COMMON FISCAL POLICY

Gabriel Mursa[*]

Abstract: *The purpose of this article is to demonstrate that a common fiscal policy, designed to support the euro currency, has some significant drawbacks. The greatest danger is the possibility of leveling the tax burden in all countries. This leveling of the tax is to the disadvantage of countries in Eastern Europe, in principle, countries poorly endowed with capital, that use a lax fiscal policy (Romania, Bulgaria, etc.) to attract foreign investment from rich countries of the European Union. In addition, common fiscal policy can lead to a higher degree of centralization of budgetary expenditures in the European Union*.

Keywords: common fiscal policy; foreign investment; taxes; public expenditure.
JEL Classification: F360; E62.

INTRODUCTION

The economic crisis that affected the global economy after 2007 manifested in the European Union as a crisis of confidence in the euro and in the monetary policy of the Eurozone. The main causes of this crisis of confidence in the European institutions was created by the trend to cover budget deficits through direct purchase of government bonds and by the increasing pressure exerted by some EU countries for debt syndication. Basically, after the onset of the economic crisis, many governments have abandoned the convergence criteria which provided strong conditions to ensure the stability of the single currency, the budget deficits of national government reaching impressive levels. The logical conclusion of supporters of European integration was that a common monetary policy can be effective if supported by a common fiscal policy (Allard *et al.*, 2013). Thus, in recent years, there is increasing pressure exerted by the most important EU countries to adopt and to accept a common fiscal policy. Basically, there is a strong trend in favoring the idea that the safeguarding of the single currency depends on the design and implementation of a common fiscal policy to enforce compliance with the convergence criteria, abandoned in recent years, which threatens the common monetary policy (Cottarelli, 2013). The role of this paper is to show that such a policy can be especially harmful to the poorer countries of Eastern Europe, that try to use the low level of tax as a comparative advantage for attracting foreign investment, taking into account that they have to that face a relative shortage of capital.

[*]Gabriel Mursa, Associate professor in Economics at the Alexandru Ioan Cuza University of Iasi, Romania, e-mail: gabriel.mursa@gmail.com.

3. TAXATION – METHOD FOR ATTRACTING CAPITAL

The economic integration under the umbrella of the European Union has many advantages for the citizens of the member states. The free movement of goods, services, capital and labor has allowed an increasing prosperity for most European citizens. However, the integration of the countries of Eastern Europe and of the three Baltic countries (Latvia, Estonia and Lithuania) revealed a significant difference in the welfare of the citizens of Western countries and of the citizens from the former communist countries. One of the main causes of this difference is the different degree of capital endowment. The EU founding countries are rich because they have tried to create the institutional conditions for capital accumulation, which can be seen in the average standard of living of citizens in countries like France, Italy, Germany, Belgium and UK. The significant amount of accumulated capital allowed these nations to significantly increase labor productivity, which contributed to an impressive growth of income *per capita*. In the same time, the former communist countries have failed to create a climate for a significant capital accumulation, which resulted in a low standard of living of their citizens. Thus, in the EU there are significant differences of prosperity, whose fundamental cause is the capital stock. However, this reality is a disadvantage for the nations of Eastern Europe, because the businesses and the citizens of these areas compete with the wealthier Western nations. One of the fundamental tools used by East European governments to reduce these gaps is a lax fiscal policy, evidenced by a relatively low rates of taxation. To stimulate the coming of foreign investment, the Eastern governments have designed and implemented fiscal policies that provided low taxes.

Therefore, the taxes have become a competitive advantage for attracting capital from rich Western countries of the European Union. This policy was a succefully one because, in recent decades, the Western countries have seen the fiscal policy as a method of wealth redistribution, from those with significant wealth to those with low incomes. Or, to be able to achieve these redistributive goals, the Western European governments have applied progressive rates of taxation, significantly increasing the share of national income spent by public institutions. Thus, in terms of fiscal policy, between the Western and Eastern countries of European Union there are two significant differences: a relatively high tax rate in the West and a relatively low tax rate in the East. In addition, the poor countries such as Romania and Bulgaria have tried to build a comparative advantage in eliminating the progressive tax policy taxation and introducing to a flat tax. Thus, the relatively poor countries of East try to attract capital from the richer countries of European Union, which are well equipped with capital but using high taxes, hoping thus may face fierce competition in the common market.

Tabel 1 - Tax rate on corporate income in EU (2013)

Highest Rates	Rate (%)	**Lowest Rates**	(%)
France	36.1	Bulgaria	10
Belgium	34	Cyrprus	10
Portugal	31.5	Estonia	15
Italy	31.4	Lithuania	15
Spain	30	Romania	16
Germany	29.8	Slovenia	17

Source: Eurostat

Tabel 2 - Personal income tax rates in EU (2013)

Highest Rates	Rate (%)	**Lowest Rates**	(%)
Sweden	56.6	Bulgaria	10
Denmark	55.6	Lithuania	15
Belgium	53.7	Romania	16
Portugal	53	Hungary	16
Spain	52	Estonia	22

Source: Eurostat

Tabel 3. Total Taxes as % of GDP (2011)

Highest Rates	Rate (%)	**Lowest Rates**	(%)
Denmark	47.7	Lithuania	26
Sweden	44.3	Bulgaria	27.2
Belgium	44.1	Latvia	27.6
France	43.9	Romania	28.2
Finland	43.4	Slovakia	28.5
Italy	42.5	Ireland	28.9

Source: Eurostat

As it can be seen from the above tables, the Eastern countries of the European Union tried to create a comparative advantage in significant lowering of taxes, as reflected in a relatively low tax burden (Eurostat, 2013) .

A careful analysis of these data reveals a very interesting thing, namely, that, in principle, the fiscal policy applied between Western and Eastern countries of the European Union presents significant differences, both in terms of capital taxation, in terms of personal income and generally in terms of overall pressure exerted by fiscal instruments on revenue. The overall differences between the two parts of the EU are clearly reflected when comparing the highest taxation level (Denmark) and the lowest taxation level (Lithuania). Basically, this degree of disparity achieves a huge level (83.4 %) when comparing the two countries of European Union.

In fact, the disparity between the rich and influential EU countries and the recently integrated nations of the East underlie the intention to impose a common fiscal policy. In a free market, such as the EU common market, the capital and the labor force move to areas where the net incomes are highest (Capie, 2004). However, these depend on the size of the net income taxes. As it can be seen from the previous tables, there is a significant difference between the taxes imposed in the two areas of the European Union. As a result, the capital owners have a natural tendency to move eastward in order to escape the tax burden from the Western areas of the Union. But this West - East transfer of capital tends to increase the interest rates in Western countries, which inhibit the economic growth and the job creation, generating a high unemployment rate, a diminishing of the income levels and increasing pressure on social security expenditures.

To avoid these undesirable effects of capital movement, supported by the fact that in principle the Eastern countries have a relatively cheap labor force, the Western countries, more politically powerful in the EU institutions, try to impose a common tax policy, using the pretext of returning to the convergence criteria, to support the common monetary policy in order to safeguard the euro and to enforce the political and economic integration of countries from the European Union.

4. DISADVANTAGES OF A COMMON FISCAL POLICY

The main argument of the supporters of the common fiscal policy is to supervise the governmental budgets of the member states, seen as an instrument to keep budget deficits under a strict control, which enables to fulfill the criteria for joining the euro for all countries of the European Union. In other words, the central institutions of the Union would impose a tougher budget discipline, which would ensure the stability of the single currency. During the last economic crisis, the huge spending of national governments, their inability to generate additional revenue led to significant budget deficits in many countries, which had created inflationary pressures that have weakened the position of the single currency. Therefore, the European Union policymakers have concluded that the stability of the euro depends on the control of deficits of the member countries. Consequently, they launched the idea that the sustainability of the common monetary policy, designed and implemented by the European Central Bank (ECB) depends on the unification of national fiscal policies in a common fiscal policy (Enderlein et al., 2012). This argument seems reasonable, but it is not strong enough because the most influential countries of the European Union, for example, France and Germany, have different views about the role of budget deficits to stimulate economic activity. Basically, Germany is part of the countries advocating for a relatively tough budgetary discipline, while nations like France and Italy are rather followers of inflationism, that is, of a lax fiscal policy. The idea of a common fiscal policy as a means of keeping control budget deficits, which tend to create inflation, to generate instability of the euro and the rise of interest rates in Eurozone, appears to be based on erroneous arguments.

In fact, the Western countries try to impose a common fiscal policy to avoid moving the capital to the East of the European Union in order to escape the high tax burden in countries like France, Belgium, Italy and Spain. An eastward migration of capital generates negative for the Western countries. First, the Western governments can not collect incomes because the capital flight. In principle, the French capital moving to Romania generates taxable income in the destination country. The French government loses revenues in behalf of Romanian government. Secondly, the movement of capital rises the interest rates in France and it diminishes the interest rates in Romania. However, the higher interest rates would adversely affect the level of investment, output, income and employment, which creates additional pressure on social security systems so ineffective in the Western countries. A high unemployment rate and a low level of personal income generates additional political pressure on governments in Western Europe, a pressure that could lead either to a decrease in public spending or an increase in the tax burden, both difficult to support by any democratic government.

Therefore, the rich and the powerful countries of the European Union have no interest in a lax fiscal policy used by the new countries of the EU as a competitive method to raise capital. This is the real reason they are declared adherents of a common fiscal policy. Obviously, they gain from the implementation of such measures. However, both the owners of capital and the Eastern countries will lose if it will be implemented effectively because they lose a comparative advantage in the dispute with the West.

A real common fiscal policy means the same level of taxation in the European Union. However, the main losers of such a policy will be the Eastern countries, which in the absence of high levels of savings can not quickly accumulate capital in order to compete with Western companies and citizens; in fact, their only opportunity to increase productivity and prosperity in the short and medium term is to create favorable conditions for attracting capital from the rich areas of Europe. A common fiscal policy would destroy this comparative advantage, because it is hard to think that the Western countries will accept the lowering of the tax burden of their own countries.

A common fiscal policy would require the leveling of the different degrees of fiscal pressure now existing in the 28 countries member. However, this leveling will increase taxes and public spending in Eastern countries, not cutting the taxes and government spending in the Western countries. The governments of the Western European Union support an impressive public sector and a social security system extremely cumbersome, producing benefits for well-organized pressure groups and for different categories of voters of different parties. Therefore, a cutting of the governmental expenditures will generate immediate effects on the political and economic status quo of these countries. A significant reduction of public expenditure would involve a profound reform of economic, political and social systems in the Western world, reforms that would impose huge costs for politicians. Therefore, it is difficult to believe that they would accept a significant decrease of public expeditures, in order to sustain a significant reduction of the tax burden. In addition, these countries are the most powerful political forces in the European institutions, which gives them a great advantage in relation to the new members, the Eastern countries. Consequently, a common fiscal policy will increase the taxes in Eastern Europe at a level close to that of the Western countries. But if this happens, the Eastern countries lose a relatively efficient way to increase the living standards of their citizens.

A single tax system would prevent the movement of capital to the poorest areas of Europe because this transfer always involves a cost. Under the current conditions, with varying degrees of tax between different parts of the EU, these costs are outweighed by the benefits of placing capital due to lower taxes in the East. A common fiscal policy would lead to the disappearance of these differences and thus eliminates capital gains from relocation. In an integrated economic system, the free movement of goods, services, capital and labor force removes some of the disparities between its different areas, it allows inputs to move from areas where they are relatively abundant to those where are relatively scarce. Through their free movement, the inputs eliminate the disparities of economic development, making the entire system more homogeneous in terms of the prosperity of its members, in fact, a major goal in the European Union. In practice, this would mean perpetuating inequalities of wealth between the member countries, which would make the European Union a heterogeneous economic space. The logic of the European common market is deepening division of labor and stimulating exchanges, but for something to happen it is necessary that competition must be an essential vehicle of resource allocation, and therefore of the capital.

A common fiscal policy equalizes the taxes and eliminate the tax competition as a mean of an efficient capital investment. The main losers after its introduction will be both the Eastern European countries and the Western European capital owners. By the rising taxes in the Eastern part of the European Union, the Western capital will remain in their countries of origin because its results will be taxed to the same extent anywhere in the 28 member states. The Eastern economies will lose an extremely important opportunity for modernization. In these circumstances, the cost of relocation from West to East will eliminate the benefits transfer. Secondly, the capital owners will lose because they will have to settle for lower yields in Western countries, where the relative abundance of capital makes generates relatively low capital incomes. But in the Western world, the capital is quite democratized, it come from a large number of individuals that save money, from ordinary employees to the traditional owners of financial funds. The high incomes of Western countries create the opportunity to save more and to place the savings in the financial system, banks, pension funds, investment funds, these amounts of being used by investors. When the free movement of capital is restricted by artificial barriers, for example, by standardizing the size of taxes between different parts of an economic system, all these individuals who save money are discouraged. Thus, a policy of uniform tax system in the European Union will result in a downward trend in the savings of the Western countries and a decreasing capital returns in this area of the world. However, a lower gain of capital will determine the trend of destroying it.

The tax competition should be one of the most important tools to compete in an integrated economic system (Teather, 2005). It is needed in order to stimulate the movement of capital to the deficient areas in this regard. Moreover, the EU countries should leave fiscal policy to the local or regional authorities, because the capital endowment differences occur not only between different EU countries, but also between regions of different countries. Thus, the fiscal policy must be a tool used by every region of a nation to solve their own problems with capital equipment; it must not be an instrument used by the national governments and by supranational structures like the European Union (Kay, 2011).

A common fiscal policy contradicts a basic principle of the European Union, the subsidiarity, as set out in Article 5 of the Treaty on the Functioning of the EU, claiming that decisions are taken by entities located as close as possible to the citizen. Between the desire to level taxes, to supervise the national budgets by the central bodies of the European Union and the alleged decentralization claimed by its principles of organization there is a glaring contradiction. Apparently, the control of the EU bureaucracy on national or regional budgets try to avoid excessive budget deficits, which under a common monetary policy and a single currency can generate inflationary pressures; but inflation leads to arbitrary transfers of wealth between countries. Actually, the express desire to supervise the national and local budgets leads to an excessive centralization of decision making related to spending the public revenues. The way of spending the revenues created by citizens depends on decisions made by entities as far as possible from them. The immediate consequence of this action is the loss of real control over the use of the tax revenues, leading to discretionary expenditures and to a reckless use of the taxpayers income. By such a policy, the welfare of the citizen in every part of the European Union depends on the anonymous bureaucracy in Brussels, not on the direct decisions of local representatives.

By applying a common fiscal policy, the European Union's founding principles does not appear to undergo significant changes. In fact, the founding documents of this political structure provide the harmonious development of its component parts, consisting of countries and regions. But the fundamental difference introduced by a common fiscal policy refers to a definite way to achieve this ideal. When national and regional entities are free to use a fiscal policy, the process of reducing the development gaps is based on the free market, that is, on tax cuts stimulating the creation of a comparative advantage in attracting capital. The relatively poor countries or areas of the European Union can attract capital from the rich ones. By this method, the local authorities create the opportunity of the free movement of capital, the final decision being made by the owners or investors. With a common fiscal policy, the process of reducing development disparities between countries or regions depends on political decision of central EU institutions. In other words, the capital moves through European investments, driven by political decisions made by those who are part of the bureaucracy of this new supranational structures. The major disadvantage of the method of resource allocation policy is to ignore economic efficiency imposed by scarcity.

CONCLUSIONS

The recent discussions about the introduction of a common fiscal policy must be viewed with much skepticism. In principle, its role is to strengthen the position of the euro through an additional mechanism to respect the convergence criteria, a position weakened during the economic crisis of recent years. Unfortunately, a common fiscal policy generates many disadvantages especially for the poor countries of the European Union, which tried to improve the prosperity of their citizens through a lax fiscal policy, which aims to attract foreign capital. The low rates of taxation in the Eastern countries have attracted capital from the Western Europe, allowing a gradual reduction of the development gap that separated and still separates the two regions of the European continent. The introduction of a common fiscal policy would lead to the loss of this comparative advantage and would seriously hamper the financing of the economies of Eastern Europe. This policy would clear disadvantages the Western capital owners and it discourages the saving in this rich area of the European Union. The equalization of tax rates would hamper the free movement of an essential factor of production, reducing the overall efficiency of resource allocation processes in the 28 member states. A common fiscal policy would lead to an excessive centralization of decisions in the European Union, seriously affecting the principle of subsidiarity in the allocation of scarce resources.

REFERENCES

Allard, C. (ed.) (2013) *Toward a Fiscal Union for the Euro Area*, IMF Staff Discussion Note, accessed on April 2014 at https://www.imf.org/external/pubs/ft/sdn/2013/sdn1309.pdf.

Capie, F. (2004) *Capital controls: a `cure` worse than the problem*, London, England: IEA.

Cottarelli, C. (2013) *European Fiscal Union: a vision for the long run*, accessed on April 2014 at http://www.imf.org/external/np/speeches/2012/110112.htm

Enderlein, H. (ed.) (2012) *Completing the Euro: a road map towards fiscal union in Europe*, accessed on April 2014 at http://www.notre-europe.eu/media/completingtheeuroreportpadoa-schioppagroupnejune2012.pdf?pdf=ok

Eurostat (2013), *Taxation trends in the European Union*, News Release, available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-29042013-CP/EN/2-29042013-CP-EN.PDF

Kay, J. (2011) *Europe's elite is fighting reality and will lose*, Financial Times, available at http://www.ft.com/cms/s/0/d5215992-fe6e-11e0-bac4-00144feabdc0.html#axzz30kP7zPEE

Teather, R. (2005) *The benefits of tax competition*, London, England: IEA.