

FISCAL DIVERGENCE AND ECONOMIC GROWTH IN THE EUROPEAN UNION

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1. Introduction

The problems of tax competition are increasingly at the centre of economic and political debate in Europe. Even though the European Union and then the European Monetary Union have assisted the growing integration of the real and financial markets, the latter has always suffered from the absence of a sovereign fiscal policy containing the marked differences between the countries in question with regard not only to tax rates or tax bases but also the same accounting policies that determine the taxable income, a fact which continues to raise serious concerns among traders.

So, this job after describing the differences in the EU' fiscal pressures, will reveal the flat tax the determinant of differences in tax policies, particularly among so-called countries in and out. We will highlight how countries have shown that over time a change downward taxation, easier to cope with the cyclical policies. Finally, we highlight how the easing of the taxation to businesses to be the major determinant of economic growth of the countries out.

2. Tax competition, countries which are *in* or *out* and economic problems

To date, the European Union includes 28 countries, 18 of which are members of the EMU (European Monetary Union) with others participating in a monetary union according to a special derogation arrangement, except the UK and Denmark who selected the opting out clause.

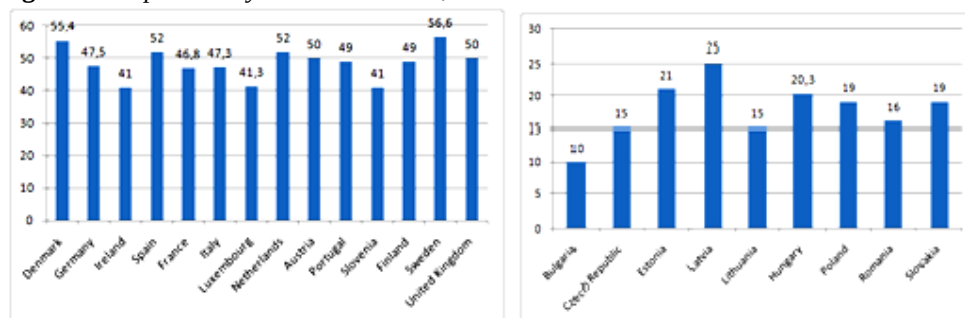
The existence of a situation in which countries are *in* and *out* has posed problems for both the former and the latter. For the countries which are in the risk that everyone feared was that currency devaluations of derogation countries might

take place which could adversely affect the competitiveness of the respective in countries' products.

The Amsterdam Treaty in June 1997 provided responses to this problem. In fact, it has forced all member countries to consider their exchange rate policy as a matter of common interest and to pursue policies consistent with price stability. The Treaty also requires developed countries which are out to present to the European Council convergence programmes for both budgetary balances and for monetary policy and has established a new exchange rate mechanism, EMS (European Monetary System), by fixing the central rates of their currencies against the euro and smoothing the fluctuations of exchange by 15%.

The economic literature (D. J. Mitchell, 1995 and 2001; M. P. Devereux, B. Lockwood, M. Redoano, 2002; B. Powell, 2003; A. Rabushka, 2003) has emphasized that tax competition may, however, be associated with positive aspects, such as, for example, the possibility of putting in place a framework that encourages expenditure control and a limit to distortions associated with too high a tax burden. For this reason, in recent times, both the Organisation for Economic Co-operation and Development (OECD) and the European Commission have focused on tax competition in a general sense, with the hope that this phenomenon could lead member states with a high tax wedge to lower their rates, to comply with the European trend.

Now, an analysis of the tax system in the 28 EU countries, the data released at the beginning of the last *Eurostat* release (May 2013) indicate significant differences between the various countries. The total tax burden reaches an average of 43.5% of GDP, a slight increase of 0.5% compared to the levels of 2012 with significant differences when we consider that the tax burden moves from 56.6% in Sweden to 15% in Lithuania, at least as regards to the taxation on income. Tax harmonisation in Europe has seen an uphill climb (except for a few goals as in the case of VAT that after the last enlargement of Europe to 28 countries, the range of VAT rates goes from 15% in Cyprus to 25% in Hungary), especially in the field of direct taxation. The field of personal income tax records, in fact, the greater resistance of the members to comply at a European Community wide level because every government tends to maintain its own sovereignty of an irreplaceable source of revenue and so there has been, so far, no plans to bring together brackets and the tax base.

Figure 1 - Top statutory income tax rates, out and in countries

Source: Eurostat, 2013

As we can see from the above Figure 1 there is a clear distinction and difference in income taxation of individuals, both for the countries *in* which those *out*. The lower rate for countries *out*, in fact, that in this case concerns Bulgaria appears to be a quarter lower than the lesser of countries, with Ireland.

The analysis of the differences in EU tax, however, cannot be considered apart from the corporate tax rate and the difference between countries *in* and *out*.

So, we can assert clearly which takes better account of the totality fiscal pressure in EU 28, the spin-off of the business records of the clear differences between countries (Eurostat, 2013). Those belonging to countries recorded a tax corporate on average 2 times higher than countries *out* with the minimum of taxation which is recorded for the countries *in* Ireland with 26.5%, compared to 16% in Bulgaria.

2.1. Fiscal divergence: the Flat tax

The main reason for the divergence in fiscal regimes among the countries of old Europe and the countries of the last enlargement to the East can certainly be found in the flat tax. In particular, starting from the second half of the nineties, in the name of greater simplicity and clarity of the tax burden, many important Eastern European countries have decided to introduce a tax with a single fixed rate with respect to all income categories and the drastic reduction of flat rate tax.

This new application has replaced the income tax rates of individuals and in some cases those applicable to legal persons and VAT. Therefore, thanks to a new economic approach, formed in the United States of America in the name of Chicago economics, the flat tax since 1994 has been adopted by all the countries of Eastern Europe. The first former communist country to introduce the flat tax in 1994 was Estonia, with the initial rate of 26%, which was subsequently reduced

and stands at 21% today; in 1995, Latvia implemented a flat tax of 25 %- 24% today - in order to prevent its foreign investments from being redirected towards its Baltic twin. In 2000, Russia embraced the theory of A. Rabushka (1996), with the introduction of a single rate of 13% instead of the previous three brackets with rates of up to 30% for personal income. Meanwhile in 2004 Slovakia introduced the rate of 19% on income of natural persons and legal persons, eliminating the five old personal income tax brackets and reducing the tax rate on business, to 25%. Finally, since 2005, Romania has also introduced a single rate of 16% on income in place of a system of five brackets for individuals and equal taxation for companies. In order not to lose competitiveness with Estonia and Latvia, the Lithuanian Prime Minister has introduced a flat tax of 15% in Lithuania. After, in Poland the centre parties introduced a flat tax that has been reduced from 32 to 19%. To properly assess the effects of the flat tax one can wonder why such a strong root has formed in Eastern Europe. It will have surely had an influence on the cultural formation of a new government elite, formed in the United States and in some cases just in Chicago. But it was even more affected by the miserable condition of the Treasury before the widespread failure of tax due and the inability of the administration to remedy the situation after decades of an economic system and communist planned economy. In such situations, the introduction of the flat tax has not had the effect of reducing tax revenue but rather increase it, because the tax revenue, while remaining unchanged in absolute terms, due to the strong economic growth of 5.5 % on average in 2012, has increased in percentage terms.

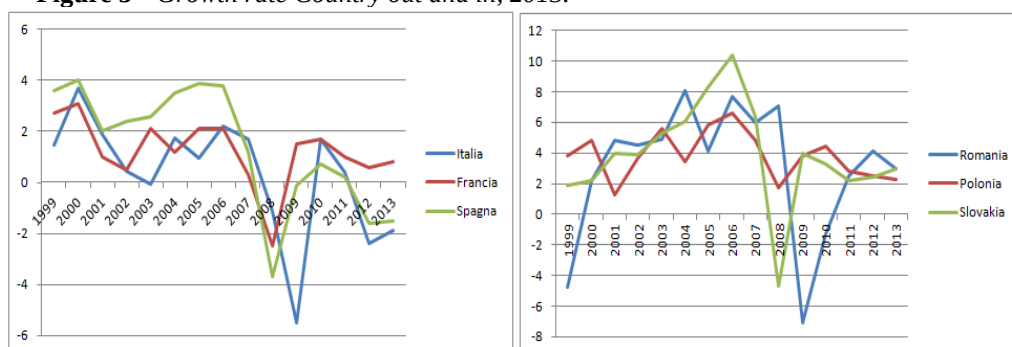
From the structural point of view, the flat tax has produced an effect in practice of extreme simplification of the tax system, the management of which does not involve any additional cost to the public administration especially during the establishment and recovery of evaded tax, and the risk-benefit ratio of evasion, including the tax obtained by authorities and the legal sanctions, given the simplicity of the system, discourages any evasion. It also discourages the effect of shifting the burden on indirect taxation, ie consumption and the effect of pushing private initiative to promote such development in terms of economic multipliers of aggregate demand. In this sense, the first driving force behind the expansionary effects is represented, in fact, by a noteworthy reduction in the tax burden that has so far accompanied the reforms. In the case of Romania, for example, the reduction was significant: before the changes, as we have mentioned previously, the maximum rate of personal income tax was 40%, while the single rate of post-reform has been fixed at 16%. In this way a portion of income was released that has been and may be destined for consumption or saving (and investment), with beneficial effects on present and future production. To enhance this effect the tax rates for business income are generally even lower and for Estonia, for example, total exemption for reinvested profits is even predicted.

The trend in corporate profits and the return on investment is directed toward the acquisition of the assets, therefore the decrease of the rates levied on business income has stimulated the inflow of capital from abroad. Another source of growth should be, finally, a willingness to work harder than those who are in the labour market and the return of discouraged workers, both of which are effects of the reduction in the tax burden on wages. all these conditions that lead to prefer the flat tax than other forms of taxation, have assisted in the countries out, economic growth and the ability to respond appropriately to international shocks.

We, therefore, wanted to investigate whether there was a positive correlation in the sense of Hodrick-Prescott between the flat tax and the business cycle, by a comparison with countries that do not adopt a flat tax instead. The countries considered are Romania, Poland and Slovakia for countries *out*, Italy, France and Spain for those *in*, with a monthly time series by 1999 to 2013 on the volumes of real GDP.

As clearly shown from the Figure 2 relating to two “sample” groups from countries which are in and out, the rate of growth of real GDP in the series considered is clearly different.

Figure 3 - Growth rate Country out and in, 2013.



Source: our representation in GRETL, time series plot on dates Eurostat, 2013

In particular, in the presence of almost synchronized economic growth rate from groups of countries, those countries which are out, starting from a situation of negative growth in the early 2000s, thanks to the application of a *flat tax* fiscal policy, have been able to record amazing first growth rates. They then overcame the adverse effects of the international economic crisis of 2007, recording growth rates since 2010, which are again positive. In contrast, in countries which are in, whose economic situation has worsened, creating a situation that has worsened with the setting of austerity-focused policies and that are slowing down the process of economic recovery after the crisis. One of the determinants of this gap not

only in economic growth but even better in response to processes of economic crisis can be sought precisely in the presence of strong fiscal differences. These differences are favorable for the new member states but are inconvenient for the western part of the European Union. In particular, the economic aggregates between the adoption of a very low single rate have reduced distortions in the countries which are out especially between demand and supply of labor: on the demand side, the reduction of the rate on businesses the problems related to not only internal low investments but also those from abroad.

In the countries which are in, for example, the total weight of taxation on profits (income tax, labor tax and other taxes) ranges from 68.3% in Italy to 38.8% in Spain, compared to 16% in Romania (3% with profits up to € 65,000), 19% in Poland, 10% in Bulgaria and 19% in Slovakia (OECD, 2013).

Table 1 - Correlation between growth rates and tax pressure, 2007-2013

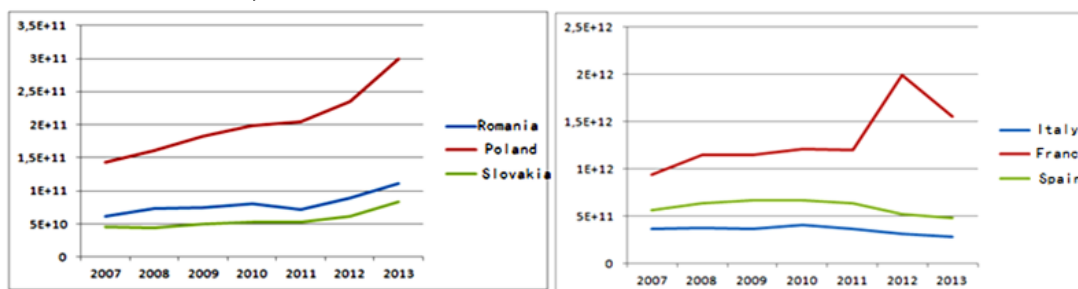
	Germany	Romania	France	Italy	Spain	Slovak.	Polan.	Tax press.
Germany	1							
Romania	0,3644	1						
France	0,9245	0,9124	1					
Italy	0,9815	0,9744	0,2154	1				
Spain	0,9454	0,9277	0,8787	0,9454	1			
Slovak.	0,3575	0,8525	0,02587	0,3254	0,5995	1		
Polan.	0,4526	0,7851	0,2598	0,2895	0,3659	0,8452	1	
Tax press	0,0852	0,8654	0,0545	-0,0154	-0,0487	0,8754	0,9852	1

As we can see from Table 1, the correlation between the tax pressure and rates of growth about *in* and *out* countries considered in the paper, for a the period 2007-2013 with quarterly data (Data World Bank, 2014), the tax burden has different effects. In particular, out countries (Romania, Poland and Slovakia) reported a positive correlation. Different it's the case about *in* country that shows a negative correlation or, in the case of Germany, a correlation value very low positive. This result can be considered as a determinant, *condicio sine qua non*, about different growth rates between countries *in* and *out*: low tax rate in countries *out* has facilitated economic growth, in contrast to countries *in* which the high tax pressure is delaying economic recovery.

The effect of these tax differences has immediately generated a shift in flows of foreign direct investment fleeing countries which are in, and arriving in those countries which are out.

Figure 3 - Stock of direct foreign investment (US dollars)

Source: Eurostat, 2013



As we can see from Figure 3 and from 2007 to 2013 according to 2013 OECD data, the stock of foreign direct investment in West European countries shows a declining trend that has become increasingly more evident since 2011. Conversely newly annexed countries clearly show an exponential growth in the stock of foreign direct investment, especially from 2011, the year in which the single rate began gradually decreasing.

3. Conclusion remark

The enlargement of the European Union did not generate any race to the bottom fuelled by tax competition but, on the contrary, it showed the presence of a process of upward convergence (R. Baldwin, Krugman P, 2004).

The need to outline appropriate tools to recovery and economic growth to the west, on the one hand capable of safeguarding the Monetary Union and, secondly, capable of responding to the inevitable competitive pressures of the tax model of the flat tax, represents the new challenge facing a European Union consisting of 28 countries. The solution must be sought in a critical review of both the stability pact and the standard economic theory that has so far inspired the various tax harmonisation projects in the European community.

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SUMMARY

Fiscal divergence and economic growth in the European Union

Tax competition in the EU-28 remains an important objective. However, the EU is characterized by two areas: countries *in* and countries *out*, members of the EMU and not yet members. The countries *in* have a tax system with high tax rates, while those out have a flat tax. The result of this paper demonstrates that it would be convenient also for the countries *in* the use of a flat tax, as pro-cyclical.

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