Enlarging the European Union: Taxation and Corruption in the New Member States

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ABSTRACT
This paper addresses the run up to the recent European Union enlargement. It considers the accession of 10 Eastern European countries in view of the pre-existing economic conditions. The paper also raises the question how the new member states can tackle their deficit problems. In particular, the paper pays attention to the question at what point the emphasis should be placed on cutting expenditure rather than raising revenues. Furthermore, the paper addresses tax capacity and tax effort in the new member states. Finally, the paper looks at possible negative relationships between corruption and tax effort on the one hand and corruption and foreign direct investments on the other.

INTRODUCTION

It was only 18 years ago that the Berlin Wall fell. Anyone who predicted at the time that the former East Bloc states would join the European Union within 18 years was considered to be a dreamer. However, after decades of communism and Soviet domination the countries in Central and Eastern Europe wanted to return to Europe, as the then Czech president Vaclav Havel put it. The European Union responded promptly and positively by encouraging the former socialist countries' reorientation to the West. As early as 1989 the European Union set up the Phare[1] program to offer financial support to the countries of Central Europe and to help them cope with drastic economic restructuring and political change. The fact that this process started with Poland and Hungary seems quite logical, since they were the first of the former East Bloc countries to distance themselves from their communist past. The German unification in 1990 marked the end of the historic division of Europe resulting from the Yalta negotiations of the allies who defeated Germany in World War II.

In 1991, Poland and Hungary were the first countries to conclude Europe Agreements with the European Union. Again, they were the frontrunners in Central and Eastern Europe. The aim of the agreements was to establish a free trade area between the European Union and the associated countries. In 1993, Agreements were also concluded with Bulgaria, the Czech Republic, Romania and Slovakia. Estonia, Latvia and Lithuania followed in 1995 and Slovenia in 1996. Next, the associated countries applied for European Union membership.

In 1992, the European Council adopted the now well-known Copenhagen criteria that candidate member countries will have to meet to a sufficient number of benchmarks before accession negotiations can begin. The benchmarks comprise political, economic and administrative criteria. In 1997, the European Council invited five Central and Eastern European countries (Hungary, Poland, Estonia, the Czech Republic and Slovenia) to start accession negotiations. Also, the European Union developed a pre-accession strategy assisting the associated countries to prepare themselves for membership.

By inviting only five countries to open accession negotiations the European Council divided the ten accession countries in Central and Eastern Europe in a first wave (the five above-mentioned countries) and a second wave (Bulgaria, Latvia, Lithuania, Romania, and Slovakia). In 1999, however, the European Union effectively abolished the concept of accessions in two waves by also inviting the other countries to start accession negotiations. As a result, the European Union engaged in simultaneous accession negotiations with all candidate member countries (including the two Mediterranean mini-states, Cyprus and Malta, but excluding Turkey).

In December 2002, the European Council closed negotiations with ten candidate member countries. As a result, they joined the European Union on May 1, 2004 and the European Union's membership increased from 15 to 25 countries. Eight of the new member countries are former East Bloc states including three former soviet republics (the Baltic States: Estonia, Latvia and Lithuania) and five countries in Central and Eastern Europe (Hungary, Poland, Slovenia, Slovakia, and the Czech Republic). The other two countries that joined the European Union are mini-states in the Mediterranean (Cyprus[2] and Malta). Accession negotiations with Bulgaria and Romania continued and resulted in their accession on January 1, 2007. In addition, there are three candidate member countries (Croatia, Macedonia and Turkey). Two of them (Croatia and Turkey) have already begun accession negotiations. Albania and the other former Yugoslav republics that are not yet (candidate) member countries are potential candidate member states.

ACCESSION AND ECONOMIC CONDITIONS

The accession of the former East Bloc countries has progressed surprisingly fast. It seems questionable, therefore, whether they were ready for European Union membership in all respects. The Treaty on European Union says in Article 49 that "any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union". Article 6(1) states that “the Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States.” The Copenhagen European Council has made the principles set out in Article 6(1) of the Treaty on European Union more concrete. These so-called Copenhagen criteria comprise a political criterion, an economic criterion, and the ability to take on the *acquis communautaire*:

1. Stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.
2. The existence of a functioning market economy, as well as the ability to cope with competitive pressures and market forces within the European Union.
3. The ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

The answer to the question whether candidate member states meet these criteria is political in nature and, thus, open to political interpretation. The impression has been raised that political pressure to keep the enlargement process going has prevailed in a number of cases and that in fact not all new member states sufficiently meet the Copenhagen criteria. The level of economic development is generally still very low (and the unemployment rate very high), while the administrative capacity is often still very limited. The political criterion - democracy, the rule of law, human rights, etc. – together with geopolitical considerations seem to have settled the matter in a number of cases. The new member states in Central and Eastern Europe have little experience with a market system and the decision-making processes in Brussels. However, the European Union's eastern enlargement is a fascinating adventure that undoubtedly will lead to more stability in Europe and a reduction of the risk of wars within the area to zero. That was precisely the main driving force behind the creation of the European Union's predecessors in the 1950s.

Approximately half of the new member states still cope with budget deficits that exceed 3% of GDP (the Maastricht criterion). Figure 1 shows the budget deficits in the period 1991-2007 in the three regions that the European Bank for Reconstruction and Development (EBRD) discerns: Central and Eastern Europe and the Baltic States, South Eastern Europe, and the Commonwealth of Independent States.[3] In the first years after the collapse of the Soviet Union budget deficits increased to high levels. The highest level was reached in the Commonwealth of Independent States, it was somewhat less high in South Eastern Europe and the relatively lowest level was reached in Central and Eastern Europe and the Baltic States. From the mid-1990s, deficits came more and more under control. Notably, from 2000 a kind of role reversal emerged. Deficits are now at the highest level in Central and Eastern Europe and the Baltic States and at the lowest level in the Commonwealth of Independent. However, the average deficit in the Commonwealth of Independent States is heavily influenced by the large surpluses in oil-rich countries like Russia (8.1% in 2005) and Kazakhstan (5.3% in 2005). The differences among individual countries are also large in Central and Eastern Europe and the Baltic States, where general government balances in 2005 varied from a surplus of 2.3% of GDP in Estonia to a deficit of 7.8% in Hungary, while estimates for 2006 and 2007 do not fundamentally change the picture.

There are also considerable differences in attractiveness of the new member states for foreign investors. Table 1 displays the cumulative inflows of foreign direct investments since the fall of the Berlin Wall in each of the new member states in Central and Eastern Europe and the Baltic States as well as in the candidate member countries in South Eastern Europe. Given the differences in population size the table does not contain the total amounts of foreign direct investments, but rather the amounts per capita. Obviously, the Czech Republic is the foreign investors' darling. Notable is the second place of Estonia. As a former soviet republic its starting position was considerably weaker than those of the other countries of the former East Bloc. Contrary to Poland's image in the popular press and with the public at large this country has attracted a mediocre amount of foreign direct investments in the period 1989-2006. Also notable is that Croatia scores relatively high with an amount of foreign direct investments that matches Slovakia's, which is number four on the ranking list of foreign direct investments in the new member states. On average, Central and Eastern Europe and the Baltic States have attracted \$3,030 per capita in the period 1989-2006, which is nearly two times as much as South East Europe’s average (\$1,658).

TAX CAPACITY AND TAX EFFORT

Since most countries in the region cope with continued budget deficits, as Figure 1 illustrates, the question arises as to how these countries can tackle their deficit problems. In principle, governments have a choice between two strategies: increasing revenues or cutting expenditure. It goes without saying that a combination of both strategies is also possible. The question arises on what basis a government can make a choice. In other words, at what point should the emphasis be placed on cutting expenditure rather than raising revenues?

Answering this question involves evaluating a country’s tax capacity and tax effort. *Tax capacity* is defined as the ability of a government to raise tax revenues based on structural factors including the level of economic development, the number of “tax handles” available, and the ability of the population to pay taxes (Chelliah, 1971, p. 293). *Tax effort* is defined as a measure of how well a country is using its taxable capacity, that is tax effort is the ratio of actual tax revenues to taxable capacity (Bahl, 1971, p. 582). Indices of tax effort provide a tool for measuring differences between countries in how effectively they are using their potential tax bases. These indices may indicate the appropriate policy for dealing with budget deficits. For example, countries with a high tax effort index may need to look at reducing expenditure rather than raising taxes (Stotsky and WoldeMariam, 1997).

Figure 2 shows general government revenue as a percentage of GDP over the period 1996-2004 in the three regions, while it includes as benchmarks the USA and the EU-15 (the European Union of 15 member states as it existed before May 1, 2004). In Central and Eastern Europe and the Baltic States, the tax burden is comparable to that of the EU-15 and, thus, well above the level of the USA. In the mid-1990s, South Eastern Europe's tax burden was well below the level of the EU-15 and even lower than the level of the USA, but it increased in the late 1990s. From the turn of the century tax levels in Central and Eastern Europe and the Baltic States and South Eastern Europe are on average within the range of European Union countries, which is roughly 30-55% of GDP (van der Hoek, 2003, p. 22). Though large differences exist across individual countries, only one of the new member states has a tax/GDP ratio below this range. The total tax level in Lithuania amounted to 27.4% in 2004, but it was somewhat higher in previous years. Slovenia's tax/GDP ratio amounted to 45.4% in 2004, which was the highest of the accession countries in Central and Eastern Europe and the Baltic States. In two other accession countries (Hungary and Slovakia) the tax burden in 2004 was also over 40% (nearly 45%). In particular in the period 1997-2000 the total tax level of Slovakia was considerably higher than in 2004.

In the Commonwealth of Independent States the situation with regard to the tax burden is the reverse. As can be expected, these countries face the greatest taxation problems. They have been under communist rule for over sixty years. The state financed itself through state-owned companies rather than taxation, so the countries in this region have little experience with taxation and markets. No wonder that they are the only of the three regions where the total tax level is clearly below the range of tax burdens in the member states of the European Union. Until the early 2000s it was even lower than the level of the USA. In 2004, five of the Newly Independent States had a tax/GDP ratio that fell within the range of European Union countries (Uzbekistan with 32.3%, Moldova with 34.7%, Ukraine with 35.6%, Russia with 38.6% and Belarus with 46.2%).

APPROACHES TO TAX CAPACITY

It seems relevant to know how well the new European Union member states are utilizing their tax capacity. Musgrave (2000) identifies three factors that determine a country's taxable capacity:

- The stage of development, often measured by per capita income.
- The existence and extent of "tax handles".
- Efficacy of tax administration.

Each of these factors contributes either to a country's potential taxable base (for example the greater the level of economic development the higher the income tax base) or contributes to the accessibility to that tax base by the government. For example, an economy with a sizeable and established manufacturing sector has more easily identifiable and accessible taxpayers than an economy that is largely agricultural or comprised of many small traders. A well-developed manufacturing sector points to the existence of a "tax handle."

A simple measure of tax effort across countries might compare countries' tax/GDP ratios, but such comparisons would ignore differences in tax capacity across countries. Countries differ with respect to their economic situations, for example per capita income, economic structure, resources, and other factors. These differences must be accounted for when measuring tax effort. Another approach, therefore, is using regression analysis across countries to predict a country's tax/GDP ratio (Bahl, 1971; Chelliah, 1971; Stotsky and WoldeMariam, 1997; Tait, Gratz, and Eichengreen, 1979; Tanzi 1968; Tanzi, 1992).

A tax effort index can be developed as the ratio of actual tax share to the predicted tax share. An index of 1 means the country's tax effort is at the "expected" level, given the structural factors of that country. In other words, the country is using its taxable capacity at a level consistent with the average of the other countries in the sample. By comparing tax effort across similar countries, it may be possible to identify countries that have the potential to increase tax revenues through increased tax effort. Alternatively, countries may be identified where tax effort is already relatively high and it would be more obvious to closely examine the expenditure side of the budget in order to reduce the budget deficit.

A study by Mertens (2003) uses a regression approach covering the period 1992-2000 and including data for ten countries in Central and Eastern Europe and South Eastern Europe: Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, the Slovak Republic, and Slovenia. Notably, this sample does not include all new European Union member countries. Rather, it comprises seven new member states, two candidate member countries (Croatia and Macedonia) and one potential candidate member state (Albania). A very interesting dimension of this study is that it presents a ranking based on each country's deviation between its actual and predicted tax/GDP ratio. Table 2 summarizes the results. The value of –14.9% for Romania in 2000 means that the country's actual revenue share was 14.9 percent lower than that predicted by the model. To my knowledge there are no comparable data available for the "old" member states of the European Union. To obtain them would require a separate research study because they will have to be calculated on the basis of a regression analysis.

The results of the Mertens study suggest that in several Central and Eastern European and South Eastern European countries - especially Bulgaria, Poland, Romania and Slovakia - deficit reduction is possible through increasing tax effort. The European Commission may use this kind of information to assess to what extent these countries prepare themselves for membership of Economic and Monetary Union. As the new member states have to accept the principles of Economic and Monetary Union, they will have to meet the Maastricht criteria regarding inflation, real interest rates, budget deficits, public debt and exchange rate stability. Contrary to the "old" member states, the new member countries do not have the latitude to opt out of Economic and Monetary Union. The European Commission may use the data pertaining to tax effort in particular in relation to the Stability and Growth Pact's budget deficit criterion.

FUTURE RESEARCH

The study cited above (Mertens, 2003) points out some possible avenues for further research. Countries in Central and Eastern Europe and South Eastern Europe have had myriad tax law changes as well as major tax reform efforts during the 1990s. Reviewing these events may shed light on what is happening with tax effort in Central and Eastern Europe and South Eastern Europe. For example, Slovenia and Croatia consistently have tax effort indices above one, while both have positive deviations from predicted tax shares for each year. These two countries have many factors in common, including a steady approach to tax reform. Slovenia introduced a new income tax law in 1994, a new tax administration law in 1997, and the VAT in 1999. Croatia began in 1993 creating its tax service, introduced income taxes in 1994 and the VAT in 1998. Because tax administration is an important component of tax effort, further examination of these relationships is warranted.

However, there is another factor that warrants further examination: corruption. Though it is a phenomenon that is not easy to study, data are available about perceived corruption levels in a large and growing number of countries. Transparency International, a Berlin based institution, publishes an annual Corruption Perceptions Index for a growing number of countries. The scores range between 10 (highly clean) and 0 (highly corrupt) and relate to perceptions of the degree of corruption as seen by business people and risk analysts. Respondents expressed their perceptions in surveys assessing a country's performance. At least three surveys are required for a country to be included in the Corruption Perceptions Index. Therefore, in its 2006 index

Transparency International could include only 163 of the more than 200 sovereign nations.

Table 3 shows the amount of perceived corruption over time in selected countries. In 2006, Finland was perceived as the cleanest country and Haiti as the most corrupt. Table 3 includes new European Union member states (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) as well as two candidate member countries (Croatia and Macedonia). In addition, it includes Russia, several large western countries (Australia, Germany, UK and USA), the two most corrupt "old" European Union member states (Greece and Italy) and a potential candidate member state (Albania).

Politicians pay lip service to the fight against corruption, but they fail to clamp down on corruption to break the vicious circle of poverty and graft. Corruption seems a self-sustaining phenomenon, since anti-corruption measures tend to be adopted where they are needed least: in countries that do not have particularly serious corruption problems (Steves and Rousso, 2003, p. 28). Transition countries with low levels of administrative corruption have been more likely to adopt intensive anti-corruption programs than countries with high levels of administrative corruption.

The low scores for countries in Central and Eastern Europe, the Baltic States and South Eastern Europe – with Estonia and Slovenia as notable exceptions - indicate that doing business in these countries is not only subject to normal business risks, but also to additional risks resulting from corruption. As a result, businesses face additional uncertainties. Particularly worrying is that the amount of perceived corruption does not diminish over time in half of the new member countries. Rather, it remains more or less stable (Bulgaria, the Czech Republic, Hungary and Romania) or even grows (Poland). It seems plausible that a negative relationship exists between corruption and economic development in general. Corruption creates additional risks for businesses and disturbs market signals hampering economic growth. More in particular, negative relationships seem plausible between corruption and tax effort on the one hand and corruption and foreign direct investments on the other hand. Corrupt tax inspectors fill their private pockets rather than the public purse, while corrupt officials make foreign direct investments more risky.

However plausible these hypotheses are, I have found only very weak empirical evidence supporting the hypotheses of negative relationships between corruption and tax effort and between corruption and foreign direct investments. Figure 3 displays how the data pertaining to the Corruption Perceptions Index and tax effort were related in 1998/1999. This figure suggests there is no relationship at all. Figure 4 shows how the averages of the data pertaining to the Corruption Perceptions Index in the period 1996-2006 relate to the average foreign direct investments data in the period 1989-2006. This figure suggests there might be some weak relationship between the two variables. Therefore, it seems worth doing more research in this area in future to unravel a possible relationship between foreign direct investments and the extent of corruption.

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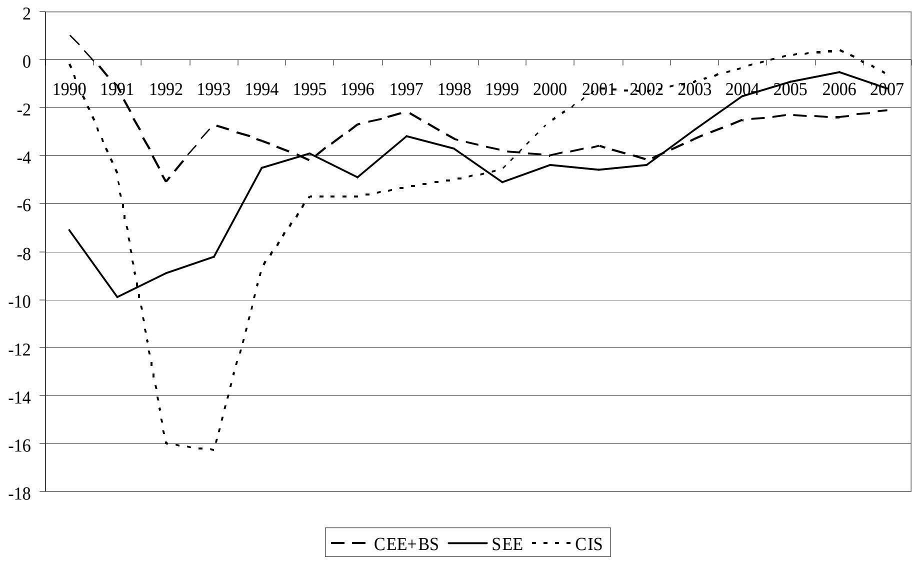
Figure 1. General Government Balances (in % of GDP), 1991-2007. [a)]



a. Estimates for 2006 and 2007.

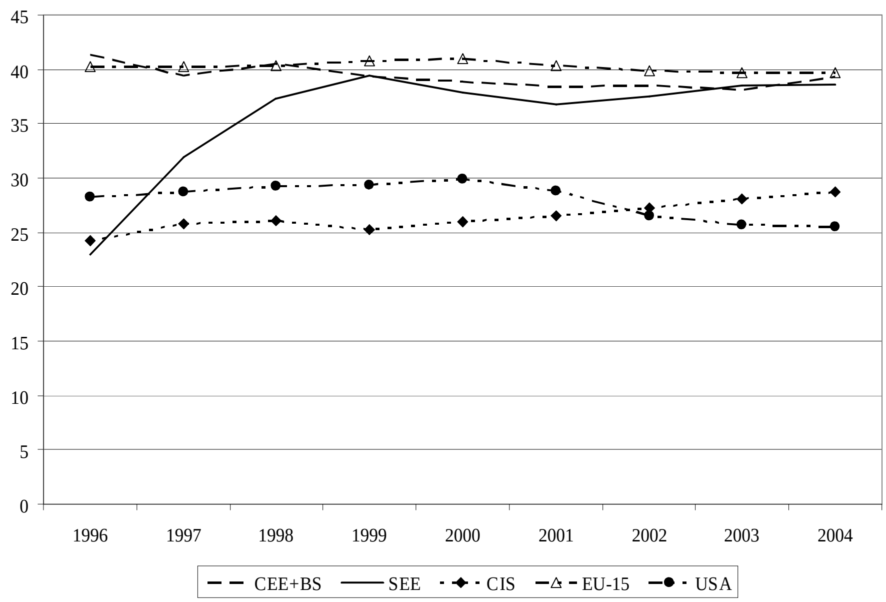
Source: EBRD

Table 1. Cumulative inflows of foreign direct investments per capita (US$), 1989-2006.

New member states		
1.	Czech Republic	5,512
2.	Estonia	5,098
3.	Hungary	4,545
4.	Slovakia	3,194
5.	Latvia	2,203
6.	Poland	2,123
7.	Lithuania	1,669
8.	Bulgaria	1,575
9.	Slovenia	1,333
10.	Romania	1,110
Candidate member states		
1.	Croatia	3,177
2.	Macedonia	814

Source: EBRD

Figure 2. General Government Revenue (in % of GDP), 1996-2004.



Source: EBRD and OECD

Table 2. Deviation of Actual Tax Share from Predicted, as a Percentage of Predicted, 1992-2000.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Albania	-4.7	17.2	15.4	14.8	-12.2	-10.6	3.3	0.4	12.0
Bulgaria	-3.5	-19.1	-8.9	-15.8	.	-6.9	-1.4	-10.1	-13.4
Croatia	.	.	21.0	22.8	21.6	17.7	25.7	10.6	7.9
Czech Republic	.	11.0	8.6	7.7	5.4	-2.0	-4.4	-2.0	.
Hungary	4.4	9.1	2.3	10.4	5.6	1.9	1.0	.	.
Macedonia	.	.	.	.	-4.1	-7.0	-10.6	-8.7	.
Poland	-3.1	3.6	-2.3	-4.2	-6.1	-8.3	-11.6	-14.7	-16.6
Romania	8.8	5.1	-5.9	-3.5	-9.8	-14.6	-15.7	-10.1	-14.9
Slovakia	.	.	-5.3	3.7	2.1	-5.9	-9.2	-14.3	.
Slovenia	.	11.6	9.7	8.0	5.5	3.7	4.0	6.2	1.7

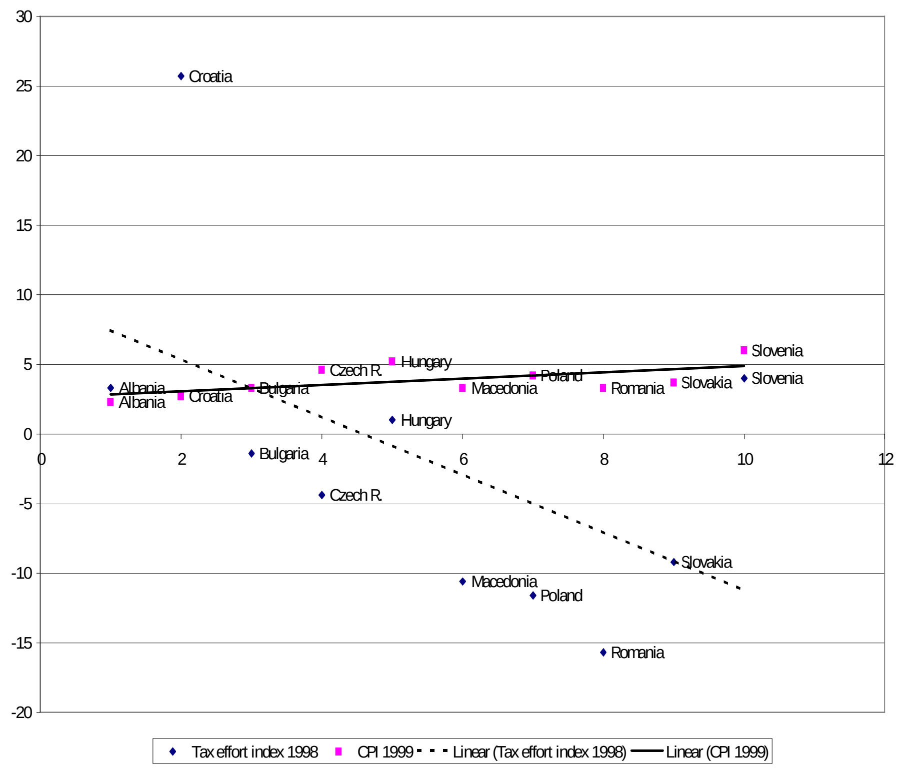
Source: Mertens (2003), p. 548.

Table 3. Corruption Perceptions Index, 1996-2006

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1.	Finland	9.1	9.5	9.6	9.8	10.0	9.9	9.7	9.7	9.7	9.6	9.6
9.	Australia	8.6	8.9	8.7	8.1	8.3	8.5	8.6	8.8	8.8	8.8	8.7
11.	UK	8.4	8.2	8.7	7.2	8.7	8.3	8.7	8.7	8.6	8.6	8.6
16.	Germany	8.3	8.2	7.9	6.2	7.6	7.4	7.3	7.7	8.2	8.2	8.0
20.	USA	7.7	7.6	7.5	7.5	7.8	7.6	7.7	7.5	7.5	7.6	7.3
24.	Estonia	-	-	5.7	5.7	5.7	5.6	5.6	5.5	6.0	6.4	6.7
28.	Slovenia	-	-	-	6.0	5.5	5.2	6.0	5.9	6.0	6.1	6.4
41.	Hungary	4.9	5.2	5.0	5.2	5.2	5.3	4.9	4.8	4.8	5.0	5.2
45.	Italy	3.4	5.0	4.6	4.7	4.6	5.5	5.2	5.3	4.8	5.0	4.9
46.	Czech Rep.	5.4	5.2	4.8	4.6	4.3	3.9	3.7	3.9	4.2	4.3	4.8
	Lithuania	-	-	-	3.8	4.1	4.8	4.8	4.7	4.6	4.8	4.8
54.	Greece	5.0	5.4	4.9	4.9	4.9	4.2	4.2	4.3	4.3	4.3	4.4
49.	Latvia	-	-	2.7	3.4	3.4	3.4	3.7	3.8	4.0	4.2	4.7
	Slovakia	-	-	3.9	3.7	3.5	3.7	3.7	3.7	4.0	4.3	4.7
57.	Bulgaria	-	-	2.9	3.3	3.5	3.9	4.0	3.9	4.1	4.0	4.0
61.	Poland	5.6	5.1	4.6	4.2	4.1	4.1	4.0	3.6	3.5	3.4	3.7
69.	Croatia	-	-	-	2.7	3.7	3.9	3.8	3.7	3.5	3.4	3.4
84.	Romania	-	3.4	3.0	3.3	2.9	2.8	2.6	2.8	2.9	3.0	3.1
105.	Macedonia	-	-	-	3.3	-	-	-	2.3	2.7	2.7	2.7
111.	Albania	-	-	-	2.3	-	-	2.5	2.5	2.5	2.4	2.6
121.	Russia	2.6	2.3	2.4	2.4	2.1	2.3	2.7	2.7	2.8	2.4	2.5
163.	Haiti	-	-	-	-	-		2.2	1.5	1.5	1.8	1.8

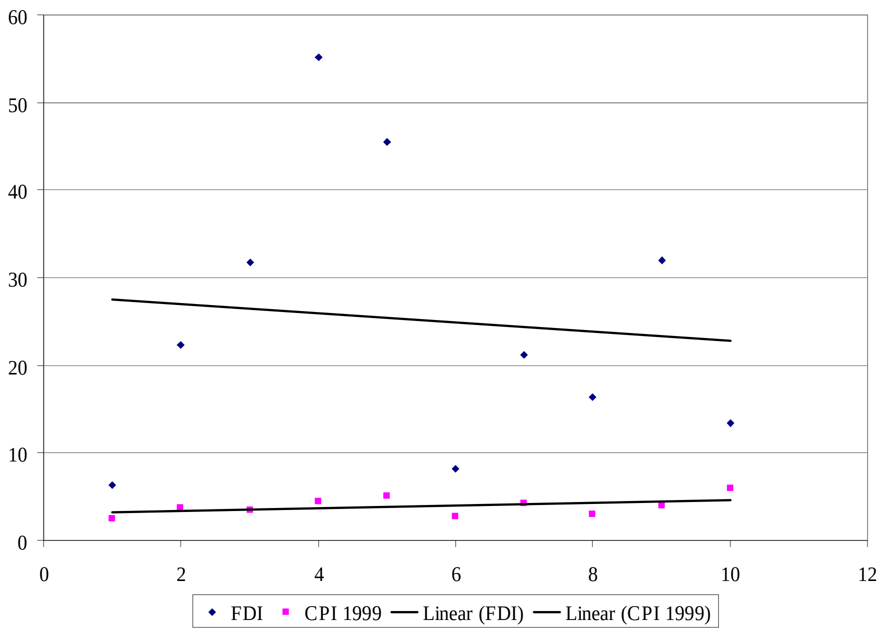
Source: Transparency International

Figure 3. Corruption Perceptions Index and tax effort, 1998/1999



Source: Transparency International and Mertens (2003).

Figure 4. Corruption Perceptions Index and foreign direct investments, 1989-2006



Source: Transparency International and EBRD

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[1] Phare is the acronym for Poland Hungary Assistance for Reconstruction of the Economy.

[2] Since Turkey occupied the north of the island in 1974, Cyprus is divided in Turkish Cypriot and Greek Cypriot communities. The Turkish Republic of Northern Cyprus is only recognized by Turkey. Officially, Cyprus joined the European Union as one country. Effectively, however, only the Greek Cypriot community joined.

[3] Central and Eastern Europe: Czech Republic, Hungary, Poland, Slovakia and Slovenia.
South Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia.
Baltic States: Estonia, Latvia and Lithuania.
Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.