

ANNEX 4. Progressiveness of labour income taxation in OECD countries

When discussing the revision of taxes and social security contributions, it may be relevant to look at the practices and insights of various countries described in the available economics literature. Labour income tax progressivity is the object of discussion that has garnered a lot of attention. Aiming to have a better understanding of the personal income tax (PIT) progressivity trends that prevail in developed countries, an analysis of an effective PIT rate progressivity level and its development in OECD states is delivered in this annex. Effective PIT rate progressivity is calculated using the methodology presented in OECD publications.¹⁶ It assesses effective PIT progressivity when household labour income changes between 67% and 167% of AW. In this annex, a 'household' refers to a single person without children.

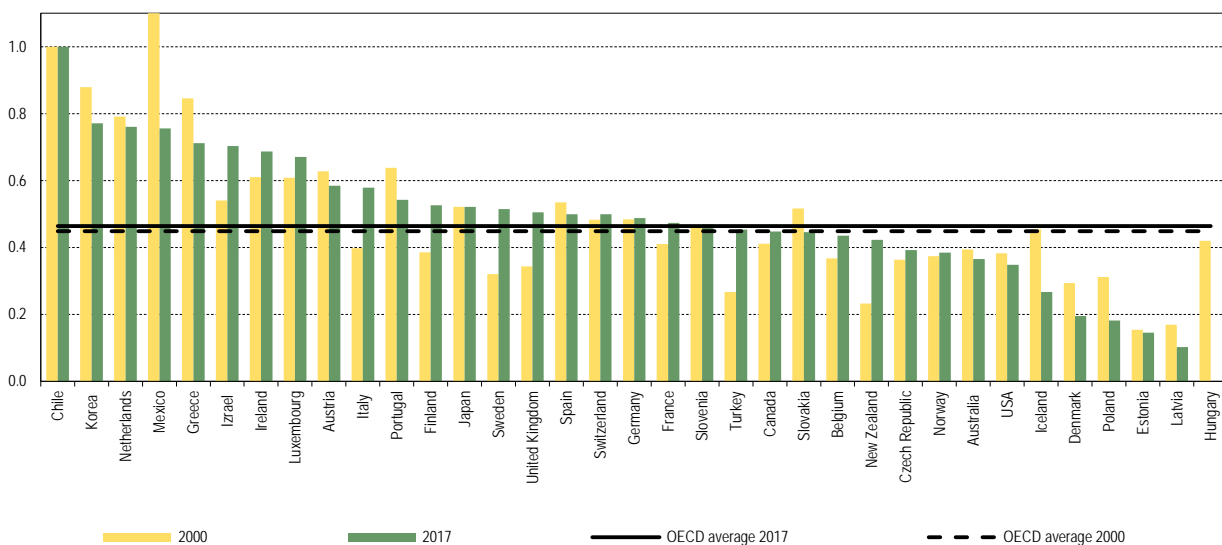
1. PIT progressivity in economic theory

Economics literature says that simplicity and fairness are one of the most important goals of a good tax system. Simplicity is ensured by aiming to develop a tax system that is clear and understandable both to its participants and developers, imposing as low as possible an administrative system and tax compliance costs. To ensure fairness, PIT must follow two principles: horizontal and vertical equity. The principle of horizontal equity states that anyone who has equal socio-economic status should be taxed equally as they have equal capacity to be able to pay that tax. In other words, persons with equal income should be taxed by applying the same tax rate, independently of the form in which their income is received. The principle of vertical equity states that tax payers who are enjoying a better economic situation should bear a higher tax burden, i.e. that they should pay a larger share of the income towards tax. In other words, personal inequality after tax must be less than it is before taxes are applied, while the effective income tax rate must be relevant for the level of income being received by tax payers. The principle of vertical equity can be implemented in several ways: through tax allowances or tax credits, or via a progressive income tax rate, or both. Taxpayers' satisfaction with the use of taxes that are collected by the state, their trust in the justifiable nature of the tax system, and the knowledge that other market participants are complying with the tax system as well are also very important for a properly functioning tax system.

2. PIT progressivity and its development in OECD states

Over the past two decades, PIT progressivity extensively varied, however, a single common trend was not noted in OECD states. In 15 OECD states PIT progressivity increased, in 16 it decreased, while in the rest it remained unchanged (see Chart A). The analysis of aggregated data from all OECD states shows that taxation differences between persons earning 167% of AW and those earning 67% of AW changed very little. The difference between effective PIT rates, which were applied to persons who were earning 167% of AW and those earning 67% of AW makes almost a half of the effective PIT rate applied to persons who are earning 167% of AW, i.e. in 2017 this indicator was at 0.46 (while in 2000 it was at 0.45).

Chart A. Effective PIT rate progressivity for household labour income in 2000 and 2017



Sources: OECD and Bank of Lithuania calculations.

Note: Higher number translates into higher progressivity. Progressivity is calculated using a formula $(T_{167}-T_{67})/T_{167}$, where T_{167} refers to effective PIT rate for a person earning 167% of AW, while T_{67} is the effective PIT rate for a person earning 67% of AW.

Nevertheless, PIT progressivity varies greatly within OECD states. In 2017, the highest PIT progressivity was recorded in Chile, Korea, the Netherlands and Mexico, while the lowest was in Latvia, Estonia, Poland, and Denmark. Hunga-

¹⁶ Progressivity is calculated using a formula $(T_{167}-T_{67})/T_{167}$, where T_{167} refers to effective PIT rate for a person earning 167% of AW, while T_{67} is the effective PIT rate for a person earning 67% of AW.

ry was the only OECD state in which a progressive effective PIT rate was not applied in 2017 to households which consisted of a single person without children. Between 2011 and 2013, this state implemented a PIT reform and replaced a previously applied progressive PIT rate with a flat tax rate (Eurostat 2014). The reform also saw the withdrawal of all PIT-related tax reductions, leaving the only exception for households with children.

Table A. Labour income tax indicators for OECD states in 2017

Country	The effective PIT rate applied by the entire governmental sector, %	Central government			Other governmental sub-sectors		
		Number of PIT rates	Lowest nominal PIT rate, %	Highest nominal PIT rate, %	Personal income tax	Lowest nominal PIT rate, %	Highest nominal PIT rate, %
Ireland	15.38	2	20.00	40.00	none		
Australia	24.38	5	0.00	45.00	none		
Austria	14.44	7	0.00	55.00	none		
Belgium	26.55	5	25.00	50.00	progressive	25.00	50.00
Czech Republic	13.11	1	15.00	15.00	none		
Chile	0.00	8	0.00	40.00	none		
Denmark	36.06	2	10.08	25.08	proportional	22.50	27.80
Estonia	16.77	1	20.00	20.00	none		
Greece	9.97	4	22.00	45.00	none		
Iceland	28.33	2	22.50	31.80	flat	12.44	14.52
Spain	15.06	5	9.50	22.50	progressive	9.50	21.00
Italy	21.99	5	23.00	43.00	flat	1.23	3.83
Israel	9.72	7	10.00	50.00	none		
Japan	7.91	7	5.00	45.00	flat	10.00	10.00
United States	18.49	7	10.00	39.60	flat	2.40	4.25
United Kingdom	13.98	3	20.00	45.00	none		
Canada	16.63	5	15.00	33.00	progressive	5.10	13.20
Latvia	18.91	1	23.00	23.00	none		
Poland	7.24	2	18.00	32.00	none		
Luxembourg	16.74	23	0.00	42.00	none		
Mexico	9.84	11	1.92	35.00	none		
New Zealand	18.13	4	10.50	33.00	none		
Norway	19.42	5	9.55	24.07	flat	0.00	14.45
The Netherlands	17.28	4	8.90	52.00	none		
South Korea	6.12	6	6.00	40.00	flat	5.00	15.00
Portugal	16.48	5	14.50	48.00	none		
France	14.84	5	0.00	45.00	none		
Slovak	10.13	2	19.00	25.00	none		
Slovenia	11.65	5	16.00	50.00	none		
Finland	20.99	5	0.00	31.50	flat	17.00	22.50
Sweden	17.99	3	0.00	25.00	flat	29.19	35.15
Switzerland	10.71	11	0.00	11.50	progressive	0.00	13.00
Turkey	12.92	4	15.00	35.00	none		
Hungary	15.00	1	15.00	15.00	none		
Germany	19.11	Formula	0.00	45.00	none		

Sources: OECD and Bank of Lithuania calculations.

Note: indicators for households which consist of one single person earning AW.

3. Nominal PIT rates

As mentioned, the principal of vertical equity can be implemented in several ways. But not all of them are equally popular (see Table A). **When taking into account tax rates applied by central governments alone, progressive PIT rates are applied extensively enough in OECD states; they are applied in 31 OECD states out of 35.** Only four OECD states – Czech Republic, Estonia, Latvia¹⁷ and Hungary – apply a flat PIT rate (one rate) as regards to labour income. Lithuania

¹⁷ In Latvia, a flat PIT rate was applied until the end of 2017. In 2018, they adopted a progressive PIT system which involved three rate bands.

also applies a flat PIT rate. Estonia and Latvia adopted flat PIT rates after the restoration of their independence, while Czech Republic and Hungary adopted them following tax reforms in 2008 and 2011 respectively. Previously, both states had used flat PIT rates. In the Czech Republic and Hungary, tax reforms were aimed at transferring the tax burden from personal income to consumption, adverse factors (those which were related to environmental or health impacts), or property taxes. The reforms were aimed at promoting efficiency and increasing employment rates (IMF 2008; Ministry for National Economy 2012).

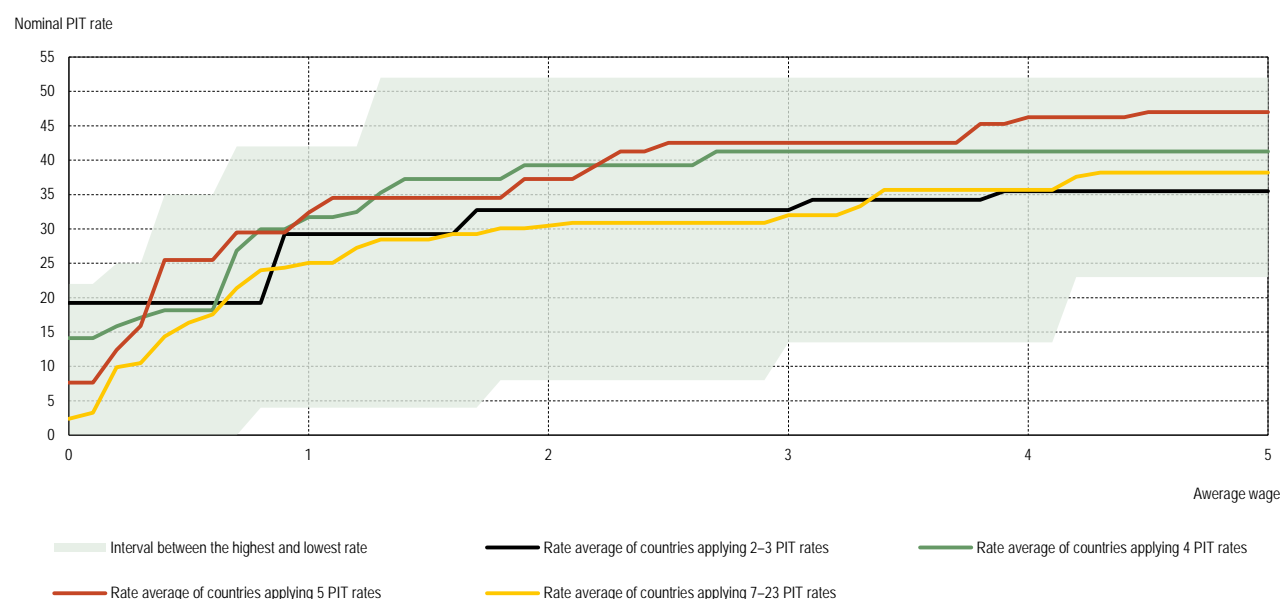
In more than a third of OECD states, PIT is also applied by other governmental sub-sectors (such as the municipality, or the federal land institution). However, PIT which is collected by them is most often calculated by using a flat rate (out of thirteen states in which labour income is taxed by other governmental sub-sectors, nine use a flat tax rate). The distribution of collected PIT varies extensively between central government and other governmental sub-sectors. In some states such as, for example, Italy or Korea, the largest proportion of PIT is collected by central governments, while in other states, such as Finland, Sweden, or Switzerland, it is collected by other governmental sub-sectors.

There are significant differences in the number and level of PIT rates used among OECD states which are using progressive PIT rates. The number of PIT rates varies from 2 (Ireland, Denmark, Iceland, Poland, and Slovakia) to 11 (Mexico and Switzerland), or even 23 (Luxembourg). In 2017, OECD states applied on average almost five PIT rates, if states with flat rates are deducted, this number would increase to almost 5.5. When compared to the data for 2000, the average number of applied PIT rates decreased slightly (0.2–0.4). And yet there were two periods with different development trends in 2000–2017. In 2000–2009 the average number of rates decreased, while in 2010–2017 the decrease was followed by an increase. The decrease in PIT rates in 2000–2009 can be explained by attempts to make the personal income tax system simpler and reduce taxes for persons who were earning the highest levels of income (OECD Tax Policy Studies 2006). While increase in PIT rates in 2010–2017 was mostly related to the need to increase governmental revenue (OECD 2014).

In OECD states, progressive nominal PIT rates tend to increase rather rapidly until household income reaches AW, and then the increase slows down (see Chart B). States with more PIT rates tend to tax households with the lowest income on a lower rate than states with less rates. However, states with more PIT rates do not necessarily apply higher average nominal PIT rates to households with the highest labour income than those states with less rates. Chart B shows the development of nominal PIT rates up to the income level of five AW only; however, in some countries, nominal PIT rates also increase when households reach an income level of eight or even 22–25 AW.

Luxembourg's nominal PIT rate system stands out amongst all of the OECD states. This involves 23 nominal PIT rates: the lowest is 0% and the highest is 42%. However, most of them are used for the taxation of household labour income which is below AW. When the income of a household which consists of one person without children reaches AW, the nominal PIT rate used is already at 39%.

Chart B. Progressive PIT rates in OECD states in which income tax is collected by central government only, 2017



Sources: OECD and Bank of Lithuania calculations.

4. Tax allowances and credits

The nominal PIT rate or the development of it does not provide the whole information needed for evaluating both the tax burden of households and effective PIT rate progressivity. Tax allowance and tax credit systems also play an important role. The same level of governmental revenue from PIT can be achieved by applying lower rates to

households and by not using any deductions from taxable income or taxes, or by applying higher rates and presenting the opportunity to reduce taxable income or taxes.

Potential deductions most often consist of two groups: tax allowances and tax credits (OECD, 2006). Tax allowances cover personal income that may be deducted from all income received, thereby reducing the amount of taxable income that is subject to PIT. In OECD states, the most popular tax allowances include basic allowances (non-taxable income), deductions for social-security contributions, work-related expense deductions, and tax allowances for people with children or other dependent persons. Tax credit is the amount of money that can be subtracted from an already-calculated tax amount. In OECD the most popular tax credit forms include the basic credit, tax credit for children, or tax credit for the main wage-earner.

Table B. Ratio of tax allowances or tax credits and income for households with income equal to AW in 2017

Country	Tax allowances			Tax credits			(percentages)
	Basic allowances	Other	Total	Basic credit	Other, %	Total	All possible deductions from taxable income and taxes
	(1)	(2)	(3) = (1) + (2)	(4)	(5)	(6) = (4) + (5)	(7) = (3) + (6)
Ireland	0.00	0.00	0.00	4.54	4.54	9.08	9.08
Australia	0.00	0.00	0.00	0.00		0.00	0.00
Austria	0.02	3.43	3.45	0.00	0.87	0.87	4.32
Belgium	0.00	7.03	7.03	0.00	3.84	3.84	10.87
Czech Republic	0.00	0.00	0.00	0.00	6.99	6.99	6.99
Chile	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Denmark	0.00	1.70	1.70	1.31	0.00	1.31	3.01
Estonia	2.92	0.32	3.24	0.00	0.00	0.00	3.24
Greece	0.00	2.24	2.24	9.10	0.00	9.10	11.34
Iceland	0.00	0.32	0.32	7.13	0.00	7.13	7.45
Spain	0.00	2.35	2.35	3.98	0.00	3.98	6.32
Italy	0.00	1.77	1.77	3.18	0.00	3.18	4.95
Israel	0.00	0.00	0.00	3.92	0.00	3.92	3.92
Japan	0.45	2.79	3.24	0.00	0.00	0.00	3.24
United States	2.94	0.00	2.94	0.00	0.00	0.00	2.94
United Kingdom	6.02	0.00	6.02	0.00	0.00	0.00	6.02
Canada	0.00	0.00	0.00	3.72	0.94	4.66	4.66
Latvia	1.50	2.40	3.90	0.00	0.16	0.16	4.05
Poland	0.00	2.00	2.00	1.12	6.69	7.81	9.81
Luxembourg	0.16	2.28	2.44	0.55	0.00	0.55	2.99
Mexico	0.23	0.00	0.23	0.00	0.00	0.00	0.23
New Zealand	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Norway	0.00	2.98	2.98	0.00	0.00	0.00	2.98
The Netherlands	0.00	0.88	0.88	0.00	1.69	1.69	1.69
South Korea	0.35	3.74	4.09	1.43	0.00	1.43	5.52
Portugal	4.87	0.00	4.87	0.00	0.00	0.00	4.87
France	0.00	5.61	5.61	0.00	0.00	0.00	5.61
Slovak	6.32	2.55	8.87	0.00	0.00	0.00	8.87
Slovenia	3.37	4.26	7.63	0.00	0.00	0.00	7.63
Finland	0.00	0.66	0.66	2.88	0.00	2.88	3.54
Sweden	0.00	0.00	0.00	0.00	13.15	13.15	13.15
Switzerland	0.00	0.25	0.25	0.00	0.00	0.00	0.25
Turkey	0.00	2.25	2.25	3.97	0.00	3.97	6.22
Hungary	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Germany	0.00	4.21	4.21	0.00	0.00	0.00	4.21

Source: OECD and Bank of Lithuania calculations.

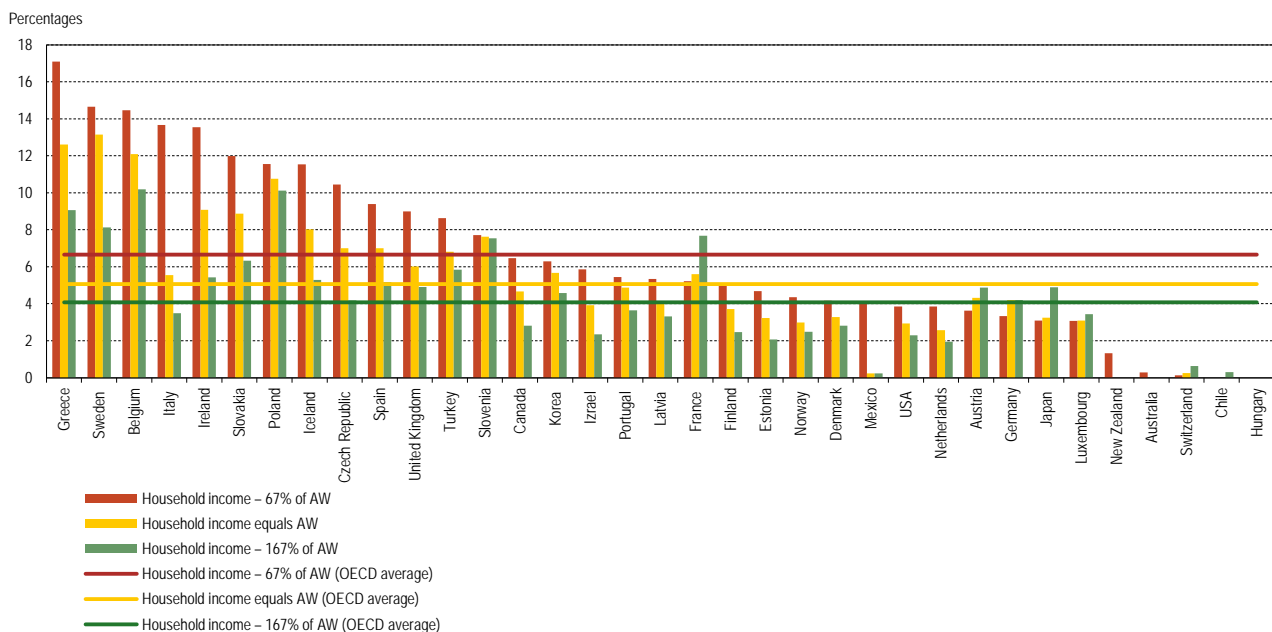
In most OECD states, the tax burden for households consisting of a single person without children and earning an income which is equal to AW may be reduced using possible deductions from income received or taxes calculated in 2017 (see Table B). Out of 35 OECD Member States, tax allowances are applied in 28 countries, tax credits in 19

countries, and 13 countries apply both tax allowances and tax credits. Households consisting of a single person without children and earning an income that is equal to AW are not able to reduce their taxable income or tax burden with legal deductions in three OECD states only: Australia, New Zealand, and Hungary.

In OECD states, the effective PIT rate for households earning an income that is equal to AW goes down by a little over five percentage points due to tax allowances and tax credits being applied. Even so, there are significant variations: some countries do not offer any such incentives, while others reduce the effective PIT rate by more than 10 percentage points (Belgium, Greece, Poland and Sweden). The effective PIT rate drops almost equally when tax allowances or when tax credits are being applied. Due to basic allowances, the effective PIT rate decreases by an average of 0.8 percentage points; other types of allowances also have a significant effect in OECD states. Out of tax credits, the most noticeable effect on the PIT rate can be seen in the application of the basic credit (1.3 percentage points).

In most OECD states, the effect of tax allowances and tax credits on the effective PIT rate drops when household income increases (see Chart C). When household income makes up 67% of AW, the effective PIT rate drops by an average of 6.7 percentage points due to tax allowances and tax credits; when an income is equal to AW – by 5.1 percentage points; whereas when it makes up 167% of AW – by 4.1 percentage points. Such a declining effect of tax allowances and tax credits on the effective PIT rate is observed in most OECD states; however, there are also countries in which the effect of tax allowances and tax credits on the effective PIT rates increases with the increase of household income (such as in Austria, Japan, Luxembourg, France and Germany). In such countries, the tax allowance and tax credit system is based on social security contributions and other deductions which can be made from income and which increase together with household income. Moreover, in Japan and France, the increase in personal income is followed by an increase in deductions for work-related expenses. However, it should be noted that in all such countries an effective PIT rate progressivity is close to or above the OECD average. This happens thanks to a quite rapid increase in nominal PIT rates when household income is rising.

Chart C. Ratio of tax allowances or tax credits and income in OECD states, 2017



Sources: OECD and Bank of Lithuania calculations.

Note: Household here means a single person without children.

In countries in which basic tax allowance has a minor or zero effect, tax credit schemes are most often used to increase effective PIT rate progressivity. Tax credits mostly affect the effective PIT rate in countries in which there is no tax allowance schemes (such as Ireland, the Czech Republic and Sweden), or where allowances do not significantly increase effective PIT rate progressivity (Greece, Spain and Poland). In countries in which both tax allowances and tax credits are applied, the latter usually have a greater influence on the effective PIT rate. While comparing tax allowance progressivity and tax credit progressivity, it has been noted that in the OECD states the tax credit impact on the effective PIT rate is reduced faster than the impact of tax allowance upon any increase in household income.

In almost all OECD states in which tax credit schemes are applied, the tax credit amount remains unchanged or drops with any increase in household income. Only in three countries – Canada, Poland and Sweden – tax credit amounts in terms of absolute value go up with any increase in household income. In Canada this is possible due to permitted deductions for the Canada pension plan and Employment insurance contributions, while in Poland – due to deductions for health insurance contributions, and in Sweden – due to deductions for employee social security contributions and Earned Income Tax Credit system. And yet, in these countries the deductible tax credit amount goes up more slowly than household income, thus its effect on the effective PIT rate decreases with any increase in household income.

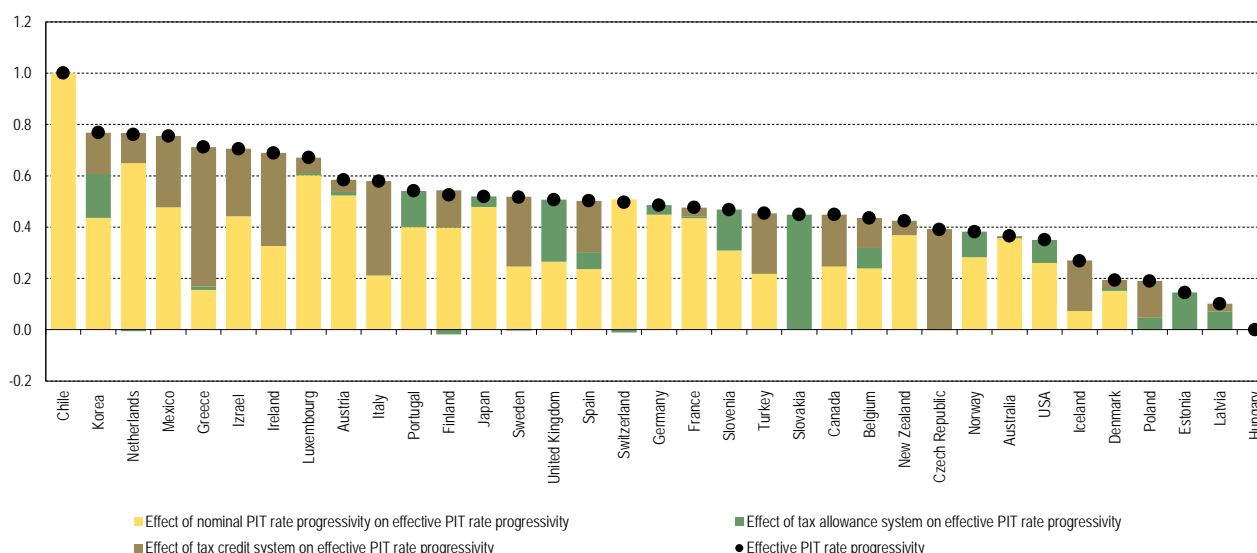
Between 2000 and the global financial crisis, the effect of tax allowances and tax credits on the effective PIT rate in the OECD states essentially remained unchanged, but then it began to increase, thereby reducing the effective PIT rate. Such changes were mostly noticeable for households which had a lower income. For example, due to possible deductions, the effective PIT rate for a household consisting of a single person without children and earning 67% of AW was lower by 5.8 percentage points than the nominal PIT rate in 2000–2002, while in 2015–2017 this difference increased to 6.8 percentage points. With household income for a single person without children being equal to AW, the impact of possible deductions increased at a lower rate, i.e. from 4.7 percentage points to 5.1 percentage points, and with income reaching 167% of AW, the effective PIT rate did not change at all and stood at 4.1 percentage points. The effect on the PIT rate of potential deductions from income earned or taxes calculated went up due to increasingly intensive use of tax credits, while the effect of tax allowances went down in the period being discussed. Such changes were observed for all levels of income that had previously been analysed, but to different extent.

The trends mentioned were mostly influenced by PIT reforms in the Czech Republic, Greece, Italy and Sweden (out of the OECD states). In Greece, changes were related to the PIT reform of 2013, which involved a reduction in the number of PIT rates, abolishment of a large proportion of tax allowances and implementation of a basic tax credit system (IMF 2013). In the Czech Republic a new PIT system was launched in 2008, when a progressive four-rate PIT scheme was replaced by a flat rate scheme (European Commission 2009), which also expanded the scope of tax credits schemes (IMF 2008). In 2007, Sweden launched a tax credit system which was dependent upon income earned (Edmark et al, 2012) with the primary objective of promoting increased participation of labour force. With the launch of this system, neither tax allowance schemes nor the PIT rate system were significantly changed. In Italy, two PIT system reforms were implemented within the period being discussed (in 2003 and 2007). In 2003, Italy reduced the number of available PIT rates and replaced the tax credit system with a tax allowance system (OECD 2004); however, in 2007 it increased the number of PIT rates again and returned to the tax credit system (OECD 2007). However, in Italy – in opposition to other countries – the tax changes had a significant impact only upon households which were in the lower income brackets.

5. Effective PIT rate progression drivers

The comparison between effective PIT rate progressivity drivers in the OECD states shows that it is mostly affected by nominal PIT rate progressivity (see Chart D). It is the most important effective PIT rate progressivity driver in almost a third of the OECD states; moreover, in some countries such as Australia, Chile and Switzerland it is the only one. When the income of households which consists of a single person increases from 67% to 167% of AW, nominal PIT rate progressivity cannot be seen only in six countries (Czech Republic, Estonia, Latvia, Poland, Slovakia, and Hungary). The fact that nominal PIT rate progressivity is an important factor when it comes to relatively higher effective PIT rate progressivity is confirmed by the data from these six countries, where effective PIT rate progressivity does not go beyond the OECD average, while in four of them effective PIT rate progressivity is the lowest of all of the OECD states.

Chart D. Effects of tax allowances, tax credits, and nominal PIT rate progressivity on effective PIT rate progressivity in OECD states, 2017



Sources: OECD and Bank of Lithuania calculations.

Those OECD states which have the highest effective PIT rate progressivity often apply not only a progressive PIT rate, but also a tax credit system. The latter has significant influence on PIT rate progressivity in Ireland, Greece, Italy, Israel and Mexico. In general, nine out of ten OECD states with the most progressive effective PIT rates apply a tax credit system, while in seven it significantly contributes to effective PIT rate progressivity. Tax credit is the main PIT rate progressivity driver in eight OECD states. In one country (the Czech Republic) the tax credit system is the only factor which determines the progressivity of the effective PIT rate.

Although tax allowances are prevalent amongst OECD states, their contribution to effective PIT rate progressivity is not extensive in most of these countries. Amongst the ten OECD states which have the most progressive PIT rates, tax allowances significantly contribute towards effective PIT rate progressivity in only one of them (Korea). Out of 28 OECD states which currently apply tax allowance systems, these systems are the main effective PIT rate progressivity driver in only three of them (Estonia, Latvia, and Slovakia). However, only in Slovakia tax allowance system allows reaching effective PIT rate progressivity similar to the average OECD level. It was done by setting the highest basic tax allowance amount of all of the OECD states, which was equal to about one third of AW.

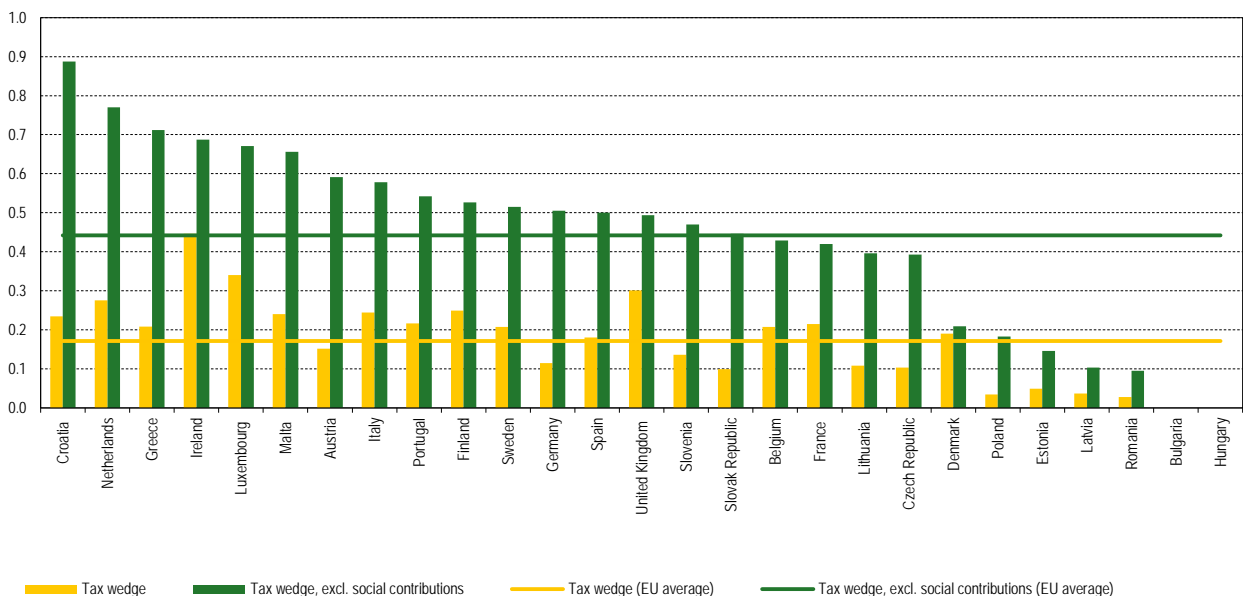
When deciding to apply or extend tax credit schemes, governments usually base their decisions on the argument that the value of the tax credit being offered is equal for everyone (as long as they pay sufficient amount of PIT), while possible tax allowances under the application of a progressive PIT rate often go up with an increase in income (OECD 2006). PIT progressivity can be increased even more if a country's government applies a so-called non-wastable tax credit. Under this scheme, if households' tax burden before tax credit is lower than the value of tax credits, the household is paid a sum of money that is equal to the unused value of the tax credits.

6. PIT and tax wedge progressivity

From the 1990s until the global financial crisis, the trend in PIT rate reductions prevailed in many countries. This reduction was often compensated by increased social security contributions and consumption taxes as well as expanded tax base. **Tax system progressivity dropped with the increased importance of social security contributions within the tax wedge.** This ensued because social security contributions are usually subject to flat rates. Tax system progressivity was reduced even more by the ceiling set for social security contributions, which were introduced in some of these countries. Therefore the progressivity is significantly lower when a tax wedge, not an effective PIT rate, is assessed (OECD 2006).

Chart E shows tax wedge progressivity in EU states which were assessed by using the previously-applied progressivity calculation method. This compares tax wedges for persons earning 167% and 67% of AW and tax wedges which do not take into account social contributions. **The comparison shows that tax wedge progressivity is higher when the effect of social contributions is not assessed almost in all countries except Bulgaria and Hungary.** As mentioned, this is often related to flat rates that are applied to social security contributions, as well as the ceiling of social security contributions being applied in many countries. Even so, progressivity differences that appear due to social security contributions rather vary between the countries. In some countries, such as Greece, Croatia, and the Netherlands, they are very high, while in others, such as Denmark, Latvia, and Romania they are rather low. In Lithuania, progressivity reduction thanks to social security contributions more or less corresponds to the average for the EU. Nevertheless, both tax wedge progressivity, which does not take into account social security contributions, and total tax wedge progressivity in Lithuania are among a third of the lowest in the EU.

Chart E. Effect of social contributions on household tax wedge in EU states, 2017



Sources: European Commission and Bank of Lithuania calculations.

Note: Higher number translates into higher progressivity. Progressivity is calculated using a formula $(T_{167} - T_{67}) / T_{67}$, where T_{167} refers to effective PIT rate for a person earning 167% of AW, while T_{67} is the effective PIT rate for a person earning 67% of AW. Due to lack of data indicators for Cyprus are not included.

Conclusions

The comparative personal income tax analysis which has been delivered in this annex calls for the following conclusions. First, effective PIT rate progressivity in the OECD states is mostly affected by nominal PIT rates, while tax allowances and tax credits contribute to progressivity to a lesser degree. Progressive PIT rates are applied by most OECD states. Second, the tax burden is reduced upon application of tax allowances and/or tax credits in many OECD states. The OECD states with the highest effective PIT rate progressivity, apart for progressive PIT rates, often apply tax credit systems, while tax allowances contribute to effective PIT rate progressivity to a significantly lesser degree, notwithstanding their popularity amongst OECD states. Third, effective PIT rate progressivity is far higher than that of the tax wedge progressivity. Usually this difference is determined by the flat rate of social security contributions and the ceiling applied to social security contributions in some countries.

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