Tax Reform and Fiscal Sustainability in Central and Eastern European Countries

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Abstract: During the last years, as response to the economic crises, most European Union member states resorted to tax reforms in order to support the financial sector, to sustain demand and reduce internal balances. Considering the even more challenging context of Central and East European countries we aim at determining the effects of tax reform on fiscal sustainability, with the purpose of bringing light, and therefore solutions, regarding future developments. This paper provides a comprehensive analysis of fiscal sustainability and tax reform implemented in some Central and Eastern European countries that are also the most recent members that adhered to the European Union (Romania, Bulgaria and Croatia). Based on the results of the analysis, we conclude on the influence of tax reform on fiscal sustainability, one of the most stringent issued faced by most countries.

Keywords: public debt; budgetary balance; taxation; VAT

1. Introduction

The economic crisis imposed important pressure on public finances. Taxation and budgetary expenditure were used as instruments to support the banking sector, to sustain demand and lead the path to economic recovery. Facing macroeconomic downturn, most governments used fiscal policies in order to solve the above mentioned issues. Whether the measures involved short term or long term effects, taxation was mostly used in order to cover the necessary supplementary budgetary funds, through either tax reduction in order to encourage economic activity, or through tax increase with the aim of collecting more revenues, hence the base remained the same. The objective of this paper is to make considerations on the use of tax reform, based on the analysis of fiscal policies changes and discuss the results in terms of fiscal sustainability in some countries from Central and Eastern Europe, which are also member of the European Union: Bulgaria, Croatia and Romania.

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2. Literature Review

During the economic crisis, many European governments used public finances in order to face macroeconomic challenges. These actions, in the context of global economic downturn, resulted in increased budgetary deficits and unsustainable public debts. This is mainly the case of PIIGS countries (Lane, 2012; Lazar & Andreica, 2013), but the situation is similar in almost all European countries. Tax reforms were widely used as anti-crisis measures. Bernardi (2014), based on his analysis of tax reforms in European Union Member States since turn of the new century, highlighted the fact that very few changes were made during 2000-2011, while afterwards there has been a broader process of tax reform in almost all European Union member states. An explanation for this intensive use of fiscal policy, even after the first years of the crises, resides in the fact that tax reform offer a path toward both resolving budgetary impasses and making the kind of public investments that will strengthen the fundamentals of the economy (Stiglitz, 2014). As the recent macroeconomic dynamics underlined the necessity of improving the fiscal outcomes, even the European fiscal framework was updated and modified through the provisions of the new European economic governance meant to avoid unsound and unsustainable fiscal policies that could affect the stability of other Euro Area member states (Hurduzeu & Lazar, 2014).

Since the first years of the economic crisis, public authorities made efforts in reducing public debt. However, the situation is still worrying, as the level of general government expenditure remains still difficult to reimburse. Lopez-Carlos (2014) draws attention on the fact that although there had been episodes of high debt in the past, there are a number of long-term challenges today that are likely to complicate the implementation of sustainable fiscal policies in the coming years, as population ageing and climate change.

Having in view macroeconomic developments, this paper addresses fiscal sustainability in some Central and Eastern European countries, providing an overview on tax reform in Bulgaria, Croatia and Romania and concluding on the importance of a proper use of fiscal policy instruments.

3. Tax Reform and Fiscal Sustainability in Some Central and Eastern European Countries

In order to collect more revenue to public budgets, as to tackle macroeconomic challenges, tax reform were implemented in most European Union countries. In Bulgaria, for instance, there were changes regarding VAT rate, social contributions and personal income tax. In 2011 the reduced VAT rate on travel services increased from 7% to 9%, state pension contribution increased from 16% to 17.8% (although in 2010 had lowered with 2 percentage points, compared to previous year), while excise duties were abolished. In 2013 a change that affected interest income from bank deposits of individuals was applied. In Croatia, during 2010-2013, main tax reform measures were taken in 2012, when it was decided on the use of a standard 25% VAT rate and on the reduction of the compulsory health insurance contributions from 15% to 13%. Also, it was taken a measure meant to sustain the entrepreneurial environment, this being the decision of allowing entrepreneurs to deduct the reinvested earnings from their fiscal liabilities. During 2010-2013, tax reform was applied also in Romania. In 2010 VAT rate was increased from 19% to 24% and a 3% tax rate on gross income was reintroduced, that applies for micro, small and medium enterprises. Other changes concern excise duties on cigars, alcohol and energy.[1] In order to sustain the financial sector and having to face macroeconomic challenges, European countries were found in the situation of raising expenditure, in the context of economic downturn that led also to a decrease in public revenues, causing a significant increase in budgetary deficits in all European Union member states. Even countries that were registering budgetary surplus before the economic crisis faced a raise in budgetary deficits, afterwards. Bulgaria is one of these countries. During 2003-2008, Bulgaria registered surpluses up to 2%GDP. In 2009 however, the situation worsened significantly, budgetary deficit reaching 4.3%GDP. Bulgarian efforts of reducing deficits succeeded, since 2011 this indicator being in the limits imposed through the European fiscal framework.

Romania and Croatia registered more unfavourable dynamics regarding budgetary deficits, compared to Bulgaria. It can be noticed that Romania registered a much more pronounced drop in budgetary balance than Croatia, as, before the economic crisis the Romanian budgetary deficit was lower than in Croatia, the situation being different afterwards. This highlights a much greater internal imbalance in the

[1] All data are according to European Commission database.

Romanian economy, compared to Croatia. Since 2012, however, Romania managed to improve its budgetary balance, the deficit lowered to less than 3%GDP, respecting the limits imposed by the Maastricht Treaty. Croatia registered the highest deficit in 2011, of 7.5%GDP (Figure 1). Since then, the situation has slightly improved, but further efforts for budgetary deficit reduction are necessary.

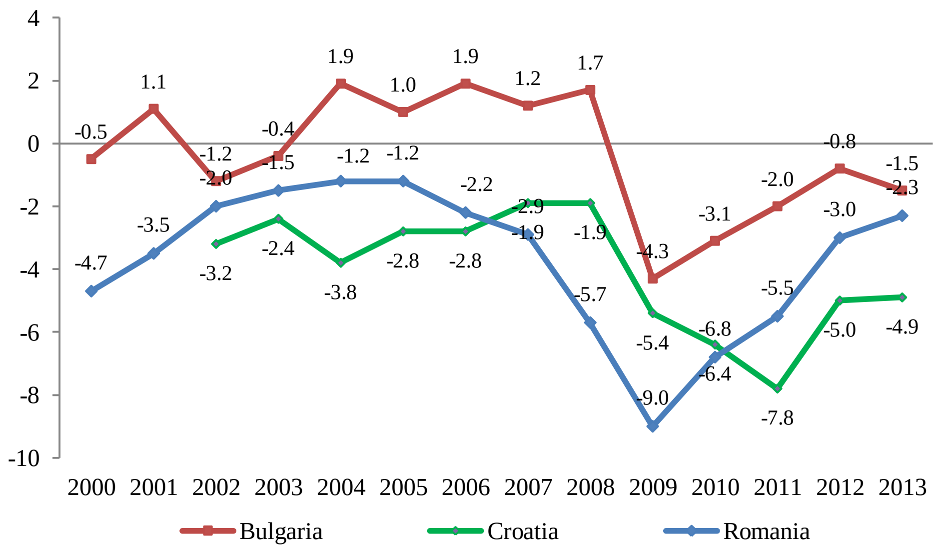

Figure 1. General Government Balance in some European Union Member States, during 2000-2013 (%GDP)

Increased budgetary deficits and the need for public action led to a raise in government debt that, in many countries, reached unsustainable levels. From the three countries analyzed, only Croatia is in a difficult situation. Although an increase in public debt was registered in all three countries, Romania and Bulgaria managed to keep the general government consolidated debt below the 60%GDP threshold. Both countries register very low levels of general government consolidated debt, compared to other European Union countries.

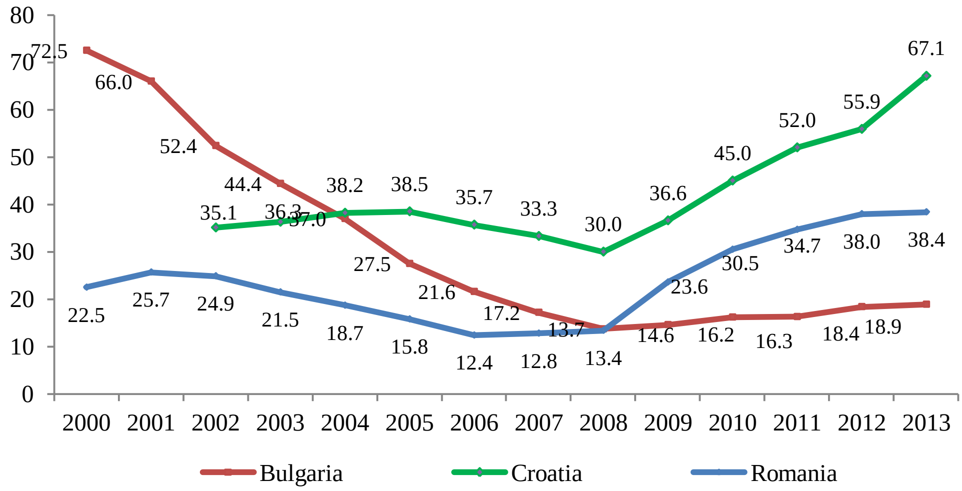

Figure 2. General Government Debt in some European Union Member States, during 2000-2013 (%GDP)

During 2000-2013 Bulgaria made significant efforts to reduce its public debt and managed to lower the level of general government debt from 66%GDP in 2000 to 13.7%GDP in 2007. In the context of global macroeconomic challenges, the Bulgarian public debt constantly increased, but is still below 20%GDP. Similar trend was registered in Romania that decreased its public debt from 22.5% GDP in 2000 to 12.8% GDP in 2006. In this country, however, public debt began to rise even from 2006, but a significant increase was registered since 2009.

In 2013 general government debt in Romania is at the pick of the period 2000-2013, but still below the limits of the Maastricht Treaty. Comparing the data regarding budgetary balance and public debt, it is highlighted the fact that indicators became to worsen even before the outbreak of the crisis. However, the most significant decrease in budgetary balance was in 2009, followed by a constant increase in public debt.

Croatia was within the European limits only in 2008 (30%GDP). Since then, public debt increased constantly, reaching 67.1%GDP in 2013. Comparing the situation of the three European Union countries taken into consideration, it can be concluded that Croatia is facing the worst situation in terms of fiscal sustainability. Considering the 60% threshold imposed on European public finances through the Maastricht Treaty, Croatia must make supplementary efforts to reduce its public debt. However, fiscal sustainability is connected not only to the level of public debt expressed as percent to GDP, but is dependent on debt service and the capacity of a country to sustain its economic activity, to collect enough public revenue and to reimburse its debt.

4. Conclusions

Macroeconomic challenges that countries had to face in the context of the economic crisis determined governments to resort to fiscal policy in order to restore economic activity. Taxation and budgetary expenditure were used as instruments to support the banking sector, to sustain demand and lead the path of economic recovery. In Bulgaria, Croatia and Romania taxation was used in order to cover the necessary supplementary budgetary funds, mostly through tax increase with the aim of collecting more revenue public revenues. These measures, taken in the context of the economic crisis, resulted in increased budgetary deficits and public debts.

The most significant drop in budgetary balance was registered in 2009 in Bulgaria and Romania. Croatia had different dynamics. Although budgetary deficits rose in the context of crisis, the pick was registered in 2011, determining the implementation of tax reform in 2012 and highlighting therefore the importance of fiscal policy in counteracting macroeconomic challenges. Increased budgetary deficits led to increased public debts. Even so, this situation does not represent an issue of fiscal sustainability in Bulgaria and in Romania. However, Croatia must make supplementary efforts in order to improve its fiscal sustainability, as in 2013, both budgetary balance and public debt level are above the thresholds, highlighting unsound and unsustainable public finances, according to the European fiscal framework.

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