complex, intransparent and often ex-post negotiable system of revenue collection must be replaced by an unequivocal and transparent tax code executed and controlled by a rigorous tax authority. The annual fixing of levies and taxes according to the plan must be replaced by a stable and predictable tax system, which economic agents may include in planning decisions.

Fiscal needs can only be covered in the long run by mass taxes that also provide for a stable revenue. As in our developed market economies, this can be achieved by introducing a general consumer tax and a general income tax. The tax system to be implemented must take into account the lack of administrative experience with respect to tax raising and control on the part of the former socialist planners.

In particular, the introduction of a credible and stable corporate tax system is inevitable from the perspective of foreign investors. Company taxes should be neutral with respect to adjustment processes induced by the market. They should be simple and thus rigorously administrable, yet flexible enough to create the necessary incentives for urgently needed capital accumulation in order to replace the worn-out capital stock of the old socialist economy.

The German Democratic Republic (GDR) was confronted with just these tax policy requirements in its transformation towards a market economy. Thus, the GDR initiated some minor tax reforms after the democratic revolution in October 1989. In contrast to the other command economies in Eastern Europe, the tax reform process in the GDR was rapid and very brief as a result of expected German unification and it took place without any broad economic debate. With the entry of the GDR into the German
Federal Republic (FRG) the existing West German tax system was adopted. This came into effect partly with the German Economic, Monetary and Social Union (GEMSU) in July 1990 and was completed in January 1991, after the unification.

The paper is organized as follows. Section 2 presents the basic structure of the socialist revenue system in the GDR up to 1989. Section 3 describes GDR tax reform measures implemented after the democratic revolution. Problems with the adoption of the West German tax laws in the new states (Länder) are discussed in Section 4. In Section 5 the hypothetical tax reform scenario "Adopt the West German Tax System" is chosen as a benchmark to analyze tax reforms for other CITs, in particular Hungary and the CSFR. We argue that the adoption approach has been a costly device so that it cannot be recommended for other CITs without major amendments and deviations. The arguments are summarized in Section 6.

2. Deficiencies of the Traditional GDR Tax System

In 1988, the public budget in the GDR accounted for more than three quarters of GDP (compared with 47% in the FRG). Tax receipts recorded in the official statistics financed roughly 70% of the total state budget. Approximately 90% of these tax receipts came from the socialized enterprises, whereas only 5% came from the taxation of labour, cooperatives and private business (cf. Table 1).

Budget revenue from the profits of socialized enterprises were collected via a four channel system (cf. Knauthe/Spiller 1987, Genser 1990):

(i) The "production fund levy" was usually calculated as a fraction of 6% of the gross productive assets of nationally owned industrial enterprises and combines. The production fund levy thus resembles a fixed rental on capital payable to the state out of enterprise profits. A corresponding levy on gross commercial assets was payable by nationalized trade companies.
(ii) The "net profit transfer" consisted of two components, viz. a lump-sum payment fixed for each firm as a particular percentage of its profit predetermined by the national plan, plus a confiscatory tax on profits in excess of the plan.

(iii) The "contribution to social funds", newly introduced in 1984, was related to the wage bill and amounted to 70% of the firm's payroll.

(iv) The complex and intransparent system of "product related levies" consisted of several thousands of surcharges determined by the difference between the prices for consumer goods regulated by the plan authority, viz. the industrial production price and the industrial delivery price. Product related levies were charged for the majority of consumer goods. Luxuries, alcohol, and tobacco were subject to extremely high surcharges. Basic foodstuff, public transport, and necessities, on the other hand, were not only free from product related levies but were in fact highly subsidised. By the end of the eighties revenue from commodity taxes net of price subsidies turned out to be close to zero.

Special tax rules applied to craftsmen production cooperatives, agricultural cooperatives, commission agents, and to private craftsmen. Thus, the scope of the general tax laws (income tax, corporate income tax, business tax, turnover tax) was restricted to a negligible number of firms and individuals. But this was fully in line with the policy objective of suppressing socially undesirable private activities via confiscatory taxes.

Consequently, the progressive income tax schedule was not applied to labour income from wages and salaries, to certain types of self-employed labour income, viz. qualified freelancers like authors, academics or doctors, and to labour income earned by members of socialist production cooperatives. These various forms of labour income were subject to different preferential tax schedules as well as to additional tax exemptions.

The complexity, the ad hoc structure, and the confiscatory character of the GDR tax
system can also be found in other eastern economies during the phase of "classical socialism" (cf. Gray 1990, Tanzi 1991).

3. GDR Tax Policy after the Democratic Revolution

The move towards a democracy and a market oriented social order in the GDR after the democratic revolution triggered tax reform measures already under the communist Modrow government.

The Joint-venture Directive of 25th January, 1990 allowed for accelerated depreciation, for tax-exempt investment allowances, and for loss carry-forwards. But all these preferences had still to be approved by the minister of finance.

The Tax Reform Law of 6th March, 1990 reduced the confiscatory top rates for the income tax (from 90% to 60%), the corporate income tax (from 95% to 50% for retained and to 36% for distributed profits), and the net wealth tax (from 2,5% to 1%), and introduced an upper limit for the aggregated tax burden equal to 75% of annual income. Generous investment incentives were introduced in the form of special depreciation allowances of 50%, 30%, and 20% in the first three years. Tax free investment allowances, loss carry forwards for five years and two-years tax holidays for new businesses were also granted.

The victory of the Christian Democrats in the first free GDR election in March 1990 established the preconditions for the creation of the GEMSU and the unification of the two Germanys. The State Treaty of 18th May, 1990 laid down that the GDR should adopt the tax system of the Federal Republic of Germany in two steps.

Since 1st July, 1990 the GDR has applied the West German value-added tax and some minor turnover taxes, e.g. the insurance tax. In addition, the regulations concerning taxable profits according to the West German income tax law and wage taxation in a
simplified version were adopted by the GDR. The corresponding tax bills, such as the turnover tax law and the tax adaption law, were passed by the People's Chamber (Volkskammer) on 22nd June, 1990. By decree of 27th June, 1990, the former GDR levy system for the socialized enterprises (cf. chap.2) was abolished. All nationalized enterprises, which had been transformed into corporations by the Public Trust Fund Law, became taxable subject to the general company tax regulations for the second half of 1990.

The application of all parts of West German tax laws which had not been adopted until then was scheduled for January 1st, 1991 in the State Treaty.

The Unification Treaty of 31st August, 1990 took over this agenda without modification. Tax laws of the GDR were retained for the remainder of 1990 and replaced by West German tax laws in 1991.

Following Kornai's (1990) terminology the history of GDR tax policy allows to identify three phases of socialist development. "Classical socialism" in the GDR lasted longer than in other European command economies and ended only with Honecker's resignation in October 1989. The period of "reform socialism" must be placed in the few following months until the end of the Modrow government's term of office in spring 1990. The period since de Maizière's taking up office may be referred to as the period of "post-socialist transformation". With respect to the implementation of economic policy measures in the third phase, GDR tax policy has followed a "big bang strategy". The adoption of the complete West German tax system within a six month period has confronted both the public administration and the enterprise sector with the challenging task of reorganizing the complete accounting system in accordance with the requirements of the West German tax code. This fast-paced adoption of West German laws has only been made possible by comprehensive assistance from the tax administration of the West German states. In addition, a number of West German institutions provided economic consulting and advice.
4. Transitional Regulations for the former GDR after the Unification

Despite the swift process of unification, the State Treaty did not export the entire West German tax code immediately into the former GDR. The treaty provided for a period of transition in which the West German regulations were phased in.

In general, the tax laws of West Germany were implemented in the East as quickly as possible with as few as possible transitional regulations. This can be interpreted as a decision in favour of the primacy of law, since full harmonization of tax regulations at that time was a judicial and administrative goal rather than an economic necessity.

Nevertheless, there are some exceptions from that rule:

- Tax preferences, especially accelerated depreciation for investments that were granted by the GDR tax reform of 6th March 1990, continued.
- Favourable turnover tax treatment of goods produced by firms located in the former GDR was granted until the end of March 1991.
- The property tax and the business tax levied on company wealth were suspended for a period of two years until the end of 1992.

The constitutional regulations for the sharing of tax revenues among governmental levels were not fully applied to both parts of Germany. The Unification Treaty suspended these important distributional provisions of the German constitution, whose target is to equalise financial resources among the states by horizontal intergovernmental transfers.

With respect to the horizontal distribution of subfederal shares of the personal income tax and the corporate income tax, the new "Länder" of the former GDR fully participate in the constitutional sharing arrangement. The state quota of the wage tax (42.5%), the assessed income tax (42.5%), the capital withholding tax (50%) and the corporate
income tax (50%) is apportioned among subfederal states (except Berlin, whose preferential treatment in the past will continue for some time) in accordance with regional revenues of the respective taxes.

On the other hand, the new states' access to the revenue quota of the turnover tax (35% since 1986) was limited and planned to be phased in on a step-by-step basis, starting with a per capita quota of 55% of the Western states in 1991. Thus, the egalitarian element of the horizontal distribution of the turnover tax, which is distributed mainly per capita (75%) and partly according to regional shortfalls of state revenues below standardized state needs (25%), should have become effective for the Eastern states only in part in 1991. Severe financial problems in the new states, whose tax revenue from own taxes and revenue sharing according to the Unification Treaty were extremely (but not surprisingly) low, led to a repeal of this regulation and offered a 100% per capita sharing of the turnover tax quota to the Eastern states already by 1991. Nevertheless the preferential distribution of turnover tax proceeds according to needs as well as the intergovernmental fiscal equalisation procedure among subfederal states is applied separately in the Eastern and the Western states and thus precludes equalizing transfers between the old and the new states up to 1995.

5. Tax Policy Options for Countries in Transition

In the face of the high economic expectations placed upon the structural reform process in the former GDR the question may be raised as to whether or not the GDR tax policy strategy is justified and desirable for other countries in transition as well.

To the extent that the adoption of the West German tax code improves the conditions for the transitional economic process in the GDR, other CMEA states might be encouraged to behave in a similar way and to support their transition towards a market economy by copying the German (or another Western) tax code as well. Comprehensive
tax reforms have been discussed in all former CMEA countries after their democratic revolutions. Hungary has taken the lead, since the first comprehensive tax reform was made already in 1988 and the postsocialist transformation phase had started well before the democratic revolution in the GDR. Czechoslovakia, whose reform programme began at roughly the same time as the democratic revolution in the GDR, has announced a comprehensive tax reform for 1993. All other former command economies of Eastern Europe including Poland are discussing transformations of their tax systems oriented towards tax structures in Western economies (cf. Gray 1990).

In the following, the actual GDR solution, viz. the adoption of the West German tax code, is used as a hypothetical benchmark scenario for other CITs. This allows to analyse the pros and cons of alternative tax reform variants already implemented or under discussion in these countries by using the experience gained from the German unification process.

5.1 Turnover Tax

The abolition of the selective turnover taxes (product related levies), which were raised in all CMEA command economies in the form of several thousand specific levies on consumer goods, is uncontroversial, and their replacement by a general, Western type consumption tax is unavoidable from the perspective of resource allocation and as a result of budgetary needs. The adoption of the West German VAT is in accordance with the goal of the CITs to intensify trade relations with the EC and to join the internal market in the long run.

The adoption of the West German VAT guarantees a broad tax base in accordance with the 6th EC Directive, which precludes major exemptions from the turnover tax base and thus can be operated with a standard rate of 14% (15% in 1993), which is relatively low by international standards. In addition, the restriction to one reduced rate of 7% and some minor exemptions is in line with EC harmonization targets for the internal market.
A recommendation in favour of the German VAT system can be qualified by the Hungarian example. In 1988, Hungary introduced a VAT with a three-tier rate structure, a 25% standard rate and two reduced tax rates of 15% and 0%. The experience of the Hungarian economy with the new VAT is ambiguous. While it is basically acknowledged that the VAT has contributed to price liberalization and market efficiency, there are severe problems concerning administration and fiscal sufficiency. A breakdown of the potential tax base for 1990 (Lukacs 1991, 224) shows that the standard rate is applied to 49% of private consumption (53% in 1988), whereas the share of zero-rated consumer goods has increased to 42% (39% in 1988). The share of consumption subject to the 15% rate and the share of exempted consumption (without credit) account for about 4% each. Tax base erosion is one major reason why VAT has not become the dynamic source of fiscal revenues in Hungary, as it was expected by fiscal authorities. Another problem is due to the high standard tax rate, which provides an incentive for tax evasion. Lukacs (1991, 222) reports a share of 10% of potential VAT revenues, which is lost according to lacking enforcement and control. The large tax wedge between the zero and the standard rate does not only create considerable distortions in relative consumer prices, it also creates strong political pressure in favour of expanding zero rating and massive resistance against attempts to narrow the group of zero-rated goods to reduce tax base erosion.

Czechoslovakia currently operates a retail sales tax and has reduced the number of their turnover tax rates to four (0%, 12%, 22%, 32%) in 1991, as a step towards introducing a VAT in 1993. Since there is a strong pressure for a preferential treatment of up to now exempted or subsidized consumer goods, the CSFR is likely to face similar problems as Hungary. An orientation towards the German rate and base structure seems more promising for the Czech VAT design in order to escape future economic and political problems.

With respect to the German rate structure, the question arises if CITs should be
encouraged to introduce a reduced VAT rate. Distributive arguments supporting reduced VAT rates should be regarded as being of minor relevance in CITs, since major adjustment processes in the goods and labour markets may even be less distorted by a low and broad based single rated consumer tax. Higher costs of living for low income earners, who are hit by the withdrawal of subsidies on necessities, may be compensated in cash by a transitional transfer that covers the additional cost element of going without a reduced VAT rate. The regressive nature of a single-rated VAT may be compensated by an income tax allowance as well. From an allocational perspective, the British or the Danish examples are to be preferred to the German system because they entail lower costs for administration and compliance and reduce the distortion of consumer prices. Nevertheless there is always the possibility of switching to a multi-rated VAT without major political and economic costs at a later stage of transition, when national skills in administration and compliance with a multi-stage VAT have improved.

Administrative simplifications of VAT operation will be of major importance in transitional economies. The German system of exempting the agricultural sector by granting imputed invoice credits that offset the tax liability on agricultural turnover, may act as a useful guideline for CITs. In excess of German regulations, imputation of VAT credits should also be considered for the growing sectors of retail trade, craft, and services. Small businesses may be offered VAT exemption without credit or presumptive taxation according to simple indicators of economic activity, e.g. years of their existence or turnover of the previous year. All measures for administrative simplifications must be designed in a way that keeps intact an incentive for a voluntary shift from imputation and presumptive taxation to itemized credits.

5.2 Excise Taxes

Although command economies didn't levy excises, high product related levies on certain luxuries were common. The adoption of the major German excise taxes on tobacco, liquors, beer, sparkling wine, and mineral oil can be recommended for fiscal
reasons and ensures conformity with EC harmonization targets. The main advantage of
these excise taxes is their relatively cheap administration and control, because they are
either levied as domestic producer taxes or as import levies. The demerit good character
and the small excess burden associated with an excise tax, if compensated price
elasticity is low, are two other traditional economic arguments that can be applied in
CITs as well.

Nevertheless it is not likely that the rate structure of Germany, which exempts wine,
puts a low tax load on beer, and stresses the unit tax component on cigarettes, is suitable
for CITs, since this tax pattern reflects the pressure of national interest groups and
protectionist attitudes. Other German excises on coffee, tea, sugar or salt, which have
been introduced in the GDR as well and are fiscally attractive for CITs, should only be
implemented temporarily, since the European Commission aims at abolishing them in
the internal market.

5.3 Corporate Taxes

For former command economies it is unavoidable to abolish the confiscatory system of
compulsory payments from socialized enterprises to the state budget. The system has to
be replaced by a homogeneous and general corporate income tax code that does not
discriminate between enterprises of different type and ownership.

A recommendation in favour of the German corporate tax system, however, raises
several problems. Above all, corporate tax systems differ markedly within the EC and
hence it is not clear whether the German system will survive in the internal market.
Corporate tax harmonization may force Germany to adjust its system of company
taxation to future EC directives. Furtheron, a reform of business taxation is on the
agenda of the German government, which concentrates on the business tax and the
company wealth tax but may have an impact on the corporate income tax as well. CITs
may therefore be advised not to rely on the German model, but to take into account
simple alternatives.

Like Germany, most industrialized countries use a corporate income tax with one marginal tax rate only. This makes sense for CITs as well, since a progressive structure can hardly be justified from a distributional viewpoint, but creates allocative distortions, triggers strategic tax avoidance, and increases problems of administration and control. In contrast to German regulations, the valuation principles to calculate the tax base should be chosen as simple as possible. At least in the transitional period, the free choice between different depreciation schemes and methods of inventory valuation, complex accumulation rules for reserve funds, and conditional tax preferences subject to prior agreements with a public authority should be avoided and a more transparent and restrictive legislation should be enacted in its place.

On the other hand, asset valuation for tax purposes must take into account inflation as a serious source of distortion, since inflationary shocks will occur in the transitional period. Especially for new firms it is important to provide measures for suitable periodisation of real revenues and costs and an inflationproof carry forward of losses.

The German corporate income tax law provides for a full integration of the corporate and the personal income tax with respect to distributed profits. Although this does not lead to a level playing field among alternative sources of finance in Germany, the tax wedge discriminating against equity capital is reduced by this measure. But by EC standards the German step towards integration in 1977 has remained unique. Indeed, there is evidence that despite double taxation of dividends the classical corporate tax system is more appropriate for less developed economies, since due to high propensities to consume in CITs retained earnings must be regarded as the most important source of private savings. The German integration system favours equity financing, but encourages dividend payments and offers no preference for retaining.

The CITs are undercapitalized economies which will have to try hard to attract
international capital, e.g. by offering tax preferences to foreign investors. Strategic tax competition among CITs may therefore lead to fiscal losses for all capital importing countries without inducing the desired efficient reallocation of international capital.

Hungary has introduced a uniform enterprise profit tax in 1989, with a statutory rate of 50% which was reduced to 40% in 1990. Although this tax rate is rather favourable in comparison with other CITs or OECD countries and despite further tax rebates and allowances for certain investments, effective tax rates on capital income nevertheless remain high due to restrictive regulations on depreciation, valuation and losses. The case of Hungarian corporate taxation also provides a good example for the inefficiency of special preferences to foreign investors. The 1989 legislation provided considerable tax relief for foreign firms engaging in joint-ventures (5-year tax exemption, substantial tax reliefs in the following years). This tax loophole made Hungarian investors channel their capital into joint-ventures via foreign intermediates to enjoy the favourable tax treatment of foreign capital. Of course, these rent-seeking activities undermined the tax incentive target and did not result in the required expansion of Hungarian capital formation.

The introduction of the German business tax ("Gewerbesteuer") as an additional tax on company earnings is not advisable to CITs. The business tax has a long tradition in the FRG as a source of revenue for local governments. Nevertheless, the position of this tax within the tax system is highly controversial and the fact that it has been retained despite its role as a discriminatory cost factor in international commodity markets is above all due to the strength of the German export industry.

In the face of the problems caused by an adoption of the German (or any other Western) corporate tax system in a transitional command economy, a cash-flow tax was frequently suggested as a suitable alternative (McLure 1991a, 1991b, Rose 1990). Whereas industrialized countries did not introduce a cash-flow tax in recent reform programmes, cash-flow tax protagonists argue that the advantage of such a tax is even
greater in transitional economies. Whereas the allocative neutrality of the cash-flow tax, which ensures an effective tax rate of zero on marginal investment, may be regarded as of secondary importance in face of the prevalence of major other distortions at least in the short run, the simplification of tax base calculations must be regarded as most desirable. Full expensing avoids all problems with the intertemporal distribution of depreciation allowances and shields corporate taxation from the negative consequences of inflation, which may severely distort investment decisions. In addition, the non-deductability of dividend payments and interests on company debt results in an implicit withholding tax on these types of capital income, which therefore may be excluded from the tax base of the personal income tax. Finally, the cash-flow tax results in neutrality with respect to different sources of corporate finance.

5.4 Personal Income Tax

In command economies of classical socialism there was no need for personal income taxes. Economies in transition cannot do without the introduction of a personal income tax. In addition to the general turnover tax, the personal income tax would be the second important source of government revenue. The importance of a general income tax will increase with the growth of the service sector.

The adoption of the personal income tax code of Germany would satisfy the target of introducing a progressive, synthetic income tax system. The tax-exempt subsistence level avoids the taxation of small income. A large number of exemptions and allowances for earnings-related expenses, for socially desirable personal outlays, and for extraordinary personal expenses gives the opportunity to use the system as a toolkit of economic policy. On the other hand, it is precisely the complexity of the German income tax system that will cause major problems of administration and control for tax authorities in the CITs. Moreover, erosions of the income tax base tend to mushroom and will lead to shortfalls of revenue in conflict with the fiscal target.
Recent evidence shows that even the experienced and well equipped West German tax authorities are not able to administer their own income tax system according to law. The speedy introduction and abolition of the withholding tax on interest income in 1989 may serve as one example. Another example is the recent verdict of the federal constitutional law court that obliged the federal government to take effective measures to enforce the taxation of capital income.

Vertical equity considerations suggest progressive tax rates on personal income. Progressive tax rates, however, will create at least three different kinds of problems in CITs. First, a progressive rate schedule has to be adjusted for inflation to avoid bracket-creeping. Second, withholding of income taxes at the source has to be supplemented by an annual assessment procedure to install horizontal equity for fluctuating incomes. Third, progressive taxes generate political pressure for tax relief and schedule modifications. Hungary serves as a good example, where the progressive schedule implemented in 1988 has already been modified twice in 1989 and in 1990. For CITs a simplified indirectly progressive tax schedule with a constant marginal tax rate over a broad income range (following the British or the US example) will avoid these problems.

Another question is, whether income taxation in CITs should subscribe completely to the Schanz/Haig/Simons standard of comprehensive income. Horizontal inequities might be avoided more efficiently by strict source taxation on a schedular base than by assessing and controlling total annual income ex post.

If a cash-flow tax is considered for company profits, the complementary personal income tax should be designed as a cash-flow tax as well. If personal income from interest payments and dividends is not deductible from the corporate tax base and is thus subject to an implicit withholding tax, the cash-flow income tax is reduced to a tax on labour income. Proposals for CITs are the Z-tax (Rose, 1990) or the Simplified Alternative Tax (SAT, McLure 1991a,b). These tax proposals are, of course, closely
related to a personal expenditure tax (Kay/King 1990), although they need not necessarily be classified in the traditional Kaldorian way.

5.5 Tariffs and Trade Levies

International trade in command economies used to be a national monopoly and there was no necessity for separate trade levies. All taxes on imported goods were hidden in the corresponding product related levies. By adopting the German tax system, CITs will forgo the possibility of using international trade as a tax base.

In comparison to less developed countries, who raise a considerable share of tax revenues from trade levies, there is the question whether or not similar arguments in favour of tariffs apply to CITs. The major advantage of trade levies are low costs of compliance and administration and easy control. Furtheron, trade levies may provide some desirable shelter for domestic production and prevent trade imbalances in early stages of transition. Of course, tariffs can generate situations of excessive protectionism and allocative distortions in international trade which jeopardize the transition process towards a market economy. In face of urgent fiscal pressure, CITs should not be restrained from applying tariffs but be recommended to introduce them by sunset legislation for a limited transitional period and according to a non-specific tariff schedule.

5.6 Payroll Taxes and Contributions to Social Insurance

Whereas social health and pension schemes existed in command economies and were financed in part by social insurance contributions related to wage income, an unemployment scheme was unnecessary since unemployment was denied to exist. CITs are forced to expand their social insurance schemes to cope with the severe consequences of transition for their workforce. In face of low wages and high unemployment rates, high tax rates will be necessary to cover only the subsistence costs for the unemployed and the old. Presently, Hungary and Czechoslovakia levy social
An orientation towards the German social insurance scheme and its financing will help CITs in two important ways. The relation between contributions to and services from a social institution, lacking in traditional socialist schemes, will reduce fiscal illusion and prevent people from demanding too much from the social system. A look at the top rates of the social system in Germany, which provides a comprehensive social safety net, should make CITs aware that excessive tax rates for social services are not sustainable in the long run.

6. Summary

The transition from command economies to market economies requires a fundamental change from the traditional socialist tax system to a new, market-oriented tax system. This new tax system will comprise the main taxes of OECD countries, a VAT and a personal income tax as well as company taxes, excises and social security contributions.

Nevertheless the GDR solution of adopting the whole tax code of West Germany cannot serve as a general guideline for CITs. There are two main reasons which emphasize the particularity of East Germany. First, East Germany didn't only import the tax code, it was also offered to import the corresponding tax administration. Second, East Germany was not forced to close the fiscal gap between state expenditures and revenues but could rely on massive fiscal subsidization from West Germany. No other CIT can act under these favourable conditions.

Administrative problems and fiscal pressure force CITs to deviate from Western tax systems, especially by taxing trade flows, making use of presumptive taxation, posing a relatively high burden on low income earners, and by using schedular techniques for source taxation of income. A major deviation from Western tax systems would be the switch to cash-flow taxation for company and personal income. Taxing personal and
corporate income on a cash-flow basis is not only attractive for reasons of simplicity and control, this step will also neutralize distortions generated by inflation and arbitrary valuation in the transitional period. Finally, imposing a cash-flow tax from scratch hardly causes any transitional problems in contrast to a mature market economy.

On the other hand, Vito Tanzi's warning must be taken seriously, who complains that some of the foreign advice that is currently offered to policy-makers in CITs "is likely to be amateurish and damaging" (Tanzi 1991, 27). Nevertheless some preliminary lessons of the German experiment tell us that giving priority to political and judicial targets may not be to the best of a society from an economic point of view. The amendments to and deviations from a tried and tested Western tax system discussed in this paper are intended to stress the economic element in the political discussion, hopefully not in an amateurish and damaging way.
7. References


### Table 1

Tax revenue structure in 1988 for selected countries
(in % of GDP)

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<th>FRG</th>
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<td><strong>Taxes on income</strong></td>
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<td>11.2</td>
<td>4.7</td>
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<td>- on corporations</td>
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</tr>
<tr>
<td>- on imports and exports</td>
<td>0.3</td>
<td>na</td>
<td>na</td>
<td>3.0</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.0</td>
<td>0.4</td>
<td>0.4</td>
<td>0.8</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Total taxes</strong></td>
<td>37.4</td>
<td>60.1</td>
<td>40.6</td>
<td>54.0</td>
<td>50.8</td>
</tr>
</tbody>
</table>

Memorandum item: GDP

<table>
<thead>
<tr>
<th></th>
<th>FRG</th>
<th>GDR</th>
<th>ØEC</th>
<th>H</th>
<th>CSFR</th>
</tr>
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<tbody>
<tr>
<td>GDP (in billions of DM, M, Ft, Kcs)</td>
<td>2111</td>
<td>342</td>
<td>-</td>
<td>1441</td>
<td>740</td>
</tr>
</tbody>
</table>

Source: OECD (1991a); Genser (1990); Tanzi (1991)