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Tax Policy and Income Inequality in the Visegrad Countries

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Abstract

The financialisation of economies is believed to be the primary cause of the increase in income inequality in the world, occurring on a scale unseen for more than 30 years. One can hypothesise that it is the state that is responsible for the widening inequality, as the state has not sufficiently used the redistributive function of taxation. The purpose of this paper is to study the impact of tax policy on income inequality in Poland, the Czech Republic, Slovakia and Hungary. These so-called Visegrad countries have, in the last several years, carried out some controversial experiments with tax policy, specifically in terms of the flattening of tax progressivity or its replacement with a flat tax, which led to the weakening of the income adjustment mechanism. The imbalance between income tax and consumption tax has contributed to perpetuating income inequality. The verification of tax systems carried out during the recent financial crisis has forced the countries included in this research to implement tax reforms. The introduced changes caused various fiscal and redistributive effects. Analyses show that the changes in income taxation and an increase in the consumption tax rate had the most negative impact on the income and asset situation in Hungary.

Keywords: tax, tax policy, income inequality, Gini coefficient

1 Introduction

The issue of income inequality is holistic in nature. It can be seen in the context of social justice, equality or dignity. Galbraith's (1999) *The Good Society: The Humane Agenda* understands the title "good society" as achievable conditions in which all its citizens must be afforded personal freedom and be provided with basic material existence requirements, racial and ethnic equality and a chance for a dignified life. According to Galbraith (1999, p. 13), "nothing more effectively limits freedom as the total lack of money, or restricts this freedom as the scarcity of money." By no means is the author an advocate of equality of income distribution, as it is incompatible with human nature and the motivation of the modern economic system. However, he claims that "the modern market economy allocates wealth and divides income unequally using socially perverse and functionally harmful methods" (p. 55).

In recent years, the phenomenon of social stratification has intensified throughout the world. The OECD report shows that the disparity between rich and poor reached the highest level in 30 years (OECD, 2011). The financialisation of economies and bad tax policies are considered to be the reasons for this phenomenon. In the United States, which has the greatest income inequality among developed countries, the Congressional Budget Office (CBO, 2011) found that the main

cause of widening income inequality was the increase in the concentration of income before taxes and social transfers; but it also indicated that it was the tax policy that has led to a deepening of these inequalities by favouring wealthy taxpayers. In the EU, the phenomenon of social stratification affects mostly post-communist countries and those countries that follow the Anglo-Saxon model (i.e., Spain, Portugal, Great Britain and Greece).

Bridging the gap between rich and poor requires an effective mechanism for income adjustment. Taxes, especially progressive income tax, as well as social transfers can serve this purpose. Weakening the redistributive function of tax, a tendency seen in the Visegrad countries, motivated us to write this paper. The purpose of this paper is to study the impact of tax policy on income inequality in Poland, the Czech Republic, Slovakia and Hungary. The analysis of this phenomenon considers data back to 2003, as an attempt was made to capture all relationships before the studied countries had entered the EU and to track changes which occurred due to the membership. In the research on verification, an argument was made that the tax policies of the Visegrad countries involved the weakening of the redistributive function of tax, resulting in the intensification of income inequalities in society.

2 Redistributive Function of Taxation

Tax is usually first considered in the fiscal context. This approach is justified, because in the modern market economy tax revenues are the primary source for meeting the financial needs of the state. This paper focuses on the economic importance of tax, which stems from the fact that taxation leads to a change in the income and asset situation of taxpayers which affects their behaviour, business decisions, consumption decisions, saving decisions, etc. (Owsiak, 2005). Hence, fiscal policy goes far beyond collecting taxes; it affects social and economic spheres. Income inequality in a society is a phenomenon determined by fiscal policy. The state has the means (e.g., fiscal instruments) to intervene in order to reduce excessive disparities in income. One should note, however, that views on state intervention expressed in literature are divided. For example, the liberal doctrine considers income inequality as a factor conducive to economic growth. For this reason, Smith (1776, as cited by Blaug, 1994) was opposed to the introduction of laws governing the privilege of the poor, seeing them as a restriction of competition and labour mobility. The relationship between privileges of the poor and economic growth has not been proven, yet the experience of many countries shows that excessive income inequality causes social conflicts and political turmoil.

According to Galbraith (1999), progressive income tax plays a crucial role in the implementation of reasonable and civilised distribution of income. The empirical verification of the relationship between income redistribution and income inequality has been carried out for many countries, including Japan (Kitamura & Miyazaki, 2014), Norway (Thoresen, 2004), Finland (Riihelä, Sullström, & Suoniemi, 2008), Romania (Voinea & Mihaescu, 2009), and the EU15 (Verbist & Figari, 2014). One should also take into account the experience of Japan, where between 1985 and 2000, the Gini coefficient¹ rose by 13% while the OECD average was 7%. Two reasons for this phenomenon have been identified: an increased proportion of low-paid non-regular workers and a decrease in income tax progressivity. The number of tax rates was reduced from 15 in 1986 to 4 in 1999, and the highest rate was reduced from 70% to 37% (OECD, 2008). Within the framework of the next reform of the tax system, the highest income tax rate was increased to 50% (Hein, 2010). In 2009,² the Gini coefficient (before tax) stood at 0.488; after taking into account taxes and transfers, it decreased to 0.336.

Theoretical and empirical studies support the conclusion that income tax based on progressivity is an essential instrument of income redistribution function (OECD, 2012; Verbist & Figari, 2014). Meanwhile, the evolution of tax systems in the Visegrad countries has led to a significant flattening of tax progressivity (Poland) or its replacement by a flat tax (Czech Republic, Slovakia, Hungary) and an increase in the indirect tax burden. The lack of resilience of public finances and economy to the shock caused by the financial crisis forced recent tax reforms, which resulted in a move away from flat tax. In the Czech Republic, although a flat tax is officially maintained, as of 2013 a solidarity surcharge of 7% was introduced for income in excess of four times the average annual salary, which has the hallmarks of a progressive tax. Meanwhile, Slovakia abandoned the flat tax, returning to progressivity in 2013 with two tax rates of 19% and 25%.

3 Phenomenon of Social Stratification in the Countries Studied

In order to identify income inequality, the following indicators were used: the quintile share ratio (S80/S20), the Gini coefficient, the at-risk of poverty and social exclusion rates

¹ Gini coefficient, the indicator of income concentration, has a value between 0 and 1 (or if it is multiplied by 100, between 0 and 100). This indicator would reach a value of zero (uniform distribution) if all people had the same income and a value of 1 if all people except one had zero income.

² Last year of available data (OECD, 2015).

(RP-SE) and the material deprivation rate (MDR). Based on the data collected (see Table 1), it can be concluded that during the period considered the highest level of income inequality was seen in Hungary. Despite the fact that the Gini coefficient (before social transfers, excluding pensions) decreased by 1.7 percentage points (pp) between 2005 and 2013, it is close to 35%. The sharpest decrease in inequality took place in Poland (by 7.2 pp), but still the Gini coefficient is only 0.9 pp lower than in Hungary. In Slovakia it is approximately 28%; in the Czech Republic, where income disparity is also consistently getting smaller, it is approximately 29%. The opposite was true in Hungary, where between 2010 and 2013 the Gini coefficient increased by 1.9 pp. In this country we can see a strong correlation between changes in the distribution of income of the population and the introduction of a 16% flat tax in 2011.

The research based on income quintile share ratio (S80/S20)³ shows that in Hungary in 2010 the sum of income received by the 20% of people with the highest income was 3.4 times higher than the sum of the income received by the 20% of the population with the lowest income. Moreover, in 2013, it was already 4.2 times higher. This ratio is also unfavourable for Poland, because the sum of the income of the highest quintile is nearly five times the sum of the income of the lowest quintile. In the Czech Republic and Slovakia, the income quintile share ratio is approximately 3.5. Levels of income disparities in the Czech Republic and Slovakia are among the lowest in the EU and are similar to those in countries that follow the Nordic model (e.g., Sweden, Finland, the Netherlands). Looking at the data from 2013, one can see a move away from the flat tax in Slovakia and the Czech Republic, combined with a decrease in the Gini coefficient and the level of social stratification. In addition, in an earlier period, abandonment of the progressive tax system coincided with an increase in the level of income inequality in Slovakia and Hungary (Table 1). This relationship did not occur in the Czech Republic due to the consideration of the “super gross” salary, defined as gross salary plus social security contributions and health insurance paid by the employer, as the tax base.

Another measure that will allow identification of the living conditions of the studied societies is the at-risk-of-poverty and social exclusion rate, which is defined as the share of people with an equivalised disposable income (after social transfers) below the at-risk-of-poverty threshold, which is set at 60% of the national median equivalised annual disposable income. The data collected in Table 1 indicate that Poland, the Czech Republic and Slovakia, to a greater extent

than Hungary, are coping with poverty reduction. From 2005 to 2013, the biggest changes took place in Poland and Slovakia, where the at-risk-of-poverty and social exclusion rates decreased by more than 19 pp. It should be mentioned that the problem of poverty in the Czech Republic was much smaller to be with in the initial year (i.e., 2005).

The equivalent income of 19.6% of the population was below the poverty line. In 2013, Slovakia got close to this level, but Poland and Hungary are still way above it. Despite the fact that the scope of poverty in Poland has decreased in recent years, as the above indicator shows, approximately 25% of the population still remains below the poverty line. The situation is even worse in Hungary, where the problem of poverty or social exclusion has intensified since 2009; in 2013, it already concerned every third person. In this context, a survey conducted by Eurostat (2014) regarding material deprivation, understood as the inability to afford several of the nine items considered in European conditions to be basic (CSO, 2011), due to the low income, is particularly interesting. The assessment of material deprivation varies depending on the adopted limit. If we define the deprivation rate as the proportion of people who cannot afford at least three items due to financial reasons, then Hungary's situation is significantly different than that in the other Visegrad countries. The rate, which in 2013 stood at 44.1%, was 28.2 pp higher than in the Czech Republic. Unlike the other countries, Hungary has not been successful in improving living conditions. Indeed, since 2011, the situation has further deteriorated.

4 Assessment of Tax Policy According to Actual or Effective Tax Rate

The variability and complexity of tax systems impede a comparative analysis of countries as well as an analysis of one country in a time period. Hence, the research method used in the remainder of this paper is based on the starting point for identifying the impact of tax policy on income inequality. The method relies on an analysis of the implicit tax rates on consumption and labour as well as changes in the development of the effective tax rate in the Visegrad countries. This approach will enable us to compare the countries and draw conclusions.

The implicit tax rate (ITR) is a measure of the actual or effective tax burden imposed directly or indirectly on different tax bases (Eurostat, 2014). ITR on consumption is defined as all consumption taxes divided by the final consumption expenditure of private households on the economic territory (domestic concept). ITR on labour is the sum of all direct and indirect taxes and employees' and employers' social

³ S80/S20: ratio of total income received by the 20% of the people with the highest income (top quintile) to total income received by the 20% of the people with the lowest income (lowest quintile).

Table 1 Income Inequality and Poverty Indicators in the Visegrad Countries against Income Tax Rates

Item	2005	2006	2007	2008	2009	2010	2011	2012	2013	Difference 2013 - 2005
Czech Republic										
Income tax rates	15,20,25,32	12,19,25,32	12,19,25,32	15	15	15	15	15	15 (22) ^{a)}	
Gini coefficient	32.5	31.7	31.3	30.5	30.0	29.8	29.6	29.1	28.8	-3.7
S80/S20	3.7	3.5	3.5	3.4	3.5	3.5	3.5	3.5	3.4	-0.3
RP-SE	19.6	18.0	15.8	15.3	14.0	14.4	15.3	15.4	14.6	-5.0
MDR	22.7	19.7	16.4	16.2	15.6	15.1	16.1	16.8	15.9	-6.8
Hungary										
Income tax rates	18, 38	18, 36	18, 36	18, 36	18, 36	17, 32	16	16	16	
Gini coefficient	36.5	41.2	34.4	34.7	33.5	32.9	35.5	34.4	34.8	-1.7
S80/S20	4.0	5.5	3.7	3.6	3.5	3.4	3.9	4.0	4.2	0.2
RP-SE	32.1	31.4	29.4	28.2	29.6	29.9	31.0	32.4	33.5	1.4
MDR	39.7	37.4	38.6	37.1	40.3	39.9	42.2	44	44.1	4.4
Poland										
Income tax rates	19, 30, 40	19, 30, 40	19, 30, 40	19, 30, 40	18, 32	18, 32	18, 32	18, 32	18, 32	
Gini coefficient	41.1	38.7	37.3	36.3	35.1	34.7	34.5	34.2	33.9	-7.2
S80/S20	6.6	5.6	5.3	5.1	5.0	5.0	5.0	4.9	4.9	-1.7
RP-SE	45.3	39.5	34.4	30.5	27.8	27.8	27.2	26.7	25.8	-19.5
MDR	50.8	44	38.2	32.3	29.5	28.4	26.4	27.8	25.5	-25.3
Slovakia										
Income tax rates	19	19	19	19	19	19	19	19	19, 25	
Gini coefficient	31.7	32.3	28.2	27.3	28.3	30.0	29.9	29.1	28.3	-3.4
S80/S20	3.9	4.1	3.5	3.4	3.6	3.8	3.8	3.7	3.6	-0.3
RP-SE	32.0	26.7	21.3	20.6	19.6	20.6	20.6	20.5	19.8	-12.2
MDR	42.6	35.7	30.2	27.8	24.5	24.9	22.0	22.7	23.4	-19.2

^a From 2012, a 7% solidarity surcharge applies. Indications in the text.

Source: Eurostat (2015).

Table 2 Implicit Tax Rates on Consumption on Labour in the Visegrad Countries, 2003–2012

Implicit tax rate	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Difference 2012 - 2003
Consumption											
Czech Republic	18.8	20.8	21.1	20.3	21.3	20.5	20.7	20.9	21.8	22.5	3.7
Poland	18.3	18.5	19.8	20.6	21.6	21.4	19.3	20.5	20.8	19.3	1.0
Slovakia	20.3	20.8	21.5	19.5	19.9	18.3	17.0	17.4	18.3	16.7	-3.6
Hungary	25.6	27.0	26.1	25.4	26.3	26.0	27.2	27.4	26.8	28.1	2.5
EU 27	19.7	19.8	19.7	19.8	20.0	19.6	19.1	19.7	19.9	19.9	0.2
Labour											
Czech Republic	41.7	41.5	41.3	41.1	41.7	39.9	37.6	38.4	39.0	38.8	-2.9
Poland	32.7	32.3	33.8	35.4	34.0	31.7	30.8	30.3	32.0	33.9	1.2
Slovakia	36.1	34.5	32.9	30.5	31.1	32.7	31.4	32.2	31.6	32.3	-3.8
Hungary	39.3	38.3	38.4	38.9	41.0	42.3	40.2	38.4	38.2	39.8	0.5
EU 27	35.6	35.4	35.4	35.6	35.8	36.0	35.4	35.4	35.8	36.1	0.5

Source: Eurostat (2014, pp. 255–257).

contributions levied on employed labour income divided by the total compensation of employees working in the economic territory. The estimates in Table 2 indicate an upward trend in the consumption tax in the Czech Republic, Poland and Hungary. Only in Slovakia did the tax rate in the studied period decrease by 3.6 pp. Since 2006, this rate was the lowest compared to the other countries.

During the studied period, the highest implicit tax rate on consumption was recorded in Hungary which, from 2007, also showed an upward trend. In 2012, the ratio of consumption taxes to the final consumption expenditure of households in Hungary (28.1%) was 11.4 pp higher than the same ratio calculated for Slovakia (16.7%). Since 2004, Slovakia has been the only Visegrad country with an implicit tax rate on consumption which fell below the EU average.

A relationship between recent changes in the consumption tax and poverty is also evident. In Hungary, where taxes on consumption increased, the material deprivation rate and the at-risk-of-poverty and social exclusion rate have also increased. It is worth mentioning that VAT in this country was characterised by high volatility. In 2003–2005, a 25% rate applied. In the subsequent two years, 2006–2007, the rate was reduced to 20%. From 2010 onwards, it returned to 25%. Since 2012, a 27% VAT rate has applied in Hungary, the highest not only in comparison with other Visegrad countries, but also in comparison with other EU countries. The change of rates was accompanied by changes in the catalogue of goods and services taxed at a specific rate. Moreover, in 2011 and subsequent years, other taxes on goods and services were introduced in Hungary, including a public health product tax, telecommunications tax, culture tax, tax on the above-ground and underground network components, tax on car accidents and tax on insurance (Moździerz, 2015). A different situation can be seen in Slovakia, where the decreasing rate of taxation on consumption was accompanied by improvement in the living conditions of the population.

Between 2003 and 2012, the implicit tax rate on labour decreased in Slovakia and the Czech Republic, but increased in Poland and Hungary. Since 2004, the ITR on labour in Poland and Slovakia has been below the EU27 average (36.1%). In 2012, the tax on labour in the Czech Republic and Hungary was higher than the EU27 average at 38.8% and 39.8%, respectively.

The weakening of the income adjustment mechanism can also be seen in the analysis of the upper marginal tax rates (UMTR), adjusted for the impact of tax credits. The 2003–2012 tax policy resulted in a decrease in UMTR: from 28% to 20.1% in the Czech Republic, from 31.46% to 20.93% in Poland, from 38% to 16.45% in Slovakia and from 55.87% to 20.32% in Hungary (OECD, 2015).

Limiting the role of the state in using fiscal instruments leads to excessive income inequalities in society, which in turn contributes to deepening poverty. This situation leads to an increase in social spending—one of the causes of budget deficits and the expansion of the public debt. The hypothesis of the beneficial effects of a reduction in income taxes on the economy and society is difficult to prove. The presented analysis shows that the opposite is true. The largest increase in public transfers occurred in Slovakia and the Czech Republic. In 2003 in Slovakia, the share of social expenditure in GDP was 15.3%, whereas in 2009–2012 it was approximately 19%. In the Czech Republic, the change was smaller: from 18.5% in 2003 to 19.9% in 2012. In 2012, cash benefits amounted to 16.4% of the GDP in Poland and 17.8% of the GDP in Hungary (Eurostat, 2015).

5 Conclusions

The analyses conducted in this article confirmed the thesis put forward in the introduction. The tax policy implemented in the Visegrad countries in the last decade was flawed for at least two reasons. First, the problem of income inequality has intensified. Second, it resulted in a decrease in tax revenues during a period of increased social spending. In 2003, cash benefits (excluding benefits in kind) were lower than the total tax revenue in all studied countries. The relationship between these categories was as follows: 93.6% in the Czech Republic, 95.8% in Poland, 80.1% in Slovakia and 65.8% in Hungary. In 2012, cash benefits were covered by tax revenues in Hungary (69.2%) and Poland (81.7%). As for the other two countries, the changes were so detrimental that social spending outweighed the tax revenues by 4.2% in the Czech Republic and by 20.7% in Slovakia, which experimented with the flat tax for the longest period.

Income inequality is strengthened by the imbalance between income tax and consumption tax, as seen in the countries of the studied group. One can believe that the return to tax progressivity in Slovakia and the introduction of solidarity surcharge in the Czech Republic were not only ways to increase the fiscal efficiency of tax, but were also caused by the acknowledged redistributive function of tax. Hungary changed its tax system the most in response to the crisis, introducing several new taxes and fees and significantly reforming the existing ones. Radical and controversial tax changes allowed Hungary to keep its public finances in check, which in 2013 resulted in the Council of the European Union lifting the excessive deficit procedure against the country.⁴ This unfor-

⁴ Council decision of 21 June 2013 abrogating Decision 2004/918/EC on the existence of an excessive deficit in Hungary (2013/315/EU), Official Journal of the European Union, L 173/43.

tunately has been done at the expense of an increased risk of poverty and social exclusion of the Hungarian society.

Multidirectional changes in the tax systems of the Visegrad countries attest to the fact that tax policies were and are conducted by trial and error, which results in positive and negative social and economic consequences. The limited availability of certain data on

income disparities and the implicit tax rates at the time of writing this article did not allow me to conduct long-term analyses. For this reason, this article is an attempt to capture the relationship between tax reforms and income inequalities in a selected group of countries. The monitoring of the social and economic spheres' reaction to the changes in tax policy will remain a research challenge in the coming years.

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Davčna politika in dohodkovna neenakost v državah Višegrajske skupine

Izvleček

Financijalizacija gospodarstev naj bi bila poglavitni vzrok za povečanje dohodkovne neenakosti v svetu. Predpostavljamo lahko, da je za širitev neenakosti odgovorna država, ki ni zadostno uporabljala redistributivne funkcije davkov in obdavčitve. Namen tega prispevka je proučiti vpliv davčne politike na dohodkovno neenakost na Poljskem, Češkem, Slovaškem in Madžarskem. Te države, države tako imenovane Višegrajske skupine, so na področju davčne politike izvedle nekaj kontroverznih poskusov. To se nanaša predvsem na izravnavanje davčne progresivnosti ali nadomeščanje te z linearnim obdavčenjem, kar je vodilo do slabitve mehanizma dohodkovnega prilagajanja. Neuravnoteženost davka na dohodek in davka na potrošnjo je prispevala k ohranjanju dohodkovne neenakosti. Verifikacija davčnih sistemov, izvedena med zadnjo finančno krizo, je prisilila proučevane države k uvedbi davčnih reform. Predstavljene spremembe imajo različne fiskalne in prerazdelitvene učinke. Analize kažejo, da imajo spremembe v davkih na dohodek in dvig stopnje davka na potrošnjo najbolj negativne vplive na dohodkovni in premoženjski položaj na Madžarskem.

Ključne besede: davek, davčna politika, dohodkovna neenakost, Ginijev koeficient