



ICEG EUROPEAN CENTER

NEWS OF THE MONTH

on EU-10 and CIS

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News of the Month, on EU-10 and CIS

The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses dealing with underlying macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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Table of Contents

Transfer of sovereignty and the new European supervisory framework	4
Tajikistan is close to flat tax	9

Transfer of sovereignty and the new European supervisory framework

Olivér Kovács

This article addresses the question of how the transfer of sovereignty could emerge during the operation of the planned European supervisory framework for financial regulation which will come into force from January 2011. The potential establishment of a financial supervisory institution has been impregnating the economic discussion regarding the future of the single market and its macroeconomic stability for years.

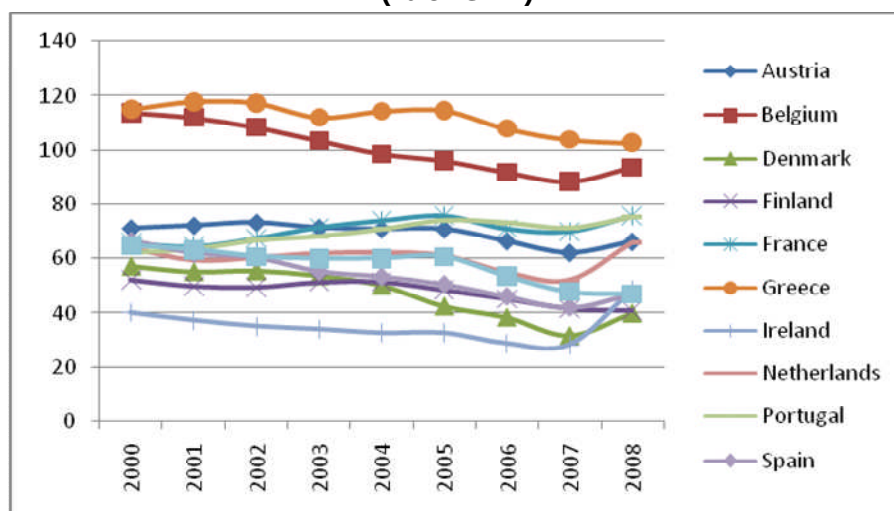
Background

The financial crisis erupted in 2007 shed light both on the great importance of a better functioning financial regulation and the requirements for more disciplinarian fiscal policy. The first one is reflected in the above mentioned supervisory framework, while the latter one was justified by the Greek experience with the skyrocketing deficit and debt. Importantly, the EU needs better financial regulation and such fiscal policies which are more likely to alleviate the macroeconomic imbalances. This type of thinking mostly relied on the empirical and theoretical findings on fiscal federalism, the major message of which is the requirement of more fiscal federalism in order to harmonise the national fiscal policies. This also implies that the European Union has to maintain the transfer of sovereignty from the national to the European level even after the establishment of such financial supervisory authorities.

While the idea of such supervisory institutions has been dissolved into the air whenever the discussion has taken into account the possibility of a strengthened Stability and Growth Pact (SGP), the financial crisis has put this topic onto the agenda again. Tightening the Pact was among the most pivotal issues since studies pointed out its inefficiency regarding the enhancement of nations' fiscal discipline. As the SGP only refers to the deficits, it does not robustly eliminate the deficit bias in the medium and long run, ultimately the escalation of the public debt.

Chart 1 clearly illustrates the weakness of the SGP because of the registrable violations of the 3 per cent deficit anchor, which led to the fact that many countries went through perceivable indebtedness over the last decade. In many cases, the debt-to-GDP ratios were significantly higher than the 60% threshold. Interestingly, if we look beyond the sheer public debt data, we can get to the conclusion that the aggregate debt of the Eurozone's private households and financial sector increased more than the aggregate government debt ratio in the period 1999-2007 (De Grauwe 2009).

Chart 1. General government consolidated gross debt in selected European countries (% of GDP)



Source: Eurostat (2010)

As a result of the inefficient SGP, the fiscal performances substantially differ across EU countries in terms of deficit paths and debt accumulation. Therefore, the EU faces different macroeconomic imbalances throughout the member states and the untenable practice of SGP.

Macroeconomic stability: Two options or one?

As the juggernaut effect of the global financial crisis hit the EU it became more obvious that the EU is imperatively on the brink of regulation-related changes. Due to the financial crisis, there is more need to underpin the financial regulation system in order to dampen the likelihood of another similar crisis. Vigilant readers can distinguish between two streams of ideas.

According to G20 and EU summits, the establishment of a well-functioning architecture for international financial regulation is possible. This is *per se* challenging. It seems that this argument may neglect the facts on the development of financial system. In a certain extent, we share the opinion that an entirely new international financial regulation is desired (Reinhart – Rogoff, 2010:282); however, we see caveats. If for no other reason than because the governments have not had the control over the financial system any more since the formation of Eurocurrency markets in the early 1970s. More specifically, the electronic and location-independent transactions have become general practice. Keeping these constraints in mind, governments are not able to influence the money supply in circulation due to the fact that it depends on private actors rather than on central banks. Thus, we cannot consider some sort of new 'Bretton Woods' as a new financial architecture.

Another strand of ideas deals with two options. Some discussions emphasised that the EU is at the cross-roads. It can choose between two mutually exclusive options: (i) reforming the SGP as it was declared in a draft document prepared by the Commission, so that it would be able to exert a bigger disciplinarian impetus on different countries; (ii) or the EU envisages the importance of the

fiscal policy of nations as a matter of sovereignty by promoting institutional reforms at national levels.

The first option can be considered seriously because the policymakers are aware of the conspicuous weakness of the Pact which was manifested already in its lenient manner concerning the sanctions on non-complying countries such as Germany and France. Still, this approach suffers from the lack of empirical evidence collected by many on SGP's efficiency which convey the message that the internal fiscal commitment is more likely to be effective than the external anchoring role of the EU. Although the SGP was accused of causing pro-cyclicality in fiscal policy rather than anti-cyclicality, it was able to help the enforcement of anti-cyclical fiscal policy, but its asymmetrical application had a deteriorating effect simultaneously.

Even if the debate on anti- or pro-cyclicality is over, the planned and enforced SGP (which would be the third version – the original one was revised in 2005) still faces a serious problem: it will not be in line with the traditional democratic rights of nations on how they impose tax and how they choose their expenditures. It seems that the extended authority of the SGP will have a deleterious effect on the democratic system if it wants to directly influence the given taxation and spending constellation of a country. As a corollary of this, the strengthened SGP will surely not serve the transfer of sovereignty of nations.

Another option is the institutional reform to be undertaken mainly not on the EU, but on the member states' level. It would support the establishment and the introduction of politically independent fiscal institutions providing the necessary flexibility for nation's fiscal policy. A potential reason behind this consideration might be the empirical findings conveying that the fiscal rules are not the panacea, and there are some countries which achieved fiscal discipline without rules (Kennedy – Robbins 2001). Additionally, the rules can easily be too rigid as well as too loose inhibiting the necessary fiscal latitude for the governments. Therefore the independent fiscal institutions, which can enhance the effectiveness of existing fiscal rules (Debrun et al. 2009), are more likely to help the more sufficient *transfer of sovereignty* by providing flexibility for countries regarding their tax systems and spending on different fields under the consideration of prudent and sustainable debt management (Wyplosz 2005, 2010; Marinheiro – José 2004).

The relation between the planned authorities and national fiscal institutions

An independent fiscal authority provides the necessary flexibility for the all-time government over the cycle. Under this angle, the clarified mandate of this institution is crucial in order to avoid the problem of time inconsistency (De Grauwe 2009) which leads to deficit bias. Nowadays many countries are using independent fiscal agencies or councils (IMF, 2009). Thus the question of how the planned European financial regulation package, provided by the mentioned independent fiscal institutions, will affect the fiscal sovereignty of nations, is relevant.

What kind of relations can we expect in the light of the planned framework? This framework will come to life at the European level with national participations contrary to the second outlined option. The framework will allegedly consist of a new institution, the so-called European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs) consisting of three authorities: (i) A European Banking Authority (EBA) based in London, a European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt and a European Securities and Markets Authority (ESMA) in Paris.

As the MEMO/10/434¹ claims on this issue: "The new authorities will be made up of the 27 national supervisors. This framework is to give Europe the control tower and the radar screens it needs to detect the risks which can accumulate across the financial system as we witnessed in the run up to and at the height of the financial crisis."

This framework will let the national fiscal policies in the hands of countries which are responsible for their own fiscal policy in the future as well, but the national supervisory authorities will have to cooperate with each other, share their experiences and findings of analyses in order to have a better picture about the all-European systematic risks.

Consequently, the national independent fiscal institutions can complement the fiscal rules and can enhance their effectiveness. Therefore, governments have the opportunity to manage their fiscal policy in a sustainable manner, to preserve their sovereignty in the field of fiscal policy, by the same token, to take part of a better financial regulation framework.

Conclusions

The planned financial supervisory framework would be a good start so that the EU will be able to take the financial system into consideration with higher diligence. But, the framework will *per se* not be enough to fend off the fiscal alcoholism /laxity/ of member states affecting adversely the macroeconomic stability, unless the EU will concentrate on the modernisation of public finances both on the EU and national levels. This approach also implies that endangering the prudential fiscal flexibility provided by independent fiscal institutions is impermissible in the interest of fiscal sovereignty. Subsequently, the processes should be integrated into a much broader EU governance reform.

Equally important is the proper interpretation of the budgetary discipline, because the recent crisis has reflected that having low deficit and debt ratio (e.g. in the case of Spain and Ireland) is obviously not a guarantee for fending off such anomalies (e.g. credit expansion) that emerged during the financial meltdown regarding the stability of euro. The EU might investigate the situation in a broader sense by incorporating the issue of credit expansion as well.

¹ The MEMO on Financial Supervision Package is available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/434&format=HTML&aged=0&language=EN&guiLanguage=en>

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Tajikistan is close to flat tax

Olivér Kovács

The aim of this article is to answer the question whether Tajikistan could be considered as a successful country with its two tax rates of 8% and 13% which is close to the flat rate. If we take a mere glimpse into the CIS countries we can conclude that their tax systems are not the same in 2010 as they were before. Turkmenistan was the first to introduce flat tax rate in 2005 for its resident individuals in order to foster the economic development by providing a competitive tax climate. The Kyrgyz Republic enacted the flat tax (10%) in 2006, Kazakhstan followed this enterprise and its flat tax rate came into force one year later.

Revolution and devolution

Hardly had a cosmonaut left the Earth's atmosphere on the board of a Soviet spaceship, when the Soviet Union collapsed in 1991. Three years later the independent Estonia decided to introduce a new tax regime with one relatively low tax rate. This was the beginning of the flat tax revolution.

The more productive inquire is to ask why Estonia shifted to a new system? The main reasons behind this step was the assumption that the introduction of a lower rate would putatively eliminate double taxation, make the tax system more transparent and simple and last but not least, it would enhance the competitiveness of Estonia by diminishing the allowances, exemptions, deductions and various loopholes. From the 1990s, more and more countries, especially former Soviet bloc nations, have decided to enter into the tax competition (*Table 1*).

Table 1. The spread of the flat tax system in the period 1994-2007

	year of enactment	rate (%)	change in real GDP growth 1 year later
Estonia	1994	22	3,534
Latvia	1995	25	5,698
Lithuania	1996	27	3,397
Russia	2001	13	-0,347
Serbia	2003	14	5,847
Slovakia	2004	19	1,634
Ukraine	2004	15	-9,381
Romania	2005	16	3,799
Georgia	2005	12	-0,216
Kyrgyzstan	2006	10	5,4
Macedonia	2007	12	-1,099
Montenegro	2007	15	-3,8
<i>Tajikistan</i>	<i>2005</i>	<i>8 13</i>	<i>0,3</i>

Note: Ukraine raises the original rates by 2 percentage points.

Sources: National tax offices.

If we want to summarise the main achievements of the juxtaposed countries we must not ignore that the given period covered a very complex economic environment (e.g., the East Asian crisis in 1997-1998 which was not anticipated by any official or publicly available papers; the Russian crisis in 1998).

In line with the conventional wisdom, the introduction of flat taxes was followed by rebounding economic growth and employment rate. The general conclusion of the introduced flat tax was the accentuation of a distinct improvement of economic growth compared to the year before the enactment.

More precisely, the real GDP growth was predominantly higher one year after the implementation of the flat tax system in case of the respective countries (the exceptions are Russia, Georgia, Ukraine and Macedonia).² Despite the visible growth effect of the flat tax we have to stress that we are unable to reveal exactly out what part of these perceptible growth was attributable to the flat tax rate, however, in a certain way the positive impetus of the newfangled tax system on economic growth undisputedly arose.³

The respective countries are about to compete each other to lower their one tax rates. This phenomenon carried initiatives to others to join the low rate race. Tajikistan intended to further mitigate the tax burden. In an effort, Tajikistan introduced the by far the lowest two lower tax brackets in the region (8% and 13%) in 2005.⁴ The “tax revolution”, as such, has begun.

Meanwhile, prominent international organisations (e.g., the IMF, the United Nations, the OECD and even the European Commission) contemplate the process with caveats. They usually consider tax competition as a source of harm (Kiegebeld, 2004). The “tax devolution”, as such, is also present. It is worth noting that the caveats refer mainly to the developed countries, which have a relatively surpassing amount of GDP per capita and where the tax moral is quite better than in the case of respected countries.⁵

As a corollary of this, some can rightly expect that Tajikistan has the opportunity to turn to a more explicit flat tax system in the future in order to catalyse the economy through the improvement of tax competitiveness.

² In Ukraine, the real GDP growth was nourished by the internal consumption for years which was mainly evaporated by 2007 due to the weakening performance of the public finance (OECD 2007). Our major conclusion would be that the characteristic of the real GDP growth is not irrelevant.

³ The first comprehensive analysis on this topic was written by Cassou and Lansing (1996) who argued that the growth effect of the introduced flat tax proposed by Hall and Rabushka (1995) mostly depends *inter alia* on the elasticity of households labour supply and the capital stock with respect to the new investments.

⁴ Cayman Islands and the Bahamas have zero tax rates. Montenegro has targeted 9 per cent in 2010.

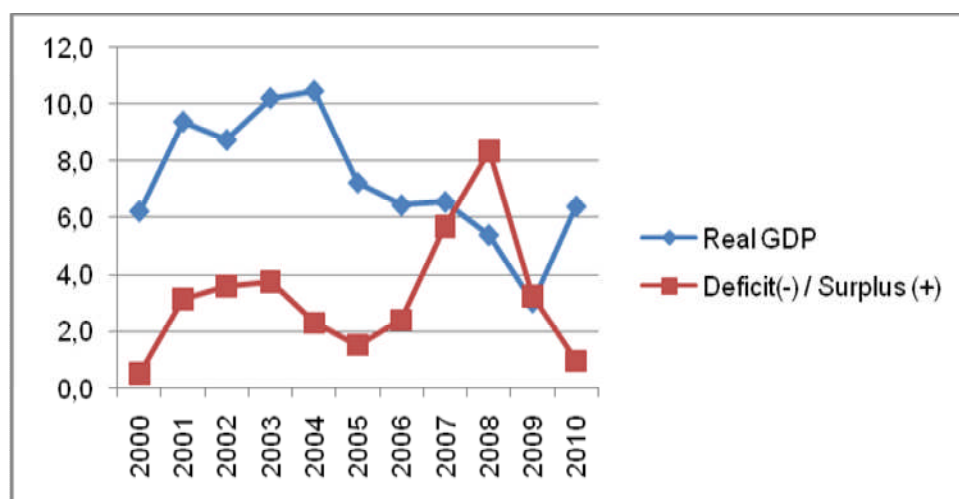
⁵ Nevertheless, the Nordic countries have progressive tax systems with high tax rates, in turn, their economies can be regarded as globally competitive.

A short review of Tajikistan's economic performance

The path of the real GDP and the government deficit corroborate that the Tajik government has been carrying out such economic policy which is more likely to serve the interest of the economy. The GDP per capita in national currency (somon) has become 20 times higher by 2010 compared to the value of 2000. The capital investment has also been going through a fast expansion since the beginning of the 2000s (it was 39 times higher than it was in 2000)⁶. As for the unemployment level concerned, the rate has been oscillating around 2.4 per cent.

The Tajik economy showed a very dynamic growth performance up until to the minds of the recent decade. This was accompanied by a more disciplined fiscal climate providing surpluses during the 2000s (*Chart 1*). This is favourable in regard to the indebtedness of Tajikistan (the present value of the debt is 30% of the GDP; Tajik government face 15% debt service payments). Interestingly, it was achieved without any applied fiscal rules; however, Tajikistan made enormous steps towards the better fiscal transparency.⁷

Chart 1. Real GDP growth and government deficit/surplus in Tajikistan (% of GDP)



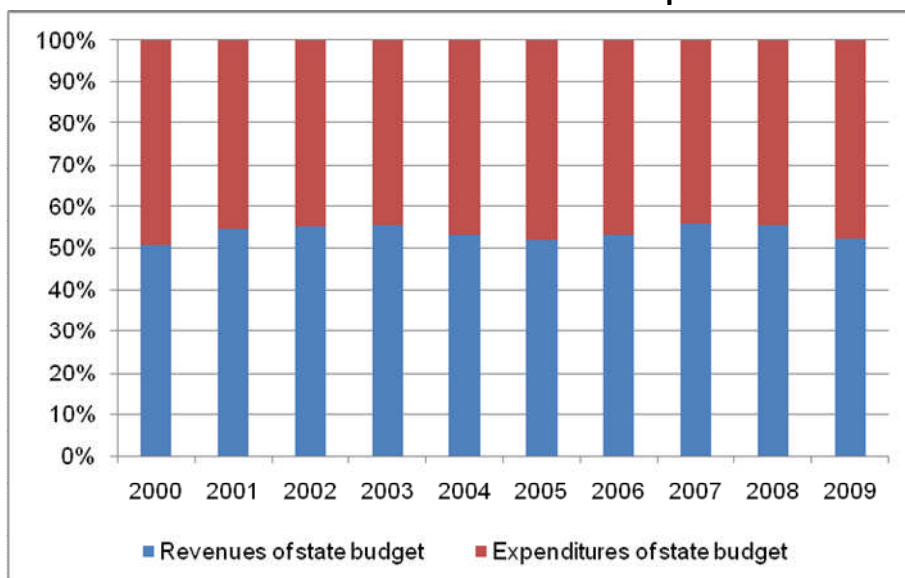
Source: Data source is the IMF (2010).

As a result of some implemented, but still ongoing, reforms embracing *inter alia* the fiscal procedures and the energy sector Tajikistan is able to reach surpluses. The introduction of the flat tax system in 2005 also helped the revenue side in coping with the expenditures (*Chart 2*). The aggravating trend reached its inflexion point as the 8% and 13% tax system came into force in 2005.⁸ Nonetheless, there is still room for improvement regarding the elimination of quasi-fiscal activities and the enhancement of the privatisation process.

⁶ State statistical committee of the Republic of Tajikistan (2010).

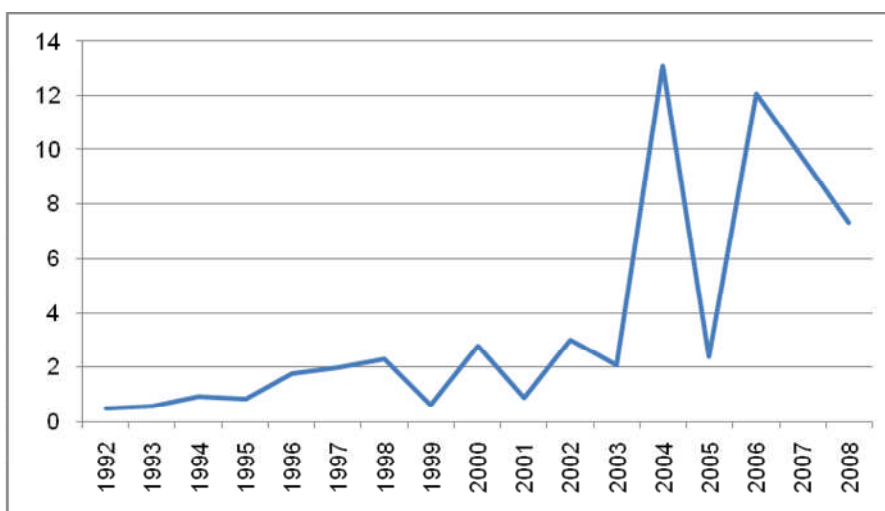
⁷ See more: IMF (2007)

⁸ The improvement was beset with difficulties as the financial crisis hit the economy in 2008.

Chart 2. Distribution of revenues and expenditures

Source: Data source is the IMF (2010).

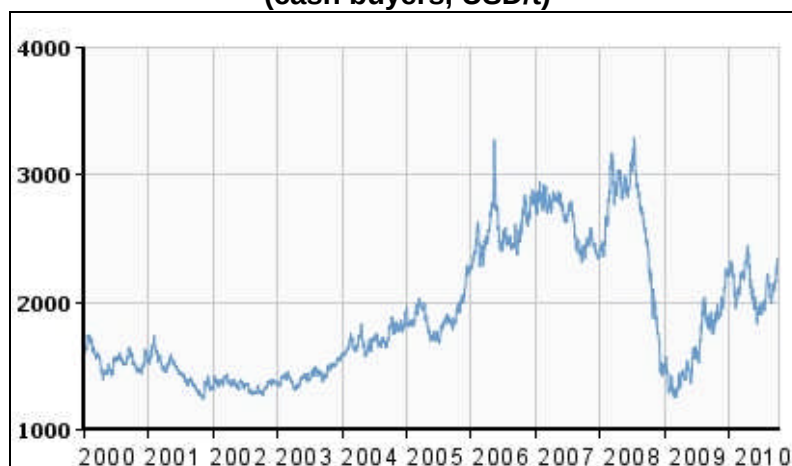
Some may lead to the rudimentary conclusion that the flat-close Tajik tax system had an impetus on the economy both in terms of fiscal aspects and ultimately the economic growth. It should be noted that the Tajik economy relies mostly on the energy sector. What is more surprising is that the foreign direct investment activity grew rapidly from 2005 especially when the already discussed flat-close tax system was enacted.

Chart 3. Foreign direct investment (net inflows, % of GDP)

Source: Data source is the IMF (2010).

From the introduction of the flat-close tax system applied to both residents and non-residents FDI flowing into Tajikistan has increased dramatically, by more than USD 320 million by 2008. Although the aluminium exposure to the total export is still the highest, more than 90 per cent of the aluminium products are exported to other countries, Tajikistan has to import the necessary raw materials for aluminium production. Subsequently, the economy lies under the price of the aluminium and the price of raw materials (*Chart 4*).

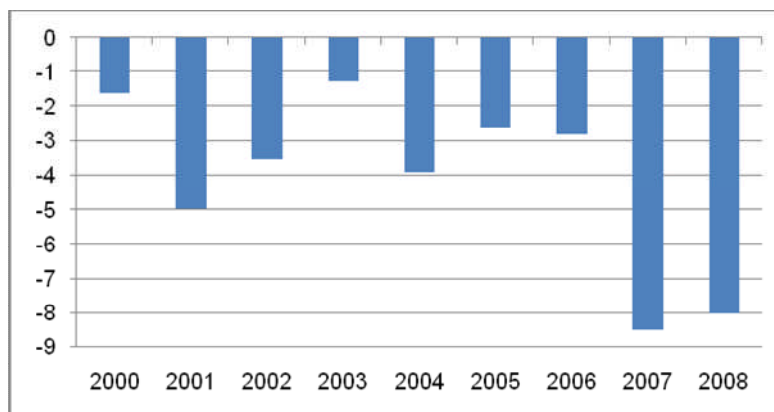
**Chart 4. Price of the aluminium on the London Metal Exchange
(cash buyers, USD/t)**



Source: London Metal Exchange (2010).

This would help understand the relatively sizeable current account deficit in Tajikistan (*Chart 5*). No sooner had the global financial crisis affected the main target countries of Tajikistan than the current account fell sharply. Export and remittances⁹ declined simultaneously, and this intensified further the serious balance of payments crisis in 2009. In order to avoid debt default, the Tajik government filed for IMF support in 2009.

Chart 5. Current account deficit in Tajikistan (% of GDP)



Source: Data source is the IMF (2010).

Conclusion

Even if Tajikistan is substantially sensitive to the price-volatility of its major export commodities (cotton and aluminium), furthermore the economy is highly influenced by the remittance inflows, as well, ignoring the effect of the flat-close tax system would be a potential failure if we try to understand how did the economic development of Tajikistan happen during the 2000s.

⁹ More than 75% of Tajiks live in rural areas, where the job-opportunity is extremely low. Consequently, lots of Tajiks seek their fortune in abroad and the remittances account approximately to 30% of the GDP. The formal remittances inflows rose dramatically from USD 100 million to USD 2500 million by the end of period 2000-2008. Source: Remittances data, Development Prospects Group, World Bank, 2010.

It seems that Tajikistan is more likely to benefit from a flat tax system than high income countries. The country could exploit its opportunities by providing a more competitive and transparent tax system both for domestic and foreign investors. The introduced lower tax rates have already enhanced the economic activity, but Tajikistan has to permanently concentrate on debt reduction in order to dampen the risk premia. Furthermore, Tajik government should curb the versatility of inflation in order to provide a better business environment for investments.

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