Taxation as a Determinant of Economic Growth in South-Eastern Europe: The Case of Bulgaria and Croatia

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Abstract:
Taxation through its impact on entrepreneurial activity, the attraction of Foreign Direct Investments, as well as disposable income and savings can be a crucial factor for economic growth. In this context, the paper examines the role of taxation as a determinant of macroeconomic stabilization in the geopolitical area of South-Eastern Europe, thus the area of Europe, which was affected in a great extent by the global financial crisis with a time lag (3rd Quarter 2008). The analysis will be based on the presentation of the current institutional tax framework prevailing in South-Eastern European Countries and focusing on the countries of the last and upcoming European Enlargement (Bulgaria, Croatia). The conceptual analysis will be accompanied by an econometric model that will test empirically the statistical significance of tax revenues on GDP of these countries.

Key Words:
Taxation, economic growth, European enlargement, South-Eastern Europe
JEL Classification*: E2, F1, H2*

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1.   Introduction

Before jumping into the morass of empirical evidence, it would be useful firstly to ask the question. How does tax policy affect economic growth? By discouraging entrepreneurial activity? By distorting investment decisions (because taxes make some forms of investment more profitable than others)? By discouraging incentives to work and acquire skills and training?

According to the theory of endogenous growth, the efficient use of taxation depends firstly on the extent to which taxation affects the behavior of individuals and motives for accumulation on physical and human capital and secondly on public expenditure that are financed by tax revenues (Dimeli, 2002). Taxes may affect savings by transferring income between households with different consumption–saving patterns. Moreover taxes may reduce income from which saving comes from and/or reduce the motive for saving either, because it reduces its return or because income losses are being made up through welfare transfers.

The relationship between consumption and saving shows even if tax policy does not affect the tax burden but transfers income among groups, something that may still reduce savings in the short term, especially if households where income is transferred face liquidity problems (Ando and Modigliani, 1963).

All the above is nothing else but the other side of the same coin, which is the efficacy of tax policy and its capability to transform tax revenues into a fiscal tool of endogenous economic growth. That's exactly the question of the article for the geopolitical region of South-Eastern Europe and especially for the examining countries of the last and next European enlargement (Bulgaria and Croatia).

2.   Taxation and Economic Performance: A Continuous Interconnection

In the 1990s a number of studies examined policies that affect economic growth (Temple, 1999). The causes of slow economic growth and high rates of unemployment in many OECD Countries since the mid 1970s have been examined in terms of the increase of tax burden and public expenditure and especially in terms of those characteristics of taxation, which cause distortions in economic behavior by affecting negatively motives to work, save and invest.

Another dimension concerns the impact of tax policy on growth through the attraction of foreign direct investments (FDI). The extensive literature on this issue suggests that FDI could be an important factor contributing to growth that counter balance any negative potential effects caused from taxes distortions. We examine such distortions below:

Distortions caused by personal income taxes affect the economic behavior of physical persons. Extensive research shows that an important determinant of the decision for work or leisure is the elasticity of work with respect to disposable income and the elasticity of work supply of income from employment. Moreover income taxes affect not only employment, but also work effort, as well as education and investment in personal skills.

Another argument for low income tax suggests that low taxes leave more income for consumption which expands the economy and creates employment. In turn, employment creates more income, more consumption, production, thus employment and income. This argument derives from the Keynsian model, according to which consumption as well as investment, public expenditure, export surplus and effective demand are the main determinants of income (Keynes, 1936). In this context, the increase of disposable income, especially of those less well off, with bigger propensity to consume, increases effective demand and thus income. On the other hand, the counterargument could be that fewer taxes imply less income for governments to spend in public expenditure. Moreover it is possible for a part of consumption to be channeled abroad. In that case, the country from which income has originated benefits less.

Consequently, we assume that there's a direct connection between taxation and saving. There are two main approaches regarding motives to save. One suggests that there is a close relationship between income and savings. According to this, savings and investment equilibrate with changes in income. High tax burden may cause decrease in savings because it reduces disposable income (Thalassinos and Liapis, 2013). On the other hand, an increase in savings, in case tax burden being reduced may reduce interest rates and thus neutralize the increase in saving. Another view considers that saving depends mainly on the choice between current and future consumption (Leach, 2003; Masson *et al.*, 1995; Bosworth, 1993´)3. Taxing savings may cause an increase in consumption today and less in the future, but also can make taxpayer poorer and thus lead to less consumption today.

Moreover companies that could borrow with low interest rates may not invest in the country where saving originated but in other countries. However, there's no doubt that taxes are an important burden, because they reduce the return to, and / or increase the cost of entrepreneurial activity. Lower returns reduce the possibility for enterprises to undertake investment and create employment. On the contrary low taxes allow them to expand and create growth (Barr, 1991).

Surely, this argument has a number of weaknesses. Firstly it overlooks the fact that business may pass on part of tax to consumers or to employees by reducing their wages, subject to market completion. Secondly enterprises have to pay to finance the production of public goods and services they use and reduce their production cost. If tax reductions lead to a decrease in public services and goods then enterprises may have to spend more on them. In this sense, public infrastructure is an important factor of production which if lacking, enterprises have to spend more to acquire.

For example if skilled labor is in shortage, they should spend more on training and education. If public infrastructure is not sufficient, then enterprises which do not wish or they cannot produce it privately, may leave the country. The conclusion is that countries with insufficient public infrastructure and poor public services will attract investment of low value added (for example investment which does not need special skills). This kind of investment offers little in terms of know-how and wages to labour force.

Moreover it is argued (Bartic, 1992) that growth is promoted with the improvement of the investment climate and trade (Thalassinos, 2007; Thalassinos, Kiriazidis and Thalassinos, 2006). That means that economic development is promoted with the improvement of those factors which comprise the investment climate and make the country more attractive to investment.

These factors are the quality of physical and institutional infrastructure, the tax environment and other financial measures that support or hinder entrepreneurial behavior.

In addition to the above, while tax incentives may affect positively the country's investment climate, they may impact negatively on other factors affecting the country's image. For example, the effectiveness of public services is an important factor for attracting investment ― a factor which may be undermined by tax incentives.

Countries with relatively low criminality, high quality public services, infrastructure and clear property rights, constitute the best investment environment for enterprises. Tax incentives may be useful, however, if they are targeted to reinforce areas with high unemployment and low income or enterprises in sectors of the economy, which are high value added.

It follows from the above, that the overall impact of taxes on growth is hard to determine, as taxes impact on a number of factors, each with different potential impact on growth. For example the quality of government and its ability to use tax

revenues productively, can be a critical factor moderating the aforementioned relationships.

Given the above uncertainty and despite some evidence (Glykou, 2010), the relationship between tax policy and GDP, for the case of Central and Eastern European Countries has, to our knowledge, not been explored so far. Our aim in this paper is to fill the gap in the literature. In particular, we analyze the empirical relationship between tax revenues and GDP in the case of Bulgaria and Croatia. The two countries have been selected as indicative of their simple tax system (flat tax rate) prevailing in the whole region of South Eastern Europe, taking into account the economic and political changes triggered by the last and the upcoming European enlargement.

For this purpose, we select to focus on tax revenues. Tax revenues can be seen as a proxy of the overall efficacy of tax policy. It can have positive or negative effects on GDP, depending on the use of such revenues and their substitutability with alternative uses of the income received as taxes, for example in productive investment. In this sense, the impact of tax revenues on GDP can be taken to reflect the extent to which tax income crowds out, or crowds in, private expenditures in consumption or investment.

3. From the Last to the Next European Enlargement: The Tax Policy of Bulgaria and Croatia

The European enlargement with the Central and Eastern European Countries (CEECs), which was initiated in May 2004 and continued in January 2007 with the accession of Bulgaria and Romania, is a milestone in the process of European integration. The "Eastern Enlargement", which will be completed in the forthcoming years, primarily with the accession of Croatia and afterwards with the other countries of the Western Balkans, transformed not only the bilateral economic and political relations between the states, but also their overall prospects about economic growth. To this direction, fiscal policy and especially the tax system inevitably constitutes a useful tool in order to promote the targets of the "new economic policy".

In this context, relatively law tax rates and the simplification of the tax system facilitate the attraction of multinational capitals, mainly Foreign Direct Investments (Table 1). It's characteristic, that despite law tax rates, total tax revenues (% GDP) in both examining countries (Bulgaria, Croatia) gradually increase (or remain standstill), something that indicates the improvement of the tax system made year by year (Tables 2,3).

Table 1 Foreign Direct Investments Flows (mill. EUR)

Year	Bulgaria	Croatia
1996	382,1084	137,3
1997	480,2218	570,2
1998	849,6589	605,1
1999	1362,909	866
2000	1140,597	1103,3
2001	1467,496	903,4
2002	1137,906	980
2003	1762,384	1850,5
2004	949,5965	2735,9
2005	1467,915	3152,1
2006	2768,313	6221,6
2007	3679,034	9.051,80
2008	4218,37	6.727,80
2009	2095,641	2.412,20

Source: The World Bank

Table 2 Tax Revenues (% GDP)

Year	Bulgaria	Croatia
1993	15,21378	21,54875
1994	21,23896	26,87202
1995	20,06809	23,13467
1996	19,36174	22,97888
1997	18,52322	22,10182
1998	18,11354	25,32091
1999	17,52573	23,34706
2000	17,87999	22,42281
2001	17,11367	21,05793
2002	16,38622	21,63418
2003	18,22702	20,92861
2004	21,27927	20,14067
2005	21,61056	20,04451
2006	22,50215	20,0894
2007	23,13009	20,18015
2008	23,2697	20,33355
2009	20,94916	19,11916

Source: The World Bank

Table 3 Total Revenues (mill LCU)

Year	Bulgaria	Croatia
1993	45	8400
1994	110	23000
1995	180	27000
1996	310	29000
1997	3100	32000
1998	4200	40000
1999	4300	38000
2000	4900	40000
2001	5200	40000
2002	5400	45000
2003	6500	48000
2004	8500	50000
2005	9800	53000
2006	12000	58000
2007	14000	64000
2008	16000	70000
2009	14000	64000

Source: The World Bank

3.1   The Bulgarian tax system

The Bulgarian tax system has undergone several changes triggered by the political and economic reforms, which have taken place during the last decades. Generally speaking, we would say that the main source of revenues for the central budget stems from indirect taxes (52.38%), social insurance contribution (about 26%) and taxes on income (almost 19%). Among the indirect taxes, the main share is held by the VAT (66%), which was introduced in 1994 and comes to 20%[4], followed by the excise taxes (32%) on products such as alcohol, tobacco, energy etc. and revenues from custom duties and charges.

A significant amendment in income taxation of individuals is that the progressive tax rate which depended on the amount of the annual taxable income and was within

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[4] 9% for hotel accommodation, 0% for exports and certain other activities, refund of input VAT within three months (regular term), faster refund within one month, if certain requirements are met. 2-year VAT exemptions for imports of equipment for investment projects over € 5 million, creating at least 50 jobs.

the range of 20% to 24% is replaced with a flat rate of 10% regardless of the amount of taxable income[5].

Real Estate Tax (RET) reaches 1.5‰, when referred to housing building and becomes twice lower when a dwelling is categorized as "first-order" and the annual RET 0.01% - 0.45%. It's important to be mentioned that the Bulgarian state has managed to decentralize the determination and collection of RET, as well as the inheritance and motor vehicle taxes[6].

Corporate income tax[7] (10%) is paid by all resident companies and partnerships (Bulgarian or multinational), which are registered under the Commercial Law, as well as permanent establishments of non-resident entities in Bulgaria[8]. Moreover, non-profit organizations or public bodies that operate as business units are also subject to the corporate income tax. Special purpose investment companies, closed-ended licensed investment companies and collective investment schemes authorized for public offering in Bulgaria are not subject to corporate income tax[9].

A withholding tax of 10% is imposed on interest, royalties, services fees, capital gains and other income accrued to non-resident entities, 5% withholding tax on interest and royalties to EU related parties, as well as on dividends distributed to non-EU residents.

Important are also the main exemptions provided by the tax system[10]. According to the Annual Report for the Advancement of the Bulgarian Economy and Economic & Commercial Relations Greece - Bulgaria (2007), "the Tax Law, which came into

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[5] Tax Law, December 2007.

[6] Transfer tax for immovable property and vehicles fluctuates between 0.1% - 3%.

[7] Corporate Income Tax Act (CITA) governs corporate income taxation.

[8] According to the Invest Bulgaria Agency (2011), "taxable persons are the resident legal persons, the non-resident legal persons which carry out economic activity in the Republic of Bulgaria through a permanent establishment or which receive income from a source inside the Republic of Bulgaria, the sole traders: in respect of the taxes withheld at source and in the cases specified in the Income Taxes on Natural Persons Act (when they perform activities liable to taxes alternative to corporation tax), the natural persons who are merchants within the meaning given by Article 1(3) of the Commerce Act, the employers and the commissioning entities under contracts for management and control: in respect of the tax on the expenses on fringe benefits".

[9] Special corporate tax regimes apply to commercial maritime shipping companies, gambling businesses, state organs etc. No corporate income tax is paid in high-unemployment areas.

[10] Taxation in Bulgaria was altered drastically. 40% for companies with fiscal revenues of more than 1 million leva annually and 30% for companies with revenues less than 1 million leva (Decree 56/1989), the tax rate decreased to 30% and 20% for a higher amount (and correspondingly lower) of 50 million leva (1998), while it decreased in all cases in 2002 to 23.5%.

force in December 2007 lightens the conditions on the exemption from tax on certain business expenses, allows retailers to deduct inventory shortages by a certain percentage of net sales, introduces certain exceptions relating to the obligation to advance corporate taxes and also bridges the gap within the tax base for monthly payments of corporate tax. Also, the definition of indirect distribution of profits is expanded to include interest in certain soft loans, while it is clarified that the capitalized interest costs through depreciation of assets are not included in thin capitalization. These arrangements apply from 1 January 2008.

With regard to tax exemptions, they can reach up to 100% for those industries that are installed in areas where unemployment is 35% higher than the national average. The validity of the exemption is for five years, whether or not in the meantime unemployment has been reduced. There might also be deductible amount up to 10% of investments in buildings, infrastructure, transport etc. (cars are excluded), if the investment takes place in areas where unemployment is higher than 50% of average. Deductible amounts are also provided from the profits up to 12 months, if they relate to recruit unemployed persons registered at the Public Employment Service. Also, the legal entities - including those employing foreigners from other EU member-states - which carry out technical cooperation projects financed by the EU Phare and ISPA - exempt from corporate tax in Bulgaria.

A 5% withholding tax is levied on dividend payments or liquidation of shares to persons - non-residents of Bulgaria, but also to natural or legal persons - residents that are not engaged in commercial activity ("passive" income). Dividends to the parent company (based in an EU Member State) are not subject to withholding tax if the parent company owns at least 15% of the capital of the Bulgarian subsidiary for at least 10 consecutive years.

3.2   *The Croatian tax system*

The Croatian tax system performs certain changes comparing to the Bulgarian one. Income tax rates are progressive (between 12% - 40%)[11], while corporate tax rate is flat (20%). The corporate tax base is the difference between revenue and expenditure assessed in the profit and loss statement under the accounting rules, which is then increased and reduced for tax-specific items under the statutory corporate tax provisions.

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[11] 0 - 43,200 (kuna) 12% ,43,200 - 129,600 (25%), above 129,600 (40%).

Investment incentives may reduce the corporate tax rate, depending on the amount invested and the number of employees connected to the investment[12.]

Deductions are available for R&D (scientific and developmental) expenditure up to double the amount of qualifying expenditure. Grants are provided to taxpayers that, in connection with a new investment, create new employment or professionally train or requalify employees. Additionally, a percentage of the general and specialized training costs not associated with a new investment may be used to reduce the income tax base.

As far as dividends are concerned, they are not subject to taxation in Croatia. On the contrary, capital gains are taxed at the standard rate of 20%. In addition to that, a 15% withholding tax is levied on royalties paid to nonresidents unless the rate is reduced or exempt under a tax treaty.

The standard Value Added Tax (Porez na Dodanu Vrijednost - PDV) rate in Croatia is 23% and is imposed on the sale of goods and the provision of services[13].

If real property is not subject to VAT (i.e. buildings completed before VAT was introduced on 1 January 1998), the acquisition of a building is subject to a real estate sales tax at a rate of 5%. The tax base is the purchase value of the building. Any subsequent transfer of a building that exited the VAT system is subject to the real estate transfer tax rather than VAT. Land is always subject to the real estate transfer tax.

Finally, social security contributions consist of pension contributions (borne by the employee but withheld by the employer) at a rate of 20% of gross salary, and a health and employment contribution (borne and paid by the employer) at a rate of 17.2% of gross salary.

4.   The Impact of Taxation on Economic Growth: An Econometric Estimate

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[12] The main statutory incentive areas are regulated by the: Investment Promotion Law, Law on Free Trade Zones, Law on Special State Care Areas, Law on Renewal and Development of the City of Vukovar, Law on Hill and Mountain Areas, Law on Scientific Activities and Higher Education and Training and Education Incentives Law.

[13] VAT returns and payments are due by the end of the current month for the prior VAT period. A taxable entity must also file an annual VAT return by the end of April of the year following the tax year. VAT-related penalties include interest at a rate of 17% per year and fees from HRK 1,000 to HRK 500,000.

To assess the impact of taxation on economic growth, we regress the following equation for Bulgaria and Croatia respectively for the period 1993-2009:

log (GDP) = C(1) + C(2)*log(R) + C(3)*log (FDI) + C(4)*log (Tax_Rev.) + u

Where:

GDP = Gross Domestic Product

R = lending interest rate

FDI = Foreign Direct Investments

Tax_Rev. = Tax Revenues

The estimation of the above logarithmic equation is using the software - econometric program E-VIEWS (7). The relatively short time series is due to lack of reliable data on the economy of neighboring countries. After checking the correlation of explanatory variables we move in the regression equation, which gives the following results for Bulgaria:

Table 4 Results of regression estimation for Bulgaria

Dependent Variable: LOG(GDP_BG)
Method: Least Squares
Date: 28/07/11   Time: 21:20
Sample: 1993 2009
Included observations: 17
LOG(GDP_BG)=C(1)+C(2)*LOG(R_BG)+C(3)*LOG(FDI_BG)+C(4)
    *LOG(TAX_REV_BG)

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	23.30556	1.012911	23.00850	0.0000
C(2)	-0.036630	0.036327	-1.008347	0.3317
C(3)	0.049696	0.031706	1.567394	0.1410
C(4)	0.610498	0.286678	2.129557	0.0529
R-squared	0.811039	Mean dependent var		23.38939
Adjusted R-squared	0.767432	S.D. dependent var		0.195258
S.E. of regression	0.094164	Akaike info criterion		-1.685239
Sum squared resid	0.115268	Schwarz criterion		-1.489189
Log likelihood	18.32453	Hannan-Quinn criter.		-1.665751
F-statistic	18.59907	Durbin-Watson stat		0.758080
Prob(F-statistic)	0.000055			

The format of the estimated equation is:

log (GDP) = 23.3 − 0.036*log(R) + 0.049*log (FDI) + 0.610*log (Tax_Rev.)

The positive sign of FDI and Tax Revenues variables basically confirms the positive correlation between the independent – explanatory variables and the dependent (GDP). Obviously, the increase in tax revenues and the subsequent reduction in consumption were offset by the promotion of investments, which raised the level of GDP. Also, the expected negative sign of Interest Rate Coefficient (-0.036) shows the negative correlation between lending interest rate and GDP.

Respectively, the format of the estimated equation for Croatia is:

log (GDP) = 20.83 – 0.042*log(R) + 0.084*log (FDI) - 0.78*log (Tax_Rev.)

Table 5 Results of regression estimation for Croatia

Dependent Variable: LOG(GDP_CR)
Method: Least Squares
Date: 28/07/11   Time: 22:24
Sample: 1993 2009
Included observations: 17
LOG(GDP_CR)=C(1)+C(2)*LOG(R_CR)+C(3)*LOG(FDI_CR)+C(4)
      *LOG(TAX_REV_CR)

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	20.83890	0.285126	73.08662	0.0000
C(2)	-0.042076	0.016083	-2.616180	0.0213
C(3)	0.084025	0.020467	4.105462	0.0012
C(4)	-0.780730	0.227482	-3.432057	0.0045

R-squared	0.932114	Mean dependent var	23.84655
Adjusted R-squared	0.916447	S.D. dependent var	0.193412
S.E. of regression	0.055907	Akaike info criterion	-2.727939
Sum squared resid	0.040632	Schwarz criterion	-2.531889
Log likelihood	27.18748	Hannan-Quinn criter.	-2.708451
F-statistic	59.49877	Durbin-Watson stat	1.374843
Prob(F-statistic)	0.000000		

For the case of Croatia, it is noticed that there's negative correlation between tax revenues (% GDP) and GDP (thus the increase in tax revenues (% GDP) does not reflect in the GDP level).

5.   Conclusions

From the analysis above we assume that despite their common economic and political background, Bulgaria and Croatia present substantial differences in the tax system, which inevitably affects their economic performance. As we observed from

the econometric estimation, tax revenues (% GDP) affect the economic growth in a different way. That makes us to think that the reality may be more complex than the one described by the conventional economic theory. Other factors, such as structural conditions, the kind of public expenditure financed by tax revenues, the diffusion of economic benefit may be more important, as well as developed institutional framework, which should be above the legal system. In the end, all is needed, to our view, is the democratization of society and the participation of citizens in public life.

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