# *Fiscal policy making in the new EU post-communist countries*

El presente artículo ofrece una visión general de los principales modelos de política fiscal en los antiguos países comunistas hoy integrados en la Unión Europea. Tras un análisis detallado de la estructura de los ingresos y gastos de cada uno de esos estados, el artículo examina su conformidad con las normas del Pacto de Estabilidad y Crecimiento y el reto que han de afrontar los antiguos Estados miembros respecto a la baja fiscalidad de los nuevos miembros.

*Gaur egun Europar Batasuneko kide diren herrialde komunista ohietako zerga-politikaren eredu nagusien ikuspegi orokorra ematen da artikulu honetan. Estatu horietako bakoitzaren sarrera eta gastuen egitura zehatz aztertu ondoren, artikuluak Egonkortasunerako eta Hazkunderako Itunaren arauekin bat datorren aztertzen du. Halaber aztertzen du kide berrien fiskalitate baxua dela eta, lehengo estatu kideek izango dituzten erronkak.*

This article provides an overview of the main models of fiscal policy followed by the former communist countries, which today belong to the European Union. After a detailed analysis of the structure of revenues and expenses made by each of these states, the article reviews its compliance with the conditions required by the Stability and Growth Pact and the challenge faced by former members regarding the low tax income of new members.

Ileana Tache
Gheorghita Dincă
Melinda Keul
*Brasov Transilvania's University*

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## 1. INTRODUCTION

The macroeconomic stability and the economic growth potential success depend crucially on the implementation of an adequate mix of monetary and fiscal policies. Fiscal policies and strategies have to ensure that the pursued social objectives are met without recourse to persistent budget deficits that could, eventually, endanger macroeconomic balances. One cannot stress enough how important it is for countries to have a healthy public finance (Balcerowicz, 2006). In the transition and EU accession context, important fiscal pressures are to be considered, such as the need to upgrade the countries' infrastructure and to develop environment projects, long-term fiscal costs for reforming the health and pension systems, the budgetary restraint needed to reduce inflation to EU levels, and the obligations to contribute to the EU budget.

The new entrants' fiscal policies are thus determined by both the apparent problems of the societies that are still suffering from transition associated costs and used to high social transfers, and the rather rigid and demanding rules for fiscal policy within the EU. According to the Maastricht Treaty, the government deficit and public debt are restricted to 3% and 60% of GDP respectively for all EMU members. In addition, if monetary policy is delegated to an independent central bank, as it is the case with the ECB, fiscal policy is significantly constrained, because, apart from ensuring sound public finances, it has to support the ECB's objective of price stability (Lungu, 2005).

This study tries to offer an overview of the fiscal policy's main patterns in the

post- communist countries that are new EU member states (NMS) (The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Bulgaria and Romania), exploring their specific fiscal issues and the associated challenges for the old Member States (OMS). In order to attain this objective, the study is structured as follows. The second section identifies the main constraints of fiscal policy in the transition period. Next, a detailed fiscal situation of each of the ten countries is presented, looking at the present structure of government revenues and expenditures, as compared to the EU averages. Then budget deficits and public debt are examined in the light of the Stability and Growth Pact rules. The following section discusses the tax competition and the new EU members' fiscal policies as a challenge for the OMS. The last section provides the concluding remarks.

## 2. CONSTRAINTS OF FISCAL POLICY IN THE TRANSITION PERIOD

The fiscal policies' concerns in the NMS can be properly understood by offering a description of the basic constraints of the transition period: the legacy of a "premature welfare state", the *free rider* behaviour and tax evasion, the problem of tax arrears, and the institutional and legal fragility. Let us look at each in turn.

### 2.1. The legacy of a "premature welfare state"

Kornai (1990) describes the oversupply of public goods in the communist economies using the metaphor of a "premature welfare state". The problem is that many citizens are used to getting these goods, in a period of deep retrenchment of public budgets. This

is an important constraint for policy, while the pursuit of balanced budgets (or easy to finance deficits) is a major policy goal. This constraint is getting more severe under the pressure of globalization, when governments resort to competitive taxation schemes – a reminiscence of the old competitive devaluations race. This race can bring about a vicious circle for both individual economies and the international economic system as a whole, to the extent social exclusion gets out of hand (Daianu, 2002).

### 2.2. Free rider behavior and tax evasion

Tax evasion is one of the central problems facing the governments of transition countries. Corrupt tax officials, lack of resources to collect taxes, and populations versed in skirting rules, force transition countries to adopt systems of taxation that unduly target those narrow groups from who money can be extracted. This narrow targeting violates the central principle of efficient taxation, which is to tax at low rates on a broad base. Tax evasion raises what Browning (1976) calls the marginal cost of public funds.

The role of social norms and attitudes toward the state are factors that explain some features of transition economies, although empirical evidence, as presented by Cowell (1990), suggests that there are considerable differences among countries and groups of people in free rider behavior. For instance, the Central European governments have been more effective at collecting taxes than the majority of their counterparts in the Balkans. This is the result of better public administration and institutions, in general.

Some experiences in transition economies were close to the Russian case of "evasion

epidemics" (Cowell, 1990). Because of unsuccessful institutional building, the economy ends up in a situation where evasion and corruption are stable features of the economy. The evasion epidemics model predicts that if this kind of equilibrium appears, breaking the vicious circle is complicated. If all firms of an economy misbehave, the economy will be stuck in a low equilibrium which can become a development trap.

Governments of transition countries have attacked the problem of tax evasion by cracking down on evaders. However another approach might be in order if we take into account the strong evidence that citizens will avoid taxes if they do not believe they are getting quality government services for the taxes levied upon them. So, a rational factor takes into account the quality of government services when making his evasion decision. Slemrod and Yitzhaki (2000) have cast doubt on the instrumental tax evasion model, according to which individuals will evade taxes if they do not fear risk and if they find low the chances of being caught and the penalty for being caught. In a major survey of tax evasion, the above mentioned authors have stated that the central mystery of taxation is not why people evade taxes, but why they pay taxes.

## 2.3. **The problem of tax arrears or quasi-fiscal deficits**

Payment arrears have been an important issue in many transition economies. In Romania, for example, the problem had a pervasive character. It comprised not only bankrupt, outdated state enterprises, but also a larger number of healthy companies that chose to maximize profits and optimize their behavior by not paying taxes on time. In the 1990's, government and lobby groups were using the state owned banks for

pumping money into loss-making enterprises and keep them afloat. When banks were privatized, the state-owned enterprises lost the access to direct credit, which led them to resort to arrears, a practice tolerated by the government. Arrears become thus a much more important source of financing for enterprises than bank credit.

Gray (1997) demonstrates that even in the leading reformers, such as Hungary and Poland, arrears were a significant problem as a result of demand and liquidity shocks in the early years of transition. An interesting explanation of use of arrears in terms of rational behavior of enterprise managers is provided by Mumssen (2000). All these studies explore the roots of tax arrears problem as an economic response to incomplete financial liberalization and argue that tax arrears and lax tax collection are consistent implications of a slow transition strategy.

## 2.4. **Institutional and legal fragility**

Even if the fragility of institutions, which is reflected by a poor capacity to collect taxes, to enforce laws and regulations varies quite widely, it is indisputable that most transition economies were plagued by institutional fragility. Olson (1996) stressed the role of sound institutions for growth and prosperity. In transition economies, which are plagued by congenital institutional fragility, the nexus institutions/economic performance has aroused a lot of interest. Stiglitz (1999) recalled attention on the need to build solid market institutions as a precondition to successful economic reform. Kozul-Wright and Rayment (1997) have stressed the impossibility of conducting "orthodox" reforms in economies lacking of basic institutions, which, in Western Europe, are the outcome of a long-term social evolution.

## 3. STRUCTURE OF GOVERNMENT REVENUES IN THE NMS

An attentive look at each of the NMS' structure of revenues as compared with EU 27 average will reveal different ways in which they cope with the new EU membership and some common features which distinguish them from the OMS.

### 3.1. Romania

Until 2004, the Romanian fiscal system was a progressive one, with several differentiated rates with regard to the taxation of the individuals. The rates were progressive (with income brackets) starting at 18% and going up to 40%. The company profit was taxed at 25%. The interest income was taxed at 1%, whereas the dividends at 5%. Micro-enterprises were paying an income tax of 1.5%.

Starting with January 2005, the new Romanian government has introduced the flat tax rate of 16% upon the incomes of the individuals and company profits, hereby reforming the Romanian fiscal system. The questions raised and which are still unresolved refer to the sustainability of the new fiscal system, to its capacity of attracting supplementary public revenues, with the purpose of reaching the average level of the EU-27 of 40-45% of GDP, given that Romania was ranking very low in 2007 with a ratio of 33% of GDP.

The fiscal system enforced in 2005 and modified in 2007 (Romanian Fiscal Code 2007) established as main objectives the increase of the overall incomes, the business expansion, the increase of direct investments, the downsizing of the underground economy, a sustainable economic growth, better employment and the increase of saving and investment ratios. Out of these goals, the analysts (Romanian Academic Society, 2008) consider that the increase of foreign direct investments (9.1 billion Euros in 2006), the high economic growth (7.7% in 2006, 6% in 2007, even if mostly consumption-based) and the expansion of the big businesses were the main successes of the new policies. It is true that the budgetary revenues have increased considerably in absolute values, but their weight into GDP did not increase significantly, as the government forecasted.

The bigger available incomes, as well as the expansion of the credit have led to an increase in consumption, especially of imported goods, which in turn deepened the current account deficit.

Table 1 presents the structure of revenues in Romania (indirect taxes, direct taxes and social contributions) from 2001 to 2006.

The overall tax-to-GDP ratio of Romania is, at 28.6 % in 2006, 8.5 percentage points lower than the EU-27 average. The level of taxation in Romania is the lowest in the EU.

The tax structure of Romania stands out in several respects. Romania has the fourth highest reliance on indirect taxes in the Union after Bulgaria, Cyprus and Malta. Indirect taxes supply 44.4 % of total tax revenue compared to a 38.9 % EU-27 average in 2006, while the share of social contributions account for 34.1 % and direct taxes only for 21.5 %. Because of this structure, the share of VAT on total tax and social contributions revenue in 2006 (28.6 %) was the second highest in the Union. The low level of direct taxes is mainly due to low personal income taxes (merely 2.8 % of GDP in 2006), amounting to one third of the EU-27 average. The revenues from corporate income taxes as a share of GDP also lie below the EU average by 0.5 percentage points.

Table 1

**Structure of governmental revenues in Romania**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | – | 11.4 | 11.7 | 12.3 | 11.8 | 12.9 | 12.7 | 12.4 |
| Direct taxes | – | 6.1 | 5.7 | 5.9 | 6.3 | 5.3 | 6.1 | 6.0 |
| Social contributions | – | 10.3 | 10.8 | 9.5 | 9.3 | 9.7 | 9.8 | 9.5 |

Source: Eurostat Commission Services.

Table 2

**Structure of governmental revenues in Bulgaria**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 15.1 | 14.6 | 14.4 | 15.8 | 17.5 | 18.6 | 19.4 | 4.9 |
| Direct taxes | 7.1 | 7.4 | 6.9 | 7.0 | 6.5 | 6.3 | 6.9 | 1.7 |
| Social contributions | 11 | 10 | 9.5 | 10.6 | 10.5 | 10.3 | 8.8 | 2.2 |

Source: Eurostat Commission Services.

## 3.2. **Bulgaria**

Compared to neighbouring Romania, Bulgaria's total tax ratio is almost 5.8 % points higher, while the difference from the remaining Central and Eastern European Member States is less marked.

Bulgaria is the EU Member State most reliant on indirect taxation. The share of indirect taxes in total taxation is the highest in the Union, amounting to 55.7 %, i.e. 16.7 percentage points above the average. In terms of its share in GDP, the level of indirect taxation is also well above the EU average (19.4 %, as compared to EU-27 14.3 %); this value is the highest in the EU and has been rising rapidly, growing by almost one third in five years. Both VAT and excise duties contribute to the high level of indirect taxes (see Table 2). Direct taxes account for only 19.3 % of total taxation, 12.1 percentage points below the EU-27 average and the lowest value in the Union. The low share of direct taxation is mainly due to the modest PIT (personal income tax) revenues, which yield less than 40 % percent of the EU average. Social security contributions

Table 3

**Structure of governmental revenues in the Czech Republic**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 11.3 | 11.0 | 10.8 | 11.1 | 11.8 | 11.8 | 11.2 | 12.8 |
| Direct taxes | 8.3 | 8.8 | 9.1 | 9.6 | 9.6 | 9.2 | 8.8 | 10.1 |
| Social contributions | 14.2 | 14.2 | 14.9 | 15.0 | 16.0 | 16.1 | 16.2 | 18.5 |

Source: Eurostat Commission Services.

have been reduced significantly over the last seven years; as of 2006 they represent only 25 % of total taxation (EU-27 29.8 %).

As of 1 January 2008, Bulgaria introduced a 10% flat PIT rate with no minimum allowance, replacing the previous progressive tax schedule.

### 3.3. **The Czech Republic**

In 2006, the Czech Republic's total fiscal revenues were 36.2 % of GDP. The tax ratio is one percentage point below the EU-27 level (37.2 %). Compared to neighbour countries, the ratio is lower than in Austria and Germany but higher than in Slovakia and Poland.

The main source of revenues is represented by social security contributions, which at 44.7 % of total taxes are 15 percentage points above the EU-27 average (29.8 %). The share of Czech social contributions in total revenues is the highest in the EU, followed by Germany. Direct taxes (24.4 % of total taxation) are below the Union average (31.4 %), and play a less important role than indirect taxes (30.9 %). Given the predominance of social security contributions, the other sources of revenues tend to fall below the EU average. In particular, indirect tax revenue is the lowest in the EU as a percentage of GDP. PIT revenue too, is among the lowest of the EU-27; its low level of revenue, 4.2 % of GDP, makes the Czech Republic one of a handful of EU countries where the PIT has a roughly equivalent revenue-raising role as the CIT (corporate income tax) (see Table 3).

As for the latter tax, the Czech Republic has been cutting rates forcefully, from 55 % in 1991 to the current 24 %, which is in line with the EU average. Nevertheless, until now this has not markedly reduced CIT revenues, which have always remained close to 4 % of GDP. In 2006, revenue from this tax was, at 4.5 % of GDP, 1.2 percentage points above the EU-27 average.

### 3.4. **Estonia**

The tax-to-GDP ratio of Estonia (inclusively social security contributions) is close to 31%. As in many other new Member States, the share of indirect taxes in total taxation is relatively high in Estonia (44 % in 2006); social security contributions also form an important

Table 4

**Structure of governmental revenues in Estonia**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 12.4 | 12.4 | 12.5 | 12.2 | 12.4 | 13.4 | 13.7 | 1.8 |
| Direct taxes | 7.8 | 7.3 | 7.6 | 8.1 | 8.0 | 7.0 | 7.1 | 0.9 |
| Social contributions | 11.0 | 10.7 | 11.0 | 10.6 | 10.5 | 10.2 | 10.2 | 1.4 |

Source: Eurostat Commission Services.

proportion of total taxation (34.1 % in 2006, over three percentage points above the Union average). The share of direct taxes, 23 % in 2005, has fallen by nearly six percentage-points since 1995 in accordance with tax reforms, which have significantly increased the basic allowance and decreased the tax rates on both personal and corporate income. Table 4 depicts the structure of revenues in Estonia from 2000 to 2006.

According to the long-term plan of the government, the tax rate on personal and corporate income is to be reduced by 1 % annually, from 26 % in 2004, to reach 18 % by 2011. Thus, in 2008, the income tax rate is set at 21 % for all income earners. Estonia is one of the new Member States applying a flat rate system to the PIT. The single tax rate, 22 % in 2007 and 21 % in 2008, is applied on all labour and personal capital income (dividends, interests, capital gains, royalties, etc.).

### 3.5. **Hungary**

As of 2006, with a total-tax-to-GDP ratio of 37.2 % (including social security contributions), Hungary's tax burden is slightly above the EU-27 average (37.1 %). Looking at neighbouring countries, Austria and Slovenia display higher tax ratios (41.8 % and 39.1 % respectively) but both Slovakia's (29.3 %) and Romania's (28.6 %) ratios lie well below the Hungarian value.

Revenues from indirect taxes are substantial, their share accounting for 40.9 % of the total. VAT revenues however decreased by 0.8 points in 2006, owing to the reduction of the standard rate from 25 % to 20 %. Other taxes on products are the highest in the EU mainly because of local business tax revenues. In contrast, direct taxes are relatively low: at 9.4 % of GDP, they are lower than the EU-27 average by almost one fourth (see Table 5). Despite a marked decline since 1995, social contributions in relation to GDP remain clearly above the European average; the majority of them fall on employers.

### 3.6. **Latvia**

The ratio of total taxes to GDP in Latvia was 30.1 % in 2006, which is the fourth lowest in the EU-27 after Romania, Slovakia and Lithuania. The tax ratio in neighbouring Estonia is marginally higher.

Table 5

**Structure of governmental revenues in Hungary**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 16.1 | 15.3 | 14.9 | 15.6 | 16.3 | 15.8 | 15.3 | 13.7 |
| Direct taxes | 9.6 | 10.1 | 10.1 | 9.5 | 9.1 | 9.1 | 9.4 | 8.5 |
| Social contributions | 12.8 | 12.8 | 12.8 | 12.5 | 12.2 | 12.5 | 12.5 | 11.3 |

Source: Eurostat Commission Services.

Table 6

**Structure of governmental revenues in Latvia**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 12.3 | 11.8 | 11.2 | 12.1 | 11.9 | 12.7 | 13 | 2.1 |
| Direct taxes | 7.3 | 7.6 | 7.7 | 7.5 | 7.9 | 7.9 | 8.4 | 1.4 |
| Social contributions | 9.9 | 9.2 | 9.3 | 8.9 | 8.7 | 8.4 | 8.7 | 1.4 |

Source: Eurostat Commission Services.

The structure of taxation has undergone significant changes since 2000 as social security contributions, particularly those paid by employers, have been cut drastically while indirect taxes have declined less and direct taxes revenue has in general gradually increased as a share of GDP. In 2006 indirect taxes constituted the most important source of tax revenues with a share on the total of 42.9 %, about four points more than the EU-27 average.

Direct taxes contribute only with 28.6 % of total revenue, compared with 31.4 %

- the EU-27 average; however, this share has increased strongly since 1995, when it amounted to 21.5 %, one of the lowest shares in the EU. Within direct taxation, the low level of corporate income taxes stands out; the CIT yields 2.3 % of GDP, the third lowest value in the EU-27, in line with the other Baltic countries (see Table 6). Despite a cut in CIT rates by one third between 2002 and 2004, CIT revenue has kept increasing and now exceeds its 2003 trough by over half. Revenues from social contributions have been declining markedly; as a share of total tax revenues they have decreased

Table 7

**Structure of governmental revenues in Lithuania**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 12.6 | 12.2 | 12.4 | 11.7 | 11.3 | 11.5 | 11.6 | 2.7 |
| Direct taxes | 8.5 | 7.8 | 7.5 | 8.0 | 8.7 | 9.1 | 9.7 | 2.3 |
| Social contributions | 9.4 | 8.9 | 8.6 | 8.5 | 8.4 | 8.2 | 8.5 | 2.0 |

Source: Eurostat Commission Services.

Table 8

**Structure of governmental revenues in Poland**

(% of GPD)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 12.6 | 12.5 | 13.2 | 13.2 | 13.1 | 13.9 | 14.5 | 39.3 |
| Direct taxes | 7.2 | 6.7 | 6.9 | 6.6 | 6.4 | 7.0 | 7.5 | 20.4 |
| Social contributions | 12.9 | 13.4 | 12.9 | 12.8 | 12.3 | 12.3 | 12.2 | 33.1 |

Source: Eurostat Commission Services.

from 36.1 % of the total in 1995 to 28.8 % in 2006.

### 3.7. **Lithuania**

Lithuania exhibits the third lowest total tax burden (including social contributions) in EU-27 (29.8 % of GDP against an EU-27 average of 37.1 %). This level is somewhat below those in the other Baltic States.

Lithuania's reliance on indirect taxes is in line with the EU-27 average (both 38.6 % of total taxation). However, in recent years the share of indirect taxes in the total has decreased in Lithuania, while the EU-27 average followed a slight upward trend (except for 2006). Given the light overall tax level in Lithuania, as a percent of GDP, the level of indirect taxes falls well below the EU-27 average (11.6 %, EU-27 14.3 %). Direct taxes represent 9.7 % of GDP (EU-27 12.0 %) while social security contributions also represent much less than the average (8.5 %, EU-27 11.0 %). The structure of revenues in Lithuania is shown in Table 7.

Table 9

**Structure of governmental revenues in Slovakia**

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 12.5 | 11.4 | 11.6 | 12.1 | 12.4 | 12.8 | 11.6 | 5.2 |
| Direct taxes | 7.3 | 7.4 | 6.9 | 7.1 | 6.1 | 6.0 | 6.0 | 2.7 |
| Social contributions | 14.2 | 14.3 | 14.6 | 13.8 | 13.1 | 12.7 | 11.7 | 5.2 |

Source: Eurostat Commission Services.

Lithuania adopted its flat tax system in 1994 (33% for PIT and 29% for CIT). The PIT rate was reduced at 24% in 2008. The current CIT rate is 15%.

### 3.8. **Poland**

As of 2006, the ratio of total taxes on GDP in Poland lay at 34.2 %, well below the EU-27 average (37.1 %). This level is lower than in other neighbouring countries such as the Czech Republic (36.2 %) and Germany (39.3 %), but is higher than in Slovakia (29.3 %).

Indirect taxes play a much more important role in Poland than direct taxes, raising almost double the revenue (14.5 % of GDP compared to 7.5 % in 2006). Indeed, the proceeds from indirect taxes lie close to the EU mean value (14.3 %), whereas direct tax revenue is well below the EU-27 average 12 % (see Table 8.).

Revenue from personal income taxes in particular account for 4.6 % of GDP, only slightly more than half the EU-27 average (7.8 % of GDP). The main reason for the low level of direct taxes is the substantial shift from personal income tax to social security contributions that took place in 1999, with the introduction of a global reform of the social security system. Social security contributions play as important a role as indirect taxes, accounting for 12.2 % of GDP, a level exceeding the EU-27 average (11.0 %).

### 3.9. **Slovakia**

As of 2006, the tax-to-GDP ratio (including social security contributions) stood at 29.3 % in Slovakia, a value markedly below the EU-27 average (37.1 %). Slovakia's overall tax ratio is the second lowest in the Union after Romania. Indirect taxes raised 11.6 % of GDP, as compared to 14.3 % of GDP for the EU-27 average. They play a much more important role in Slovakia than direct taxes, as the latter yield only around half as much revenue. Not surprisingly therefore, direct tax revenue lies well below the EU-27 average (6.0 % of GDP compared to 12.0 % of GDP). The ratio of tax revenues from social security contributions to GDP has decreased over the last 10 years by 3.3 percentage points from 15.0 % of GDP in 1995 to 11.7 % of GDP in 2006 (see Table 9).

Since 2004, Slovakia has switched over to a comprehensive flat tax system featuring a

## Table 10

### Structure of governmental revenues in Slovenia

(% of GDP)

| Structure of revenues | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | bn euro 2006 |
|---|---|---|---|---|---|---|---|---|
| Indirect taxes | 16.1 | 15.8 | 16.1 | 16.3 | 16.1 | 16.0 | 15.5 | 4.7 |
| Direct taxes | 7.5 | 7.7 | 8.0 | 8.1 | 8.4 | 8.9 | 9.3 | 2.8 |
| Social contributions | 14.5 | 14.7 | 14.5 | 14.4 | 14.5 | 14.5 | 14.3 | 4.4 |

Source: Eurostat Commission Services.

## Table 11

### Government revenues by country

(% of GDP)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| EU 27 | – | – | 44.4 | 44.4 | 44.2 | 44.7 | 45.2 |
| BG | – | – | 39.6 | 40.3 | 42.0 | 41.6 | 40.3 |
| CZ | 38.1 | 38.7 | 39.5 | 40.7 | 42.2 | 41.3 | 40.7 |
| EE | 36.2 | 35.0 | 36.0 | 36.4 | 35.9 | 35.4 | 36.6 |
| LV | 34.6 | 32.5 | 33.4 | 33.2 | 34.7 | 35.2 | 37.0 |
| LT | 35.9 | 33.2 | 32.9 | 32.0 | 31.8 | 33.1 | 33.4 |
| HU | 43.6 | 43.2 | 42.4 | 41.9 | 42.4 | 42.1 | 42.6 |
| PL | 38.1 | 38.6 | 39.2 | 38.4 | 36.9 | 39.0 | 40.1 |
| RO | 43.8 | 36.7 | 37.6 | 32.1 | 31.2 | 32.2 | 33.2 |
| SL | 43.6 | 44.1 | 44.6 | 44.4 | 44.2 | 44.5 | 44.1 |
| SK | 38.3 | 37.8 | 36.6 | 37.7 | 35.6 | 35.6 | 33.9 |

Source: Eurostat, Government statistics.

low 19 % basic rate for PIT, CIT and VAT and a wide base with a limited number of allowances.

### 3.10. **Slovenia**

Slovenia's total tax-to-GDP ratio (including social security contributions) amounted to 39.1 % in 2006, a value that exceeds the EU-27 average (37.1 %) by almost two points. The country is unique amongst the newly acceded Member States to have a higher ratio than the euro area average (38.4 %). Compared to its neighbours, Slovenia's tax ratio lies clearly above Hungary's but well below Italy's and Austria's. Table 10 presents

the structure of revenues in Slovenia from 2000 to 2006.

Slovenia displays a relatively high share of indirect taxes (39.5 % of total taxes). Social contributions play an important role, too, with a share of 36.9 %, i.e. 7.1 points above the EU-27 average. Given the predominance of indirect taxes and social contributions, direct taxes yield a low share at 23.5 % of the total (EU-27 31.4 %). It is worth noting that employers liable for payment of social security contributions are also subject to a payroll tax, introduced in the second half of 1996 to finance a cut of social security contributions from 42 % to 38 % of wages. As for employees' social contributions, measured as a percentage of GDP they are the highest in the EU.

Across ex-communist countries the share of government revenues into GDP varied strongly (see Table 11). In 2006, government revenue to GDP was lowest in Romania (33%), Lithuania (33%), and Slovakia (34%), whilst in Slovenia the weight of the public revenues was 44.1% of GDP, as compared to the EU-27 average (45.2%).

The NMS hold eight out of the first ten positions among the EU countries with the highest share of indirect taxation.

The above presented data and the trends in the fiscal policy of the NMS lead to the following remarks:

1. The indirect taxes have the biggest contribution to the formation of financial public revenues in almost all NMS (for example in Romania indirect taxes had a 44.4% share in the total public revenues in 2006, whereas in Bulgaria, in the same year, the weight of indirect taxes was 55.7%) with only two exceptions, the Czech Republic (in 2006, the share of social contributions

in total public revenues was 44.68%) and Slovakia, which exhibits high shares of social contributions.

2. Almost all the ex-communist countries have decreased the weight of the direct taxes into the overall public financial resources for a number of legitimate reasons (for example, Slovakia has registered a 20.6% share of direct taxes in total public revenues or 6% of GDP): the relatively low level of economic development, which implies a small taxation base, both as regards the company profits and the incomes of the individuals; the need for attracting new productive investments, which determined lower tax rates for companies and individuals (and sometimes even the insertion of flat taxes systems); the direct taxes affect the international competitiveness of the products and services, whereas the VAT is refunded on export and has no effect on the ability of domestic firms to make export; the motivational psychology of the individuals favours the indirect taxes in comparison with the direct taxes, often perceived as a threat to personal well-being; direct taxes are more difficult to collect than indirect taxes.

3. The flat tax reform has been commonly adopted by new governments anxious to signal a fundamental shift towards more market-oriented policies. It was also motivated by the need to reduce the huge level of legal and non-legal tax evasion (in the case of Romania, for example, the efficiency of the progressive taxation system which functioned until 2005 was severely hindered by the legally-offered possibilities to avoid taxation, available especially for the high income individuals. The flat tax signal

Table 12

**Government expenditures by country**

(% of GDP)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| EU 27 | – | – | 46.9 | 47.5 | 47 | 47.1 | 46.8 |
| BG | – | – | 39.7 | 40.3 | 39.7 | 39.6 | 37.1 |
| CZ | 41.8 | 44.5 | 46.3 | 47.3 | 45.1 | 44.9 | 43.6 |
| EE | 36.5 | 35.1 | 35.6 | 34.6 | 34.1 | 33.4 | 33.0 |
| LV | 37.3 | 34.6 | 35.6 | 34.8 | 35.8 | 35.6 | 37.2 |
| LT | 39.1 | 36.8 | 34.8 | 33.2 | 33.4 | 33.6 | 34.0 |
| HU | 46.5 | 47.3 | 51.3 | 49.1 | 48.9 | 49.9 | 51.9 |
| PL | 41.1 | 43.8 | 44.2 | 44.6 | 42.6 | 43.3 | 43.9 |
| RO | 40.6 | 38.8 | 39.6 | 33.6 | 32.7 | 33.6 | 35.0 |
| SL | 47.4 | 48.2 | 47.1 | 47.1 | 46.5 | 46.0 | 45.3 |
| SK | 50.5 | 44.3 | 44.8 | 40.5 | 38.0 | 38.4 | 37.7 |

Source: Eurostat, Economy and finance, Government statistics

appears to have been well-received: the Hungarian opposition party announced its intention to introduce a flat tax system should they win the upcoming general elections. However, success in improving tax collection depends in part on complementary reforms in social insurance contributions. High marginal rates of pay-roll taxes can be a major obstacle to improve tax collection after the reform.

4. Experience shows that it is important for policy-makers to look further than the simple dichotomy between taxes on consumption and taxes on income and to analyze the specific features of each tax in the context of their country. For example, the effect that taxes on consumption have on economic efficiency depends on whether they are broadly uniform or target specific goods, while the effect that taxes on income have on labour supply depends on how progressive they are. This means that each country's decision on how to vary its pattern of taxation involves detailed technical analysis but also a difficult political choice between greater economic growth and greater equality (OECD, 2007).

4. **GOVERNMENT EXPENDITURES IN THE NMS**

This section presents the size and evolution of the government expenditures in the NMS and shows the problems they encountered after the EU accession.

In 2006, EU-27 government expenditures represented 46.8% of GDP, the lowest value in five years (see Table 12). The highest ratio was reported in 2003 (47.5%). Lower

expenditure growth than GDP growth brought the ratio slightly under its 2002 value in 2006. Comparing expenditures-to-GDP across post communist countries reveals relatively large differences. In Hungary the government expenditures exceeds 50% of GDP, while in several NMS the level of expenditures-to-GDP was equal to or lower than 35%: Romania (35%) Lithuania (34%), Estonia (33%). The adequate size of government spending is difficult to determine since it depends on a country's social preferences.

The Schneider and Zapal's idea (2006) to divide the ex-communist NMS into two categories (big government type and small-government type, according to the level of public expenditures) can be further developed if we include Romania and Bulgaria, the newly entered members in 2007. As a consequence, the structure of the two categories for 2006 can be presented as follows:

| "Big government" type (expenditures as a percentage from GDP) | "Small government" type (expenditures as a percentage from GDP) |
|---|---|
| Czech Republic – 43.6% Hungary – 51,9% Poland – 43.9% Slovenia – 45.3% | Estonia – 33% Lithuania – 34% Latvia – 37.2% Romania – 35% Slovakia – 37.7 Bulgaria – 37.1% |

Whereas the first group of countries are located around the European average (of 47.8% of GDP), the other countries of the second group are situated well below the European average. An interesting evolution had Slovakia, which registered a significant decrease of the public expenditure share into GDP, from 50.5% in 2000 to 37.7% in 2006 (see Table 12). In this period Slovakia experienced high economic growth as it attracted a big amount of direct foreign investment.

As Table 11 and 12 indicate, there could be a direct connection between the size of the governmental expenditures and the size of the fiscal deficits. One could conclude that these states, which all seem to fit into the "Big government" category are facing difficulties covering the governmental expenditures with corresponding incomes (for example Hungary, which has the biggest governmental sector, of 51% of GDP). On the other hand, the fiscal deficits attract public loans, which in turn are leading to the subsequent increase of the public expenditures in the coming periods, from interest and principal repayments. During the period of 2004-2006 Slovenia succeeded however to register a better situation, with budgetary deficits located below 3% of GDP. The fiscal policy of this fore-mentioned group of countries did not seem to have the expected results and their official authorities announced the intention of either lowering the rates of the direct taxes or of instating the flat tax system.

The countries of the second group have registered moderate deficits, located usually under 3% of GDP, with the exceptions of Estonia, which registered in 2006 a budgetary surplus and of Slovakia, which shown a budgetary deficit of a little over 3% of GDP. One can notice that all the countries from the "Small Government" group have instated flat tax systems, which leads to believe that they succeeded to have a better collection of budgetary revenues and a better control over the budgetary deficit.

Even if the decrease of the public sector and government spending has generated obvious positive effects for the economy of the NMS, there are still some threats and problems connected with a reduced power of the government to influence the economy and society. All these countries still have to make important investments that need to

be sustained in order to attain the European standards and development, such as in education, health and infrastructure. Their main objective is however the economic growth and only secondly a better redistribution of the incomes for the benefit of disfavoured categories of population. Since the early 1990s, average government investment has been consistently higher in the Central and Eastern European transition countries than in the EU (Gábor and Szápary, 2004). This is normal, since the social marginal productivity of infrastructural investment will tend to be higher in less developed countries.

For the period ahead, the NMS will need to maintain a relatively high level of public investment expenditure given their relatively low stock of public capital.

5. **COMPLIANCE WITH THE STABILITY AND GROWTH PACT RULES**

With the EU accession, the member states have given up the control over their currency and inflation, therefore the monetary criteria are no longer in national competence, but mainly in the responsibility of the European Central Bank (ECB). The power to adjust the structure and level of taxation is the last tool which remained at the EU Member State's disposal to stimulate or regulate their economy, and this emphasizes the importance of the fiscal criteria.

In the NMS, governmental decisions regarding the taxation policy face additional challenges and dilemmas compared to OMS. Fiscal policy of the new EU member states must support economic growth by allowing an increased level of investments and at the same time must fulfill the budget requirements of the European laws and

standards. Since May 1, 2004 the NMS have to comply with the same fiscal requirements outlined by the Treaty of the European Union and Stability and Growth Pact (SGP) as the OMS. The more inexperienced and more vulnerable economies of the NMS find it very difficult to live up to the high SGP standards.

The NMS joined the EU with structural fiscal deficits, and now confront on the one hand, with high macroeconomic vulnerabilities, fiscal imbalances and institutional inadequacies; on the other hand the EU membership requires the implementation of strong fiscal position for achieving the reform in tax and pension systems, labour market, subsidy programs, in condition of increasing expenditure pressures related to an aging population within a sustainable medium- to long-term macro-fiscal framework (Schwartz et al., 2008). As countries emerge from the transitional recession, they need to manage the normal economic cycle and answer the question: how should the structural budget deficit be managed?

This is a new situation for the NMS given that prior to accession their fiscal situation was not the subject of regular and binding surveillance. Furthermore, the NMS are obliged by the Accession Treaty to join the Economic and Monetary Union (EMU) at some moment, and meeting the fiscal convergence criteria is perhaps the most serious obstacle along this road, for some EMU candidates at least (Dabrowski et al., 2005).

In the recent years the majority of NMS have managed roughly well to cut their general government deficits below 3% of GDP (see Table 13). The Baltic countries - which enjoy a relatively comfortable macroeconomic situation, and register a low rate of public debt - made significant progress in reducing their fiscal deficits between 1999 and 2007.

Table 13

**Government deficit (–) / surplus (+)**

(% of GDP)

|  | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| Bulgaria | : | — | –0.1 | 0 | 2.3 | 2.0 | 3.2 |
| Czech Republic | –3.7 | –5.8 | –6.8 | –6.6 | –2.9 | –3.6 | –2.9 |
| Estonia | –0.3 | –0.1 | 0.4 | 1.8 | 1.8 | 2.0 | 3.6 |
| Hungary | –2.9 | –4.1 | –8.9 | –7.2 | –6.5 | –7.8 | –9.3 |
| Latvia | –2.7 | –2.1 | –2.2 | –1.6 | –1.1 | –0.4 | –0.2 |
| Lithuania | –3.2 | –3.6 | –1.9 | 8.7 | –1.6 | –0.5 | –0.6 |
| Poland | –3.0 | –5.2 | –5.0 | –6.2 | –5.7 | –4.3 | –3.8 |
| Slovenia | –3.8 | –4.1 | –2.5 | –2.7 | –2.3 | –1.5 | –1.2 |
| Slovakia | –12.2 | –6.5 | –8.2 | –2.8 | –2.4 | –2.8 | –3.8 |
| Romania | 3.2 | –2.1 | –2.0 | –1.5 | –1.5 | –1.4 | –1.8 |

Source: Eurostat.

The Baltic states tended to run tighter fiscal policies (Lewis, 2007). For instance, Estonia registered a budget surplus since 2002 till today, while Latvia implemented a fiscal consolidation reform with higher public investment, supported by much enhanced revenue efforts and cuts in other expenditures, and managed to post a balanced budget in 2007. In Estonia the fiscal easing reflected the reclassification of some entities within the governmental sector, while in Lithuania referred to compensation payments to pensioners. For 2008, the European Commission (European Commission, 2008b) forecasts a continued fiscal surplus ratio for Estonia, although this ratio is projected to decline in 2008-2009 and the deficit ratio is expected to increase in Latvia, Lithuania (European Central Bank, 2008).

In contrast, the Central and Eastern European countries (CEE) have shown more inertia in improving their budgetary positions. In particular, Hungary stands out as the NMS with the largest fiscal imbalances measured by either fiscal deficit or public debt levels (with a deficit in excess of 9.2% of GDP in 2006 and 5.5% in 2007). Other CEEs have been able to bring deficit levels and debt levels to below the reference value under the SGP. Slovenia has high and stable government expenditures (43.3% of GDP in 2007), but still manages to keep its budget deficit under control (Schneider and Zápal, 2006). In Slovenia, as in most Visegrad countries, the fiscal adjustment had structural implications, reflecting expenditure restraint and cuts in social expenses.

Of the most recent NMS, Bulgaria achieved strong fiscal outcomes over the last few years, and posted fiscal surpluses in 2007, while Romania registered fiscal deficits within the reference value but with comparably lower debt levels (see Figure 1).

For 2008 the European Commission projects reduced deficit ratios for the Czech Republic, Hungary and Slovakia, whereas the

Figure 1

**Government deficit (surplus) and government debt in the NMS**
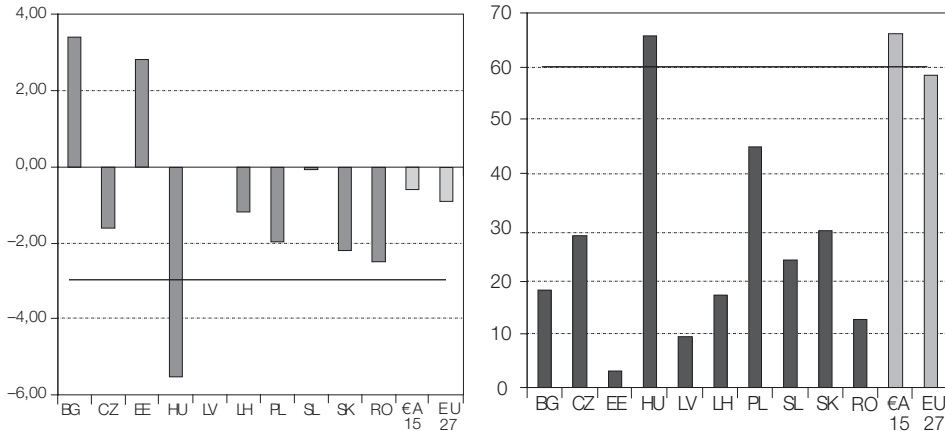


Source: Made by the authors using Eurostat database.

deficit ratio is expected to increase in Poland and Romania. Buoyant revenues, reflecting a combination of improved tax collection, surging inflation and stronger inflows of EU funds, have helped improve fiscal positions thus far in 2008 in the Visegrad countries, Bulgaria and Romania (World Bank, 2008).

The overall government indebtedness is usually lower in the NMS than in the OMS (see Figure 2). Only Hungary exhibited a debt ratio above the 60% of GDP reference value in 2007, increasing by 0.4 percentage point to 66.0% of GDP from the previous year. In the other countries debt ratios were lower, between 40% and 50% of GDP in Poland, around 30% of GDP in the Czech Republic, Slovenia and Slovakia and below that level in the other five countries.

The explanation behind this phenomenon was that the ex-socialist countries started the transition with a low initial level of public debt. The Baltic countries did not inherit the former Soviet Union's liabilities, Poland obtained partial debt forgiveness and Romania paid back most of its debt in the last years of the communist era. After the fall of the socialist regimes the privatization process helped them to keep down the debt by either using the proceeds of privatization directly to reduce the budget deficit and the debt, or by transferring the debt of the privatized companies to the new owners (Darvas and Szapáry, 2008).

The assessment of the fulfillment of the fiscal criteria shows that in the past few years four out of the ten new member countries failed to fulfill the SGP deficit limits and were subjects to the excessive deficit procedure. Till 2008 the Czech Republic, Hungary, Poland and Slovakia were the subject of a Council Decision on the existence of an excessive deficit (European Commission, 2008a).

Figure 2

**Government debt**

(% of GDP)
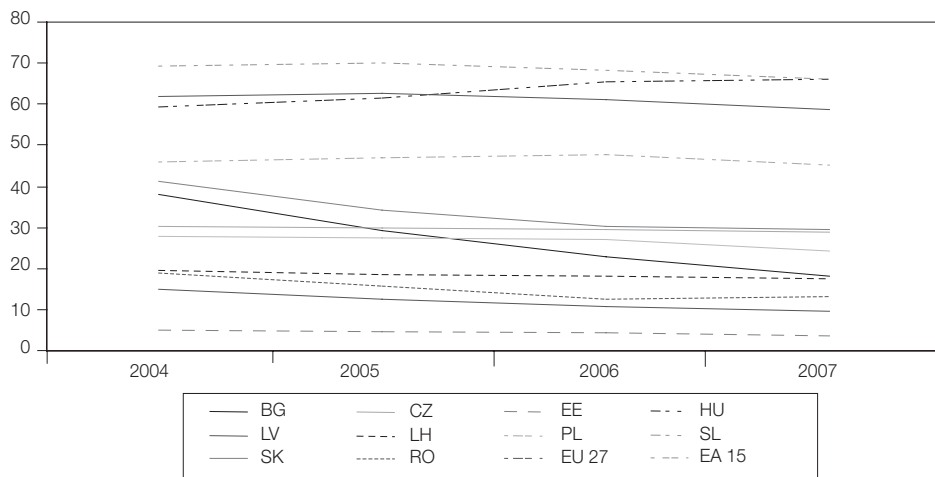


Source: Made by the authors using Eurostat database.

Since joining the European Union, the Czech Republic was confronted with the excessive deficit procedure. Although the Czech Republic has achieved a substantial reduction in the budget deficit since 2004 (around −1.6% of GDP in 2007), this trend must be continued in a credible and sustainable manner. According to the Commission services' Spring 2008 Forecast (European Commission, 2008b), which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 1.4% of GDP in 2008 and decrease slightly to 1.1% of GDP in 2009, while the general government debt is expected to decline from 28.1% of GDP in 2008 to 27.2% in 2009.

Compared with the rest of the Central and Easter European countries, Hungary is at the bottom of the league. In the reference year 2007 Hungary recorded the highest government deficit in percentage of GDP across the Union. Hungary followed expansionary budgetary policies in 2002-2006 and even with the fiscal consolidation program started in 2006 (tax growths and spending reductions, combined with improved tax collection), the budget deficit fell only to 5.5% of GDP in 2007 (well above the reference value) from 9.2% in 2006; therefore Hungary does not fulfill the criterion on the government budgetary position. Thus this retrenchment managed to narrow the current account deficit, but at the same time had the side effect to slow down real GDP growth. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2006 and 2007. As regards the

sustainability of public finances, Hungary appears to be at high risk.

Poland's general government deficit has been reduced substantially since 2004, from –6.3% in 2003 to –2.0% of GDP in 2007. Hence, the fall of the deficit under 3% is mainly cyclical, not structural. The sizable public debt, with debt service blown up by increased interest rates, aggravates the situation. The promised governmental action concerns the raise of wages in the public sector and the social aid expenditures will grow due to the re-introduced indexation of pensions. As a result, the growth of government budget expenditures by 1.5 % of GDP can be expected (Janáĉek, 2008).

In March 2008, in order to meet the Commission and the Council invitation, the Polish authorities submitted a new convergence program update. This one described the medium-term budgetary strategy for the whole legislature, geared towards confirming a durable correction of the excessive deficit in 2007 and making progress towards the medium-term objective thereafter. Further consolidation is required for Poland to keep the deficit ratio below the reference value and to comply with the medium-term objective specified in the SGP.

The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit (-3.6% of GDP in 2006) down by 2007 in a credible and sustainable manner. Slovakia's general government deficit has been reduced substantially since 2002. Both the revenue- and expenditure-to-GDP ratios have decreased, the latter at a higher rate. The deficit-to-GDP ratio was 2.2% in 2007 and according to the Commission services' Spring 2008 Forecast (European

Commission, 2008b) which is based on a no-policy-change assumption, it will amount to 2.0% of GDP in 2008, followed by a moderate widening to 2.3% in 2009. General government debt declined significantly since the beginning of the decade to reach 29.4% of GDP in 2007. The general government debt ratio is projected to 29.2% of GDP for 2008 and 29.7% in 2009.

In June 2008, the improved fiscal achievements led the European Council to adopt the decision of abrogating the excessive deficit procedures with regard to the Czech Republic, Poland and Slovakia, following the reduction of their government deficits below 3% of GDP, the maximum threshold set by the EU's SGP (Council of the European Union, 2008). After the closure of the procedures against the three countries only one procedure now stays open amongst the NMS - against Hungary.

Even if the majority of NMS managed to comply with the fiscal criteria and their long-term fiscal sustainability is not threatened by a slow pace of economic growth (most register an impressive GDP dynamics), further fiscal consolidation is required. At the same time, even a small government deficit is dangerous to those states (mostly OMS) which register lower growth ratios (Dabrowski et al. 2005). For the NMS with budget deficits below the reference value, the implementation of sufficiently ambitious consolidation measures is highly important for achieving lasting compliance with their respective medium-term objectives.

The compliance with the SGP fiscal rules is imperative for the NMS. Choosing to postpone EMU entry for reasons of fiscal non-compliance would make meeting the convergence criteria at a later date even more difficult, due to the accumulation

Figure 3

**Overall Tax to GDP ratio (incl. SSC) in the EU – 2006**

(in %)
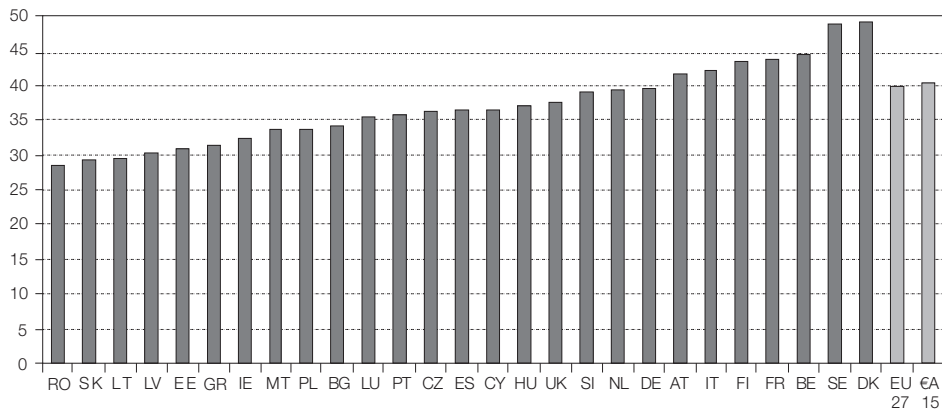


Source: Eurostat.

of additional public debt (or delay in its reduction) and higher interest rates during the "waiting" period. This could lead to the necessity of deeper cuts in non-interest expenditures or tax increases.

## 6. **NMS' FISCAL POLICIES AS A CHALLENGE FOR THE OMS**

An attentive look at the structure, characteristics, trends and level of taxation across the European Union reveals various ways in which citizens interact with the government, especially when the OMS are compared with new entrants. There are substantial differences in the total tax burden between the old and the new EU member states.

Examining the overall tax to GDP ratio in 2006 (the last year for which detailed data

are available) one can observe that the new member states are characterized by lower ratios than the old members (see Figure 3). The first nine positions in terms of overall tax ratio are indeed occupied by OMS, even though there are some exceptions: for example, Greece's and Ireland's tax ratios are about seven points below the weighted EU-27 average. The euro area (EA-15) shows a slightly higher overall tax ratio than the EU-27 (40,5 % compared to 40 %, in the weighted average), which is not surprising given that it is mostly composed of OMS (European Commission, 2008c).

In sharp contrast with the OMS - where the three main components (direct income taxes, indirect taxes on consumption and social security contributions) hold roughly an equal share in government tax revenue - the predominance of indirect taxes is the main

characteristic of the structure of government revenues in the newly acceded member countries.

Consumption taxes are easier to collect than labor income taxes, this is one of the reasons why the new member countries' fiscal policy rely more significantly on indirect taxation. Corporate and personal income taxes characterized by progressivity permit more important revenue redistribution than indirect taxes (even if this role suffered a significant cutback with the adoption of the flat tax systems), therefore they have a greater impact on the electorate.

The accession of the NMS with lower corporate taxation has raised fears about tax competition within an enlarged Europe (Jakubiak and Markiewicz, 2007). Tax harmonization has re-emerged in the public political debate of several EU member states against the background of the enlargement of the EU (Verrue, 2004). Given that corporate taxation is strongly linked to the economic policy, it has become a battle field for winning or losing trade and investments, which are challenging areas to retain autonomy over.

The newly joined members have different jurisdictions and tax regulations which are designed to boost growth and attract economic activity. Given the ease with which EU investments can relocate to these new EU members, it is not surprising that the competitive pressure on EU's corporate tax rates will increase as investors take advantage of more favorable tax rates.

In Europe it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations. This means that the reward for good tax policy is greater than ever before, but it also means that the penalties for bad policy are greater than ever

before. This is why so many nations are lowering tax rates and are reforming their tax systems (Mitchell, 2005).

Spatial tax competition is more and more buoyant since the accession of the NMS. Amongst the OMS tax reforms are frequent as a reaction to the lower tax rates of the newcomers. The last few years corporate tax rates of the EU15 registered important decreases.

Tax competition is stronger for countries relatively closer to the low tax region of the new members like Germany and Austria than for the OMS further away from the new member states such as Spain, UK and Portugal (Crabbé and Vandenbussche, 2008).

There are different predictions as to how tax competition will affect an integrated Union. The opponents' point is that tax competition leads to a distorted market (European Commission, 2008c).

The free flow of capital gives new opportunities to competitors to minimize tax payment or even avoid it. Investors taking the tax advantages provided by governments make very high profit (high above their performance) which trespass fair trade and might set in motion several uncontrolled financial operations. Tax competition may distort the investment pattern and distribution of resources. It also may have a deep impact on the direction and volume of the capital flow. As a result of delocalization of the companies the number of workplaces may decline and the job opportunities decrease. The drop of labor market and of savings from wages may affect the demand and may slow the economic growth (Galántainé, 2008).

The tax basis may decline in the countries where tax rates are higher because numerous companies will move to other countries providing more favorable tax conditions.

The erosion of tax bases threatens the government's obligations such as providing public goods. This obviously hurts the main principles of taxation.

These tendencies contradict the efficiency and neutrality of taxation and give a good reason for all those countries which worry about tax competition. For these countries the entrance of the NMS seems to be a real threat.

Diverging opinions on the role of government led to different answers. Those who share the opinion that governments act as a "leviathan", according the public choice literature, consider tax competition as a useful way to curtail the expansion of the public sector. Others may believe that governments act in the public interest and tend to maximize social welfare instead of tax revenues and political rents connected with public expenditures: in their opinion, tax competition has negative effects on global efficiency (Ceriani, 2005).

## 7. **CONCLUSIONS**

The analysis of governmental revenues structure in the NMS indicates that the indirect taxes have the highest contribution to the formation of public revenues in almost all NMS. The need of attracting new productive investments led to lower direct taxes.

The flat tax adoption, motivated by the need to reduce the relatively high level of tax evasion, characterizes six of the NMS (Estonia – 1994, Lithuania – 1994, Latvia – 1997, Slovakia – 2004, Romania – 2005 and Bulgaria – 2008) and appears to have been well received. However, success in improving tax collection depends in part on complementary reforms in social insurance contributions. High marginal rates of pay-roll

taxes can be a major obstacle to improve tax collection after the reform.

Each country decision on how to vary its pattern of taxation goes beyond the simple dichotomy between taxes on consumption and taxes on income and involves detailed technical analysis.

The size of the governmental sector differs significantly from one country to another, with the extremes being Hungary (the government expenditures hold 51% of GDP) and Estonia (with government expenditures holding 33% of GDP). The decrease of the public sector and government spending has generated obvious positive effects for the economy of the NMS, yet there are some threats connected with a reduced power of the government to influence the economy. All these countries still need important investments and public services in order to attain the European standards in education, healthcare and infrastructure. For the period ahead, the NMS should maintain a relatively high level of public investment expenditure, given their relatively low stock of public capital.

Even though the majority of the NMS managed to comply with the fiscal criteria of the SGP and their long-term fiscal sustainability is not threatened by a slow pace of economic growth, further fiscal consolidation is required. The compliance with the SGP rules is imperative for the NMS. Choosing to postpone EMU entry for reasons of fiscal non-compliance would make meeting convergence criteria at a later date even more difficult, due to the accumulation of additional public debt and higher interest rates during the "waiting" period.

There are substantial differences in the total tax burden between the old and the new EU member states. Examining the overall tax

to GDP across the EU, one can observe that the NMS are characterized by lower ratios than the OMS. The accession of the NMS with lower corporate taxation has raised fears about tax competition within an enlarged Europe. In Europe it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations. This means that the reward for good tax policy is greater than ever before, but it also means that the penalties for bad policy are greater than ever before.

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