TAXES, TAXATION AND THE TAX SYSTEM

prof. Ing. Vladimír Mokrý, CSc., University of Economics in Bratislava

The tax system fulfils an important task and role in the generation and subsequent use of state revenues and in the implementation of national economic policy. It follows from this that far from being marginal issues, the tax system and taxes are to a certain extent key. In the context of a national economy functioning on the basis of a market and market mechanism, the validity of this observation is doubled.

State revenues fulfil an irreplaceable role and purpose in ensuring economic development and, in particular, economic growth. To find our way around them, some sort of classification is necessary. State revenues are understood to include:

1. Income which the state earns from its own economic activity, as well as from its sharing in the activities of other corporate entities;

2. The state's public revenues, which the state levies and collects from various entities on the basis of legislation.

3. "Credit income", which the state may acquire if income from the previous sources appears to be insufficient; it consists of loans received from the banking sector. This, however, is another issue – the issue of government debt, both internal and external.

In this article, we will look mainly at public revenues, seeing them as state revenues in the true sense and, for the purposes of the following analysis, dividing them into (a) fees, (b) contributions, and (c) taxes.

Fees are understood to mean payments made in return for requesting certain civic acts (administrative fees), as well as fees for the use of public facilities. Contributions are understood to mean payments for certain state operations which have a society-wide relevance and provide the contribution payers with direct benefits. Finally the third and most important component of state revenues are taxes, both direct and indirect, which altogether constitute the tax system of the national economy.

From this it is clear that fees and contributions are based on specific outputs of public administration, in other words, they are related to a certain economic basis (cause). That is why they are also known as causal contributions. The general rule is that these causal benefits may not be set higher than the state expenditure in relation to the provision of the specific output. Were this relationship not observed, causal benefits would take on a partially fiscal character, and we could then identify them as a mixed tax.

Having regard to taxation principles, i.e. the performance principle, equivalence principle and causality principle (causing a given phenomenon), it may be observed that fees and contributions are based on the equivalence principle and causality principle, while taxes are based on the performance principle of a given entity in regard to the conduct of economic activity. The performance principle relies on the fact that the individual citizen is, in accordance with regulations, taxed according to monetary income, profit, assets, consumption or other economic indicators, without any account taken of the extent to which his activities have made use of public outputs. As a consequence of this, there are redistribution processes. The equivalence principle centres on the fact that the citizen is taxed according to the benefits they accrue from given public outputs, while his own economic performance is not taken into account. Finally, the causality principle is based on the fact that the citizen is taxed according to the costs he causes by virtue of using certain public outputs, for example, the removal of waste material, while his economic performance is not taken into account.

The source from which tax is collected represents the source of the tax system. From this statement it follows that such a source may be:

a) household income from employment;

b) income arising from the corporate activity of individual economic entities;

c) the assets of households and corporate entities in the national economy.

Taxation within these three groups may be direct or indirect.

Direct taxation of income means its direct reduction (the taxing of a part of monetary income). Indirect taxation means the reduction of real income by the taxing of individual consumer operations, as a result of which the household consumer purchases less on the market with the same income.

Direct taxation of profit means its reduction (the taxing of a certain part of profit), while indirect taxation of profit is understood as the taxation of individual (partial) corporate operations from which profit is gradually generated, and therefore represents the taxation of profit in advance.

Direct taxation of assets means their reduction as a whole. This involves the taxation of a certain part of the assets owned by the given entity. Indirect taxation of assets is understood as the taxation of individual acquisitional operations, by which the generation of assets is reduced in advance.

Basic outline of the tax system in a national economy functioning on the market principle and market mechanism

	Taxation of income	Taxation of profit	Taxation of assets
Direct	Reduction of monetary income	Reduction of final profit	Reduction of final assets
Indirect	Reduction of real income	Reduction of profit generation	Reduction of asset generation (acquisition)

In this respect, we shall attempt to identify the basic requirements which a tax system must respect and meet if it is to be considered rational, efficient and relatively permanent, and therefore such that will not have to undergo fundamental changes at frequent intervals. That is not to say that some sort of partial modification cannot come into the reckoning.

A rational tax system must respect the fact that taxes in general have a fiscal but also non-fiscal purpose. As regards their fiscal purpose, taxes are used to cover and fulfil the income side of the state budget. Non-fiscally, they are used as a means of potentially affecting the behaviour of economic entities carrying on activities in the national economy, so that the income structure of households and the asset structure are deliberately changed towards greater fairness.

The specific requirements on the tax system may be interpreted as follows:

1. The tax system should be framed in such a way that the costs incurred by the state in raising taxes are as low as possible. In this respect, it concerns the elaboration of the tax system as a whole, but in particular the costs which the state incurs when creating a new tax system.

2. The tax system should be framed in such a way that costs incurred by taxpayers in the quantifying and subsequent payment of taxes are bearable in both personal and material terms. Each tax needs to be examined for its burden on taxpayers, which should be further broken down into the personal burden and material burden. With income tax, for example, it is necessary to establish how the personal burden affects education, health-care and life in general, given that this tax reduces the scope for consumption. Likewise with the material burden, we need to know whether sharply progressive tax rates resulting from the personal burden will not have a negative effect on the generation of income above the taxable level, whether they will undermine savings and the generation of new capital, whether capital will be "driven" abroad, and other matters.

3. The next requirement may be identified as tax burden relief, meaning that the taxes imposed on taxpayers are appropriate in the sense of not having an adverse effect on their economic activity.

4. The requirement of tax neutrality centres on the fact that the tax system, especially tax adjustments therein, should be designed so as not to disrupt the optimal balance between the national economy's output and the needs (material, cultural and social) of the population; to put it another way, if this balance does not exist or is disrupted, it will have to be established through the tax system and by adjustments to tax rates.

5. The requirement of business-cycle efficiency in the tax system is based on the fact that business cycles or business waves are an organic part of the market and market mechanism. Consequently, the tax system should be designed so that it can operate to a certain extent as a macroeconomic regulator of the business cycle and can react positively to individual phases of the business cycle.

6. The efficiency requirement of the tax system in terms of redistribution processes means that the tax system should be used to ensure that the distribution of income between individual socio-professional sections of the population is implemented with the aim of ensuring greater fairness and the adequacy of their economic performance. When setting tax rates, it is necessary to respect the representation of economically poorer classes within the structure of the population as a whole. In framing the tax system in the context of a pluralist, democratic system, the emphasis is on the principle of an equal tax loss, expressed not as equal amount or an equal percentage, but as equal detriment to culture, health and standard of living in general.

7. The requirement of respect for the privacy of taxpayers involves ensuring that inquiries into the personal relations of individual taxpayers within the process of determining and verifying tax liability are kept to an absolute minimum.

8. The requirement of internal consistency in the tax system, and the internal closure of the tax system, demands that individual taxes relating to various

objectives are harmonized so as to create a harmonized and interconnected whole. In establishing such a tax system, it is necessary to prevent the occurrence of unjustifiable overlaps between individual taxes or the creation of tax loopholes, in the sense that certain matters, operations or processes remain untaxed.

For the last of the requirements of the tax system, it is necessary to ensure that each tax in the system is a "productive tax". A long-term productive tax means a tax which brings a net benefit to the national economy over the long-term. While such a tax need not have a high tax rate, it must have a wide scope, include many taxpayers, and not allow for tax avoidance. As yet, not a single productive tax has been found and the attempts in this direction continue.

When introducing new taxes or when raising existing tax rates, it is particularly important to know how taxpayers will behave or what effects the tax changes will have on the activity of corporate entities. The experience of advanced economies clearly shows that taxpayers strive to use basically legal ways to avert and avoid taxes. This involves taking the following courses: to prevent tax and to defer tax. Tax prevention may come in various forms: material adjustment, time adjustment or spatial adjustment. Tax prevention is an attempt to preserve the original tax liability or to lower the tax burden, while material adjustment represents an attempt to replace the taxable act or fact with a non-taxable one: for example, the introduction of bank deposit taxes in one country will lead to an outflow of deposits to another country. Time adjustment is seen where the corporate entity, as a potential taxpayer, tries to defer the tax burden in time: for example, more advantageous rates of depreciation – in this case, higher rates – will enable it to perform expected investment operations at an earlier date. Spatial adjustment involves a change in the taxpayer's domicile or permanent place of residence with a move to a location offering a more favourable tax rate for the exceptionally rich.

The deferring of taxes, flexibility of taxes and variability of taxes represents a special problem of the tax system in general. Tax is basically a subsidiary reimbursement of public administration. From subsidiarity follows the variability of taxes – the need to raise or lower taxes. In regard to such movements, account should be taken of the loss aspect, which means that it is necessary to reduce those taxes which are the most loss-inducing and to increase those which cause the least loss, from the view, naturally, of the taxpayer's material and personal burden. The tax total may be raised or lowered by putting up or cutting existing taxes, by bringing in new taxes, or scrapping old taxes. Considering the versatility of the tax system, the focus will be on raising or lowering existing taxes. In this regard, it is necessary to realize the effects of tax movements – the fact that just because a certain corporate entity or natural person is required to pay a particular tax does not mean that they also bear this tax in the sense of suffering a tax loss. If, for example, a sugar refinery is required to pay a certain tax on each kilogram of sugar sold, it does not mean that the company will pay this tax out of its corporate profit. It may raise the price of sugar to cover the tax, as a consequence of which this tax will actually be borne by the consumer and will ultimately have an adverse effect on the real income of sugar consumers.

The issue of taxes and taxation is at present formulated as a question of what is optimum in both quantitative (rate of taxation) and qualitative (method of taxation) terms. These two principles – the rate of and method of taxation – cannot be separated from each other and should always be seen in connection.

Taxation rate

As to what the rate of taxation should be, it is never possible to answer this question abstractly. The general thesis of classical economics, and for some time also neoclassical economics, that the minimization of the tax burden is ideal within the market mechanism has not been confirmed in situations where insufficient effective aggregate demand (in the national economy) has led to stagnation or even an economic crisis. On the contrary, such situations have proved the correctness and effectiveness of a national economic policy that is based on state expenditure together with an increase in the taxation rate, since this situation both directly and indirectly (through a multiplier) leads to an extended renewal of aggregate demand and thereby also to economic dynamism, or an increase in economic growth. The use of highly progressive tax scales has, in order to stimulate effective aggregate supply, supported the mobilization of that part of higher-income household groups which had seen both their disposable income grow and a clear decline in their propensity to consume – especially in regard to private consumption, representing as it does a substantial component of the household living standard.

A fundamentally different situation came about in a majority of advanced social market economies towards the end of the 1960s. While a policy of stimulating economic growth through higher state expenditure had stimulated aggregate demand, it also resulted in marginal tax rates reaching such a level that economic entities had no motivation to engage in additional business. Indeed, the marginal rate of capital efficiency fell substantially, which in turn caused a decline in economic growth. Exceptionally progressive tax scales did not support an increase in tax revenues but rather contributed to a tax avoidance on a mass-scale, which along with other factors led to a chronic deficit in the state budget and a subsequent upsurge of inflationary trends in the economy.

In this regard it is necessary to mention the Laffer curve, which examines the relationship between tax rates and tax revenue. The American economist A. S. Laffer showed that as tax rates rise, tax revenue will increase up to a maximum level that is the optimal tax rate. Should tax rates continue to rise, there will be a clear decline in tax revenue. The result or final outcome will be a decline in the economic activity of corporate entities and steadily diminishing tax revenues. It should be noted that not only does tax revenue fall, but also social contributions have a detrimental effect on the performance of economic entities.

The Laffer theory has its own genesis. What is today popularized as the Laffer curve goes back to Jonathan Swift, who in 1728 analysed a similar relationship using the Swift multiplication table: this says that two times two need not, in the field of taxes and tariffs, equal four, but may be less. Even the German economist Wilhelm Gerloff, in his 1948 book "Financial Management", shows that as far back as 1672, the economist Puffendorf addressed a similar relationship and noted that the state collects low tax revenue where it imposes low taxes but will not necessary acquire more tax revenue with high taxes.

But the fact remains that Laffer's 1979 monograph "The Economics of the Tax Revolt" actually set into motion tax reform in many countries.

Selection of the taxation method

Tax systems in most of the advanced social market economies are at present a combination of taxation on goods and services – typically described as indirect taxes or consumer-type taxes – and the taxation of institutions and entities, in other words the taxation of natural and legal persons. It should certainly be noted that each method of taxation has its benefits and drawbacks since each is more-or-less able to meet a certain set of the various requirements that different social groups place on taxation. It is therefore natural that whenever a modification to the tax system is planned there is an re-emergence of the old disputes over the method of taxation. For the past ten years, these discussions have come to centre on the shift of taxation towards goods and services and away from the income of legal and natural persons. This preference has been reflected in a considerable expansion of value-added tax at various stages in the processing of certain products. There are various merits in this, including the fact that:

- allocational neutrality under a flat rate means that the effect on goods and services is identical and does not bring about a substitution reaction from economic entities through the allocation of production factors. It should also be stated, however, that this relative benefit is being eroded by the rising number of tax rates, while the probability of unanticipated substitution processes, reactions and effects is rising substantially;
- this method of taxation all but prevents tax avoidance, and any attempts at avoidance in one phase of processing are typically revealed within settlement during the next phase; the result is to ensure the stability of tax revenue on the income side of the state budget.

If this tax method has its benefits, then there are also issues to which it reacts indifferently. For example, the principle of equality that is a characteristic of taxation of goods and services is applied towards persons of unequal economic and social standing. This difference in the standing of persons in society concerns the fact that some are rich, some are poor, some are earning more, others less, some are single, others are married with children. In this regard, we may mention consumption tax on food and food products en bloc, which has an equal effect on households as consumption units. Whereas in some households, foodstuffs account for a substantial share of overall consumer spending, in others the share is considerably less significant. This information may be ascertained in practice without any difficulty, and a development trend may even be inferred from statistical data, the indication being that consumer spending on food is rising alongside growth in disposable income but its share of total consumer spending is regularly falling. This means that the higher the disposable income, the lower the expenditure on food as a percentage of total consumer spending.

Apart from that, there is another problem here. Consumer foodstuffs encompass a range of quality, and therefore their taxation needs to address the problem in the classification of consumer goods. For example, consumer goods may be basic necessities, necessities of a less basic nature, or luxuries. They may be further defined as independent, substitutional, complementary, and consumer goods with various levels of saturation, or with different periods of consumption (short-term, long-term). And this does not mention all the approaches to the classification of consumer goods. This is a fact ignored by flat taxation. Although it is true that the flat taxation of goods and services creates the maximum scope for the application of market forces in the behaviour of corporate entities, it does not allow for taxes to be used in the regulatory activity of the government, which both frames the national economic policy and implements it. In fact, the taxes which fulfil this regulatory function are income taxes, whether for natural persons or legal persons.

It naturally follows from this that the social market economy, whether an advanced social market economy or an economy in the midst of transformation, would appear to be best served by a tax system based on a rational and effective combination of, on the one hand, taxation of goods and services and, on the other hand, taxation of persons and institutions (enterprises), with VAT representing a relatively significant share of the tax on goods on services.

From both the theoretical and practical view, it should be acknowledged that the tax system has national-economic, fiscal and social dimensions. As regards the national-economic dimension, it is necessary to understand the effect that a change or reform of the tax system has on macroeconomic and microeconomic processes and on the behaviour of economic entities – meaning on enterprises, households and the state, since it is the behaviour of these entities that results in and to a certain extent determines economic development and, above all, appropriate and permanent economic growth. The fiscal side of the tax system should be seen mainly for its connection to the income side of the state budget. The social dimension is to be understood in terms of the living standards of the population and social development. All three dimensions constitute a single organic whole and are interconnected. To ignore or neglect any one of these dimensions when adjusting the tax system means in effect to ignore or neglect all three.

Changes to any of the tax system's parameters should be made in the knowledge of what the direct and indirect effects of these changes will be. If, for example, the tax burden on legal and natural persons is reduced, this change will be reflected positively in aggregate supply growth. If indirect taxes are put up, consumer prices will rise as a result and the final outcome could be a downturn in aggregate demand. It is clear from this that a reduction in the direct tax burden will increase the capital and wage income of households, which will in turn increase nominal purchasing power; on the other hand, a rise in indirect taxes will reduce the real income of households as consumer units, which will then be reflected in lower living standards.

Differential processes should also be considered in this regard. A blanket increase in indirect taxes does not affect the population as a whole, but rather it applies to a varying extent and intensity since there are households with high- middle- and low-incomes. It is the low-income households which are most affected by a blanket increase in taxes and whose living standard declines. When reforming the tax system, we usually expect certain positive effects, but, considering that every economic reform carries a certain risk, there is no need to be absolutist. Efforts must be made to realize what the risks are, to become familiar with them and to have at hand an effective range of economic instruments for minimizing them. There is a simple reason why the implementation of any economic reforms should reckon on risks. Economic processes always were, are, and will be stochastic and not deterministic. This means that economic processes and phenomena are affected by factors which we know about and are able to quantify, but also by random factors which we do not know about. These appear (emerge) haphazardly and suddenly, and may substantially modify the original exact plans. Such random factors and their effects bring about the stochastic character. There is a great difference between technical processes, which are deterministic, and economic processes that are stochastic owing to the effect of random factors. Setting tolerance thresholds within which the development of economic processes and phenomena may fluctuate is an issue that stochasticsm only partially address.

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