



**ICEG EC**

**International Center for Economic Growth  
European Center**



**NEWS OF THE MONTH**

*April 2004*

**14 Korompai Street, H-1124 Budapest, Hungary**

***Tel: +36 1 248 1160 E-mail: [icegec@axelero.hu](mailto:icegec@axelero.hu) Website: [www.icegec.org](http://www.icegec.org)***

## **CONTENTS**

<i>I. Croatia: Closer to EU membership</i>	<u>3</u>
<i>II. Hungary: 100 basis points rate cut in three steps</i>	<u>5</u>
<i>III. Tax competition and EU-accession</i>	<u>7</u>



## I. CROATIA: CLOSER TO EU MEMBERSHIP

At the end of April 2004, some days before the largest EU Enlargement round and after a one-year work period, the European Commission (EC) published its report on Croatia's EU bid for membership. The EC's opinion is that Croatia is ready to start the accession negotiations and the report proposes to the Council that Croatia should receive the "official" candidate country status at the next EU Summit in mid-June.

Croatia applied for EU membership in February 2003. The recently published EC report is the first document which reflects the official opinion of the European Union on this issue.

**Table 1.**  
**Main Macroeconomic Indicators in Croatia (2001-2003)**

	2001	2002	2003*
<b>GDP (bn EUR)</b>	21,8	23,8	24,7
<b>GDP growth (%)</b>	3,8	5,2	4,4
<b>Export (m EUR)</b>	5312,2	5313,3	5564,4
<b>Import (m EUR)</b>	9890,6	11311,4	12577
<b>Trade deficit/GDP (%)</b>	-21,0	-25,2	-28,4
<b>Unemployment rate (%)</b>	23,1	21,3	19,1
<b>Inflation (yearly average, %)</b>	2,6	2,3	1,8
<b>General government deficit/GDP (%)</b>	-6,8	-4,8	-4,6

\* Forecasts

Sources: European Commission, own calculations

The EC's report on Croatia is comparable to the so-called Country Reports on the progress of the candidate countries, so it is based on the Copenhagen criteria and the accession chapters.

According to our expectations, as it was mentioned above, Croatia can become an official candidate country in June 2004, consequently, in addition to Bulgaria, Romania and Turkey, Croatia can be the fourth EU candidate. The negotiation process is not expected to start in the period of the recent Commission, because that will end in November 2004. Thus, the negotiations are expected to start at the end of 2004 or at the beginning of 2005.

The Copenhagen criteria - set in 1993 -, which were the main guidelines in case of the integration process of the new member states, certainly remain the main criteria in case of Croatia. These Copenhagen criteria for candidates are the following: the membership requires (1) "that the candidate country has achieved 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 capacity to cope with competitive pressure and market forces within the

Union” (3) and “the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union”.

According to the EC’s Opinion, Croatia is a functioning democracy with stable institutions guaranteeing the rule of law, thus the country meets the Copenhagen political criteria. In the past, one of the main obstacles of the European integration was that the country had not cooperated fully with the ICTY, the International Criminal Tribunal for the former Yugoslavia in case of the war criminals. In the last months, the cooperation between ICTY and Croatia strengthened significantly. The case of refugee return and minority rights should be solved, however, these issues are not hindering the beginning of the negotiations.

In case of the economic criteria, the Commission says that “Croatia can be regarded as a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its reform program to remove remaining weaknesses.” This opinion is remarkable considering the fact that in case of Romania the EC stated a “more conditional” statement on the existence of a functioning market economy. In case of Romania the objective date of the EU accession is 2007 and the accession negotiations are well-progressed.

According to the European Commission, in the medium term Croatia can achieve the other criteria set in Copenhagen.

The positive opinion on Croatia’s EU application is not only favorable for Croatia but also for the other – mostly former Yugoslav – states in the region targeting the EU membership in the future. After Slovenia, another former Yugoslav state becomes an EU candidate, which means a positive message to Albania, Bosnia-Herzegovina, Macedonia, Serbia and Montenegro. It suggests it is worth beginning and continuing the economic reforms because that is a path to the so awaited EU membership.

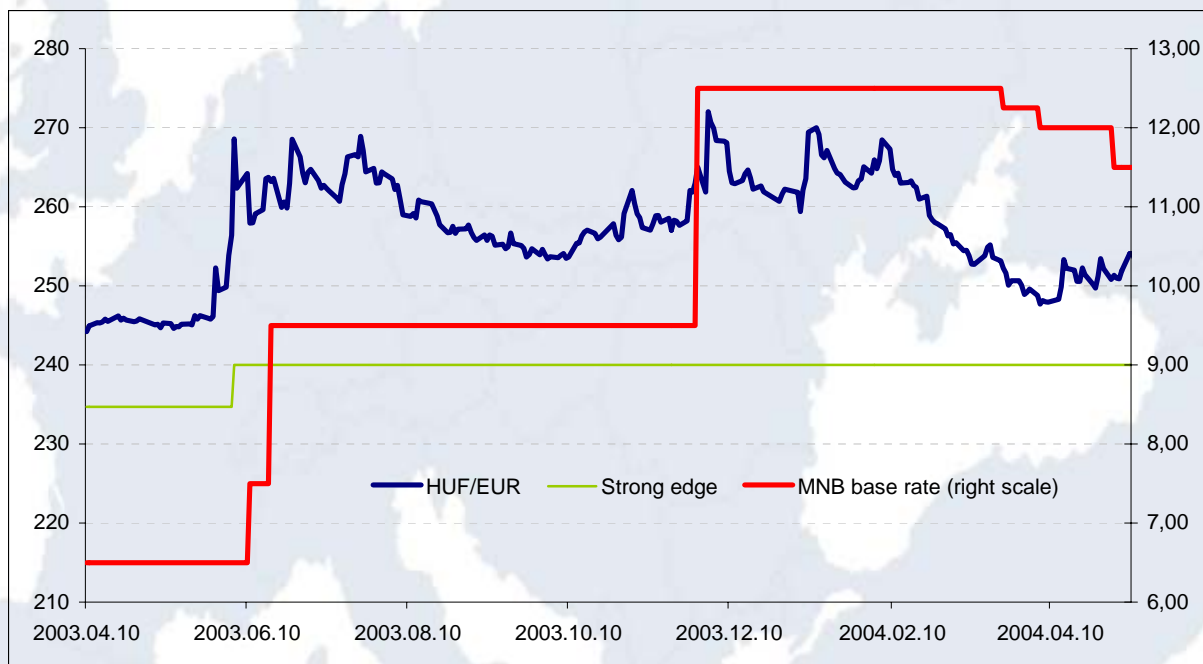
In our point of view, Croatia can be a member of the EU together with Bulgaria and Romania in case of the constellation of some favorable factors. The objective date of 2007 seems a bit too early for another enlargement round after 2004 and Romania’s negotiation process moves ahead slower than it was expected earlier. The pace of negotiations should be accelerated to be able to close all negotiation chapters until the end of 2004, as it was targeted. Thus, it is easily imaginable that the next enlargement round will be delayed to 2008-2010. In that case, Croatia could catch up with Bulgaria and Romania. In addition, the EU members welcomed Croatia’s application so they support the membership of the country. According to the experiences of former enlargement rounds in the past, the political support has significant influence on enlargement policy.

**Prepared by: Péter Bilek**

## II. HUNGARY: 100 BASIS POINTS RATE CUT IN THREE STEPS

The National Bank of Hungary (MNB) cut its main policy rate from 12,50% to 11,50% in three steps during the last two months. The first 25 basis points rate cut was announced on the March 22 meeting of the Monetary Council (MC). The decision of the MC surprised the markets, but could be considered only as a symbolic act that represents cautious optimism on behalf of the central bank. Released data on industrial production (+10 %, y-o-y, seasonally adjusted in March 2004) and exports (+11,3% y-o-y in Q1 2004) suggested improvement of underlying economic factors and supported the decision of MC. Government securities market showed a slight decrease in yields on all maturities. Cautiousness however was justified, since uncertainties concerning the government's 2004 budget deficit target (and central bank's end 2005 inflation target) still remained.

The second rate cut of 25bp on the 5<sup>th</sup> of April meeting of the MC was in line with expectations, since financial markets interpreted the first "symbolic" rate cut as a starting point of a smoothly decreasing interest rate path. Although MNB does not have an official exchange rate target, it is hard not to see that significant strengthening of the Forint preceded the interest rate decision. During April HUF/EUR exchange rate moved near to the strong edge of the Forint's fluctuation band. Meanwhile Treasury bill auction and secondary market data suggested that short-term carry trade reached a high and somewhat worrying level. However, in late April Forint weakened again above the 250 level, and fears of returning speculative flows eased.



On the 3 May MC meeting another rate cut (50bp) was announced, which again surprised markets both in terms of timing and magnitude. Although Q1 inflation data was slightly under expectations, the concerns about the 4,6% ESA-95 deficit target of government persisted both on behalf of MNB and market participants. Thus the latest rate cut can be considered as “optimistic”, without “cautiously”.

Budget deficit developments are of key importance for interest rate decisions since due to the near 60% of GDP gross debt level and significant weight of foreign investors a sort of fiscal dominance on monetary policy can be observed in Hungary. As it was the case during the last quarter of 2003, sudden changes in foreign investors' expected risk premium can force MNB to adjust its base rate accordingly. Combined with the fluctuation band, this sort of fiscal dominance limits the scope for monetary policy, especially when foreign investor confidence and/or policy credibility is low.

Days after the decision Forint showed a slight weakening parallel with other emerging markets, indicating changes in expectations concerning U.S. Fed policy, rather than local developments. For the coming months markets do not expect further rate cuts, as the average yields on 3 month treasury bills also suggest. A possible change in monetary policy stance can be expected in the second half of the year, when the course of budgetary developments is clearer to see.

**Prepared by: Máté Tóth**

### III. TAX COMPETITION AND EU-ACCESSION

With 1st May approaching, fears and concerns about the accession were increasingly articulated by politicians of the member states. Besides the concern about huge flows of job seekers from the new member states a new dimension emerged in the public debate that gained the largest room in Germany. Chancellor Schroeder expressed his fears about the fact that new member states may be able to maintain their low levels of wages and taxes with the help of EU structural and cohesion fund assistance. This, as he expressed, may cause new member states to unfairly attract new investment, to deprive member states of jobs and at the same time remain dependent on the financial support of the union. These concerns are further magnified by the fact that Germany is one of the largest net contributors to the EU budget. For this reason, Chancellor Schroeder argued for increased tax harmonisation in the EU, but this proposal was declined by the European Commission and the governments of the new member states in April. Wolfgang Clement, German federal minister of economy and labour also pointed out that if new member states maintain low tax rates, structural funds flowing to them could potentially be curbed. However, instead of emphasising the concerns, Günter Verheugen pointed out the hope that low corporate tax rates in new member states could accelerate tax system reforms in the EU15 as well. If Austria, France or Italy opt for smaller tax rates, that would harm German interests far more than tax cuts in the accession countries.

A tax competition in corporate taxation has indeed emerged among the future member countries, but not closely linked to the date of accession. Some member states also have joined it, for example Austria and even Germany did reduce this tax to 25%. The corporate tax rate is the lowest in the EU in Ireland (12,5%), the average corporate tax rate is 31,7% in the EU. Already in the nineties tax burdens in the accession countries were lower than in the member states and further reductions have been implemented since January. Among the accession countries, nominal tax rates are lowest in Latvia and Lithuania (15 and 13%), Hungary ranks well with 16%, but recently Poland and Slovakia also decreased rates to 19%, and the Czech Republic with 24% and Estonia with 26% still have a smaller rate than the EU15 average.

Additionally, the actual tax burdens are much lower, due to tax allowances and exemptions. Based on research carried out by Ch. Spengel and by KPMG, the average effective tax burden in the accession countries is 16 percentage points smaller than in Germany (36%). Taking into account tax exemptions and allowances, taxes payable in the accession countries can be as small as 40% of the German tax level. Based on effective burdens, Lithuania (minimal effective rate is 7,3%) offers the most favourable business climate. It is followed by Latvia, Cyprus, Slovakia and Poland, all of which have only slightly higher effective tax rates than Ireland (12,5%). The

effective tax burden in Hungary is approximately 13% if firms in all sectors and of all sizes are considered. However, in Hungary local business tax adds to the tax burden of companies, the rate of which varies from municipality to municipality. In spite of its 2% maximal nominal rate it may entail an effective tax burden comparable to the national corporate tax, since it taxes net turnover. This type of tax is absent in almost all accession countries, while is present in different forms in core EU member countries. In Estonia, the effective tax burden is around 22,5% based on the estimations of ZEW. All Estonian profits and incomes that are reinvested are tax exempt. Effective tax burdens higher than this can only be found in the Czech Republic and in Malta. It is clear that the accession countries aim to follow the Irish tax policy in the attraction of investments.

However, not only corporate income taxes influence the competitiveness of a country in the competition for investment. The interest rate tax is the smallest (Slovenia 80%), in Latvia and Lithuania (10%) and the Czech Republic (15%). In Hungary, it is linked to the corporate income tax along with royalty incomes, so it is taxed by a nominal tax rate of 16%. All the other Central and Eastern European countries have higher interest rate taxes.

The burden of the value added tax is hardly comparable across countries, it is only possible to compare nominal tax rates. Hungarian tax rates are the highest among the accession countries. This type of tax affects competitiveness of businesses mainly by its indirect effects: in most cases enterprises can shift the burden of the value added tax on consumers. The situation of the companies becomes worse if they can only partially shift this burden. A large value added tax can have impacts on businesses even if they are able to fully shift the tax burden on customers: if private consumption and private savings shrink, the indirect macroeconomic effects affect businesses as well. Value added tax is the least distortionary tax, but its hardly measurable distributionary consequences often disproportionately affect the population in the lower income deciles.

The corporate tax and the local business tax, as well as the taxes on interest rate, royalty and dividend incomes mean direct costs for companies, while the effects of the value added tax are indirect. Besides value added tax, social security contributions payable by employers affects indirectly the costs of labour force, and thereby impacts on the competitiveness of the company. Social security contributions payable by employers are generally higher in the CEE countries than in the EU. They are the lowest in Poland (21%), followed by Hungary (29 %). Highest rates can be found in the Czech Republic and Slovakia (35 and 38 %). It is interesting to note, that the overall reduction of taxes in Slovakia left social security contribution levels intact.

Personal income tax affects competitiveness of enterprises directly. In this type of tax Hungarian rates are considered average in the region, but the income bracket that is subject to the highest tax rate is far the lowest there. Therefore tax burden of the



population is rather high. Labour taxes remain high in tax competition since labour is less mobile than capital. This may lead to labour carrying the burdens of a harmful tax competition.

The debate on tax harmonisation and tax competition is going on for years in the EU. In order to decide on tax harmonisation in the EU, the consensus of all member states is needed. Further, the principle of subsidiarity applies, and without serious reasons, community level actions in the field of tax policy cannot be carried out. In spite of several attempts, an overall agreement on tax harmonisation could never be reached in the past, mainly because of the opposition of Great Britain and Ireland. The corporate tax rates are the lowest in the EU-25 in Ireland. New member states would hardly vote for increased corporate taxation, therefore any hope is futile for a minimum tax rate or a minimum and maximum tax rate decided at the community level. New member states quickly reacted on the proposals of the German politics. They argued, that accession countries compensate their infrastructural backwardness in the competition for new businesses. Also, they claim, that the financial situations of the accession countries cannot be considered to be similar, and therefore common measures are not needed.

Do low tax rates in accession countries really undermine own national investment spending? Are they harming the EU15 countries, among them the largest net contributors to the EU budgets? Economists tend to answer that fears of politicians are not really well-grounded. For example after the accession new opportunities emerge for large companies opening subsidiaries in the new member states, based on the parent-subsidiary directive and on the regulations in order to avoid double taxation. By at least 25% share, the subsidiary can transfer funds to the parent company without being taxed.

Low corporate taxes are not a breach against EU tax codes, if they are not designed to favour one sector or one type of firms. Previous tax exemptions and allowances designed especially for large foreign investors are to be phased out in the accession countries, and new ones must not be given.

Low tax rates and the lack of tax allowances broaden the tax base, and it lead to better tax compliance in several accession countries. In this case, low tax rates cannot be directly associated with lower government incomes. Also, the argument of western politicians applies only if low tax rates and low state incomes are associated with low infrastructure spending. But the new member states tend to spend generally less on social security and welfare payments, and tend to maintain smaller welfare subsectors. While this is partly due to the poor state of these subsectors, it also shows, that not the German taxpayers are most likely to be affected by low accession tax rates.

Responding to the claims of Gerhard Schroeder, the six most influential German economics research institutes argue in their regular yearly paper that there is nothing dishonest in the taxation policies of the new member states. Tax competition is not an unfair breach of competition. In line with their reasoning, differences in tax and wage levels are needed, and an artificial reduction of these differences would only lead to the stop of the convergence process taking place. Also, it would jeopardize the exports of the member states to the accession countries. Low wages in the new member states reflect lower levels of productivity, and so the complaints about wage dumping make no sense. If taxes would be set to a common level, new member states could not realize the effects of efficiency increases in their economies. The researchers point to the fact, that it is not the tax policy of the EU that would need to be reformed, but rather its regional policy.

**Prepared by: Anita Halász**