# The Role of Taxes in Financing of Public Expenditures and the Implications for Fiscal Policy in the Countries of the European Union

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## Abstract

*The analysis made in this paper, for the 1995-2016 period, in the EU confirms that the fiscal resources are the main public resource and pointing out the fact that they are sensitive to the economic conjuncture. By analyzing the structure of financial resources, we found that most of the Member States also used extraordinary resources in financing the public spending even if the economic situation allowed the balancing of resources with public expenditures, with negative consequences on the situation of public finances, but also on macroeconomic stability, while breaching and the existing Community regulations. A second direction of analysis was to identify the position of the Member States towards the rules of a sound fiscal policy in relation to the economic conjuncture. As a result of the analysis, we have concluded that most of the Member States have led a pro-cyclical fiscal and budgetary policy, more pronounced in 2001-2007 period.*

**Key words**: taxes, public expenditure, fiscal policy, economic growth
**J.E.L. classification:** E62, H60, H20

## 1. Introduction

In our approach, we aim to analyze the structure of the main forms of public financial resources in terms of their coverage of the total public expenditure at the EU level in the period 1995-2016, in order to identify the peculiarities of structure on one group of states (EU15 and the new member states respectively). Secondly, with the emphasis on the role played by the tax revenues from the taxes, we wish todynamically analyze their evolution in terms of public spending coverage. Also, considering, on one hand, the overall economic conditions in the analyzed period and, on the other hand, the existing community norms, we intend to identify the implications of the evolution of the indicators analyzed with a reference to the type of fiscal policy -the budget adopted by the Member States.

## 2. Conceptual approach

Taxes have been the main form of public financial resources ever, since their emergence. The purpose of these levies was and it is financial, namely, the procurement of financial resources at the state's disposal to cover its expenses, even if others have been added as a result of the mutations in society.

On the backgound of the modern doctrine, the state involvement in society and economy was focused on the development of the state economic sector and the influence of the evolution of the private economic activities and, on the other hand, the redistribution of the financial resources among the members of the society, in the context of its manifestation as a state of welfare. Ont this background, alongside taxes and fees that were considered to be fiscal levies, others have also been stated, such as social contributions to various public financial funds, framed by some authors in the generic category of parafiscal levies, as a result of the development of the state functions in the society, amid state interventionism (Lowenthal, 1996, p.112). However, from an economic point of view, the taxes and the social contributions are considered to be similar to taxes. Also, due to the fact that the state itself is an economic agent, it participates in the processes of primary distribution of the created product, the revenues obtained are a source of coverage of all the public expenditures, those of a non-fiscal nature.

The two major categories of public financial resources, namely those of fiscal and non-fiscal nature, give the current of ordinary public financial resources used to meet the public needs. To this, extraordinary financial resources are added, mainly purchased through public loans, whose involvement in the formation of the public financial resources has become more and more intense in the contemporary society, on the background of the state-interventionist doctrine and in compaison to the economic and social difficulties, the majority of the states accepting the financing of the budget deficits, in order to relaunch the economy, on their account.

## 3. Implications of the European integration process on the structure of public resources

If the Maastricht Treaty laid the foundations for a fiscal-budgetary discipline, in 1997 the Stability and the Growth Pact (SCP) outlined the multilateral surveillance system of the Member States whereby the level of government deficit and government debt is monitored by the European Commission, in order to maintain the sustainability of the public finances. The implications of the CFP for how public expenditure is covered are the limits imposed on the maximum level of extraordinary financial resources, the value of which should not exceed 3% of GDP. If this maximum threshold is exceeded, it is considered that the Member State in cause has an excessive deficit, which violates the Article 104 of the EU Treaty, and it is therefore necessary to start the correction process. However, since its adoption, the CFP accepts a number of situations where the public deficit, although higher than the maximum threshold, is not considered excessive, such as natural disasters, wars or severe economic recessions.

In 2005, as a result of the amendment of the two European Council Regulations (Regulations 1466/1997 and 1467/1997), to the exceptional situations already existing, added the slowing down economic growth regulation. This change was seen as a *complete relaxation* of the tax rules by the Member States and the convergence criteria risked being viewed as a minimum and not as a maximum (Tanzi, 2005, p.12). In other words, even in the state of economic growth, Member States were allowed, accepted and financed with a budget deficit in order to stimulate economic growth to the level which was desired by the public authorities, which is to a larger extent contrary to another provision of the PCS, according to which, at the level of an economic cycle, the "budgetary position is close to the balance or in surplus", thus accepting public deficits only when economic conditions are unfavorable in order to promote a sound economic growth and create new jobs (European Council, 1997).

We note that the existence of "deep imbalances and market failures that affect both financial and real flows" justifies the promotion of a debt-financed budget deficit as a solution imposed first of all by the need to unlock and relaunch the economy in the periods of recession or stagnation, when it does not work normally and it does not fully self-regulate (Filip, 2002) . In times of economic growth, however, the promotion of a budget deficit and its financing due to the extraordinary resources is not an indicative measure, making the realization of the budgetary surpluses to be rational.

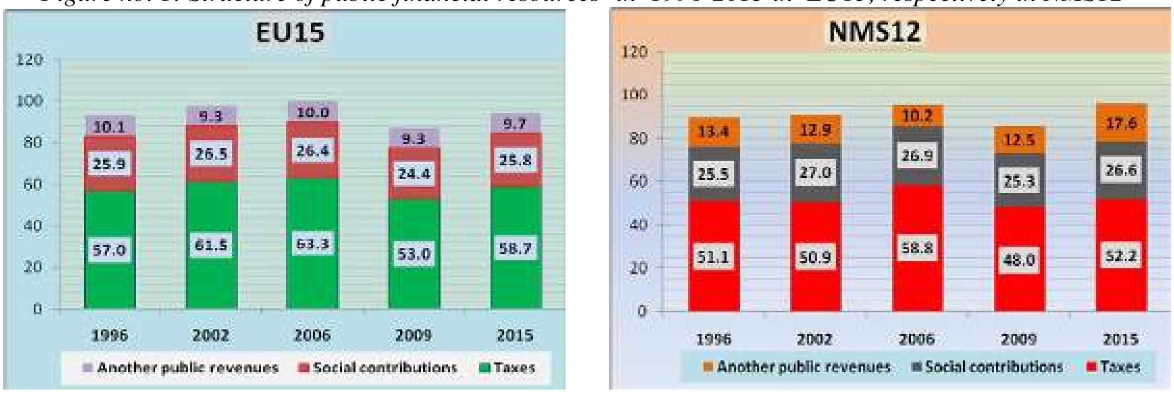
In essence, the CFP requires a sound and prudent conduct by the Member States, where the public deficit is only acceptable under extraordinary circumstances and not as a pervasive reality, irrespective of the economic situation. The danger of non-compliance with these rules is to accentuate the economic cycle by undermining the effects of embedded stabilizers. In this respect, the conductedstudies showed and warned that the fiscal policies were apparently pro-cyclical in the developing countries between 1960 and 2006, and in the industrialized countries they contained some pro-cyclical elements (Kaminsky et al, 2004, p. 18). Moreover, final public consumption, in developing countries, accentuates the economic cycle. However, at the level of the G7 states, fiscal-budgetary policies were either acyclical or anti-cyclical (Talvi et al, 2005, p.24).

As a result of the negative economic developments caused by the economic and financial crisis, on the one hand, but also by the worsening the state of the public finances in some of the Member States, on the other hand, in 2011, some provisions of the PCS were reconsidered; Firstly, the possibility of financing a deficit was eliminated when the growth rate is below the potential. In addition, the Directive 85/2012 reiterates the respect of the two fiscal anchors, the acceleration of the fiscal consolidation process in favorable economic times (European Parliament, 2012). Moreover, the provisions of the CFP also refer to those Member States out of Eurozone: they are also a subject of the Commission's multilateral surveillance system, with the obligation to present convergence programs, in which the present and the foreseeable situation of the public finances (deficit and public debt) is monitored (European Council, 1997). We will continue to see whether these fiscal prescriptions have been respected both before and after the crisis.

## 4. The importance of taxes in financing public expenditure – structural analysis

In the period under review, it is noted that between the EU15 and the new EU Member States (for reasons of systematization, we will refer to them as "NMS12"), there are differences in the structure of the financing of the public expenditure in general and the degree of the public expenditure coverage on the revenue of a fiscal nature.

*Figure no. 1: Structure of public financial resources[a] in 1996-2015 in EU15, respectively in NMS12*




*Source*: own calculation based on data provides by Eurostat: [a] –as a public expenditure financing degree

Overall, over the period 1996-2007, we observe that in the EU15 as well as in the NMS12, the level of the finacing public expenditure has not exceeded the 100% threshold in any of the reference years, as required by the PCS. Correcting this result with the macroeconomic outcomes of the pre-crisis period (economic growth exceeded 3% between 1995-2001 and 5% NSM12 in the period 2002-2007), we can conclude that there were objective conditions for increasing public revenues (which follows mechanically the GDP trend), but the fiscal policies were some pro-cyclical, both in the reduction of taxation and in the increase of the public expenditures.

Looking individually, in 2002, compared to 1996, the coverage of the government expenditures from the ordinary resources remained constant in the new Member States, while in the EU15 Member States it improved significantly, with the exception of Greece. This improvement comes in the context of the fiscal consolidation process imposed by the Maastricht Treaty in 1993 with a view to adopting the single European currency in the EU15, in contrast to the NMS12, where, in order to increase the territorial attractiveness, the cutting tax on profit and income, with an impact on the budget revenues. In 2006, in the EU15, eight Member States had budget surpluses, and in the NMS12 only Bulgaria and Estonia financed their full public spending from ordinary resources. At the opposite end, there are countries like Greece, Portugal, the UK and Italy, where the level of funding was well below the group average.

In 2009, as a result of the economic and financial crisis, with GDP falling sharply in all Member States (Poland is the only exception), budget revenues have fallen dramatically, especially those stemming from taxes. At the same time, the situation of the public finances has worsened steeply, the level of public expenditure financing on the account of the budgetary revenues decreased to 86% in the EU15 Member States and to 85% in the NMS12. Far below the average are Greece, Ireland, Portugal and UK, namely Latvia, Lithuania and Romania; in these states, the total public expenditure was covered only by 80% of the ordinary budget revenues, the remainder being secured on the borrowed resources. Also, the average, financial resources from the social contributions and non-government public resources have not significantly altered their contribution to the total public spending, the tax revenue has fallen to around 18% in the EU27.

The collapse of the public finances had as its main causes, first of all, the economic crisis itself, the fiscal revenues being sensitive to the economic conjuncture. The programs proposed by the governments in most of the Member States, included either measures to increase the public spending or the tax cuts, to mitigate and combat the economic downturn, have also had a significant impact on the level of government spending.

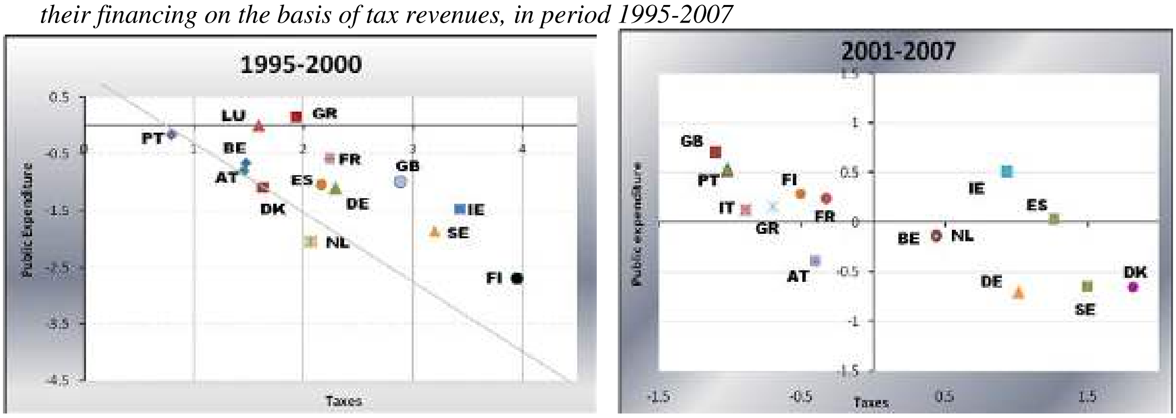
In 2015, the Member States recovered the situation of the main fiscal-budgetary indicators, with the usual resources financing over 94% of the public spending in the EU15, compared with only 96% in the NMS12. Negative situations are still recorded in Greece, Spain and UK, where ordinary resources covered less than 90% of all public spending. In comparison, in the NMS12, the fiscal anchor of the deficit is met, but no state has recorded a surplus, while in Germany, Luxembourg and Sweden the level of public expenditure financing exceeded 100%.

## 5. The role of taxes in financing public expenditure – approach in dynamics

From the above analysis, we can notice that fiscal resources from the taxes have been more fluctuating compared to other types of public financial resources. Public ressources from social contributions and non-fiscal contributions, as a cover for the total of the budget expenditures, experienced small fluctuations, even insignificant, between 1995-2016.

Under these circumstances, for an analysis in dynamics, we will correlate the level of the financing of the public expenditure, on the basis of tax resources with the dynamics of the public spending, to see if the Member States acted in a pro-cyclical manner during the analyzed period, in three periods: 1995-2000, 2001-2007 and 2010-2015. The delimitation considered some peculiarities in the macroeconomic evolution: the adoption of the euro in the EU15, the manifestation of the NMS12 states as emerging economies starting with 2001, respectively the resumption of the economic growth in most of the EU7 countries fom 2010.

*Figure no. 2: Distribution of EU15 SM according to the trend[a] of public expenditure[b] and the degree[c] of their financing on the basis of tax revenues, in period 1995-2007*




*Source*: own calculation based on data provides by Eurostat.

*Note*: [a] – the value of "a" from de linear equation of trendline Y= aX+b; [b] as % in GDP; [c] as ratio between fiscal revenues (without parafiscal and non-fiscal revenues) and the level of public spendings

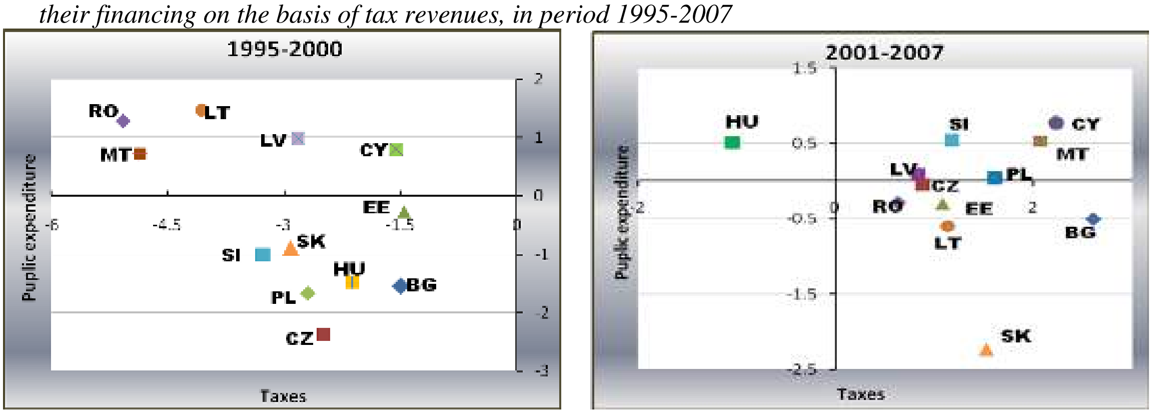
Starting from the assumption that in the periods of sustained economic growth there is an automatic adjustment of the budget balance, we will analyze whether this has happened, and if not, which were the causes and the implications.

**In the first period**, it is consistent that in most of the EU15 countries, the public spending (as a share of the GDP) had a strong downward trend, with the exception of Greece (whee the trend was rising), Luxembourg and Portugal (downward trend). In the case of these three states, tax revenues has been rising in terms of the level of financing public spending. The second group (Belgium, Austria and Denmark) and the third group (Germany, Great Britain, France, Spain) are characterized by a moderate downward trend in public spending, although below the upward trend in their funding on the basis of the tax revenues, is lower for the first group, compared to the second one (here also confirming fiscal measures to increase the level of taxation). In the case of the fourth group (Finland, Ireland and Sweden), the fiscal consolidation process is most evident (significant public spending cuts, discretionary tax increases) (*Figure 2*). Concluding, the trend in most of the EU15 Member States confirms the start of the fiscal consolidation process that has begun with the adoption of the EU Treaty.

In the **second period**, characterized by the sustained positive economic growth and very high values, the EU15 Member States are very dispersed, given the two indicators analyzed. From the perspective of a prudent fiscal and budgetary policy, the Member States should have been in the second corner of the chart on the right, a situation corresponding to a negative dynamics of public spending and a positive one in terms of their degree of funding on the revenue side taxes (this increases either as a result of the reduction of public expenditures, the revenues from this source remain constant, or as a result of the increase of the tax revenues, while the public expenditures remain constant). If this trend has not been confirmed, then the implications lead to two scenarios that are not mutually exclusive: in the first scenario the public spending has increased strongly, outpacing the rate of increase in tax revenues; the second, fiscal measures have been adopted and led to a decrease in the revenues from this source (either quota cuts or tax incentives).

Thus, looking at Figure 2, there is a *first group* of states in opposition to the scenario of a prudent fiscal-budgetary policy, namely the states in the fourth quadrant of the chart: UK, Portugal, Finland, France, Greece and Italy. Public spending coverage had a downward trend, more pronounced for Greece, Portugal and UK, indicating measures to reduce taxation. *A second group* is formed by the states in the second quadrant, of which Germany, Denmark and Sweden are individualized, where public spending has a steep downward trend and the tax revenues are a steady upward trend in line with Community rules. *A third group* is formed by Belgium, the Netherlands and Luxembourg, characterized by moderate fiscal consolidation measures. In the case of Ireland and Spain, significant increases in tax receipts were recorded, outpacing the growth rate of the public spending.

*Figure no. 3: Distribution of NMS12 according to the trend[a] of public expenditures[b] and the degree[c] of their financing on the basis of tax revenues, in period 1995-2007*




*Source*: own calculation based on data provides by Eurostat.

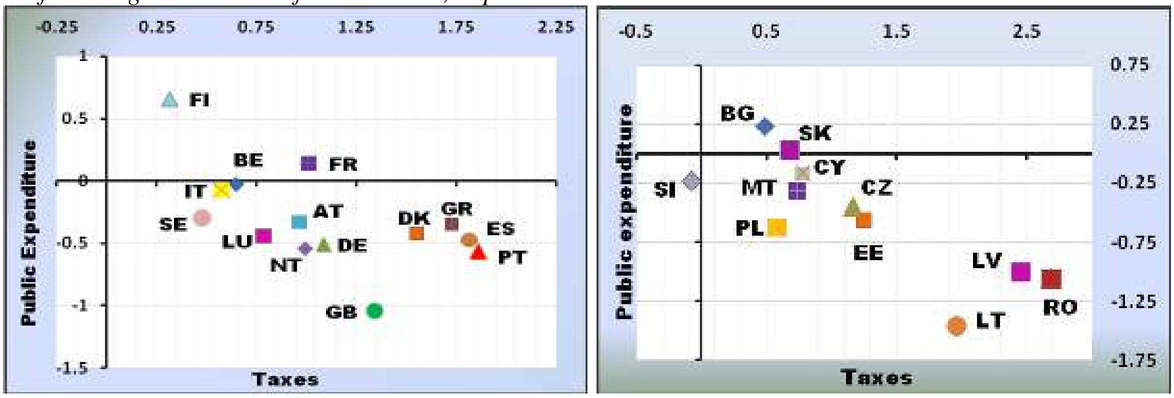
**In the case of the new Member State**s between 1995 and 2000, the trend of the two indicators is largely explained by the profound changes in the economies of these states, which are in the process of transition to a functioning market economy. As can be seen from *Figure 3*, the level of the financing of the public spending had a downward trend in all 12 analyzed Member States, more pronounced in Romania and Malta, and moderate in Estonia, Cyprus and Bulgaria, the causes of extensive reforms including the tax plan, the fact that tax systems were still immature and the existence of fluctuating tax bases and considerable tax evasion.

The situation is a special one for the third-quarter states, which have seen a fall in the level of financing public spending from tax revenue, against a background of a downward trend in public spending, which signifies a strong reduction in tax revenues, indicating tax measures to reduce the level of taxation (quota cuts, tax incentives to attract foreign investors).

In the second analyzed period, most countries recorded an economic growth of over 5%, and in some cases even a two-digit one (Latvia, Estonia, Lithuania, Slovakia), which creates the conditions for the increased tax revenues, as as a result of the increase of the tax bases, provided that the quota cuts/tax allowances are not passed.

Futhermore, we can notice that, apart from Hungary, all the other Member States recorded increases in the tax receipts, more significant for those in Q1, where although public expenditure had an upward trend, it was outpaced by the rising pace of the tax revenue growth. In the case of the Member States in II, the increase in the level of financing the budget expenditures is partly explained by the downward trend of the public expenditures.

*Figure no.4: Distribution of EU27 according to the trend[a] of public expenditures[b] and the degree[c] of their financing on the basis of tax revenues, in period 2010-2015*




*Source*: own calculation based on data provides by Eurostat.

After the resumption of economic growth in the period 2010-2015, the EU27 countries returned to the "correct" fiscal-budgetary position, standing in the second quadrant or very close to it, as can be seen in the figure above. This indicates changes in the structure of tax bases, including the tax increases, even if the economic growth is modest compared to the previous period (0.97% in the EU15 and 2.32% respectively in the NMS12).

## 6. Conclusions

The analysis shows that a number of the Member States have made fiscal and budgetary policy decisions in contrast to the recommendations of the Community legislation, their actions endangering the sustainability of public finances and macroeconomic stability as a whole. The appeal of some Member States to extraordinary financial resources in times of economic growth, either as a result of an upward trend in the public spending or as a result of the tax reduction measures, has led to the undermining of the effects of the automatic stabilizers, with an impact on developments in the real GDP level, which, in the background of the economic and financial crisis, has seen a significant decline in all Member States (with the exception of Poland), and in some even severe, over 10% (Baltic States). Moreover, in countries such as Greece, Portugal, Spain, Italy, Cyprus, Estonia and Latvia, the economic contraction period was prolonged for several years, and the resumption of the economic growth was modest.

The reactions of the supranational bodies have led to the development of the Community norms to strengthen the Member States' oversight, both in the Eurozone and in the Non-Euro zone, with the aim of preventing or correcting the potential negative developments in the main indicators by monitoring the situation of the public finances. In addition, the new norms have the role to change the attitude of the Member States, by looking at the limits imposed by the convergence criteria, as a maximum and not as a minimum, as it did in the pre-crisis period.

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