



Policy brief

**Tax Justice in
Southeast Europe
How to reduce inequalities?**



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Tax Justice in Southeast Europe – How to reduce inequalities?

Taxation is an important part of our lives. Tax policies have a major impact on economy, society and environment, while they also shape our public finances and public services. Having a fair tax system is of high importance, yet many countries' tax systems are not fair. The study *Tax Justice in Southeast Europe – How to reduce inequalities?* analyzed the tax systems in 7 Western Balkan countries. It identified several developments and trends in the WB countries that need to be reshaped in order to achieve fiscal sustainability and tax justice:

- The tax systems have become less redistributive since the mid-1990s, contributing to increasing inequality, instead of decreasing it. Tax rates of the main taxes – Corporate Income Tax (CIT), Personal Income Tax (PIT) and Value Added Tax (VAT) – have decreased and the burden of taxation shifted to indirect taxation of consumption rather than wealth, making the tax systems more consumption oriented. Tax exemptions for companies and rich individuals means further shifting of the tax burden to the less well-off parts of the society.
- There is a general decline in quality of publicly financed infrastructure and services, due to which people, who can afford it, turn to privately financed alternatives; this in turn makes public services decline and the wealth-income divide grow further.
- Tax rates on capital and labor are being decreased, plus a relatively large number of incentives are applied, with the objective to give to the business a stimulating tax environment for their economic performance, but leading to large amounts of lost revenues for financing of public services.
- The companies and rich people are able to use the loopholes in the tax laws and in that way to pay less taxes, which means that the ordinary citizen in the end pay relatively more into the system. Coupled with the race to the bottom, in which also many of the countries in the region take part, the tax revenues that could be obtained from businesses are seriously impeded.
- Tax education is low as tax paying is not perceived as a citizen's duty and even sign of responsible and conscious citizen; it is rather the avoidance of tax paying that was perceived as a national sport, leading to high levels of tax evasion.
- VAT has a high share in tax revenues. As VAT is the most regressive tax, it burdens the less well-off people most. The countries rarely implement exemptions from VAT for basic products that are mostly consumed by the most vulnerable parts of society.

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Perception of taxes

In the region tax-related opinion surveys are a very recent development. The few surveys undertaken are oriented towards professionals and businesses; however, there is not much evidence that tells us what the general public thinks about tax. Better understanding of tax perception in the region is needed to help to set a fairer tax system that could work towards decreasing tax evasion.

The key factors influencing the tax morale in the region are complexity of tax regulations, poor transparency and inefficient tax administration, low trust in institutions, existence of an informal economy and failure of the state to provide adequate public services. These aspects need to be tackled in order to build towards a just tax system in the region, while at the same time working towards quality services by the state. Only with increasing tax morale we can introduce greater tax discipline in the 7 countries and this is possible only through providing high quality public services funded by the government.

Another point that needs to be outlined is that the companies also receive benefits for their taxes. They use roads, energy infrastructure, education and health system for their workers, justice system for stabilizing the operating environment etc. In this aspect it is important that they stop perceiving taxes as a mere burden and start seeing it as something that enable their business investment and pays for services that companies use.

Tax systems in the region

In EU-28 taxes represent 38.7 % of GDP, while in the Western Balkan countries the participation of taxes in GDP is below 30%. Therefore, there is a room for increasing the taxes, mainly for rich individuals and companies, and at the same time abolishing the tax exemptions and tax credits given to foreign and domestic companies in the 7 analyzed countries.

Taxes on labor are the largest source of revenue in EU countries, contributing nearly 50 % of all the revenues, followed by consumption taxes at roughly 33 % and then capital taxes at around 20 %. In WB countries the picture is somewhat different: the highest share of taxes in budget revenues are VAT revenues. The lower shares of direct taxes in the WB countries are counterbalanced either by relatively high proportions of indirect taxes (for example 53.5 % in Bulgaria or 30% in Macedonia) or by relatively large shares of social contributions (for example 30 % in Macedonia). Also the contribution of CIT in the GDP in all of the analyzed WB countries is very low and also the CIT rates in all of the 7 countries are extremely low. By having low CIT rates, the WB region has established its own tax heaven for companies. The low and flat tax rates and tax cuts on corporate and higher earners have shifted the tax burden on ordinary citizens. This has resulted in a disproportionately large tax burden on goods and services when compared with the OECD average.

Tax dodging

Tax dodging is a term that describes situations where tax is being avoided or evaded, or a combination of both. Tax dodging costs public budgets dear, often resulting in lower level of public services from which all citizens could benefit. The presence of tax dodging is a problem and a challenge for all the tax administrations in the region. The level of tax dodging cannot be determined precisely, it can only be estimated; yet all the countries in the region are doing a poor, if not entirely disinterested, job in detecting and monitoring tax dodging. Tax dodging is only monitored to a limited extent, leaving a large part of the tax dodging scene relatively untouched. In spite of numerous measures to prevent tax dodging, all the countries in the region are still facing a challenge in limiting tax dodging, hence the first step is to monitor the problem better. Another important step is to show a more active engagement in international efforts for eliminating tax dodging.

Use of assertive tax planning methods causes concern that the tax burden is not equally carried by the multinational companies and local companies and SMEs. The multinational companies can benefit from aggressive tax planning through many jurisdictions, whereas the local companies and SMEs cannot compete with such practices.

Race to the bottom

Tax competition is the process by which countries compete with each other to attract investment from companies by lowering tax rates or providing special exceptions to tax rules. The tax competition often leads into a so called 'race to the bottom', where incentives offered to investors are pushing a spiral of lowering tax burdens, which means less revenue for the budget. The countries in the studied region take an active part in the race to the bottom, hoping to bring investments into their territory that would revive economy and create jobs. However, it is an important challenge that data on extent of support for companies is not publically available. Also the benefits of such incentives are either poorly studied or not studied at all.

The limited available studies point out that empirical results do not indicate that tax incentives would have positive effects on the increasing of employment, while the effects on investment are negligible. This suggests that abandoning tax incentives at corporate income taxation could be a good move, making the tax system more just. Regular studying of the effects (cost-benefit analysis) of tax incentives and publishing of those could be a starting step in eliminating the race to the bottom, as it would show whether there are real benefits from taking part in the race to the bottom.

Another outlined challenge is that attracting investment with tax exemptions favors large foreign investors, while the local companies and SMEs can rarely benefit from such policies.

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Progressive taxation

A progressive tax is a tax where the tax rate increases as income increases. Many countries in the studied region have a flat tax rate system or a system with low or moderate progressivity, hence the region is far from reaping the full benefits of progressive taxation. Of the studied countries, only Slovenia has a progressive system in place when it comes to personal income tax, while the other countries show a low level of progressivity in personal income tax. The VAT in some countries contains elements of progressivity, while corporate income tax is everywhere flat. The tax system is skewed towards indirect and thus regressive taxation.

Progressive tax modernization can and should raise significant revenue to finance job creation and public investments, shrink deficits, and ease pressure elsewhere in the budget. It can moderate recent and persistent trends toward widening income inequality and hyper-concentration of wealth, helping to restore a society of shared prosperity. Progressive taxation is fiscally responsible, economically sensible, and politically viable. Hence, policy reforms towards progressive taxation are needed in the region.

Expanding the social services

In spite the fact that tax dodging estimates are largely missing, the Western Balkan region still has ample space to increase tax revenues. This would provide a basis for improving the state services. All the researched countries face problems in servicing basic social needs, including pensions and health, often not only due to insufficient amount of collected taxes, but also due to competing priorities, such as paying off debts. Often countries are opening possibilities for commercialization of sectors that provide social services, which leads to even less trust in tax system. Citizens who cannot see that paying taxes provides high quality, affordable and functional public services, are not stimulated to pay taxes.

Although extra public revenues would not necessarily translate into better public services (because of the current state of affairs the public revenues could simply be extracted by the political class), it is a must that Western Balkan countries start thinking how to attract more tax revenues to be able to support quality public services. Such services depend on tax justice, but tax justice must also be linked to a new model of public investment and spending. Tax policy reforms need to go hand in hand with social policy reforms.

Recommendations for reforms for fair taxation

Governments of the analyzed countries, but also the EU institutions (as some of the countries already are EU member states, while all the others aspire to become ones) must promote progressive tax systems to address the rising inequality both at national and global level. They must close the windows of opportunity for tax dodging and stop the race to the bottom on corporate taxation, which contributes to ever lower corporate tax rates and ever more harmful tax practices that facilitate corporate tax avoidance.

The WB countries must take the challenge and conduct thorough reforms of their tax systems. The reforms should mainly be directed to reduce income inequalities, make tax systems more just and fairer, increase tax revenues and expand and improve the social services through increasing tax revenues. Working on both sides, the revenues and expenditures, is of crucial importance, as the currently exhausted social service sectors urgently need new public resources to get back to life.

There are several key steps that the governments should take to work towards the described broad objectives and they are outlined below.

Stop the “race to the bottom” with ever diminishing corporate income tax rates and ever-increasing tax incentives, tax subsidies and tax exemptions. Corporate income tax should be increased towards the Eurozone average. A thorough analysis of the costs and benefits of tax exemptions, incentives and subsidies to corporations needs to be done and published in all countries. Such assessment should be done and published annually. Based on the assessment, a plan needs to be elaborated on how to abandon the incentives that bring more costs to the public budgets than benefits to the economy. The assessment should have a special emphasis not only on the number of jobs created, but also on the quality of those jobs and the protection of workers.

Stop tax dodging at national and international level. At national level countries must adopt all possible measures to stop tax dodging. More details on steps to take are listed below, as they are valid also for the international efforts to stop tax dodging.

The prevailing existing model of flat tax rates should be abandoned and model of a fairer **progressive taxation should be introduced** where it does not exist yet. This applies particularly to the personal income tax and corporate income tax. In most of the countries PIT needs to be made more progressive, especially with the introduction of a top tax brackets (of 40% or more). Corporate income tax should also be made progressive and in line with the Eurozone average. Also a progressive VAT structure should be implemented with higher rates (of 25% or more) on luxury goods and a minimum rate (of 5% or less) for basic products and services. Also, increasing tax rates and making them progressive for real estate is a must in all of the countries.

Companies that engage in tax dodging should not be allowed to take part in publicly financed activities, be it taking part in public procurement processes, in public infrastructure project or in public-private partnerships. National and EU regulations should be amended to ensure that companies, involved in tax dodging, cannot benefit from activities, financed with public money.

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Redirecting taxes from labor to resource use is a must for stimulating more efficient resource use. Most of the countries in the region should assess the potentials for a so-called green tax reform and as far as beneficial start redirecting tax burden from labor to resource use, mainly energy use.

Strengthening capacity of the tax administrations (technical, administrative and institutional) in each of the countries is necessary in order to improve the collection of revenues.

The tax authorities must begin **comprehensive monitoring of the informal economy** and introduce Eurostat/OECD methodology for non-observed economy adjustments to GDP. Regular tax gap assessments should be undertaken and cross-checked with statistical assessments of the size of the informal economy. Policies need to be regularly reviewed according to findings.

Improving parliamentary oversight capacities in properly evaluating budget planning and execution, including the evaluation of fiscal risks, is a crucial step, along with taking further steps towards establishing an independent fiscal body.

Considering commitments of all governments of the 7 analyzed countries to infrastructure projects and impromptu increases on wages, pensions, etc., especially within pre-election period, all countries fiscal policy is associated with ad hoc decision making with significant budget impact. What is crucial is that the fiscal frameworks should primarily aim to **discourage and limit ad hoc tax changes**.

Tax regulations and reporting and remitting **procedures should be simplified** for employers, especially by introducing an e-payments system in line with EU regulations and practice.

An important factor for increasing tax revenues is also **improved tax discipline** in the countries. Improving tax discipline requires increasing tax morality, ie raising awareness of the people about the benefits of paying taxes to the state.

As improving tax discipline is closely linked to **providing high quality public services** funded by the taxes, improving of the public services is a must step for all the countries. Rather than limiting the access to public services or their commercialization, the countries must turn to increasing tax revenues through stopping tax dodging and race to the bottom in order to be able to support quality public service.

Another crucial step on the expenditure side is **reconsidering the system of subsidies**. As already mentioned, the corporate subsidies of dubious benefit should be abandoned. The same path should be taken for harmful subsidies, such as subsidies for polluting industries. Instead, more public funds should be directed into sustainable technologies and green jobs. Transparent, inclusive, carbon neutral and resource efficient technologies and jobs should be established as the only reasonable way of spending tax money.

The previously listed recommendations are mainly important for the national level. However, the global game in tax dodging can only be tackled at an international level. Better cooperation between the countries is necessary to fight tax dodging. Governments and

EU Institutions must allow the public to access the key corporate information necessary to ensure accountability and tax justice. They must also ensure full and effective exchange of information between all the governments. Furthermore, they must support all international decision-making on tax matters being fair and transparent, including the participation of all countries on a truly equal footing, and an intergovernmental decision-making process that allows full access for observers. The WB countries should contribute to the international levels through advocating for ambitious and effective solutions, such as:

- Following a Global Standard on Automatic Information Exchange
- Establishing fully publicly accessible registries of the beneficial owners of companies, trusts and similar legal structures
- Adopting a full country by country reporting for all large multinational corporations
- Supporting Common Consolidated Corporate Tax Base (CCCTB) at the EU level
- Stopping the spread of and removing existing patent boxes and similar harmful structures
- Showing data the flow of investments through special purpose entities
- Publishing basic elements of all advance tax agreements granted to multinational corporations
- Making tax advisors legally liable for promoting and advising on practices that violate the law
- Adopting effective whistleblower protection to protect those who act in the public interest
- When negotiating or renegotiating tax treaties with developing countries, conduct and publish a comprehensive impact assessment, fully respect source country rights to tax the profits generated by business activities in their countries, stop reducing withholding tax rates and ensure full transparency around every step of treaty negotiation
- Establishing an intergovernmental tax body under the auspices of the UN
- Replacing or fundamentally reforming the EU Code of Conduct Group on Business Taxation
- Introducing effective measures against tax evaders from the corporate sector
- Enabling the CSO sector to participate in the monitoring of public finances



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