

The Turbulence of the Solutions

*“Subjectivity is objectified into the invisible hand
which becomes the supra-rational authority
for certifying economic truth.”*

The turbulences at a decision making level in matters of economic crisis are now obvious. The causes, though, deserve scrutiny from at least a couple of perspectives: firstly, because the ideological blockage of standard economic theory is already visible and, secondly, because the ideological resilience produces examples of defiance of the human aspect with regard to the consequences of the crisis.

In the spectrum of causal outcomes takes shape a problem whose solution has always been avoided: the problem of the objectifying of economic knowledge, as an ambition of scientificity, has removed from the equation the only determinant of economic phenomena which makes the certifying of truth through experiment impossible: subjectivity. Somewhat contrary to the rules of rational knowledge, economic knowledge cannot have access to certitudes but through an approximately rational formula (in essence, barely rational!), in the sense that it operates in the fluid space of intuition in order to – often deceptively – identify sources of deduction.

Economic knowledge, respecting its object, haunts the paths of intuition and hopes to reach the solid steps of deduction. The drama of economic knowledge is the fact that it remains suspended between intuition (though while hooked to it) and deduction (but without reaching it, in an experimental formula). When it announces truth, economic knowledge rather believes that intuition has been fixed in a reason-able field.

More finely put, economic growth calls on conjectural operators whom it finds on the artificial island of rationality, inhabited by subjectivity, declaring the logical probability as a possible fact, identifiable and provable through experiment. However, a forgery of maximal magnitude takes place here, as economic knowledge does not apply to facts or objects, but to economic phenomena emanated in inter-subjective contexts and having sense only in those contexts. Through their nature, the inter-subjective contexts are under-stretched, in indefinite proportions, by both rational and irrational determinants. The demarcation line between the determinants is oscillating in a very particular object-oriented framework of a reflexive, sensitive and chaotic nature; human nature, in other words.

The excess of reason in the knowledge of human nature means its reduction to the human condition, and can never be treated as itself without being transformed in that which it essentially is not: an object, a fact for experimental knowledge to be applied on. Economic knowledge has no chance of reaching regularities, except in a reductionist way, focusing on the human condition as a world of economic facts, of economic objectives; what come out of the knowledge process are notions of economic physics, of the mechanics of de-subjectified gestures. Apart from the danger of escaping in the absurd imaginarium, knowledge such as this is itself a product of the imagination of something which cannot in essence be imagined.

But the contents fixed by economic knowledge throughout history are in part arisen from imagination. The markings are represented by metaphors, by nebulous concepts, confused and diffused in equal measure – like the invisible hand – which attribute the market with extra-subjective capacities eminently imagined in order to fill-in the objectified area of certification through experiment. In a metaphysical way, subjectivity is “objectified” into the invisible hand which pretends to be the authority which certifies the truth. It’s just that the truth-function of the market has sense in an inadequate, extra-logical and supra-rational way. The error is immense; the truth thus certified not being an extra-subjective, implacable, omniscient and omnipotent object.

The economic truth is an uncertain result of a inter-subjective transaction which is tied to a precise value originating in the determinants of the human nature. But these determinants are not exactly rational, they’re even eminently imprecisely rational, even in the sense of being – most often – obviously irrational.

The decisional turbulence revealed by the present economic crisis is amplified by the non-rational intermediary between science (even in an approximate sense) and faith, meaning ideologies. These don’t do anything but

exacerbate the limitations of knowledge to favored approximations from the cognitive universe of Economics. Which translates as a sort of reduction of the second degree (a reduction to the reduction), constructing theories on this cognitive parsimony.

There is no chance for the crisis not to deepen as long as ideological visions are being used, visions which maim even further the already crippled product of economic knowledge. Ideologies seem potent in matters of the economy because they either objectify the faith of predetermination (a sort of *fata morgana* of expectations), or subjectivize the faith of salvation (a sort of utopia of the means). Meaning, the ideologies invariably reduce the multiverse of human nature to a minuscule dimension. That is why they are not apt to operate on the reason-able and on rationality, where the solutions to the crisis might be found.

The crisis lingers because ideologies search for rationality in other places than the human nature.

Marin Dinu

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Cost Drivers. Evolution and Benefits

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Abstract. *The purpose of this article is to capture the evolution of applying cost drivers in calculating costs since their initial occurrence until the present times. There are different conceptual approaches of cost drivers, and new insights from applying cost modeling techniques from the Activity-Based Costing method (ABC). The article looks at the typology, criteria for selection of cost drivers and their benefits. The cost allocation method is also presented with specific steps corresponding to the ABC calculation method. In the end, the authors conclusions on the benefits of cost drivers are presented.*

Keywords: activity-based costing; cost drivers; allocation method; cost object; advantages.

JEL Code: M41.

REL Codes: 14I, 14K.

1. Cost drivers. Conceptual approaches

Since the emergence of the concept of calculating the cost of activities based on a consumption view, cost drivers have been defined in various ways by specialists in the field, with many definitions being similar. Here are a few:

1. The strategic purpose of a *cost driver* means the factor which causes or produces a change at the cost level. This effect is illustrated by Michael Porter, referring to the long term efficiency factors of activities. Porter shows how “*cost behavior depends on a number of structural factors, called factor of development costs*”. A cost factor is the economic logic that explains the cost level for an activity and a certain level of functioning.

2. The accounting purpose of a *cost driver* means the cause factor changes the nature of costs to be allocated. The basic purpose of an *allocation base (or factor) – cost driver* is complementary to the first inductive effect. In accounting terms, the activities are consuming resources and activities are based on their underlying triggers (e.g., products, service-lines, customers).

3. The measurable effect by a *cost driver* means the measure unit of activity. Compared with the first two meanings, according to Brimson J.A. “*as the activity measure is the factor by which the cost of a process varies directly, but so far activity measure is not a cost driver*”⁽¹⁾. In fact, a cost driver is the factor which generates occurrence of the consumption of resource (capacity) expenses.

Traditional approach. Pre-cost drivers

Due to the lack of a proper causal relation between allocated indirect and shared expenses to cost objects⁽²⁾ and the chosen basis of allocation criteria being non-causal, the costs were inaccurate and sometimes wrong; the result led to the so called pre-cost drivers. Pre-cost drivers were typically broadly selected factors, such as the number of units produced, amount of sales, or direct labor input hours.

Serving like a proxy, at a simplistic level these examples of drivers appeared somewhat reflective to cost accountants of how products consumed indirect costs, but they violated costing’s *causality principle*. If the quantity of those types of cost drivers increased or decreased it may have had little or no change in the amount of indirect or shared expense. Early in the 20th century traditional management accounting and cost calculation methods widely used these types of broadly averaging cost drivers. There were no detailed studies on their identification, use, accuracy and effectiveness. Ironically, industrial engineers applied causal cost drivers for manufacturing studies, but these applications were independent of the methods applied by cost accountants for financial reporting.

Modern approach. Contemporary cost drivers

Until the emergence of the concept of *activity-based costing*, *cost drivers* were rarely questioned for several decades. Specifically, in 1987, Kaplan, Cooper and Johnson outlined such a system based on the book “The Hidden Factory”⁽³⁾, developed and published by Jeffrey G. Miller and Thomas E. Vollman. The traditional terms of “allocation base or factor” were replaced with the term “cost driver”. The most significant cost driver’s definition applies to the Activity-Based Costing method (ABC).

Specific approach of ABC method (Activity-Based Costing)

With ABC, *cost drivers* are units that are used to causally assign and trace indirect and shared resource expenses related to activities (production, administration, sales, etc.) based on the consumption that cost objects (e.g., products, works executed, services, orders) place demands on resources. According to the Activity-Based Costing method, the products consume activities and activities consume resources. Hence, any factor that causes a change in the cost of an activity or how much of an activity’s cost is consumed can be called a cost driver.

Cost calculations derived from causes

Cost allocation methods are used to calculate the cost of resource expenses that are consumed. They should comply with the costing’s *causality principle*. The cost drivers’ quantities are the cause of producing structural changes of activity costs and resource expenses.

2. Criteria for selecting cost drivers

The two major categories of criteria underlying the description of different types of cost drivers are optional (of choice) and specifying (of determination). A description and advantages of the two categories of criteria are given below.

According to experts, the underlying criteria for selecting cost drivers are optional though they are still very important. They are:

1. *Easy identification, use and understanding*. To easily identify a cost driver we must investigate its relationship with indirect costs. After identifying all work activities (typically in an “activity dictionary”), a cost assignment model is constructed that contains complete information about the origin of resource expenses and their cost allocation methods.

2. *The existence of a direct relationship between indirect costs and cost drivers.* Starting from the correct identification of cost drivers that highlight the causal connections between indirect costs and cost drivers, this then allows for obtaining accurate and true actual costs of cost objects (e.g., activities, products, customers).

3. *Positive or negative influence on staff.* Explaining the concept of a cost driver to managers and employees creates the advantages for better understanding of the behavior of costs and what influences changes in them. This leads to an inner harmony within the enterprise between employees and management, thereby increasing business performances by providing visibility as to what factors drive the consumption of costs. For commercial companies it accurately reports layers of profit margins for analysis and actions.

According to experts, the criteria for determining and selecting cost drivers are particularly important. They are:

1. *Degree of complexity, diversity and variation of the product (e.g., number of colors, sizes, ranges).* There should be a sufficient number of cost drivers to reflect how the uniqueness (heterogeneity) of each cost object (e.g., product) consumes each activity cost. It is a one-to-one relation of the number of activity costs to their activity cost driver (See the typology of cost drivers and their allocation's levels below).

2. *Degree of accuracy of calculation.* A rational number of cost drivers should be selected. If too few are selected, then some products will likely be over-costed and the others *must* be under-costed. This is because it is a zero sum cost error model. If too many are selected, then the extra administrative effort to collect the cost driver data may not offset the informational value from the incremental increase in accuracy of the product cost.

3. *Degree of usefulness of information.* The level of costing detail and accuracy depends on the type of decisions that the information will be used for.

3. Typology of cost drivers. Allocation levels. Allocation method

In terms of the level of allocation of indirect costs we find three types of cost drivers: *the resource level, activity level and cost object level.*

Resource drivers measure the consumption of work activities on resources (e.g., salaries, supplies). Activity drivers are defined according to specific units, reflecting activities as consumed by outputs. That is, activity drivers measure the consumption of cost objects on activity costs. The cost object drivers represent the sum combination calculation of other final cost objects (e.g., customer costs consume the mix and volume of product costs each customer purchased). Hence, there are three cost allocation levels:

Level 1. *Resources to activities*. Allocating resources to activities (main and/or support) applies resource drivers.

Level 2. *Activity to cost objects*. After re-concentration of support activities into the main activities (which is an activity-to-activity cost assignment as *intermediate* cost objects), the main activity costs are assigned and traced to costs objects using activity drivers.

Level 3. *Cost objects to final cost objects*. Cost object drivers are assigned and traced to other cost objects and ultimately sum into the *final* cost objects (e.g., customers) using final cost object drivers.

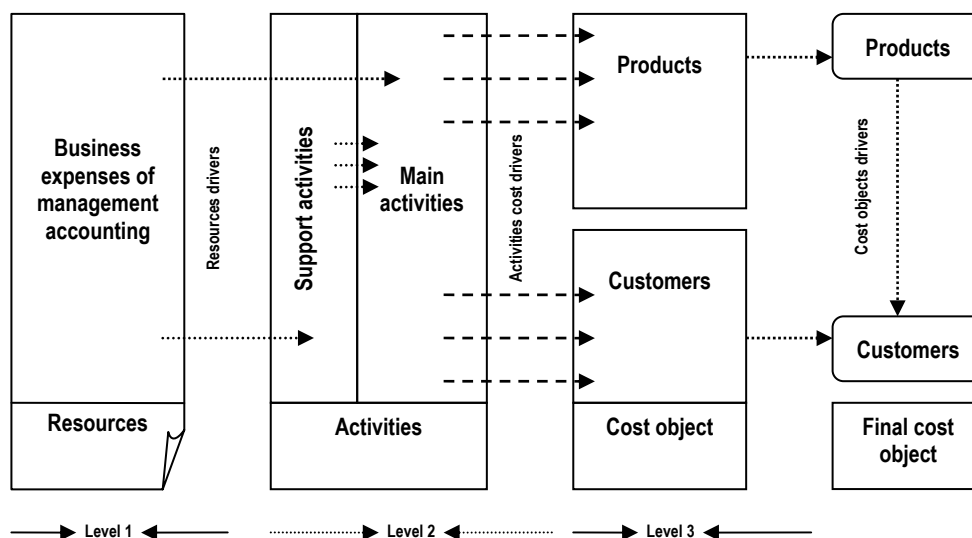


Figure 1. Scheme for the identification and allocation of expenditure according to drivers

Practical experience has shown that we can speak of two categories of activities: main activities and secondary activities (support). Many authors consider that the support activities are not anything else but resources available to serve the main activities and that, without them, main activities will not perform well. We believe that between main and the secondary activities (support) may be a relationship of concentration of several secondary activities in the main activity, concentration that can be made in whole or in part, based on different measure units. In most cases a number of 3-7 cost drivers can trace the majority of the total indirect costs. Choosing cost drivers should be done with caution, because wrong choices of them can lead to misallocated costs (i.e., errors) upon cost objects and ultimately flawed costs that are not reflecting reality.

After a careful selection of cost drivers for both main and support activities, then next proceed to measure cost driver quantities for the two types of activities. First are the quantities related to support activities (secondary), which are actually the standard measure for the volume capacity and outputs of cost centers. You can choose one of two possible methods⁽⁴⁾, either capacity-oriented planning or planning in restrictive conditions (sales plan). *The case of capacity-oriented planning* first determines the share occupied by the partial process in the total of activities, and then occurs the capacity to divide its value for a single ongoing of partial method. This thereby achieves volume that can be obtained on the secondary process. *The case of planning in restrictive conditions* determines planning-related values of each process.

Allocation method

Common cost accounting literature refers to the allocation method that allocates indirect costs of both the products and the locations of cost centers. If we take the allocation mechanism of indirect costs and use cost drivers that are based on specific allocation criteria, then we can get a modern, useful method called *the allocation method*. In determining the share of indirect costs to be allocated (i.e., assigned and trace) to the cost objects, these steps should be followed:

1. Choose an allocation base and factor with the following conditions:
 - a) The cost driver established in the ante-calculation stage must not change in the post-calculation stage to avoid distortion of costs within the period or month to month within the financial year;
 - b) The cost driver must have common nature (using the same cost driver), but different quantity;
 - c) Between the activities costs to be allocated and cost driver must be a direct causal relationship of dependence, so that using it to create the possibility of obtaining accurate information in terms of selection allocation criteria and interpretation of obtained results from comparison at costs by activities;
 - d) The chosen cost driver must be recommended by the ABC project team that assumes full responsibility for the chosen criteria and the obtained results for use by company management.

2. Calculation of the allocation coefficient (A_k):

$$A_k = \frac{E_A}{\sum_{c=1}^n A_{bc}},$$

where:

E_A = expenditure on activities;

A_b = allocation base (i.e., factor);
 n = number of calculated objects;
 c = calculation object.

3. Determination of each bearer share expenses (Share E_c) is performed as follows:

$$\text{Share}(E_c) = A_k \times A_{b_c}.$$

Example

A unit is running two lots of products in the following amounts: A = 3,000 pieces, B = 2,000 pieces. Indirect expenses incurred during the month in the production process is 300 lei, consisting of expenditure of lots of launching the production of 50 RON depreciation expenses machinery used in the two amount of 150 RON and 100 RON electricity. Direct salary costs related to enforcement of the two batches of products are 1,500 RON (A = 140 hours, B = 160 hours).

Traditional method

Distribution of indirect costs of production on the two batches of products will be using as a basis for apportionment of direct salaries.

$$A = \frac{300}{700 + 800} \times 100 = \frac{300}{1.500} \times 100 = 20\%.$$

Share of indirect costs related to those two groups of products is as follows:

$$\text{Product A} = 20\% \times 700 = 140 \text{ lei} \quad \text{Product B} = 20\% \times 800 = 160 \text{ lei}$$

The total cost per product is as follows:

$$\text{Product A} = 700 + 140 = 840 \text{ lei} \quad \text{Product B} = 800 + 160 = 960 \text{ lei}$$

ABC method

Proceed to the first group of two activities (*launching in manufacturing, processing section*) in the *production process*. For each activity are selected different cost drivers, as follows:

Production process	
Activities	Cost drivers
1. Release into production	Number of products
2. Processing section	
- Equipment depreciation	The normal duration of use
- Electricity	Registered consumption

Centralized data situation we have is as follows:

Production process			
Activities	Sum (lei)	Cost drivers	Total
1. Release into production	50	Number of products (pieces)	5.000
2. Equipment depreciation	160	The normal duration of use (years)	5
3. Electricity	90	Consumption (kWh)	300
Total	300	-	-

Allocation costs in the manufacturing launch of the two groups of products will be using as cost driver, number of items (pieces).

$$A = \frac{50}{3,000 + 2,000} \times 100 = \frac{50}{5,000} \times 100 = 1\%.$$

Share of expenses related to the production launch in two batches of products are as follows:

$$\text{Product A} = 1\% \times 3,000 = 30 \text{ lei} \quad \text{Product B} = 1\% \times 2,000 = 20 \text{ lei}$$

Distribution of depreciation expense on the two machines will be lots of products using cost driver, calculated monthly using the normal depreciation schedule for equipment. The share of machinery depreciation expense related to the two groups of products is as follows:

$$\text{Product A} = 90 \text{ lei} \quad \text{Product B} = 70 \text{ lei}$$

Distribution of electricity costs on the two batches of products will be using as cost driver, consumption in kWh recorded.

$$A = \frac{90}{130 + 170} \times 100 = \frac{90}{300} \times 100 = 30\%.$$

Share of indirect costs related to those two groups of products is as follows:

$$\text{Product A} = 30\% \times 130 = 39 \text{ lei} \quad \text{Product B} = 30\% \times 170 = 51 \text{ lei}$$

The total cost per product is as follows:

$$\text{Product A} = 700 + 30 + 90 + 39 = 859 \text{ lei}$$

$$\text{Product B} = 800 + 20 + 70 + 51 = 941 \text{ lei}$$

4. Cost drivers advantages

The most important advantages of applying contemporary cost driver concepts are the following:

1. *Improving enterprise performances.* Because many companies still use traditional management accounting and cost calculation methods using non-causal cost drivers, they produce unrealistic, inaccurate and flawed cost information. But based on new contemporary approaches to cost drivers and using advanced management accounting and cost calculation methods, as with the ABC method, reliable information is obtained that can be the basis for intermediate and long-term decisions.

2. *Improving employee and manager awareness.* Each employee or manager of a company can become aware of the benefits that the knowledge of the causes of costs has on obtaining improved performance. Managing enterprise performance based on cost drivers can contribute to individual wage gains, such as bonuses, premiums, etc.

3. *Periodically reviewing costs.* Understanding cost drivers and their effect on cost behavior can help in the analysis of production costs in the short-term as well as the long-term. Many resource expenses, typically considered as period costs or fixed costs in the short-term, may be examined to determine if some of the resources (and their capacity level) are adjustable up or down in as the planning horizon extends, thus resulting in classifying them as variable costs rather fixed costs. Thus all costs are subjected to a better control.

4. *Controlling costs with better calculations.* To have better control of costs we must control the causes, namely cost drivers. If one can reduce the quantity, frequency, or intensity of a cost driver, then its activity cost will be lowered. Using traditional cost calculation methods causal-based cost drivers are “hidden”. Consequently, with the desire to reduce indirect costs, managers and employees may be mislead to reduce a non-causal cost driver (e.g., number of labor input hours) and have no impact on reducing the indirect costs. Using however causal-based cost drivers, the accountant will provide visibility to the work activities and their cost drivers that consume activity costs and in turn resource expenses.

5. *Eliminating costs.* Identification of cost drivers of non-value-adding activities (e.g., the number of inspections) facilitates the elimination of the activity cost if its purpose can be eliminated by removing the root cause. The indirect costs allocation method on products using cost drivers contributes to this effect.

6. *Actual costs to individual products.* Compared with traditional cost allocation methods (i.e., non-causal), the most important advantage offered by cost drivers is far more accurately calculating total and per-unit costs of

products, channels, and customers. Accurate determination of total and per-unit costs is invaluable when evaluating selling prices and profit margin layers to strategically rationalize types of products, channels, and customers to sell to.

5. Conclusions

We think that those cost drivers advantages aforementioned will better explain for those accountants and managers who interested in superior performance management accounting practices and consequently in obtaining more visibility of costs as well as more accurate costs.

In conclusion we can say that a cost driver is the *key element* around which revolves cost behavior. This then ensures the viability and accuracy of information obtained for aiding a company to make better long-term strategic decisions and intermediate-term operational decisions. Both types of decisions will improve the company's level of profitability and its success in future periods.

Notes

- (1) See Brimson, J.A., *Activity Accounting: An Activity-Based Costing Approach*, New York, John Wiley & Sons Inc., 1991, p. 52.
- (2) Cost objects are the actual result of realization of the manufacturing process, which consists in obtaining the products, the execution of works or services.
- (3) According to Miller, J.G., Vollmann, T.E. "The hidden factory", *Harvard Business Review*, 1985.
- (4) See Ebbeken, K., Possler, L., Ristea, M., *Calculation and cost management*, Teora Publishing House, Bucharest, 2000, p. 370.

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Entrepreneurial Perceptions and Activity – Differences and Similarities in Four Eastern European Countries

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Abstract. *The aim of this article is to reflect upon the differences between entrepreneurial perceptions, attitudes and activity in Croatia, Hungary, Romania and Serbia in 2007-2008 period using Global Entrepreneurship Monitor Adult Population Survey database.*

Keywords: entrepreneurship; entrepreneurial perceptions; entrepreneurial attitudes; early-stage entrepreneurs; nascent entrepreneurs; baby business owner-manager; global entrepreneurship monitor; efficiency-driven economies.

JEL Codes: M13, J26, C83.

REL Codes: 9B, 14D.

Introduction

Entrepreneurship is a subject widely treated in the economic literature. Despite that there isn't any universally accepted definition of the entrepreneur or the entrepreneurial process, the specialists agree on their importance in the economic development. The aim of this paper is the comparative analysis of the Croatian, Hungarian, Romanian and Serbian entrepreneurial activity and behaviour emphasizing the attitudes and the perceptions of the population towards entrepreneurship.

1. Theoretical background

The entrepreneur concept isn't clearly defined, being significantly changed through its evolution in economic theories. Researchers' debate on this topic proved to be endless, without resulting until now a universally accepted definition (Bygrave, Hofer, 1991).

Accepting the Global Entrepreneurship Monitor theoretical model for this analysis, we used the following terms in assessing the entrepreneurial activity of the adult population:

- *Nascent Entrepreneurs* are those who are actively planning a new venture. These entrepreneurs have done something during the previous 12 months to help start a new business, that he or she will at least partly own. Activities such as organizing the start-up team, looking for equipment, saving money for the start-up or writing a business plan would all be considered as active commitments in starting a business. This business has not paid salaries, wages or any other payments to the owners for more than three months.
- *Young Business Entrepreneurs* (baby business owner-managers) are those entrepreneurs who at least partly own and manage a new business that is between 4 and 42 months old and have not paid salaries for longer than this period. These new ventures are in the first 42 month after the new venture has been set up.
- *Early-Stage Entrepreneurs* refers to the early stage entrepreneurial activity among the adult population aged between 18-64 years, identified as nascent or young business entrepreneurs. In those cases when the respondent is involved both as nascent and young business entrepreneur then the respondent is counted only once as a nascent entrepreneur.
- *Established Business Owners* are those entrepreneurs who have set up businesses that they have continued to own and manage and which had

paid wages and salaries for more than 42 months (Bosma et al., 2008, p. 11).

The newly created businesses will create new jobs and they will contribute further to the economic growth, stimulating both product and labour force market. On the other hand, not all of the entrepreneurs will succeed. Van Praag (2005) sees the entrepreneurial failure in the two following ways: the entrepreneur doesn't reach the phase in which he should employ labour force to turn his business in a profitable organisation, the business created doesn't survive the first period and bankrupts. This indicates also the psychological and social cost of the entrepreneurial failure.

In Bygrave and Minniti's (2000) opinion different cultures and regions from many countries indicate a geographical concentration of the entrepreneurial activities. The entrepreneurial activity might create proper conditions for new market development and also new business opportunities, catalysing the whole set of economical activities.

2. Data used

In our article we used the Global Entrepreneurship Monitor (GEM) 2007 and 2008 Adult Population Survey database for Croatia, Hungary, Romania and Serbia.

GEM is a large scale research program launched in 1997 by leading researchers in the field of entrepreneurship at London Business School and Babson College. The first research was published in 1999 and it included 10 countries. Since then the project has been extended to include 42 countries in 2007, 43 in 2008 and 54 countries in 2009. The main aim of GEM research is to study the complex relationship between entrepreneurship and economic growth, to measure the level of entrepreneurial activity between countries, to uncover factors determining the levels of entrepreneurial activity and to identify policies which may stimulate the level of entrepreneurial activity. GEM, as a research program that focuses on a major driver of economic growth, on entrepreneurship, admits the widely acknowledged phenomena that entrepreneurship is one of the most important forces shaping the changes in the economic landscape.

In each country, a survey company conducts a telephone survey or face to face interview of the adult population aged between 18 and 64 year. This survey was carried out to measure the entrepreneurial behaviour and the attitudes of adult population in Croatia, Hungary, Romania and Serbia. The survey data are used to calculate the Total Entrepreneurial Activity Index (TEA), a comparable measure of entrepreneurial activity across countries.

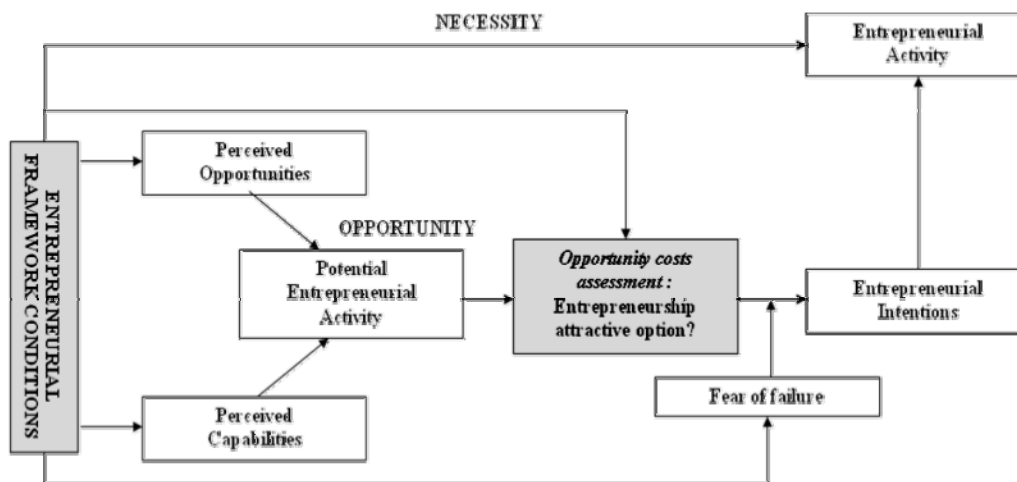
According to the Global Competitiveness Report, in the first stage, the economy is *factor-driven* and countries compete based on their factor endowments: primarily unskilled labor and natural resources. Companies compete on the basis of price and sell basic products or commodities, with their low productivity reflected in low wages. Maintaining competitiveness at this stage of development hinges primarily on well-functioning public and private institutions, well-developed infrastructure, a stable macroeconomic framework, and a healthy and literate workforce. As wages rise with advancing development, countries move into the *efficiency-driven* stage of development, when they must begin to develop more efficient production processes and increase product quality. At this point, competitiveness is increasingly driven by higher education and training, efficient goods markets, well-functioning labor markets, sophisticated financial markets, a large domestic and/or foreign market, and the ability to harness the benefits of existing technologies. Finally, as countries move into the *innovation-driven* stage, they are able to sustain higher wages and the associated standard of living only if their businesses are able to compete with new and unique products. At this stage, companies must compete through innovation, producing new and different goods using the most sophisticated production processes (Schwab, 2009, pp. 7-8).

The analyzed countries are efficiency-driven economies, from which three (Croatia, Hungary, Romania) are in transition to innovation-driven economies.

In Romania in 2007 a representative sample of 1739 adults aged between 18-64 years, in 2008 1667 adults was interviewed using the standard GEM questionnaire. The size of the sample in Croatia was 1541 in 2007, 1696 in 2008, in Hungary 1500 in 2007, respectively 1994 in 2008, while in Serbia 1766 in 2007, 1813 in 2008.

3. The evolution of the entrepreneurial perceptions and attitudes in the analyzed countries

According to Davidsson (1991) an important driver of national entrepreneurial capacity is how people perceive entrepreneurship. Perceptions about entrepreneurship may affect the supply side and the demand side of entrepreneurship. The following figure presents the main components of entrepreneurial attitudes according to Wennekers (2006).



Source: Bosma et al., 2008, p. 36.

Figure 1. *Entrepreneurial perceptions, attitudes and entrepreneurial activity*

The individual perceptions and attitudes regarding the entrepreneurial activity in Croatia, Hungary, Romania and Serbia describe a changed situation in the analyzed period as it can be seen in Table 1.

The obtained results emphasize similarities in the perception of Croatian and Serbian people towards entrepreneurship in the both analyzed years, in comparison with Romania and Hungary. In Croatia and Serbia, entrepreneurship informal networks might be built easier and entrepreneurial models are easier observed in the personal environment of the people. In 2008 in Croatia 57.21% (60.04% in 2007) and in Serbia (59.11% in 2008) of the adult population aged between 18 and 64 years know somebody who started a business in the past two years, while in Romania 41.23% (46.96% in 2007) and in Hungary only 32.39%. The share of those who saw good business opportunities for the next half year was similar in Romania and Hungary in 2007 (27.36%, respectively 29.62%), share which remains at the same level in 2008 in Romania and decreased to 22.42% in Hungary. These results describe much less opportunity recognition than the around 50% positive answer in case of Serbia and Croatia in the analyzed period. The opportunity perception of starting a new business decreased in the analyzed countries, with one exception, Serbia.

Serbian and Croatian citizens seem to be, according to our analysis, much more self confident in their entrepreneurial skills, almost two thirds of the adult population thinking that they have the required experience and skills to

start a business, while in Hungary half of the population considers this. While this share remained at the same level in the three mentioned countries in 2008 as it was in 2007 (with a slight increase in Hungary), in Romania the lowest share from the four analyzed countries decreased from one third to 28.67% in 2008. The proportion of those whom the fear of failure would prevent from starting a new business increased considerably in Hungary and Romania (from 29.57% in 2007 to 39.77% in 2008, respectively from 29.05% to 40.62%), while in 2007 it was indicated the same (around 30%) level in each country. The entrepreneurship, as career of choice, is appreciated positively in each country. In Romania, in 2008 almost half of the adults think that people would prefer that everyone should have the same standard life, this aspect is much worse in Hungary, especially (with around 80%) in Serbia and Croatia. The proportion of those who consider that the successful businesses get a good media coverage and are properly promoted is much lower in Hungary than in the other analyzed countries.

Table 1
(%)

Entrepreneurial perceptions and attitudes, 2007-2008

		Croatia	Hungary	Romania	Serbia
Do you know someone personally who started a business in the past two years?	2007	60.04	32.80	46.96	59.11
	2008	57.21	32.39	41.23	57.91
In the next six months there will be good opportunities for starting a business in the area where you live?	2007	47.26	27.36	29.62	49.10
	2008	46.66	22.42	28.01	54.02
Do you have the knowledge, skill and experience required to start a new business?	2007	65.89	53.50	34.84	69.15
	2008	65.10	55.92	28.67	69.67
Would the fear of failure prevent you from starting a business?	2007	32.37	29.57	29.05	29.24
	2008	33.54	39.77	40.62	28.51
In my country, most people would prefer that everyone had a similar standard of living.	2007	80.87	66.03	48.31	76.56
	2008	79.90	61.27	48.93	79.88
In my country, most people consider starting a new business a desirable career choice.	2007	72.22	58.80	63.07	78.17
	2008	70.70	46.97	-	71.60
In my country, those successful at starting a new business have a high level of status and respect.	2007	50.88	65.23	63.48	62.05
	2008	53.94	57.63	68.68	65.18
In my country, you will often see stories in the public media about successful new businesses.	2007	63.92	23.71	53.39	65.58
	2008	60.76	20.55	57.71	67.24

Source: Own calculations in SPSS based on GEM, Adult Population Survey, 2007-2008.

The comparisons of proportions of those who gave a positive answer to the above questions are shown in Table 2. In each analyzed year the proportion of those who know a nascent entrepreneur in Croatia and Serbia is significantly higher than in Romania and Hungary, and in Romania is significantly higher than in Hungary. In 2008 the proportion of those who perceive good opportunities for starting a business in the next six months in the area where they live is significantly higher than in the other analyzed countries.

Table 2

**Comparisons of proportions of entrepreneurial perceptions and attitudes,
2007-2008^{a,b}**

(%)

		Croatia	Hungary	Romania	Serbia
		(A)	(B)	(C)	(D)
Do you know someone personally who started a business in the past two years?	2007	B C	-	B	B C
	2008	B C	-	B	B C
In the next six months there will be good opportunities for starting a business in the area where you live?	2007	B C	-	-	B C
	2008	B C	-	B	A B C
Do you have the knowledge, skill and experience required to start a new business?	2007	B C	C	-	B C
	2008	B C	C	-	B C
Would the fear of failure prevent you from starting a business?	2007	-	-	-	-
	2008	D	A D	A D	-
In my country, most people would prefer that everyone had a similar standard of living.	2007	B C	C	-	B C
	2008	B C	C	-	B C
In my country, most people consider starting a new business a desirable career choice.	2007	B C	-	-	A B C
	2008	B	-	-	B
In my country, those successful at starting a new business have a high level of status and respect.	2007	-	A	A	A
	2008	-	-	A B	A B
In my country, you will often see stories in the public media about successful new businesses.	2007	B C	-	B	B C
	2008	B	-	B	A B C

Note:
Results are based on two-sided tests with significance level 0.05. For each significant pair, the key of the category with the smaller column proportion appears under the category with the larger column proportion.
a. Tests are adjusted for all pair wise comparisons within a row of each innermost subtable using the Bonferroni correction.
b. Cell counts of some categories are not integers. They were rounded to the nearest integers before performing column proportions tests.

Source: Own calculations in SPSS based on GEM, Adult Population Survey, 2007-2008.

The proportion of those who perceive themselves capable (i.e., they believe they have the required skills and knowledge to start a business) in Croatia and Serbia are significantly higher than in Hungary and Romania, this rate is the lowest in Romania. While in 2007 there is no significant difference between the proportions of those who have fear of failure in the analyzed countries, in 2008 this proportion is significantly higher in Hungary and Romania. In 2007, in Serbia it was the highest the proportion of those who consider that starting a business is a good career choice, in 2008 it was higher only than in Hungary. In Croatia the people attach the less high status to successful entrepreneurs in 2007 than in the other analyzed countries. In 2008 in Serbia is the higher the media attention for entrepreneurship.

4. Differences in entrepreneurial activity in case of the analyzed countries

The entrepreneurial perceptions and attitudes have impact on the entrepreneurial activity of the countries. As it can be seen in Table 3, the proportion of nascent entrepreneurs is the lowest in each analyzed year in Romania. The proportion of baby business owner-managers and established business owners are the highest in Serbia in each year, despite of the measured decrease of baby business owner-manager rate in 2008. Analyzing the entrepreneurial motivation, we can conclude that in Romania can be found the lowest opportunity-driven early-stage entrepreneurial activity rate. The necessity-driven early-stage entrepreneurial activity is the lowest in Romania, but also here can be seen a considerable increasing in accordance to 2007.

Table 3
Evolution of the entrepreneurial activity in the analyzed countries, 2007-2008 (%)

		Croatia	Hungary	Romania	Serbia
Involved in total early-stage entrepreneurial activity	2007	7.27	6.86	4.02	8.56
	2008	7.59	6.61	3.98	7.59
Actively involved in start-up effort, owner, no wages yet (nascent entrepreneurs)	2007	5.31	3.77	2.90	4.75
	2008	4.91	3.84	2.54	3.97
Manages and owns a business that is up to 42 months old (baby business owner-managers)	2007	1.96	3.10	1.32	4.01
	2008	2.75	2.80	1.56	3.62
Manages and owns a business that is older than 42 months (established entrepreneurs)	2007	4.22	4.83	2.51	5.27
	2008	4.83	5.34	2.07	9.26
Involved in opportunity early-stage entrepreneurial activity	2007	4.16	5.01	2.68	4.02
	2008	5.43	4.44	2.12	4.69
Involved in necessity early-stage entrepreneurial activity	2007	2.90	1.60	0.56	3.94
	2008	2.16	1.87	1.37	2.53

Source: Own calculations in SPSS based on GEM, Adult Population Survey, 2007-2008.

The total early-stage entrepreneurial activity rate is significantly lower in Romania than in the analyzed countries in each year. The proportion of baby business owner-managers in 2007 is significantly lower in Romania than in Hungary and Serbia, while in 2008 only in Serbia is significantly higher than in Romania. The rate of the established business owners is significantly higher in Serbia and Hungary than in Romania, meanwhile in 2008 this rate is significantly higher in Serbia than in all analyzed countries. We can observe that the opportunity-driven early-stage entrepreneurial activity rate measured in Romania is significantly lower than in Croatia, Hungary and Serbia. In 2008 there is no significant difference in case of the necessity-driven early-stage entrepreneurial activity rate.

Table 4

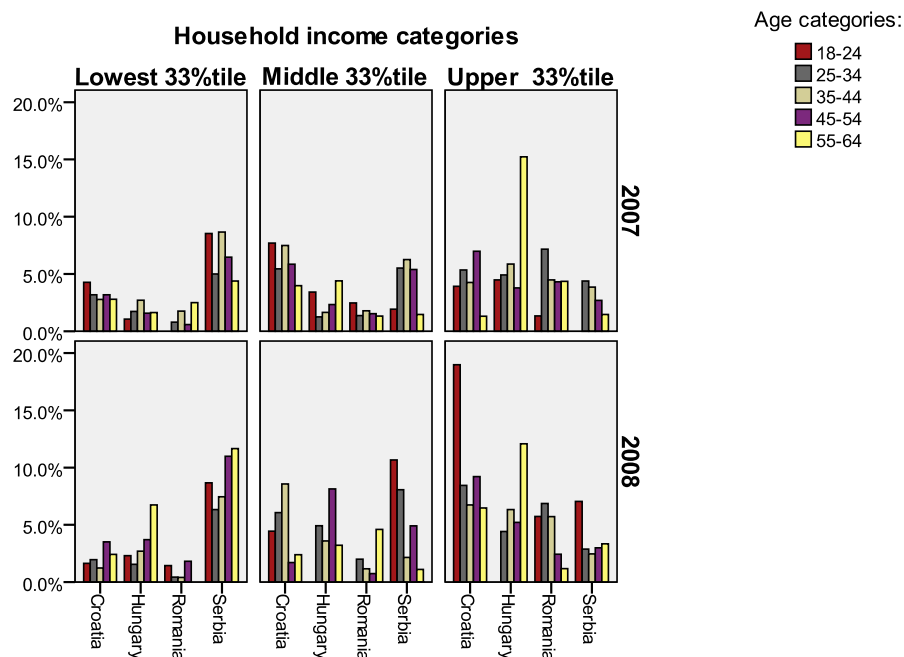
Differences between the means of the entrepreneurial activity rates of Croatia, Hungary, Romania and Serbia, 2007-2008^{a,b}

		Croatia	Hungary	Romania	Serbia
		(A)	(B)	(C)	(D)
Involved in total early-stage entrepreneurial activity	2007	C	C	-	C
	2008	C	C	-	C
Actively involved in start-up effort, owner, no wages yet (nascent entrepreneurs)	2007	C	-	-	C
	2008	C	-	-	-
Manages and owns a business that is up to 42 months old (baby business owner-managers)	2007	-	C	-	A C
	2008	-	-	-	C
Manages and owns a business that is older than 42 months (established entrepreneurs)	2007	-	C	-	C
	2008	C	C	-	A B C
Involved in opportunity early-stage entrepreneurial activity	2007	-	C	-	-
	2008	C	C	-	C
Involved in necessity early-stage entrepreneurial activity	2007	C	-	-	B C
	2008	-	-	-	-
Note: Results are based on two-sided tests assuming equal variances with significance level 0.05. For each significant pair, the key of the smaller category appears under the category with larger mean. a. Tests are adjusted for all pairwise comparisons within a row of each innermost subtable using the Bonferroni correction. b. Cell counts in some subtables are not integers. They were rounded to the nearest integers before performing pairwise comparisons.					

Source: Own calculations in SPSS based on GEM, Adult Population Survey, 2007-2008.

Analyzing the entrepreneurial profile, according to Figure 2, we can affirm that the early-stage entrepreneur in 2007 and 2008 is male, aged between 25 and 34 years in all countries, except for Serbia, where the most frequent age category is 35-44 years. In Hungary and Romania in each year the income of

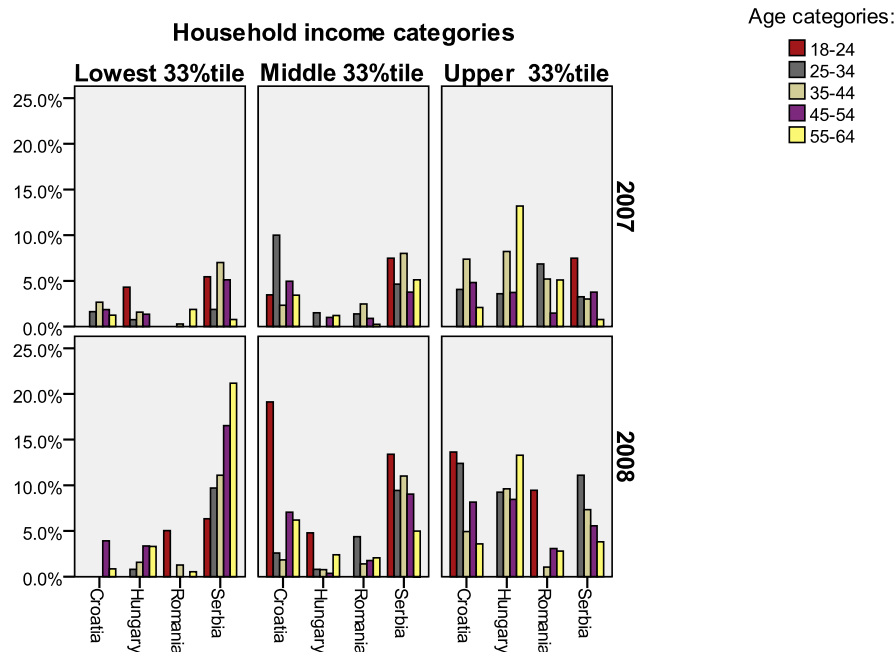
the early-stage entrepreneur's household is situated in upper 33% tile, while in Serbia in the lowest 33% tile. The educational level of the early-stage entrepreneur is significantly higher in Romania and Hungary than in Croatia and Serbia.



Source: Own calculations in SPSS based on GEM APS data.

Figure 2. *The distribution of early-stage entrepreneurs by household income, age categories, year of survey and country of origin*

The figure below shows that the established entrepreneur in 2007 is male, aged between 35 and 44 years in all countries, except Hungary (where the most frequent age category is 55-64 years). In Hungary and Romania, in each year, the income of the established entrepreneur's household is situated in the upper 33% tile, while in Serbia in the middle 33% tile in 2007, while in 2008 the lowest 33% tile, meanwhile in the case of Croatia in 2007 the household income category was middle 33% tile, which in 2008 moved to the upper 33% tile category. The educational level of the established entrepreneur is significantly higher in Hungary than in Croatia, Romania and Serbia.



Source: Own calculations in SPSS based on GEM APS data.

Figure 3. The distribution of established entrepreneurs by household income, age categories, year of survey and country of origin

5. Conclusions

We studied the main differences between the entrepreneurial perceptions and attitudes in Croatia, Hungary, Romania and Serbia in 2007-2008 time period based on GEM Adult Population Survey database. In each analyzed year the proportion of those who know a nascent entrepreneur in Croatia and Serbia is significantly higher than in Romania and Hungary, and in Romania is significantly higher than in Hungary. In 2008 the proportion of those who perceive good opportunities for starting a business in the next six months in the area where they live is significantly higher in Serbia than in the other analyzed countries. The proportion of those who perceive themselves capable in Croatia and Serbia are significantly higher than in Hungary and Romania, this rate being the lowest in Romania. While in 2007 there is no significant difference between the proportions of those who have fear of failure in the analyzed countries, in 2008 this proportion is significantly higher in Hungary and Romania.

Our findings regarding the entrepreneurial activity are: the total early-stage entrepreneurial activity rate is significantly lowest in Romania than in the analyzed countries in each year; while the rate of the established business owners is significantly higher in Serbia and Hungary than in Romania, meanwhile in 2008 this rate is significantly higher in Serbia than in all analyzed countries.

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Controversies Regarding the Corporate Tax Harmonization Trend in the European Union

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Abstract. *The idea of harmonizing corporate income taxes is currently one of the most important topic of debate on the agenda of the European Commission, but also in the specialists' theoretical approaches. The extreme diversity of these approaches is a relevant indicator for the complex problems that prevent the formulation of well known solutions in this field, disregarding the political feasibility considerations. This paper present a critical approach of the main reactions of experts, politicians and business representatives regarding the trend of harmonizing corporate income taxes in the EU.*

Keywords: fiscal policy; harmonization; common consolidated tax base; effects; controversy.

JEL Codes: G32, H25.

REL Codes: 8K, 14K.

1. Introduction

Recently, many experts and politicians have been in favor of achieving a coherent and centralized policy at the EU level in order to corporate income tax. The key word used by those who believe that all Member States should align their tax systems to executive directives from Brussels is „harmonization”.

One of the arguments used in favor of this measure is that the Union should have the power to set and levy taxes and not only to make recommendations to the Member States regarding measures of fiscal policy (Trovato, 2007). Moreover, according to the opinions expressed by the European Commission in 2001, the operation of different national tax systems in the Member States is the source of many problems:

- influencing (distorting) resource allocation, with negative consequences on capitalization of the true single market advantages, but also in terms of international distribution of tax revenues, which may disadvantage some Member States in relation to others;
- weakening of budgetary revenue through income loss associated with tax competition;
- trend of increasing the fiscal system inequity through the preferential approach of mobile tax bases;
- risk of double taxation.

The problems outlined above generate economic inefficiency because between taxpayers (corporations) and tax administrations occur frequently conflicts related some restrictive or discriminatory measures of the latter or competitive distortions caused by corporate actions. These conflicts are resolved with the cost of spending significant financial resources for achieving inspections and investigations, tax audit and others.

The problem of distortions caused by different taxation corporate income may be summarized as follows: if taxes are higher in a certain area, capital will migrate to areas with lower tax if other economic considerations do not keep better the original location. Countries affected by this migration will react to this situation, either by imposing barriers to free movement of capital or by reducing the tax to boost their inflow (James, Oats, 1998).

To solve these problems, at the EU level it is said frequently the need to partial harmonization (only the tax base) of corporate income taxation. Note that in order to prevent the “migration” of national tax bases, by moving corporate headquarters in countries with more favorable tax regimes, there have been proposals for total harmonization (both tax bases and tax rates) of corporate income taxation.

2. Positioning European politicians regarding the corporate income tax harmonization trend

The issue of corporate tax harmonization raised many political controversy in European Union Member States, generated by the doctrinal orientation of the empowered political parties. Thus, in England and Ireland the economic policy is focused on the role of the free market in allocating resources, promoting the principle according to which the state intervention through taxes should be minimal. The Continental European countries promote the importance of maintaining the state as a “dynamic player agent” of regulating some economic and social mechanisms if the taxation generates minimum distortions in the process of market economy. The Scandinavian countries promote the idea of social assistance universality and the important role of state involvement through tax levels to ensure a proper social development. The simple presentation of the main characteristics of economic and social models in European Union countries are sufficient to guess the position of their political leaders against the idea of corporate tax harmonization. Thus, countries with a predominantly neo-liberal political ideology (see England and Ireland) will not approve the idea of eliminating tax competition between governments, because it is the engine of efficiency and economic progress, and countries with a predominant socialist political ideology should be interested in the tax corporate discipline increase and the removal of the uncertainty related government tax revenue decrease as a result of foreign investments migration to advantageous locations in terms of tax.

Conversely, the positions of politicians against the tax harmonization depends on the real interests of their constituents which is in direct relationship with changes in economic and social environment and with the constraints to which they are subjected, and not with the political ideology. Thus, political leaders in the new Member States (which practice smaller income tax rates for companies), regardless of their doctrinal orientation, should be on a hostile position against the corporate tax harmonization, because their economies will lose such a substantial advantage when attracting foreign direct investment.

Description of key positions of European politicians against the issue of corporate tax harmonization will confirm this supposition.

In the late 1990s, the political leaders of some Western European countries considered the harmonization of corporate income taxes a way to eliminate "harmful tax competition", particularly after the publication of the first report of the Primarolo Group, which identified 66 "harmful tax measures" in Member States. Primarolo Group investigations were initiated after several politicians (in Germany, Belgium, Austria and others) have reported that

differences between national tax profit systems on financial investments have led to the migration of their residents economies in other Member States in order to avoid domestic taxes. Since the restrictive legislation in the field of banking secrecy harms the cooperation of public authorities to combat tax evasion, the harmonization of income tax rates in all Member States should contribute to solving of this problem.

Another concern expressed by the political class in these countries cover reducing the amount of public goods and services provided to citizens under the influence of reducing revenues from direct taxes (as a consequence of tax competition manifested in the internal market). This idea is folded on the principles of socialist doctrine, represented politically by the governments of many European countries in the late 1990s and early 2000s. Clear positions in affirmation of these ideas were taken by the minister Oskar Lafontaine and Gerhard Schroeder - Federal Chancellor of Germany. These politicians have fought the idea that nation-states should compete in the tax area, showing that this approach is based on a mercantilist principle: "a state can become richer only acting in the detrimental of others". Such competition was counterproductive and could not be compatible with the proper functioning of the European market (Ussher, 1999).

The accession of new countries to the European Union has sharpened the political disputes on corporate tax harmonization theme. Thus, joining German Chancellor Gerhard Schroeder, who argued the need for the EU of a "tax corridor" (setting minimum and maximum rate of corporate income taxation), Dutch Minister of Finance, Gerrit Zalm, proposed, in 2004, the setting minimum corporate income tax rate of at least 20% (the Mooij, 2004).

A study about the attitude of European Parliament Members (MEPs) about the introduction of a minimum corporate income tax rate across the Member States, after questioning a number of 156 MEPs, from March to July 2007, revealed the situation shown in Table 1 (MPs responses were recorded on a scale from -4, representing total disagreement with the introduction of the minimum rate, to +4, representing total agreement with the introduction of the minimum rate):

Table 1

Results of the MEPs questionnaire regarding the introduction of the minimum rate of corporate income taxation in the European Union, according to the doctrine of the political group the respondents were affiliated to

Classification according to the political group	Political doctrine	Share of respondents in the parliamentary group (%)	Average Score
Alliance of Liberals and Democrats for Europe (ALDE)	Liberal	17.31	-0.11
European People's Party (EPP-ED)	Conservative, Christian democracy	19.78	-0.72
European United Left/Nordic Green Left (GUE-NGL)	Socialism, communism	1.2	1.4
Independence and Democracy Group (IND/DEM)	Euroscepticism	29.17	-3.71
Identity Tradition and Sovereignty Group (IST), dissolved in November 2007	Nationalist	17,39	1
Non-attached members (NI)	-	23.08	-4
Party of European Socialists (PES)	Social democracy	23.15	2.02
Greens – European Free Alliance (Greens-EFA)	Green, regionalism	14.29	3.17
Union for Europe of the Nations (UEN)	National conservatism	22.73	-1.8

Source: Osterloh, S., Heinemann, F., *The Political Economy of Corporate Tax Harmonization – Why Do European Politicians (Dis)like Minimum Tax Rates?*, Conference papers: Reflections on Fiscal Federalism: Elaborating the Research Agenda, October 2009.

It is noted that the parliamentary representatives of socialist orientation have a more favorable position regarding the corporate tax harmonization (including through tax rates) compared with the parliamentary representatives of liberal orientation.

In terms of respondents origin, the survey results in the European Parliament showed that representatives of Poland, the Czech Republic and Great Britain opposed, in mostly, the corporate tax harmonization idea, and representatives of Portugal, Austria and Belgium were most vehement supporters of the idea. Grouping the respondents according to accession to European Union of represented countries, the research generated the following result: almost all parliamentarians from the new Member States opposed the idea of minimum corporate income tax rate introduction, position also inferred by as above (Osterloh, Heinemann, 2009).

Addressing the fiscal harmonization issue of politically, we ask us why so many politicians support this process accepting to give up control of one of the most important levels of economic policy: the tax system. We find an answer in Masimiliano Trovato (2007) study, which argues that if the capital and labor move easily between countries, and developments in technology allow people

to communicate easily among themselves and to establish fruitful business relationship, regardless of where they are, tax bases tend to become increasingly mobile. Public authorities can do little or nothing to prevent this trend. The role of politics in fiscal area will diminish, perhaps with the deepening of globalization. Thus, with the cost of short-term loss of their fiscal powers, politicians try to counteract the effects of globalization, replying that powers on a much larger scale.

3. Debates in the European business regarding the corporate income tax harmonization trend

European business reaction regarding the corporate income tax harmonization trend may be summarized by presenting the position of the Association of European Chambers of Commerce and Industry. Thus, in 2007, the Association of European Chambers of Commerce and Industry considered the fair tax competition between EU Member States a powerful driving force for the reduction of tax rates, the business growth and the job creation in Europe. Compliance costs are much higher for the companies with cross-border activity, and these costs are disproportionately high for the small and medium enterprises, since they must meet the requirements of 27 different tax systems. European Chambers of Commerce were positioned for a transparent tax competition because it is very important for small businesses wishing to expand their business abroad and are often unable to afford tax advice. Corporation tax rules in all Member States should be sufficiently comparable, so companies to easily identify the differences between tax systems and procedures in different countries. In these circumstances, the Association of European Chambers of Commerce and Industry supports measures that would help to minimize the tax costs for businesses operating within the European Union Member States. These measures should be translated by creating a common tax base and strengthening the free competition in terms of tax rates. However, the European Chambers of Commerce stated that the engagement of Member States in a “race to reduce tax rates” cannot express any European business interests and, still less, the interests of EU citizens.

A common consolidated tax base would provide companies established in more than one Member State the possibility of their income group determination in accordance with a single set of rules. This would facilitate the elimination of discretionary practices, the decrease of compliance costs, the reduction of administrative burdens, the elimination of double taxation situations, would allow automatically the strengthening of profits and losses (in this context, unrealized profits should not be taxed) and would contribute to

creating a tax system more transparent. For these reasons, the Association of European Chambers of Commerce and Industry supports European Commission proposals for creation of a common consolidated corporate income tax, provided it is clear, simple and easy to use.

Harmonization of corporate income tax base is supported by most members of the Association of European Chambers of Commerce and Industry, with the exception of Chambers of Commerce in Great Britain and Ireland who are not convinced that this model is best suited to meet the needs of economic growth in EU. Although Cyprus Chamber of Commerce expressed reservations about the model of “the common consolidated corporate income tax”, it was willing to consider the impact of its introduction (Eurochambres, 2007).

Between 2004-2007, commenting the European Commission proposals on the introduction of a common tax base for corporate income taxation, the Union of Industrial and Employers' Confederations of Europe stated its support for the project, as far as the reform of corporate income tax system from Member States will contribute to increased efficiency of firms operating in multiple markets. The support of European business representatives for the corporate income tax harmonization project was demonstrated by a study of KPMG International in 2007, which shows that the most of EU corporations wants a single formula for the profit tax calculation. The study was accomplished by interviewing financial managers in over 400 companies from all 27 EU member states and Switzerland. Thus, it was revealed that a significant number of specialists in taxes supports the European Commission proposal about a single formula for calculating the profit tax base applied in EU. Politicians interviewed in the Czech Republic, Denmark and Spain were the most enthusiastic, in 100% they said that support the initiative. In Italy, in 96% they were in favor of the proposal, while in Greece, Luxembourg, Poland, Slovenia and Sweden it has been a support of 90%. The proposal was supported by 84% of the politicians interviewed in Germany and by 80% of the politicians interviewed in Austria, Finland, Hungary and Portugal. Among the most skeptical country was Britain, with a support of only 62% for the Commission's plans, while in Ireland and Slovakia 50% of respondents opposed this.

Is noteworthy that the European Commission's proposal does not support the introduction of a flat tax at EU level, but 69% of those interviewed said that in addition to a single tax base would accept a flat income tax throughout Europe. Only in Great Britain, Cyprus, Ireland, Poland and Switzerland, most respondents have decided against a flat tax.

4. Supporters and opponents of the “Common Consolidated Tax Base”

The “Common Consolidated Tax Base” system reflected the European Commission conception concerning the partial harmonization (only the tax base) of income tax for companies doing business within the European Union Member States. Technical solutions regarding the implementation of this system were (and are) discussed by experts of the European Commission and representatives of the Member States reunited within a working group established in 2004. Some European Union countries (Ireland, Great Britain, Poland, Latvia and Slovakia) were expressed against the introduction of the common consolidated tax base for corporate income, which created a real concern in the European Commission because the new legislation on direct taxes would need the unanimous support of Member States. The arguments presented by representatives of these countries can be summarized as following (Gnaedinger, 2008):

- during debates on the adoption of the Lisbon Treaty, Irish politicians have argued that the “Common Consolidated Tax Base” is a violation of national sovereignty in taxation, and the ultimate goal of the European Commission in implementing this system would be full harmonization (tax base and tax rates). Common consolidated tax base was defined as a “Trojan horse of Europe” which, once adopted, will allow the Commission to put pressure on Member States to harmonize the tax rates;
- Great Britain refuses to give the EU more powers in the fiscal area (such as those required by the operation of a common consolidated tax base);
- in 2006, Polish finance minister Michal Tarka said that his government could support the introduction of consolidated common tax base if this would apply obligatorily for all companies with cross-border activity. In 2007, the same minister said that, despite his personal opposition to the European Commission proposal, the Polish government decided to participate in further at debates on the system “Common Consolidated Tax Base.” Opinions expressed by Polish politicians resonate with business representatives position in this country. Thus, a report of the Polish Confederation of Private Employers, published May 15, 2008, stated that the introduction of the common consolidated tax base would have a negligible effect on FDI inflows into Poland, but could generate the reduction of tax revenues and the increase of work volume in tax administration;

- in Latvia, we find the view according to which the introduction of the common consolidated tax base for corporate income will generate a reduction in government revenue collected by income tax because the new system would require a smaller tax base than currently exist. A similar view was expressed in 2007 by Slovak Prime Minister Robert Fico.

Even the above states opposed the European Commission, they have not refused to participate in working group discussions, realizing that, on the long-term, the introduction of the “Common Consolidated Tax Base” will generate undeniable benefits for the EU economy. To avoid a possible rejection of the project currently it has established that the proposal of Directive who introduces this system could be enhanced cooperation between Member States, that there is at least eight participating countries (DG ECOFIN Training and Support Community, 2008).

Business representatives were actively involved in discussion of technical aspects of the common consolidated corporate income tax. The Union of Industrial and Employers' Confederations of Europe and the Association of European Chambers of Commerce believe that the introduction of “Common Consolidated Tax Base” should be speeded up, because a tax system based on a broad tax base and lower tax rates and on the principles that generate stability and reducing administrative costs is an important incentive for investors. It should be noted that business representatives were pronounced tight to keeping the optional of consolidated common tax base adoption.

5. Conclusions

The necessity of a corporate income tax reform in the European Union has become urgent, but it should not ignore the fact that the social preferences of each state reclaim independence in creating a national fiscal policy. Since the fiscal diversity is considered a form of independence and sovereignty manifestation of a state, we can explain the resistance of some politicians against the introduction of a tax system based on common rules. In the context of economic integration, for the European companies' representative, predictability, stability and neutrality of the tax laws are the essential elements of a stimulating business environment. For investors it is important to know the exact tax burden that will be subjected before deciding the location of their capital to achieve an adequate business plan. Given that all participating companies in the game market will be subject to the same rules for determining the tax base, and will be consolidated at the group level and shared Member entitled, the income tax will no longer be an element of distortion in investment

location, realizing a more efficient allocation of capital within the European Union. With the implementation of “Common Consolidated Tax Base”, public authorities in countries that currently bet on low corporate taxation to attract foreign direct investment will have to engage in action to identify and value other benefits available in their economies. It is explicable so the reluctant attitudes of the representatives of Member States in Central and Eastern Europe (who practice a relaxed tax on corporate income) regarding the introduction of the common consolidated tax base.

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The Effects of Tax Competition

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Abstract. *Tax competition between governments is a research topic of growing importance in the context of globalization. This subject is particularly important for the European Union, characterized by a high degree of economic integration, single currency and free movement of goods, services, persons and capital. In this paper we define the concept of tax competition and we provide a review of the literature to highlight its potential effects.*

Keywords: concurența fiscală; armonizare fiscală; redistribuire; mobilitate; bunuri publice.

JEL Codes: H87, H77.

REL Codes: 13E, 13D.

1. The concept of tax competition

The tax competition literature has developed considerably in the recent years, but there were only a few attempts to define this phenomenon.

Michael Keen (2008), in *The New Palgrave Dictionary of Economics*, defines tax competition as a “*strategic tax-setting in a non-cooperative game between jurisdictions – whether countries or states or provinces within a federation – with each setting some parameters of its tax system in relation to the taxes set by others.*”

In *Encyclopaedia of Tax Policy*, Robert Tannenwald (1999) defines tax competition as explicit or implicit: “*governments engage in explicit tax competition when they enact tax laws and regulations expressly designed to enhance the attractiveness of their jurisdictions to businesses, residents, employees or consumers...(and) ..in implicit tax competition when they modify their pursuit of other tax policy goals-such as equity, neutrality, simplicity, revenue adequacy, or tax exporting, in order to mitigate anti-competitive consequences*”.

Wilson and Wildasin (2004) gave a definition according to the multiple forms of tax competition, from a general broader definition to a narrowest one. *In a broad definition*, tax competition is any form of non-cooperative tax setting by independent governments. *In a narrower definition*, tax competition is any form of non-cooperative tax setting by independent governments and each government's tax policy influences the allocation of tax revenues across government treasuries. This definition includes vertical tax competition when different levels of government (central, regional, local) impose taxes on the same tax base. According to the *narrowest definition*, tax competition is any form of non-cooperative tax setting by independent governments, under which each government's policy choices influence the allocation of a mobile tax base among jurisdictions or regions represented by these governments. This definition eliminates vertical tax competition and includes competition for capital, companies, labor and cross border shopping. This form of competition is commonly referred to as the *horizontal tax competition*, because it implies competition between governments at the same level.

Tax competition can take many forms, according to the goals pursued by the authorities, the tax instruments involved, as well as, the hierarchical relations between the public authorities.

According to the objectives pursued by the governments, tax competition takes place for attracting:

- Foreign direct investments;
- Portfolio investments, highly mobile financial capital, essential for financing the local companies and strengthening the local financial markets;

- Internal financial flows within the multinational companies that can be lured to own jurisdictions by attracting those corporate units used for international transfer of profits;
- Cross border shoppers, especially for those products subject to excise taxes, when there are significant differences in the level of those excises;
- High skilled labor, characterized by high mobility.

According to the hierarchical relations between the public authorities involved, we have: *horizontal tax competition*, when the authorities are on the same level of government, and *vertical tax competition*, when public authorities on different levels of government are taxing the same tax base.

According to the tax instruments used by the authorities, we distinguish: competition through *tax rates*, when the authorities set lower tax rates relative to rates charged in other tax jurisdictions; competition through *tax bases*, if the authorities use various facilities for determining tax base (granting deductions, provisions on tax treatment of losses, different ways of recording depreciation); *expenditure competition*, when the authorities compete in providing public goods that increase productivity of businesses (eg, infrastructure, various subsidies) in order to make them choose their own jurisdictions.

Although the tax competition literature has focused mainly on competition between governments to attract capital by lowering tax rates, there are other forms of intergovernmental competition that are not based solely on fiscal variables. Where environmental standards are not regulated at national level, in an attempt to facilitate the location of firms within their jurisdiction, regional or local governments compete with each other by reducing environmental standards (Oates, 2001). Another possible form of competition between governments is by regulating the quality standards of the products manufactured within their jurisdictions. Sinn (1997) argued that governments, acting independently, will set lower quality standards for domestic products, as long as most of the production is exported.

Although the forms of competition between governments are multiple, in this paper we will refer to tax competition only in the narrow sense, the horizontal tax competition, intended to attract high-mobility factors.

2. The negative effects of tax competition

The standard tax competition model

The starting point in modern literature devoted to tax competition is the volume of Wallace Oates (1972), *Fiscal Federalism*, which seeks to provide an explanation for any inefficiencies arising from the fact that local governments are involved in a competition to attract mobile capital. Following this discussion, in the mid 80s were built the first formal models in an attempt to

explain this phenomenon. Among them were John D. Wilson's (1986) model and that developed by George R. Zodrow and Peter Mieszkowski (1986), which became commonly known in literature as "the standard tax competition model".

In the Zodrow-Mieszkowski model, the local governments finance their expenditures using a capital tax (a source based tax), and the result is a reduction of tax rates that lead to underprovision of local public goods. Yet, the model is based on some restrictive assumptions:

- there is a large number of homogenous jurisdictions (cities, regions, counties, states);
- for each of these jurisdictions the after tax return on capital and the tax rates in other jurisdictions are taken as fixed;
- population is fixed in each jurisdiction and the residents have identical tastes and incomes. Therefore, redistributive aspects can be neglected, and the utility function for the residents takes the form:

$$U(C, G) \quad (1)$$

where,

C – private goods consumption;

G – public goods consumption.

- a fixed national capital stock that is perfectly mobile across jurisdictions;
- in each jurisdiction companies produce a single representative good using two inputs: one mobile, capital, and one immobile, labor. Once the decision to invest and start production is taken, the good is sold to residents as a final consumption good and to the government as an intermediate consumption good, becoming a public good;
- this public good is consumed only by the local residents, and has no spillover effects to other jurisdictions;
- the local officials act to maximize the welfare of their residents.

In this setting, the local governments must choose the tax rate on capital, t , to maximize the resident's utility, subject to a budget constraint such as:

$$tK(r + t) = G \quad (2)$$

where,

t – tax rate;

r – after tax return on capital, which is equal to all jurisdictions because of the capital mobility and treated as fixed for any given jurisdiction;

$K(r + t)$ - demand for capital and $r + t$ is the cost of capital.

As more capital is invested in the jurisdiction, its marginal product falls and the marginal product of labor rises. Thus, companies invest up to the point where the marginal product of capital equals its cost, $r + t$. The problem facing local authorities is given by the impossibility of increasing the variable G without an increase in the only one variable available, t . Therefore, the cost of capital rises, causing the demand for capital to shrink by ΔK . Since the after tax return on capital (r) is an exogenous variable, the higher tax rate will not reduce the resident's capital income, but they will pay the tax indirectly through lower wages. Thus, a unit rise in the supply of public goods, G , requires the tax rate to be raised by Δt , to balance the budget, while wage income will fall by $K\Delta t$. This tax increase must be high enough to cover both the marginal cost of G , denoted MC , and to offset the impact of the capital outflow on tax revenue, $t\Delta K$. Therefore, the resulting fall in the immobile factor's income will exceed MC by the amount, $-t\Delta K$. According to Samuelson's rule for optimal provision of public goods, maximum efficiency is achieved when the sum of individuals' willingness to pay for the public goods equals the marginal cost of these goods. In other words, governments will increase tax rates up to the point where marginal benefits of public goods are higher than its costs. In equilibrium, the marginal benefit must equal the marginal cost ($MB=MC$).

In the tax competition setting, for an optimum level of G we have a modified Samuelson rule for public good provision:

$$MB = MC - t \times \Delta K. \quad (3)$$

And since $t\Delta K < 0$, then the marginal benefit must be greater than the marginal cost of G to compensate the capital outflows induced by the increased taxation. In other words, we are dealing not only with the actual cost of producing public goods, but also with an indirect cost to the local economy due to capital outflows directed to other jurisdictions with lower tax rates. Raising t to finance an increase of G in a jurisdiction generates a positive externality on other communities because authorities are concerned only for their own residents. Basically, another jurisdiction j will benefit from this tax increase, with an amount $t_j\Delta K_j$, where t_j is its tax rate, and ΔK_j is the capital inflow that it experiences.

Thus, a government can increase the welfare of its residents at the expense of other jurisdictions by simply reducing the tax rate because it is associated with an influx of capital. But this equilibrium is not stable. If we assume a community A which proceeds in such a manner, it is possible that other community B to do likewise, reducing taxes and public spending to attract capital from A. This will reduce the level of welfare in A, which may react by a successive reduction in taxation to attract back some of the capital. At each

stage in the community that reduces taxation welfare increases to the expense of other communities, causing a worsening global economy because the gained result is less than the losses suffered by other communities. Following successive tax cuts both communities will be worse off since the public goods provision will fall below the optimal level.

The model's result is a phenomenon often called to in the literature as a "race to the bottom", since all capital taxes are abandoned in favor of taxes on immobile factors. Moreover, if there are some restrictions imposed on the maximum level of taxation on immobile factors, the authorities will choose to reduce the level of public services to a sub-optimal level in all jurisdictions.

Starting from the standard tax competition model, the literature has developed numerous extensions obtained by modifying one or more of its assumptions. In the following we will present the most important extensions, highlighting the various negative effects that are likely to occur.

Large jurisdictions

The Zodrow - Mieszkowski model is based on the existence of many small communities, so that none of them can influence the after tax return on capital. Taking into account the possibility of large jurisdictions, then each jurisdiction decision regarding the tax rates may influence the return on capital throughout the economy. In this case there is a Nash-type competition between communities, because each community will make decisions based on the strategies adopted by other communities. The strategic variables may be either tax rates or the public service level, but usually, in the literature, the tax rates are used most often, public services being adjusted to government revenue collected from such taxes. Thus, a community will determine the tax rates based on the tax rates charged in other communities. The after tax return on capital will depend on the chosen tax rates and, at the same time, on the tax rates from the rest of the communities.

$$r = r(t_1, t_2, \dots, t_N), \quad (4)$$

where:

$t_1, t_2 \dots, t_N$ –the tax rates in the N communities.

If a jurisdiction j increases its tax rate by one unit, then the cost of capital, $r + t_j$, increase with $1 + \Delta r$, where $\Delta r < 0$. Thus, the demand for capital, $K(r+t_j)$, will depend less on t_j , comparing to the small jurisdictions case, where r is fixed. We are still facing a positive externality induced by capital outflows due to increased taxation in a jurisdiction, but its level is lower because the increase in t_j is accompanied by a decrease in r . Therefore, we can say that the welfare loss from suboptimal provision of public services is lower than in the case of small communities.

Asymmetric tax competition

The standard tax competition model assumes the existence of many small homogeneous regions. Modifying this assumption, by considering some different regions in terms of size, an “Asymmetric tax competition” is created between large and small regions. Bucovetsky (1991) and Wilson (1991) analyzed the consequences of such competition between the two types of regions, the differentiation between them being made by the number of residents. Larger region has a greater demand for capital and thus an increase in its tax rates will cause a more significant reduction in return on capital after taxation. Consequently, the cost of capital, $r + t$, is less dependent on changes in tax rates for larger regions than in the small regions case.

We can say, therefore, that large jurisdictions are less concerned about capital outflows caused by taxation and thus will set higher taxes. The difference between taxation levels will lead to a relocation of capital from large towards small jurisdictions, explaining the formation of tax havens in small states. Moreover, Wilson (1991) has shown that if the difference between regions is large enough, then the small ones will actually benefit from tax competition. Thus, although tax competition throughout the economy is causing adverse effects, some jurisdictions (the small ones) can actually benefit from it by attracting capital, and hence provide a higher level of public services.

Trade between jurisdictions

In the basic tax competition model the private consumption is aggregated on a single representative good for simplicity reasons, putting into evidence the effects of tax competition on capital allocation decisions between regions. Further, it raises the question of the possibility that production and consumption decisions may be influenced in any way by tax competition.

Wilson (1987) developed an extension of the standard model by introducing a system with many regions and two private goods, one capital intensive, and the other labor-intensive. Under a free trade between regions, although regions are initially identical, they will choose different levels of taxation, and those with lower taxes will specialize in production of capital intensive goods, while those with higher taxes will specialize in labor-intensive goods. Basically, some regions will choose to compete to attract capital intensive industries, their residents enjoying higher incomes, but fewer public services and others will keep taxes at a higher level, attracting labor intensive industries and residents will benefit from higher public services, but residents' income will be reduced. Since residents are considered identical (have the same utility function given by the ratio of public goods and private consumption), this situation makes them adjust this ratio according to the type of region they belong. Thus, production and consumption

decisions are decisively influenced by the promoted tax policies, which is another distortion attributable tax competition

Labor mobility

The standard tax competition model assumes a fixed population in each tax jurisdiction, involving individuals unable to move from one jurisdiction to another. Thus, the basic model and the extensions discussed so far are suitable to study the effects of tax competition between countries, where individual mobility is seriously limited by restrictions on migration, political, cultural and religious or other barriers. In modern economies, however, the population is not stationary, especially in the European Union, where one of the four fundamental freedoms is freedom of movement of persons. For this reason, we think it is useful to discuss an extension of the basic model that takes into account the mobility of individuals.

Such an approach was made by Brueckner (2000) who assumed that individuals vary in preferences over public goods, and they can choose both the community where to invest and the community where they want to live. Assuming that public goods are not subjecte of economies of scale, so their cost per capita does not decrease as the community's population grows, individuals will adopt a Tiebout-type behavior, choosing to settle in the community that offers the desired level of public services. Unfortunately, different capital income taxes between communities continue to generate a positive externality, influencing investment decisions, and leading to a suboptimal provision of public goods. Moreover, individuals who have a lower demand for public goods will even benefit from tax competition to the detriment of others.

Income redistribution

The tax competition literature is focused on models in which public expenditure is targeted exclusively to the provision of public goods. In reality, however, a large proportion of public expenditure of the states, and in particular the European Union Member States, is intended to grant financial transfers to the benefit of certain social categories. Moreover, the theory of public finance identified the need for state intervention in the redistribution of income and wealth to ensure social equity, giving substance to the redistribution function.

Orientation of public spending for social transfers has important implications when analyzing the effects of tax competition. As noted, tax competition leads to under taxation of important sources of revenue when the tax base mobility is high. Depending on the composition of public expenditure by governments, this may limit the social transfers, hampering the achievement of redistributive function of the states. Sinn (1994) studied this issue at EU level, indicating that increased competition among states to attract mobile

capital will limit the capacity of Member States to maintain their current high level of social transfers. He considers necessary to establish a central authority responsible for the EU redistributive policies so that Europe “should not be forced to give up its social achievements” (Sinn, 1990, p.502).

Income redistribution problem is of great concern in the European Union because, according to the theory of fiscal federalism, the responsibility for redistribution function must rest with the central authorities and at the moment the EU budget dimension is not a suitable to allow this.

The magnitude of the negative effects of tax competition

Given the distortions caused by tax competition it raises the question of calculating the magnitude of these negative effects. This is because those effects can be either insignificant and require no concern from the authorities or they can be significant and cooperation between governments is needed in order to implement some tax harmonization measures. While measuring the welfare loss attributable to tax competition is very difficult empirical task, in literature there were several attempts in this direction.

Wildasin (1989) attempted to quantify the inefficiencies attributable to tax competition through a model derived from the basic model. He showed that the tendency of under-providing public goods can be offset by providing subsidies for each jurisdiction by the authorities located on a higher level of government. Wildasin estimated that in the United States, without taking into account the current budgetary transfer system, the subsidy required is a substantial, around 40%, and the cumulative cost of the loss of efficiency due to suboptimal local public provision is the order of 8% of total public expenditure. However, if one takes into account the budgetary transfer system, these estimates are significantly reduced: the level of subsidies required is 10%, with an aggregate cost of loss of efficiency in public resource allocation of only 0.6% of total government expenditure.

In a more recent study, Parry (2003) has made an analysis that calculated the cumulative impact of various economic effects of tax competition. He found that the welfare losses attributable to tax competition are quite modest, less than 3% of all capital taxes or 0.15% - 0.45% of GDP. This result is valid if it is assumed that public officials are only concerned about the welfare of the citizens. Moreover, considering the possibility of governments adopting a “Leviathan” behavior, these effects can easily turn into positive effects.

In an attempt to quantify the potential benefits of tax harmonization process at EU level, Sørensen (2001) developed a model and showed that the volume of each country's public services will not reduce, but instead will decrease public expenditures for redistribution. Thus, Sørensen simulated various types of cooperation between governments, such as coordination of

fiscal policies, implement a minimum tax rate on capital income, or even full harmonization of the corporate income taxes. The results of these forms of cooperation between governments, expressed by the gain of wealth, have proved positive, but their size was extremely small, the order of 0.16 to 0.35% of GDP. Moreover, lower mobility of capital between the EU and the rest of the world leads to these results. If, however, one would consider perfect capital mobility at the global level the gain brought by the coordination of fiscal policies in the European Union would fall significantly, up to 0.075% of GDP. He also demonstrated that high heterogeneity of preferences between states regarding the degree of income redistribution, differences in productivity and the share of assets owned by foreigners would have a major influence on the distribution of these benefits. Thus, tax harmonization is expected to face strong political opposition due to uneven distribution of benefits that would result.

3. The positive effects of tax competition

All the aspects discussed before highlight the negative effects of tax competition. However, all these models are based on a large number of restrictive assumptions, some unrealistic, and not considering the possibility that the public authorities to pursue their own interest in the policies they promote. Subsequently, we will try to identify any positive effects of competition between governments and to describe specific situations when tax competition could prove to be a factor for improving public sector efficiency.

Tax exporting

The theory of fiscal federalism has identified numerous instances in which taxes imposed in a community are ultimately paid by residents of other communities, phenomenon called “tax exporting”. Even the possibility that a jurisdiction’s government taxing the capital income of nonresident investors may also be considered a transfer of tax burden. Thus, the local government imposing taxes which are susceptible to the phenomenon of exporting will tend to oversize the volume of local public services provided since the consumers will perceive that they have a lower cost (Zodrow, 2003).

As globalization process is evolving and thus increase the share of assets held by non-residents, this issue becomes relevant in the international context. Thus, the possibility of passing the tax burden to non-residents may result in unjustified increase in public expenditure. In this case, competition between governments to attract mobile factors can have a positive impact by limiting these trends. Therefore, we can argue that in economies where a large proportion of assets are held by non-residents tax competition has greater potential to produce beneficial effects.

The agglomeration economies

In modern economies there is a phenomenon of concentrating production in certain geographical areas. This is highlighted by the center-periphery models, where due to “congestion” is reached the concentration of industrial production in some developed countries (“core countries”), whose citizens enjoy a high volume of public goods and taxes supported by the residents are high. These higher taxes are justified, because in those countries also the possibilities of investing are greater than in the peripheral countries.

Baldwin and Krugman (2004) showed that tax harmonization by adopting a common tax rate will affect at least one of the two types of countries. Moreover, choosing a common tax rates between the high levels of developed countries and smaller levels in peripheral countries will affect both countries. The less developed would lose their tax advantages in attracting foreign investments and the industrialized (core countries) would have to reduce the public services volume. One possible solution to prevent amplification of tax competition between governments would be adoption of a minimum level of tax rates, regardless how low that level would be. This would represent a Pareto improvement because the industrialized countries would benefit without undermining the position of peripheral countries.

The impact on public sector dimension

Probably the most important positive implication of tax competition is given by its impact on public sector size. This line of research in the tax competition literature has its origins in public choice theory, developed during the '60s, following the contributions of James Buchanan, Gordon Tullock, William Niskanen and Geoffrey Brennan.

One of the fundamental tenets of public choice theory is related to the natural tendency of the public sector to increase. Analyzing the action taken by governments in the same manner as they are considered actions taken by individuals, these theorists have shown that governments are formed by people who themselves have their own interests, and they will pursue them using public positions held. Thus, the public authorities actions are not necessarily driven by measures designed to maximize the welfare of citizens, but rather to maximize their personal welfare. Therefore, those responsible for public decisions will continually seek to maximize the size of public budgets in order to achieve personal objectives such as: increased power, influence, more subordinates, higher wages, to reward interest groups that funded election campaigns. In this way, the public sector is compared to a “leviathan”, which always seeks to increase its size by maximizing revenue collected from the private sector. Buchanan and Brennan (1980) argue that competition between governments, just as competition from the

private sector, is limiting the ability of the monopoly (in the case represented by the state), to strengthen its control over the economy.

This skeptical view on the role of public sector in the economy which favors tax competition has gained ground in recent years. The idea that the existence of tax competition has positive effects on the efficiency in the public sector is based, among others, on the argument that public sector representatives (politicians and bureaucrats) are able to allocate public funds in ways that represent a “government waste” from the society’s point of view. In this context, tax competition is able to limit this tendency of channeling public resources in favor of interest groups, acting just as a constraint from the electorate.

The first theoretical approaches in order to identify the positive effects of tax competition in leviathan type models were built in the second half of the '90s. These include models developed by Edwards and Keen (1996), Rauscher (1998) and, more recently, Wilson (2005), Eggert and Sørensen (2008) or Janeba and Schjelderup (2009). All these models consider that governments act partially in favor of interest groups and are allocating public expenditure for the benefit of the whole society as well. The various results identify the potential for tax competition to limit public sector expansion, but citizens' welfare implications are not very conclusive.

In the Edwards and Keen (1996) model of total public expenditure only a part is used to provide public goods that benefit all citizens, the rest being directed in favor of interest groups, representing a true “government waste”. In this framework, using a model derived from the standard model, they reported two adverse effects of tax competition on the welfare of citizens. On the one hand, there is welfare improvement by reducing government waste and, on the other hand, is the tendency of underprovision of public goods. They show that up to the point where the elasticity of tax base is less than the fraction of wasted public funds (marginal propensity of governments to waste public resources), tax competition is beneficial. Long-term implications of the Edwards-Keen model is particularly interesting in the context of increasing international economic integration, as it increases the mobility of taxable bases, and hence its elasticity on the tax rates, reducing the potential benefits of tax competition, unless the fraction of the public funds wasted increases.

Eggert and Sørensen (2008) have developed a model in which politicians raise their political capital by increasing public sector wages unjustified. Outcome of tax competition is indeed the reduction of these inefficient public spending, up to their complete elimination, but, at the same time, there is a tendency of underprovision of public goods. They concluded that institutional and policy reforms, however, would be a straightforward solution to counter this phenomenon.

In conclusion, we can admit that while tax competition certainly limits expansionist tendencies of the public sector, citizens' welfare implications are not clearly outlined in the literature. It is possible that the reductions in public expenditure to operate in those areas without sufficient political support rather than in those areas where most waste is generated. Moreover, politicians are likely to disregard this constraint on the revenue side, public expenditure continuing to grow, with disastrous effects on the budget deficit. However, given the imperfections of the democratic system in which citizens have relatively limited possibilities to choose, tax competition remains a method, even indirect, to promote efficiency in the public sector.

4. Conclusions

The tax competition literature does not offer a clear solution on the implications of this phenomenon. On the one hand, tax competition leads to reduction of taxes levied on mobile factors and to a decline in the volume of public services and, on the other hand, it increases the efficiency of public funds. The basic model and some extensions emphasize various negative effects associated with competition between governments, suggesting the need for budget transfers that could offset these effects. This is of particular importance for the EU because the size of the EU budget is currently not suitable to allow the granting of such transfers. For this reason, harmonization of direct taxes, and especially those levied on capital income, could prove beneficial solution. However, several studies have attempted to determine the magnitude of undesirable effects attributable to tax competition and have concluded that they are insignificant for citizens' welfare. Moreover, tax harmonization benefits would be modest and the uneven distribution of these benefits among states could lead to a strong political opposition on the harmonization process. The tax competition literature does not provide, however, a solution on the net impact of these presumed effects. It is very difficult to predict which of these effects are dominant, and which are more likely to occur.

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Public Debt Evolution in the Eurozone and the Need of Policy Coordination

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Abstract. *The Eurozone sustainability could become a real challenge in the current economical environment, characterized by uncertainty and lack of credibility. The issue of public debts represents a threat for the European financial system, while the coordination process of the economic policies at the Union's level is almost inexistent. The extremely high discrepancies between the budgetary balances of the member states makes the SGP or the strict fiscal rules become an utopia. The discretionary application and lack of credibility induced by SGP have worsened the perceptions on the economic system on European level, and the authorities' answer was not coherent enough, leaving room for interpretation by the Euro-skeptics.*

Keywords: policy coordination; optimum currency area; monetary integration; fiscal policy; stabilization.

JEL Codes: E62, E63.

REL Codes: 8K, 20G.

The lack of symmetry of economic shocks is a cost deriving from the integration in an optimum monetary zone. The problem becomes more sensitive as the economic structure and, especially, the exports' structure is becoming less diversified. The aspect of the diversification degree was intensely analyzed by Peter Kenen (1969), while various studies indicate that the tendencies in case of joining an optimum monetary zone are towards specialization. So, each country will become focused in the fields in which it holds a comparative advantage. At the level of the entire system, the economic structure will be less diversified, creating the premises for a weak correlation of the business cycles. It is an unwanted situation, but the studies performed on USA have proved it in an empirical manner. The problem becomes more sensitive in the Eurozone, due to the lack of a fiscal authority destined to inject capital incentives in the case of an accentuated decrease of the output. Sachs and Sala-i-Martin (1991) have indicated that over 40% from the shocks suffered by the American states are absorbed through the federal fiscal system. The lack of this mechanism attaches an additional cost to the Eurozone level, while the premises for creating a common fiscal block having this power seem extremely low. The moral hazard and chronic deficits existing in certain member states seem to be a barrier which cannot be crossed in the path towards a central fiscal body. In addition to these considerations, we must not forget that the historic evidence at the European Union level is not at all gratifying. I think a pretty relevant clue is offered by Simona Talani in "The Future of EMU": *"We must not underestimate the importance of moral hazard. The experience of many states in which the governmental budget is centralized and distributes large transfers to certain regions (eastern Germany, southern Italy, southern Belgium) is unhappy. These transfers persist for decades and seem to be the main reason for which these regions are never adjusted"*.

It is obvious that the problem will persist in time due to multiple factors. The richer states will not rush to introduce additional distributive mechanisms, due to the political loss on national level. How could the authorities in Germany explain the necessity of some significant redistributed aids towards the less developed states in the system? The need of investments in the public sector is continuous in this states also, so the central budget does not allow too large maneuver ranges. Even in case the occurrence of these additional distributive mechanisms were possible, how would the less developed states perceive the transfers they should render in case the rich states suffer an exogenous shock?

The problem appears when the countries' economic evolutions become increasingly divergent. The appearance of the Euro was perceived as a success, but also as a threaten to other powers at the global level. Together with the extension of the Eurozone and the inclusion of other states in the system, the problems seem to multiply. These new members are marked by a series of important or less important issues that affect the monetary union:

- Inefficient economic restructure;
- Supersized public sectors and even large social transfers that could be permitted by the future budget projections;
- Industries directed on producing goods with low value added and high consumption of raw materials which determine an extremely rigid and inflexible costs structure;
- Questionable sustainability of pension systems and public finances;
- Low developed infrastructure which reveal raising transport costs and reduces trade;
- Big discrepancies in the competitiveness of current and future economic situation between the developed and the new member states caused by inefficient salary policies promoted by the authorities.

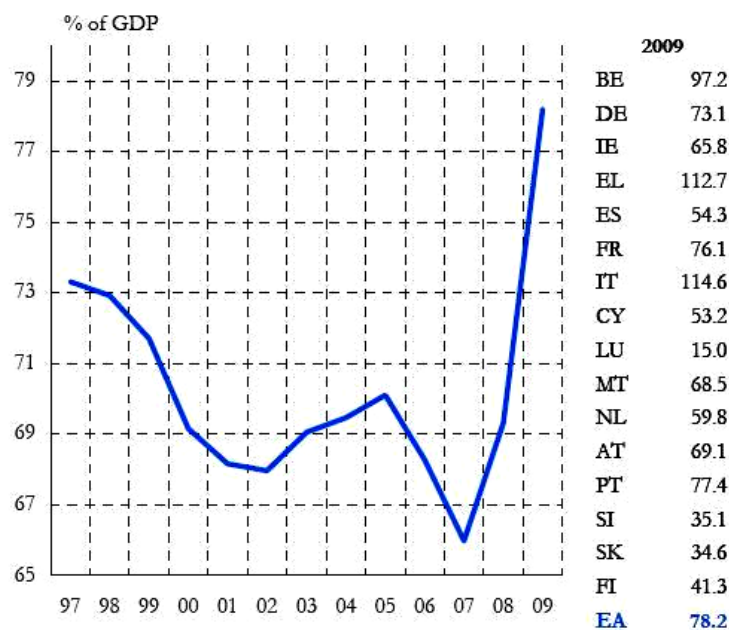
The stabilization and adjustment in the system could become a target extremely hard to reach. The common monetary policy may have a strong procyclically influence for the Member States, the ones with high economic growth and even higher inflation rates will confront with low real interest rates, while the other ones will be affected by higher real interest rates. The monetary policies will induce a perverse effect, they will slow the volume of credit for consumption and investment where it is needed and grow it where it is not (Enderlein, Goodhart, 2006). The renounce to the local currency should not determine a high cost. However we should not forget that the situation was far from perfect before the introduction of the common currency. Before 1999 the exchange rate didn't protect the states by eventually external shocks because its level counted other factors and was not exclusively determined by the volume of traded goods and services. The whole approach has to evade one thing, the unemployment rate must not always raise when an adverse shock affects the economy. If the prices and salaries would rapidly and automatically adjust, then the utility of an optimum currency area would become null. But the reality shows that the economy suffers from structural rigidities and the prices and salaries do not adjust automatically.

De Grauwe suggests in his studies that the long term existence of the European project is exclusively dependant on the performance of a political

unification. A vision that is concordant with the one of other supporters of a federal system on European level that will be able to continue the integrative process. De Grauwe's thesis suggests that this political unification would reduce the impact of asymmetric shocks and would tighten the political bonds so much needed in the moments when the states in the Eurozone have divergent evolutions. This institutional movement would counteract one of the great issues of the European construction, the democratic liability and legitimacy. The politicians on national level continue to suffer consequences for the adopted fiscal decisions, which many times become unpopular in case of extended recessions. The transfer of these decisions at the level of the European institutions would create a real problem, since they do not assume any kind of political responsibility. How can the European system prevent the free-rider behavior or the neighbor's deprivation politics? Are there other levers aside from the disputable construction represented by SGP?

The choice of the Maastricht criterions tried to regulate this issue, a Monetary Union in which states are strongly differentiated through public debt could create pressures on the inflation rate and common currency credibility. Meanwhile, the states with high public debt would face a growing sovereign risk, so how should we find the optimal authorities approach? The Maastricht Treaty clarified this dilemma introducing the "no bailout" clause through which the monetary authority of the national governments could not be forced to save a member which faces hard problems. However, the Greece case demonstrated the solutions in the reality could differ from the theoretical ones. Nowadays the public debt problem in the Eurozone became extremely serious and could bring large prejudices to the future system functionality. Some part of the fault could be attributed to SGP, which does not bare the necessary force to adjust the budget criterion and cannot represent an efficient punitive mechanism in case of eventually budget slide-slips by the states. In order to clarify the public debt problem we should reiterate the factors that influenced this process. The difficult situation of the Eurozone and the speculative pressures on the common currency are not random. The Euro appearance in the 1999 created a situation without precedent for the European monetary system. Along with the costs derived from the accession in the Monetary Union, the states confronted with a series of real benefits. The elimination of the exchange rate uncertainty represented the big present for the new members that adhered to the last stage imagined by the Delors report. Unfortunately, this gift proved to be a Trojan horse and the consequences can be observed nowadays. Even if it comes to your surprise, the public debt has its origins in the beginning years of the Eurozone.

Analyzing the public debt graph for the Eurozone in the period 1997-2009, we will observe some interesting features. The period precursory to 1999 was marked by a common effort of the states to reduce the weight of public debt in GDP in order to meet the criterions of the Maastricht Treaty. Despite all the efforts, the rapport between public debt/GDP calculated as an average for the Eurozone could not be lowered under 60%, even if it recorded a descendent trend. Along with the construction of the Monetary Union and the Euro appearance the trend starts to reverse. We can remark an inflexion point in 2001, a difficult year for the American economy because of the dot-com bubble. The crisis extended to Western Europe reducing the interest rate in order to adjust the external shock. The ascending trend of public debt was continuously influenced by the governmental injections destined to adjust the macroeconomic disturbances. The public debt average for the Eurozone reached a minimum point of 66% in 2007 followed by a strong ascendant trend which still marks the current situation. Which was the principle cause for the suddenly appearance of the inflexion point?



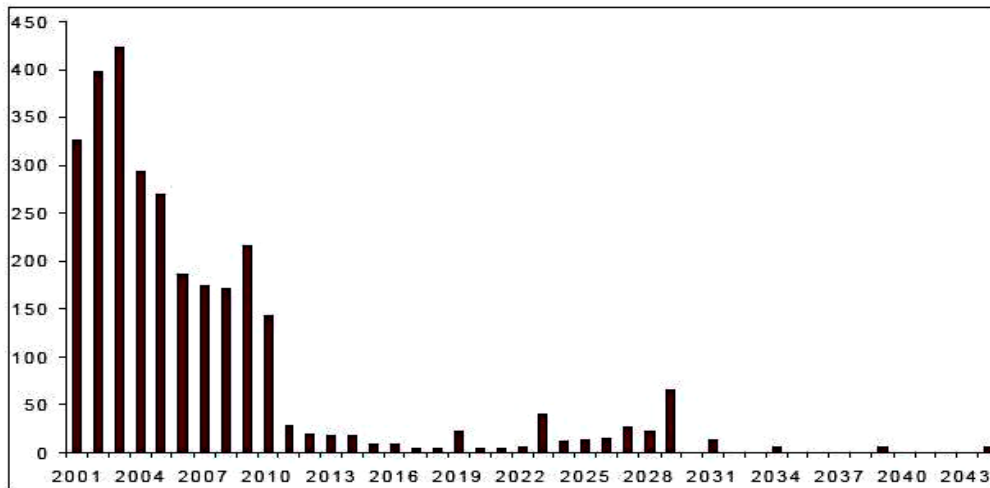
Source: Eurostat.

Figure 1. Public Debt Evolution in Euro Area (1997-2009)

Many scientists believe that the escalation of the economic problems in the US in 2007 has strongly influenced the developed European states' economies. Indisputable, the American crisis has had a great impact over the economic evolutions of many European states, especially Great Britain and Ireland, which strongly rely on the Anglo-Saxon banking system. This model has shown its boundaries and has created real problems regarding developed economies.

Unfortunately the crisis of public debt on European level was also fed by another important factor. Next to the massive public injections caused by governmental interventions, the Eurozone was confronted with another issue. Together with the integration in the Monetary Union, a large part of the European states began to profit from a specific situation. Both in the public and the private sector, they have taken advantage of the opportunity arisen together with the disappearance of the exchange rate between national currencies. The issuing of state or corporative bonds had an ascendant tendency after 1999 for two reasons: one closely connected with the significantly smaller interest rates, which did not include the exchange rate and had attached the credibility of the single currency, and the second, related to the duration of these bonds. The states could now roll the public debts on longer periods, taking advantage of a higher maturity.

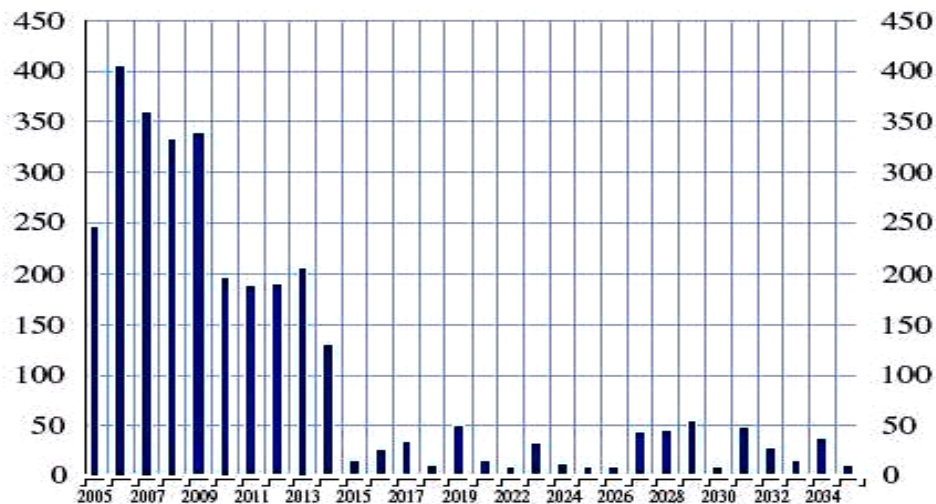
The first cycle of debts had a maturity average between 4 and 6 years, with differences between the more powerful states with a higher credibility (Italy – 6.1 years, Germany – 6.8 years, France - 6,2 years) and the ones from the Mediterranean group (Portugal – 4.7 years, Greece – 5.2 years, Spain – 5.5 years). The first cycle reached maturity beginning with 2004 and the largest part of the debt was accumulated in a period of time extended until 2007. The breach on SGP in 2002 and 2003 by Germany and France was to indicate a smaller credibility degree of this mechanism designed to supervise the fiscal evolutions in the member states. Without a strong coordination at the Eurozone level and with an entire series of states with “free-rider” behavior patterns, the situation could not have a favorable end. The descendent trend of public debts was reversed after the appearance of the single currency, due to the disappearance of a strong fiscal mechanism with this purpose. The Growth and Stability Pact did not have the necessary strength to control it and the Maastricht criteria became a real problem for the states wishing to adhere to the Eurozone, but not for the ones already integrated in the system.



Source: BCE – Bond Market Report 2001.

Figure 2. Euro area government bond maturity (mld. Euro)

A first rolling of the debts was possible upon the completion of this cycle, as indicated by the analysis date of the Central European Bank. A large part of the debts that managed to be rolled with the help of the secondary or primary market had a new maturity peak in 2008 and 2009. Unfortunately, no one could have anticipated that this cycle will overleap the financial crisis bursting in 2008, and the possible rescheduling of the debts will be extremely hard to perform, especially in the states with delicate fiscal positions. In addition, we must not forget the issue of budgetary deficits, becoming extremely sensitive with the massive injections of public funding. The eternal issue of the states with large structural budgetary issues that cannot be automatically regulated and in which the automated stabilizers have a significant role continued to exercise a high amount of pressure. It seems that the situation is also suffering due to an endless string of factors, with negative influence on the entire development.



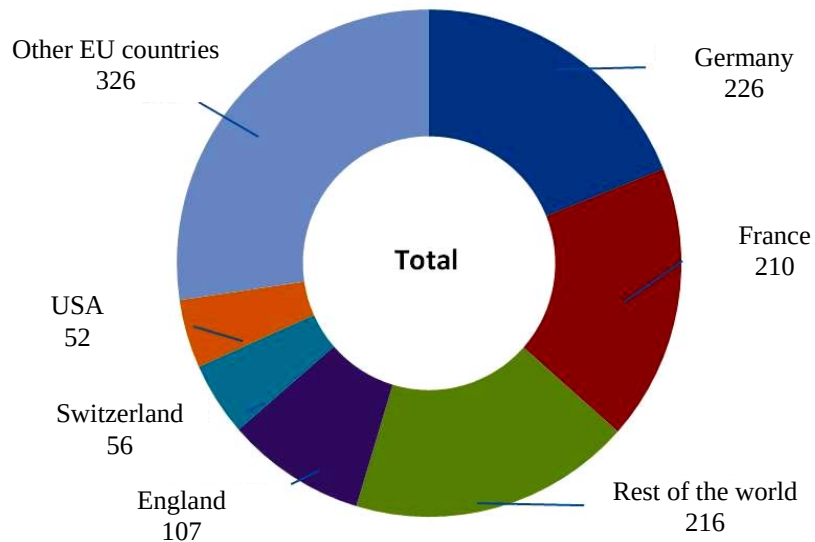
Source: Bloomberg, estimation Deutsche Bank.

Figure 3. Euro area government bond maturity profile (mld. Euro)

Without a doubt, the first states affected by it were the ones included under the generic denomination PIIGS. Once this debt crisis became more acute, the entire credibility of the Eurozone was to suffer and the no bailout politics seemed not to operate, due to various reasons:

- No one can anticipate the real loss suffered by the Monetary Union in case a member state would become bankrupt
- A large range from the state bonds issued by Greece, Portugal and Spain are held by banks in Germany, France and, in other words, these states would be put in a delicate situation, and either willingly or not they have to come up with a plan to save Greece and other states in difficulty.

It might be possible that the biggest problem of the Eurozone is the lack of a joint fiscal system that may absorb a large part of these shocks. But, this type of supranational institution can not be incorporated without a larger political unification, consolidating the coordination of economic politics, as De Grauwe was anticipating in his analysis in 2010: *“Joint solidarity can not be avoided in the Monetary Union, even if it means having dinner with sinners”*.



Source: Bank for International Settlements.

Figure 4. *Foreign Banks Exposure in Greece, Portugal and Spain*

The rising exposure in the PIIGS states creates an unpleasant situation for the authorities in the Western European States. The plan performed with the help of the IMF and the national governments was destined to inject credibility and ease the speculative pressures on Euro. Meanwhile, we have to take into account that the structure of the private debt is clearly affected by the current economic crisis. The trouble could become even larger if we analyze the future budget projections for the European states. The crisis has dried the financial markets which reacted by restricting credit and raising the premium risk. If the coordination process in the system would function better in the future and the national governments maneuver would become perfectly correlated then the situation would appear more optimistic.

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The Impact of Welfare State to Labour Market. European Submodels Differences*

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Abstract. *In this study, we show the effects which the measures to implement welfare state have to labour market. All knows that the employment represents the most important component of the welfare state, as it supports the fulfillment of the objectives for the economic and social policies. The argument of the previous statement is very simple: the expenses for social protection are made on the basis of the returns from taxes and social contributions paid by the employed persons. The higher their number, the bigger the tax basis, and the budget for the social policy will become sustainable, even though measures for decreasing taxation would be applied to companies and to the employed population. The entire virtuous mechanism may disintegrate if a low rate of employment persists. In case of a high unemployment on a long-term, of an early exit from the labour market, of a lower integration on the labour market of women, of young persons, of aged persons and of poorly qualified persons, the social expenses will increase and the budget revenues will decrease, the result being the increase in the state's debt.*

The crisis will prove whether the increase in employment recorded since 2000 was conjunctural (determined by the favorable macro-economical evolutions) or structural (induced by the reforms implemented on the labour markets and in the social protection systems).

Keywords: employment, Lisbon Strategy, unemployment trap.

JEL Codes: D63, E24.

REL Codes: 7G, 20B.

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1. Employment rates evolution

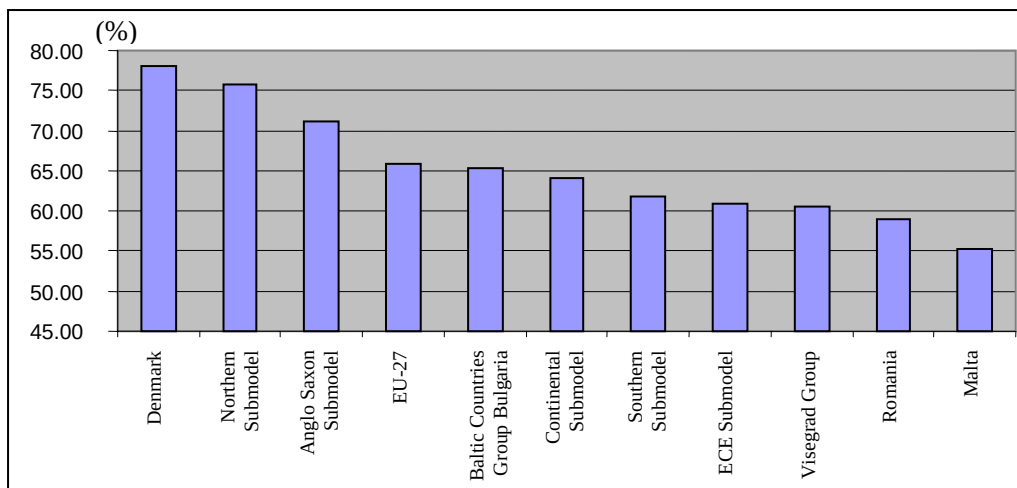
The Lisbon Strategy admitted all these potential risks for the stability of the social model and that is the reason why the main objective of EU's functioning was to increase the degree of using the labour force, an additional objective being that, until 2010, the employment rates should increase up to 70% for the active population, 60% for women and 50% for aged persons between 55 and 64 years old⁽¹⁾. In order to solve the deficit in the European employment, the policy decision makers proposed to achieve a combination of measures which could encourage the jobs creation (labour demand) and the labour force's participation (labour offer). An important element of the strategy for increasing the employment rate was constituted by the improvement of incentives in order to enter the labour market and to extend the working period. They allow the fulfillment of the proposed employment standards and they also provide long-term sustainability for the public finances.

During the period between 2000 and 2008 there were records for a 7% increase of the employed population, and this reflected in the 3.7 percents increase of the employment rate, up to a level of 66% in EU-27. The new member countries have quite low efficiency with reference to employment, and this negatively affects the European average. Thus, in the case of the other four sub-models (included in EU-15), the average employment rate was 67.3% in 2008, this value being 4 percents higher than the records from 2000. The employment rate for the population over 55 years old increased by 8.7 percents between 2000 and 2008, as a result of the approximate 37% increase of the employed population within this age category. Despite this evolution, the percentage of the persons who are between 55 and 65 years old and who have a job is 4.4 percents, inferior to the target of 50%. The employment rate among women increased by 5.4 percents, the value from 2008 being 59.1% for EU-27; most of this evolution was determined by the women's employment with part-time contracts. In the case of employment rates for women and for aged persons, the EU-15 countries were more efficient, as they surpassed the target of 60% settled for the first rate, being 2.5 percents lower than the target for the persons who are over 55 years old. According to this brief description of employment's trajectory, EU recorded significant progresses with reference to the categories which are more vulnerable on the labour market, the aged persons and the women.

As for employment, EU is still characterized by gaps compared to other external models of economy (such as the American one), and also by disparities

between sub-models. Regarding USA, the total employment rate was 6.3 percents lower in 2007, and that of women's employment was 7 percents lower, and for the employment of the persons over 55 years old the difference was 17 percents. Within EU, the most efficient states are the Scandinavian countries, which have fulfilled the target settled for 2010 since 2000, with reference to the total employment and the women's employment. Among the EU-15 sub-models, the Southern ones has the lowest employment rate, and among the new member countries, the Baltic economies obtained results which proved to be superior to the continental and Southern sub-model (Figure 1). Since 2000, the employment rate increased in 25 of the member states, except Portugal and Romania, our country recording the most important decrease in the percentage of the employed. This rate decreased from 63% in 2000 to 59% in 2008, under the terms of persistence in the informal labour, of early pensions, of labour force migration and of the youthful people's difficulties in entering the labour market.

The results obtained by the European economies with reference to employment were those related to the reforms implemented on the labour market for adjusting to the flexicurity principles. In 2008, eight of the EU-27 countries already fulfilled the objective of 70% settled for 2010, and among them, four belong to the Northern sub-model, two belong to the continental sub-model (Austria and Germany), one to the Southern sub-model (Cyprus) and one belongs to the Anglo-Saxon sub-model (Great Britain)⁽²⁾. As for the two continental economies, the increase of the employment rate was the result of the reforms implemented on the labour market. In Germany, the Hartz reform for decreasing the unemployment assistance decreased unemployment on a long term and increased the flexibility of the labour force, and in Austria a flexicurity system was implemented, and this was considered to be even more efficient than the Danish system. On the other hand, most of the Southern economies and of those belonging to the ECE sub-model have labour markets which are not reformed, the education systems are not efficient and they have a quite high percentage of labourers in the informal sector. Moreover, they promote quite high taxes applied to labour, and this fact discourages the creation of new jobs. That is the reason why Greece, Italy, Hungary, Malta, Poland, Romania and Slovakia have an employment rate which is even lower than the European average recorded during the year when the Lisbon Strategy was elaborated.



Source: Eurostat (2009).

Figure 1. *Employment rates in the European sub-models (2008)*

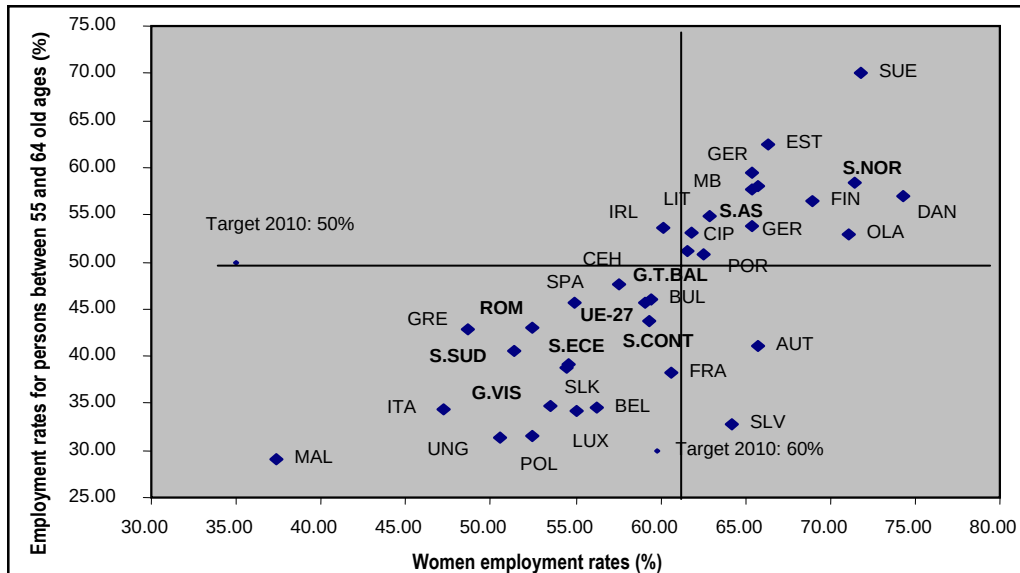
Two segments of the labour market which have benefited the most from the creation of jobs in EU since 2000 are represented by the persons who are between 55 and 64 years old and the women. The European sub-models' ranking from the point of view of the employment rates for these categories of labourers is similar to that for total employment. As for the women's employment, more than half of the member states record a percentage for employment which is superior to the threshold settled for 2010. Romania was the only economy of which employment rate decreased if compared to 2000, from 57.5% to 52%; the same observation is valid for the employment of aged persons, under the terms of a decrease by 6.4 percents up to a level which is only 7 percents below the target of 50%⁽³⁾. If in all the other economies of the ECE sub-model the economic growth induced an increase in the employment rates, for Romania the effect was exactly the opposite; this phenomenon can be explained by the existence of a very low real pensioning age for labourers, namely only 52 years old for women, and 54 years old for men (according to the World Bank).

Among the economies which fulfilled the target of 60% in 2008 for women employment, Austria and France record a negative gap, of 9 percents, respectively 12 percents compared to the limit of employment for persons between 55 and 64 years old. These economies have negatively influenced the weighted value of the continental sub-model, this being 6.5 percents below the

target of 50%. The decisions of early pensioning for the aged population implemented by the countries from the continental and Southern sub-models in the '80s generated the decrease by approximately 20 percents of the aged labourers, and the effects of these measures are also mirrored in their current efficiency. This reality supposed the implementation of radical measures for reforming the pension systems, by increasing the number of years for mandatory contributions at 45 years, as for Belgium, which recorded a rate of employment for aged persons with 15.5 percents lower than the target value.

Among the European sub-models, only the Northern and the Anglo-Saxon ones achieved the employment rates settled for 2010 since 2008, as it can be noticed in Figure 2. With reference to the employment rate for women, the values obtained by the Northern economies are the result of increase in part-time employment, and also of granting budget resources for children, which allowed the reconciling of the family life with the women's participation on the labour market. As for the employment of the aged persons, the Northern countries have recorded the highest progresses since 2000. The improvement in the functioning of the labour market for this category of labourers represents the result of the reforms which limited the access to early pensioning and stimulated them (including financially) to continue the participation on the labour market as long as possible.

The same efficiency was recorded by the group consisting of the Baltic States and Bulgaria, which obtained significant increases of the two employment rates during the period 2000-2008, and this fact made them different from the other new member countries; for example, Bulgaria recorded the highest increase rates for employment both of women and also of the aged population in EU, namely 13.2 percents, respectively 25.2 percents. The levels of the percentages for employment in the ECE sub-model can be compared to those of the Southern sub-model; compared to them, the new member states have a 3 percents higher average employment rate for women and a 1.7 percents lower of aged labourers.

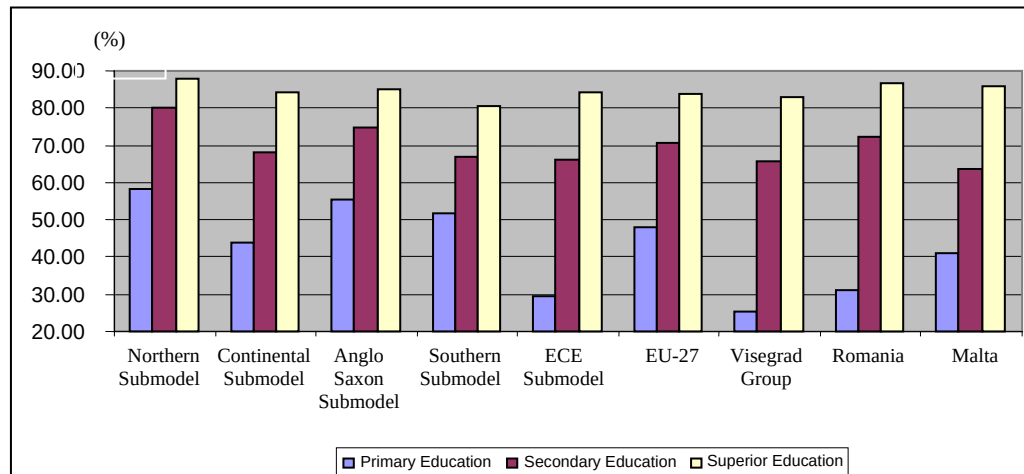


Source: Eurostat (2009).

Figure 2. Rates of employment for women and for aged persons in EU-27 (2008)

A factor which influences the persons' possibilities to get employed, and also their flexibility is their educational level. For EU-27, the average employment is 48.1% for those with primary education, 70.6% for the labourers who have secondary and post-secondary education, respectively 84% for those with superior education. In almost all the EU countries (except Italy and Hungary), the employment rates for persons with superior education is of minimum 80%, this value being with 20-25 percents higher than the rate of total employment. If for the percentage of the employment for labourers with superior education there is a convergence between the European sub-models, for the persons with primary divergences are the highest (Figure 3). Thus, for 18 out of the 27 EU economies, their employment rate is below 50%, while Portugal, Denmark and the Netherlands have an approximate rate of 62.5%. The employment rate for those who have primary education is the highest in Portugal, as this economy has the highest percentage of labourers with such an education level. Among the European sub-models, the Northern and the Anglo-Saxon ones are characterized by a superior capacity to offer jobs to labourers which only have primary education. Under the terms in which they constitute the group which is the most vulnerable to the economic changes, an increase in the employment rate among them represents a condition for decreasing the

poverty risk. The most inefficient sub-model, when referring to the insertion of the poorest qualified persons, is that of the new member countries, and among them, only Romania and Slovakia record employment rates which are slightly over 40%.



Source: Eurostat (2009).

Figure 3. *Employment rates according to the education level (2008)*

According to the analysis made on employment and unemployment in EU and within the sub-models, we may draw the conclusion that it is practically impossible to achieve all the three medium term targets settled by the Lisbon Strategy. Besides causes such as the weak reforming of the labor markets and of the social protection systems, especially for the Southern and for the new member countries, we may add the impact of the financial crisis, which will undermine EU's capacity to decrease the employment differences⁽⁴⁾. The decrease in the external and internal demand, caused by the economic and financial crisis, may determine a net loss of jobs, and this aspect will materialize in the increase in number of the unemployed persons and in ceasing the favorable evolutions recorded during the period between 2000 and 2008. However, the economic recession recorded in almost all the member countries has generated a fast return of the unemployment rate up to a level of 7.4% in December 2008 and to 8.3% in March 2009. These evolutions are recorded by the annual data corresponding to 2008 for a series of countries, such as Spain, Latvia, Lithuania, Estonia and Ireland, these economies recording decreases in the real GDP since the middle of the last year. The pursuit of this evolution may

partially cancel the advantage from employment and unemployment recorded during the period between 2000 and 2008.

2. The impact of the social transfers upon the participation on the labour market in EU

The modernized European social model, through the Lisbon Strategy, suggested to provide not only the sustainability of the redistribution system, but also the increase in economic competitiveness, by means of a high growth rate which could allow the increase of the employment rate; the previous measures for increasing the transfers and the taxation, taken before 2000, generated a low level of employment and the slowing down of the economic growth process within EU⁽⁵⁾. So that these objectives could not be opposite, it is necessary to reform the structure of the social transfers and the interaction method between them and the labour market, within the framework which has been settled by the flexicurity principles. According to these principles, the European Commission proposed the following measures: the increase of the incentives for entry/maintaining on the labour market, the promotion of active policies and of preventive policies for the vulnerable categories, assistance granting in searching for a job, participation to permanent training programs and providing social security. As for this last aspect, the harmonization between the social and the fiscal benefits systems has been settled in order to generate both the decrease of dependency on the insurance budget, and also the provision of social protection, as it happens in the case of the countries from the Northern sub-model.

This chapter makes an analysis of the relation between social protection and the participation on the labour market within the European sub-models in order to show the extent to which the differences between the employment rates can be explained by the incentives for employment. For this purpose, we have used a series of indicators which outline the impact of taxation upon the additional incomes. The lower the additional net revenues for entry/maintaining on the labour market, the more stimulated will be the persons to stay dependent on the social policy. This study has outlined five indicators, also used in the analyses made by the European Commission:

a) unemployment trap

According to the hypothesis of the unemployment trap, the unemployment assistance is quite high if compared to the predicted wages and they are granted during a long period of time, and this fact induces the decrease in the incentives for searching for a job. To invalidate it, the net wages should

not be lower than the unemployment assistance, respectively the social assistance, even for the poorly qualified labourers. This indicator is calculated according to the marginal rate of revenues from taxation (RMC) related to the employment of an unemployed person:

$$\text{Unemployment trap} = 1 - \text{RMC}$$

$$\text{RMC} = (\text{net wage earned by a labourer} - \text{net revenues earned by an unemployed persons}) / \text{gross salary}$$

It is calculated for an employee who obtains 67% of the average salary when being employed. For example, Germany recorded a value of *unemployment trap* of 74% in 2007; as a consequence, the difference between the net wage obtained by a German employee and the transfers he benefited from when being unemployed is 260 m.u. only, under the terms of a gross salary of 1000 m.u. The lower the marginal rate of earnings, the lower the additional earnings generated by the transition on the labour market, and this fact increases the dependence on the social protection.

b) low-wage trap, poverty trap

This indicator refers to the situation in which a person's decision to increase his labour effort (by increasing the number of working hours, by the transition from a part-time job to a full-time job or by the desire to have a better job) does not generate earnings in terms of available revenues. This situation is characteristic for the labourers who earn low wages, in their case the previous net income being approximately equal to the net income obtained when they decided to work more. In order to calculate the value of this indicator, the marginal rate of earning (RMC) will be initially calculated, this one corresponding to the working effort:

$$\text{RMC} = \text{increase in net income} / \text{increase in gross income}$$

$$\text{Low-wage trap} = 1 - \text{RMC}$$

The lower the RMC, the more the labourers who earn quite low wages will be stimulated to stay dependent on certain social transfers and not to join the professional reorientation programs. Any additional income earned as a result of re-qualification/professional training would generate very low net additional benefits, under the terms of high taxation of the income plus. This indicator is calculated under the terms of wage increase from 33% to 66% of its average level, for a single person. As a calculation example, we have considered the same case of Germany, which recorded a value of this indicator

of 57% in 2007. Thus, when increasing the gross wage by 100 m.u. (i.e. from 33% to 66% of the average national wage), the net income of the German employee was 43 m.u., the remaining of 53 m.u. including the additionally paid taxes by increasing the effort and the previously obtained benefits.

c) the inactivity trap

In its significance, the indicator resembles the unemployment trap, illustrating the case of the inactive persons who prefer to stay dependent on the social assistance (and not on the unemployment assistance, as in the case of the other variable), rather than searching for a job and be employed. In such a case, the marginal rate of revenues from taxation outlines the additional net benefit of the decision to make the transition from the social assisted statute to that of labourer:

$$\text{Inactivity trap} = 1 - \text{RMC}$$

$$\text{RMC} = (\text{net wage earned by a labourer} - \text{net revenues earned by a socially assisted person}) / \text{gross wage}$$

The lower the RMC, the more stimulated the inactivity, and this will be mirrored in the national decrease of the employed population.

d) net replacement rate

This variable also constitutes a measure for the incentives of the citizens in order to entry/remain on the labour market. It can be calculated both for the unemployed, the inactive persons, and also for the aged labourers who will get retired:

$$\text{Net replacement rate} = \text{Net revenues from social transfers (unemployment assistance, social assistance or pension)} / \text{Net revenues from labour.}$$

The higher this rate is, the lower the incentives in obtaining a job are for the persons who are able to work.

e) tax wedge on labour cost

This indicator includes the taxation obstacles in employment and it is calculated as a ratio between the taxes paid by the company (income tax, employees' and companies' social contributions) and the total cost for labour force. This variable measures both the incentives for getting employed (the labour offer), and also the company's capacity to fire/hire labourers (the labour demand). The higher this ratio, the more difficult the company's creation of new jobs, and this fact will generate a higher unemployment rate (*ceteris paribus*)⁽⁶⁾.

The presentation of the five users of intensity in the incentives to have a job also suggests the main measures for reforming the taxation and social protection systems which should be implemented by the EU member states:

- decreasing the unemployment assistance quantum and of its granting period, the purpose being to decrease the voluntary unemployment;
- conditioning the granting of unemployment assistance with the active search for a job and with joining professional reorientation programs;
- decreasing taxation for low wages, resulting in increasing the employment of the poorly qualified labourers and their joining permanent training programs; at present, these employees compose a vulnerable group in EU, which is below the relative poverty threshold;
- decreasing the social assistance for the inactive persons, the purpose being the increase of the employment rate; this measure should be accompanied by the decrease of the companies' incentives to employ labourers *illicitly*, as many inactive persons perform activities in the underground economy;
- decreasing the taxation applied to labour, with the purpose to decrease the companies' costs and to increase the demand on the labour market; moreover, this fact would also allow the decrease of the underground economy's percentage (under the terms of strong institutional constraints).

Among the EU sub-models, the Northern and the Anglo-Saxon ones promoted *workfare* type measures, but the first of them accompanied these measures with the granting of more generous social transfers. The analysis made for the five indicators, which are specific to the incentives on the labour market in the case of the European sub-models, should not be generalized, but it has to be mainly correlated with the conditional side. The Northern countries provide a generous social security only under the terms of the active search for a job or of the postponement of pensioning. Secondly, it is necessary to make a connection with the current stage of development in the case of the countries belonging to a certain sub-model or with the current macro-economical evolutions; although an economy has a low taxation level, and consequently high incentives both for the labour demand and also for the labour offer, the unemployment rate of that economy can be increased (for example, the case of an economy in recession).

As for the problem regarding unemployment and the transfers related to it, the economical theory asserts that the existence of generous benefits and of a longer period for granting them determines the decrease of the incentives for searching for a job and it negatively affects the national employment rate and the long-term productivity of labourers. Moreover, the sustainability of the

welfare state can be negatively affected, under the terms of the absence of connection between economy and society. Starting from this reality, *most of the economies which are EU members have reformed the insurance systems and the unemployment system during the last years and they have promoted the subsequent measures for the coordination between social protection and searching for a job:*

- decreasing the unemployment assistance, as a percentage of the total net wage, in countries such as Germany, Greece, Austria, Portugal, Sweden, Slovakia, Great Britain;
- settling a ceiling for the unemployment assistance to 14% of the average national wage in Great Britain and to 31% in Ireland (for a labourer who has 20 years seniority);
- decreasing the period for its granting, even up to maximum five months in the Czech Republic;
- settling severe obligations to actively search for a job in Austria, Belgium, France, Spain, Portugal, Slovakia;
- creating individualized action plans by the national agencies and by the unemployed persons, in the Northern countries, France, Hungary and Great Britain;
- applying penalties to the unemployed persons who do not proceed in finding a job, as in Belgium, Latvia, Germany, Portugal and Italy;
- granting the unemployment assistance only depending on the observance of the condition related to the previous contribution to the social insurances; for example, a previous contribution for 12 months during the last two years in Germany and one year during the last four years in Hungary.

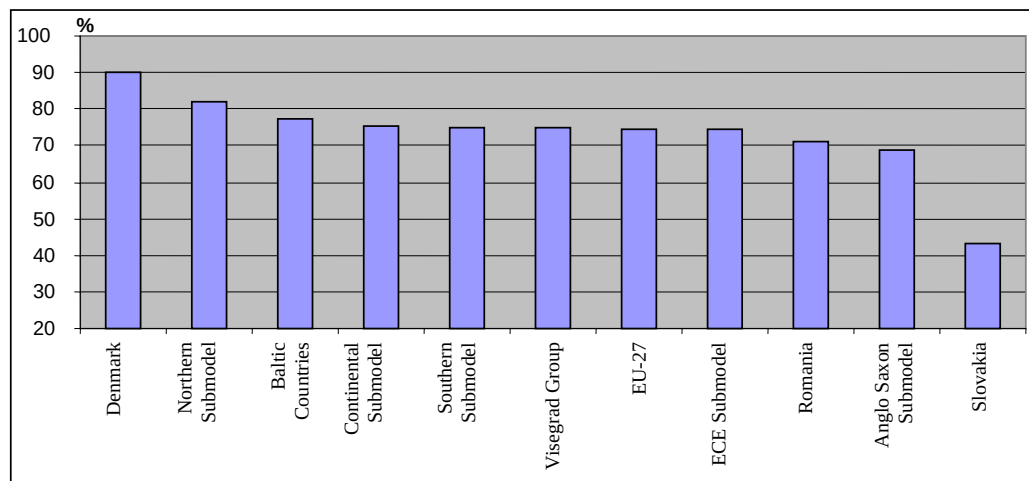
The effects of the measures implemented in the case of unemployment by the member states may be outlined by means of *the net replacement rate*, which refers to the percentage net income earned by an unemployed person out of the net wage he could obtain. In EU-25 (except Romania and Bulgaria), there is an inverse relation between the period for granting the unemployment assistance and the received benefits. Thus, the net replacement rate (for a wage of 67% of the average) decreases to 66% during the first unemployment month, to 63% after six months, reaching 53% after one year. If we did not consider the social assistance received by an unemployed person, then, after one year of being unemployed, the benefits would represent 41% of the net wage. Among the EU-25 member states, Belgium and Denmark grant unemployment assistance for a longer period of time, the first during an unlimited period, and the second on maximum four years.

2.1. Unemployment trap in EU-27

As for the indicator represented by the *unemployment trap*, we have used the methodology proposed by the European Commission, according to which analyses are made for the case of an unemployed person who obtained a wage equal to 67% of the average national wage at the previous job and who gets employed for a wage of the same percentage. We have analyzed the case of a single unemployed person, without family or children, as for such a case we have available statistic data for all the EU member countries. The values of the *unemployment trap* indicator would be different if we studied the situation of the unemployed persons who have family and children, as they would benefit from additional social assistance granted for children. Moreover, the situation of the second family member is important, as he/she could influence the quantum of the social transfers received by that family.

Making a study for the intensity of *unemployment trap* in the European sub-models (the case of a single unemployed person), we can notice, in Figure 4, that the Northern countries record the highest values for this indicator, due to the generous social assistance granted to the unemployed. In 2007, the unemployment trap for these economies was the highest, namely 82%, i.e. an unemployed person would earn an additional income of only 18% of the gross wage by getting employed. On a rough estimate, the economy which is characterized by the lowest incentives for searching for a job is Denmark, as the transition from unemployment to a job brings an additional income of only 10%. However, this economy is the one which records the lowest unemployment rate in EU, as a result of the implemented flexicurity system. As a consequence, this economy records no trade-offs between the high benefits of the unemployed and their integration on the labour market.

Compared to 2001, all the Northern countries decreased the unemployment trap by two percents as a result of reforming the insurance and unemployment systems and of a decrease of taxation applied to the employees who have low wages. The other sub-models (except the Anglo-Saxon one) recorded a high convergence of this indicator's values, the variation between them being of only one percent (75.6% for the continental sub-model and 74.6% for the new member countries). Austria, which is another economy adjusted to the flexicurity principles, had a marginal rate of income from taxation which is superior to the sub-model in which it is included, i.e. 32%, the quite higher incentives being correlated with a level which is lower than the unemployment rate in this⁽⁷⁾.



Source: Eurostat (2009).

Figure 4. *Unemployment trap within the EU-27 sub-models (2007)*

Figure 4 presents the classification within the group including the Baltic States and Bulgaria, these economies having promoted decreases of taxation and economically and socially resembling the Anglo-Saxon sub-model. The implementation of the unique quota in the Baltic States and in Romania has not generated the expected effects upon the employment incentives, in the case of the unemployed who have poorer qualifications. Their earnings were very low, if compared to those of the employees who have revenues over the national average. Thus, in the case of Latvia, the marginal rate of employment revenues was 14% in 2007, for a wage which is equal to 67% of the average and 44% for a wage which is 50% higher than the average. On the contrary, Slovakia adopted the same fiscal measure in 2004 and it recorded the most improvement of employment incentives (by 30 percents), being characterized by the lowest poverty trap in 2007. An explanation for this divergent evolution between the economies which introduced the unique quota refers to the granting of fiscal deductions to the persons who have low wages and to the decrease of the social benefits which were granted to the unemployed, and this resulted in the increase of the marginal rate related to the net employment income.

The economies which recorded an improvement of the incentives during the period 2001-2007 (Slovakia, France, the Northern countries, Romania, the Czech Republic, Slovenia, Germany, Austria, Belgium and Poland) promoted measures for decreasing the taxation and the social benefits of the unemployed and other support forms for their families; however, these incentives varied according to the unemployed person's family type. For example, in the case of

the Czech Republic, the increase of the minimum national wage and also the granting of salary deductions for families with children generated higher earnings for these families, if compared to the single unemployed persons.

2.2. Low-wage trap

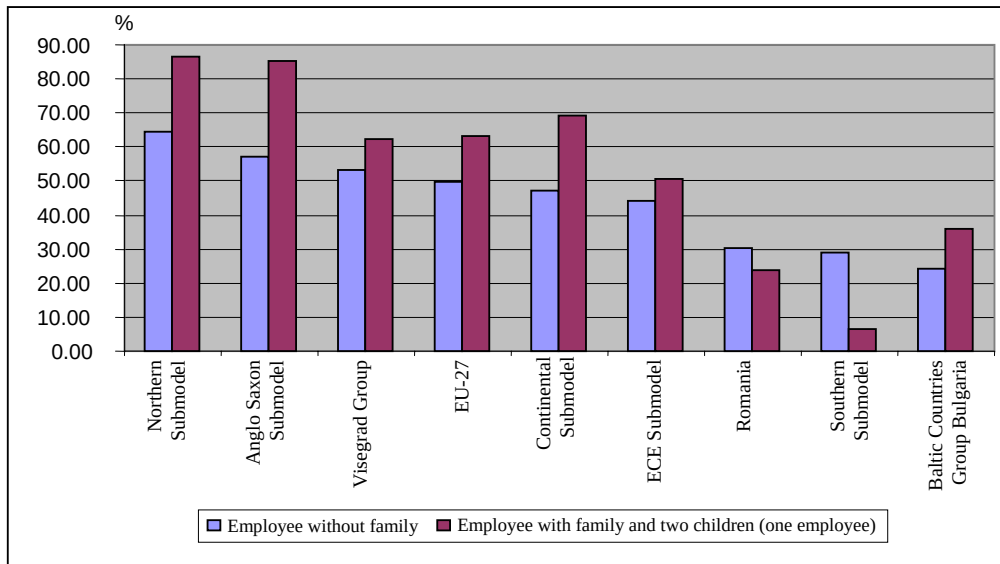
The strategies implemented by the member states with reference to the social expenses for family and for children (which have a 2.1% share in the GDP of EU-27) can also be noticed in the analysis made for the *low-wage trap* for the single labourers and for those who are the single employed members within a family with two children. We have made a comparison between the sub-models according to the indicator proposed by the European Commission, with reference to the marginal rate of income for the employees with low wages, i.e. those who earn an income of 33% of the average salary and who could transit to a job for which they could get paid 67% of the average salary. This analysis is valid for the poorly qualified labourers and for those who could transit from a part-time job to a full-time job, i.e. those categories which are potentially affected by the poverty risk. The interpretation of this indicator's evolution according to the effect upon the social cohesion can be made in two ways. On the one hand, the possible progresses in improving the incentives by decreasing taxation or their social benefits will generate a higher income by increasing the wage. On the other hand, the decrease of incentives could be generated by the increased social transfers applied to the persons who earn low incomes and to their families. In both cases, the social cohesion would be supported, but in the last case the dependency on the state would be kept.

Within the period 2001-2007, EU-27 was characterized by the increase of the low-wage trap indicator related both to the single labourers, from 55.4% to 63%, and also to the employed persons belonging to families with two children, from 48.1% to 49.7%. The risk of persisting in this situation is maintained high, especially for the families with two children in countries which belong to all the European sub-models: Germany (84%), Finland (100%), Great Britain (86%), Cyprus (115%), and Poland (74%). On the contrary, the economies which introduced the unique quota (except Romania) recorded significant increases of the additional income rate in case of salary raise, especially in the case of the employed persons coming from families with children; thus, Slovakia recorded a decrease by 93 percents from a previous level of 123%, Bulgaria recorded a decrease by 57 percents, Estonia 56 percents and Latvia 36 percents.

The reason for which the poverty trap indicator is higher for employed persons with children than for the single ones consists in granting generous

social transfers to the first category. Cyprus is the most relevant for this argument; thus, the increase in the working hours would generate an additional income of 94% of the gross wage for a single employed person and a loss of 15% for the employees which are part of a family with two children. The result is that the social system of this country does not encourage the poorly qualified labourers to find a better paid job. The situation is exactly opposite in Italy, where a single employed person would earn an additional income of 34%, and a labourer with two children would earn 113% (i.e. the negative wage trap indicator is of -13%). The economies belonging to the Southern sub-model, except Cyprus, have the lowest levels of the low-wage trap for both categories of labourers. On the one hand, these economies stimulate the poorly qualified persons to earn a higher wage, even though the labourers' flexibility is lower, and on the other hand they grant lower social benefits for families and for children.

The countries belonging to the Northern sub-model record a high value for this indicator due to the granting of generous benefits to the poor families. In all the economies belonging to the continental sub-model, the social assistance granted to families with children is mirrored in the existence of higher additional incomes for the single labourers; as a consequence, the incentives for professional training decrease if the labourer has a family and children. Romania is one of the less EU countries where the low-wage trap is higher for the single labourer than that for the labourer who has children, and this fact is explained by the existence of fiscal deductions for an employee belonging to the second category. In Figure 5 we can notice that, surprisingly, the Anglo-Saxon sub-model is similar to the Northern sub-model if we consider the values of the low-wage trap, as a result of the increase in the social benefits for the poor families (since the end of the last decade). In their opinion, it would rather be necessary to provide social protection to the employees, to the families with low earnings, than to improve the incentives for increasing the labour effort. As for the ECE sub-model, the economies which grant more from the GDP for the family's social protection, namely the countries belonging to the Visegrad Group (except Slovakia), have the tendency to implement the same strategy applied by the Northern, Anglo-Saxon and continental sub-models. On the contrary, the Baltic States, Romania and Bulgaria, through their implemented measures, resemble to the average levels of the Southern sub-model.



Source: Eurostat (2009).

Figure 5. Low-wage trap within the European sub-models (2007)

To conclude, the EU-15 countries (except the Southern ones) admit the importance of decreasing the poverty trap as a measure for increasing the incentives for requalifying/training, but they maintain its high level as a social protection measure for those employees and for their families.

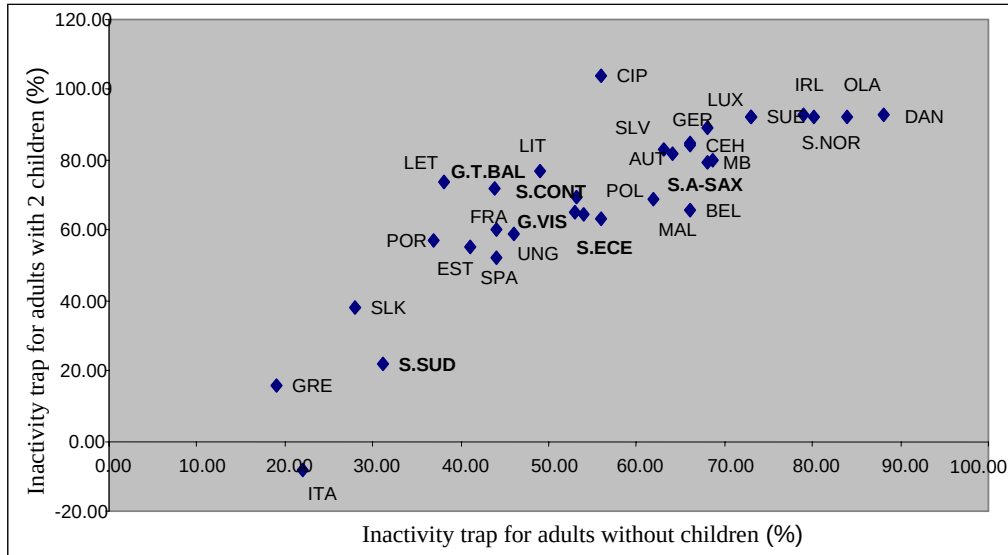
2.3. Inactivity trap

The third indicator used in the analysis of the relation between the social transfers and the employment incentives is the *inactivity trap*, which refers to the persons/the members of a poor family who had a job in the past and who are no longer eligible to benefit from the unemployment assistance, but who receive social assistance. The European Commission calculated the marginal rate of the additional net income generated by the transition from inactivity to a job according to a salary which represents 67% of the average national wage. Naturally, the value of this indicator should be significantly lower than that of the unemployment trap, assuming that the benefits of a person in his quality of social assisted are lower than those obtained by an unemployed person. This situation is not valid within the economies which belong to the Anglo-Saxon and Northern sub-models, in these cases the net incomes resulting from a

person's transition from unemployment to a job being lower and similar to those recorded in the case of the transition from inactivity to employment.

Even though the inactivity trap decrease in 12 EU member states, if compared to 2001 (from one percent for Great Britain to 52 percents in Slovakia), this corresponding to an improvement of the incentives for the inactive persons towards employment, their additional income coming from employment is still very low. The decreases were caused by the modifications brought in the social assistance schemes combined with the introduction of taxation deductions applied to the employees (as in Sweden, Slovakia, France and Latvia) and also by the changes in the subsidies granted to those who have low wages (as in Austria). According to the data which have been available since 2007, which have been used to create Figure 6, we can notice that the absence of incentives for employment is higher, especially for the families in which there is only one employed person, with or without children. Thus, in seven EU member countries (the Northern countries, Ireland, Cyprus and Luxembourg) the marginal rate of the income obtained from employment is 10% at the maximum for a family with only one employed person and two children. As a consequence, there is a high long-term risk of dependence on the social assistance programs of the Governments.

As in the case of the low-wage trap, the Northern, Anglo-Saxon and continental sub-models deals with the problem of the inactive persons as it is a problem of social protection for very poor families. Moreover, most of the EU economies (except France, Italy, Cyprus, Poland) encourage these labourers to not accept wages which are lower than 67% of the average national wage, namely the initial reference level. One of the possible motivations could be the existence of a minimum wage, but its level is lower than 45% of the average national wage. Italy is the only economy which is characterized by incomes which are higher than 80% for employment obtained by the inactive persons who have families and children and by income losses for the inactive families, even at a level of 33% of the wage they could obtain. The result is that the social benefits granted to poor families with children are very low, and this could be mirrored in the increase of the poverty risk for them.



Source: Eurostat (2009).

Figure 6. Inactivity trap within EU-27 countries (2007)

The interpretation of the data included in the chart above, only based on the strict correlation between the absence of incentives and the tendency towards inactivity, could result in the fact that the Southern economies and a part of the continental ones are characterized by quite high incentives, and this could generate a lower inactive population and, consequently, an increase in employment. On the contrary, these economies are characterized by a quite lower rate of employment, especially for the labourers who have quite lower qualifications. *As a consequence, the incentives for the labourers are not important as long as there is an absence of permanent training policies, the possibilities of this category to entry the labour market are quite low, and the companies' capacity to create new jobs is limited.* The indicators which are specific to the transition from unemployment and inactivity towards employment have an influence only upon the citizens' initiative and not that of the companies. That is the reason why the existence of a labour demand from behalf of the companies is essential so that these variables could have finality. One of the most important factors which influence the companies' activity is the sum of the taxes which they pay.

2.4. Tax wedge on labour cost

High taxation has a negative effect upon the functioning of the labour market, thus affecting both the demand and also the offer; for example, the increase of the social contributions paid by the employees will result in the increase of the companies' costs and in the decrease of the employees' available income. The effects of increase in taxes will be mirrored in the slowing down of the economic growth rate, in the maintenance of a low employment rate, in the increase of the underground economy's percentage and in additional stress upon the welfare state. The indicator used to record these effects is the *tax wedge on labour cost* related to the companies' labour costs for low wages. Within EU, the countries belonging to the Northern and continental sub-models promoted measures to increase the taxation applied to labour, in order to support the redistribution process. These measures represented a support for the welfare state on a short-term, but affected its sustainability on a medium and long-term.

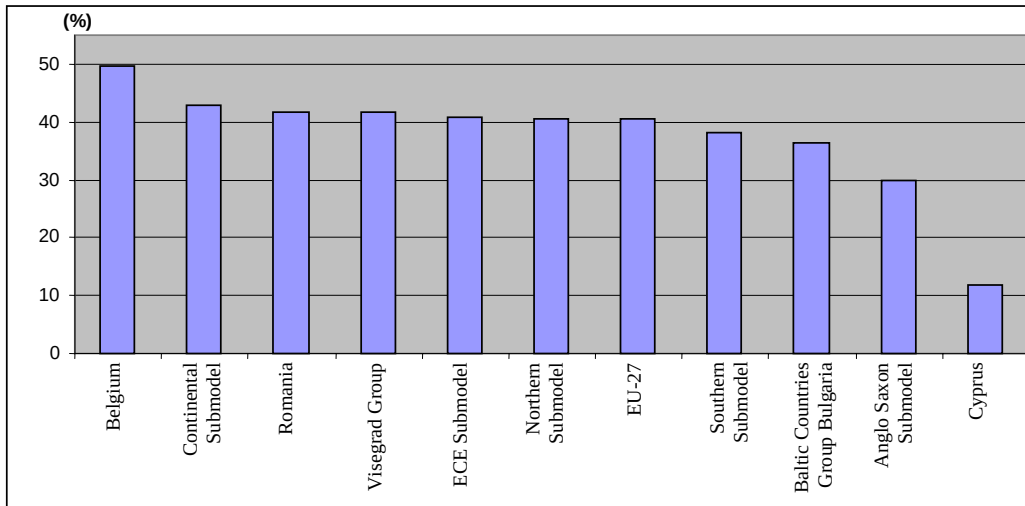
In order to respond to the new economic challenges, most of the EU economies changed their fiscal orientation, by promoting decreases or deductions of the contributions to the social insurances during the last years, all these being fiscal advantages for the labourers who earn low incomes. The main measures applied during the last eight years for decreasing the percentage of the taxes for labour were as it follows:

- decreasing the employers' and the employees' social contributions in 14 out of the 27 EU member countries during the period 2001-2007;
- decreasing the contributions paid by the companies in the account of the unemployment assistance, in Austria, under the terms of the significant decrease in the national unemployment rate;
- decreasing the social contributions of the employees who have the lowest wages, in Belgium;
- correlating the paid social contributions with the nature of the labour contract; for example, Portugal settled the decrease of the paid contributions to 50% during the next three years only under the terms of concluding a permanent labour contract;
- applying a temporary decrease of the social contributions in case of hiring unemployed persons on a long term (in Malta) and when hiring the persons who benefited from social assistance for health care (in Sweden);
- granting fiscal deductions to the employees with low wages in Belgium, Denmark, France, under the terms of increasing the wage basis below which taxes are not applied;

- conditioning the fiscal deductions applied to labourers by joining permanent training programs (Austria) or by continuing the activity on the labour market for the labourers who are over 64 years old (Denmark).

In EU-27, the percentage of the labour taxes for an employee who earns 67% of the average national income decreased from 40.9% in 2000 to 40.4% in 2007, under the terms in which 21 member states recorded a decrease in taxation. Two of the economies belonging to the Northern sub-model recorded decreases by more than 4.5 percents (Finland and Sweden), the same situation being applicable for a country belonging to the Southern sub-model (Cyprus) and for three countries from the ECE sub-model (Bulgaria, Hungary, Slovakia). The other countries belonging to this sub-model (except Estonia) also decreased the percentage of taxation, from a level which was close to the Northern and continental countries in 2000. The taxation strategy of the new member countries recorded a significant decrease of the profit tax and of the income tax, while the social contributions supported by the employer and by the employee remained quite high.

If in the case of the profit tax there are significant differences between EU-15 and the new member countries, under the terms of the existence of the unique quota in six economies, we cannot say the same thing about the percentage of the taxes supported by the companies, which are included in Figure 7. There is a convergence between four of the five European sub-models, the Anglo-Saxon one traditionally promoting lower taxes. Among the sub-models which used to be characterized by a high fiscal stress upon companies, the Northern one made a faster transition towards lower levels, by means of the favourable macro-economical evolutions. Among the new member countries, the Visegrad Group, together with Romania, are more similar to the continental sub-model, while the Baltic States and Bulgaria recorded levels which were similar to those from the Southern sub-model in 2007, the tendency recorded in 2008 being towards the average values of the Anglo-Saxon sub-model.



Source: Eurostat (2009).

Figure 7. Taxes percentage of the wage costs within the European sub-models (2007)

3. Conclusions

Under the current conditions from the European Union, the analysis made on employment and unemployment in EU and within the sub-models, we may draw the conclusion that it is practically impossible to achieve all the three medium term targets settled by the Lisbon Strategy. The weak reforming of the labor markets and of the social protection systems, especially for the Southern and for the new member countries, and the impact of the financial crisis will lower EU's capacity to decrease the employment differences. The imperativeness to implement measures for reforming the taxation systems and the protection systems in EU member states is obvious, for example: the decrease of the unemployment assistance quantum and of the period for its granting; granting the unemployment assistance should be conditioned by the active search for a job and by joining professional reorientation programs; the decrease of taxation with reference to the low wages; the decrease in social assistance for the inactive persons, so that the employment rate could be increased and the decrease in taxation for labor, in order to reduce the costs of the companies and to increase the demand on the labor market.

Notes

- (1) In 2000 approximately two thirds of the gap compared to USA was explained by two factors: a quite lower employment rate and the decrease of the working hours.
- (2) In 2007, the estimates demonstrated that it would have been necessary to create 20 million additional jobs in order to fulfil the target of 70% for EU UE-27, and this would have corresponded to an average annual increase of employment by 3% during the period 2008-2010, i.e. almost twice, if compared to the 1.2% average recorded during the period 2001-2007.
- (3) In 1999, only four of the EU countries recorded an employment rate for the persons over 55 years old, among them being Romania, too.
- (4) In October 2008, the European Commission estimated that only 250 thousand jobs would be created in 2009 in the entire EU, and in 2010 the number would be 0.5 millions, if compared to 6 millions of new jobs during the period between 2007 and 2008. Under these terms, the employment will seignificantly decrease in countries such as Spain, Ireland, Latvia, as a result of the real estate downfall (which contributed to the increase of the emplyment rate between 2002 and 2008).
- (5) The economic literature considers that certain redistributive systems automatically result in the persistence of a high unemployment rate and of the social assistance which is granted by the state.
- (6) According to Vork (2006), there is an inverse relation between the percentage of taxes for labour and the employment rate in the case of the new EU member countries, while in EU-15 there is not a significant relation between the two variables.
- (7) If the Austrian unemployed person were part of a family with two children, and the other member of the family is employed, then the additional benefit of employment would have decreased from 32% to 18%, as a consequence of the social transfers granted for children.

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The Impact of the Culture on the International Negotiations: An Analysis Based on Contextual Comparaisons

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Abstract. *The negotiation could be considered as critical part of the success within the international affaires. The participants' culture is one of the most powerful and influential factors that could give a stimulus or an obstacle to the negotiation process and outcome. The cultural differences prevalent in the international negotiations influence the most verbal and nonverbal language within negotiation. The culture distance has as a result the appearance of task and non-task related interactions. The cultural differences and similarities between the participants are shaping the negotiation styles too.*

We are suggesting a single structure of the negotiation styles, which is capable of differentiating behavior of the negotiations, and benchmarks that could support the stimulation and efficiency of the negotiation process as a whole.

Keywords: business negotiation; negotiation process; culture; cultural gap; negotiation style.

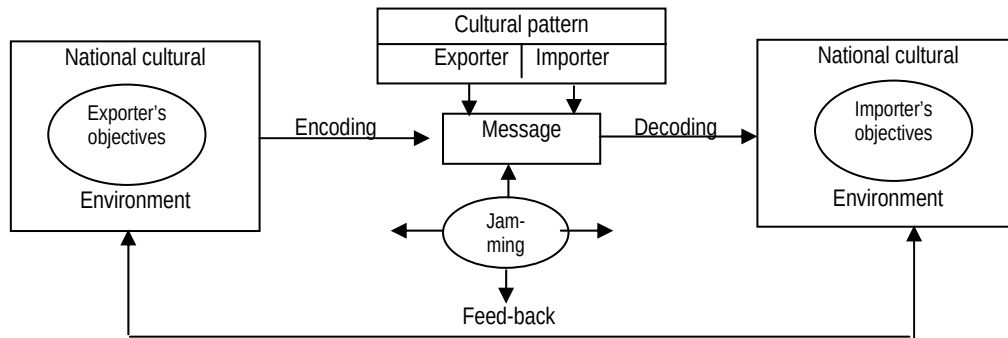
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REL Codes: 10D, 14G.

1. Introduction: The negotiation as a communication process influenced by culture

In the XXI century, the competent businessmen should easily adjust to each circumstance that is the result of the cultural diversity of the markets. Who doesn't know the market rules of the business game has a competitive disadvantage. The international business has to derive advantage from the good knowledge of the markets culture and business partners. The negotiation is among the dimensions of the international business which requests and benefits by cultural knowledge. The importance of knowledge of business partners as part of the entire particular business and negotiation process becomes clear if Toffler's point of view according to which the business negotiations may be viewed as a constituent part of the integrated system of added value which "is more and more dependent on the data, information, and knowledge exchange" is accepted (Toffler, 1995, p. 239). First and foremost the negotiation is a way of communication. The communication is the essential link between the interested parts that are involved in business activities and operations. The negotiation has to be placed in the center of the international business process and content. This central place is a result of the definition of the negotiation. Hollensen (2008, p. 416) thinks "the negotiation is a process in which two or more entities come together to discuss common and conflicting interests in order to reach an agreement of mutual benefit". I. Popa (2001, p. 120) views the international business as an organized communication process between two or more partners from different countries. Beyond the differences all the definitions have two common elements, which are communication and process like characteristic of the negotiation. The distinctness and the effectiveness of the communication depend on the various influences of some favorable factors, and on the many sources of noise or jamming. The same influences are an impact on the chances of a correct and whole perception and understanding of the message by the addressee, which is the foreign customer. The sources of noise or jamming for example could begin by causing various distortions of the transmission and perception of the message and could end in the obstruction of the communication (Danciu, 2009). The culture of the participants is one of the most powerful and influential factors, which could stimulate or distort the communication as part of the business negotiation.

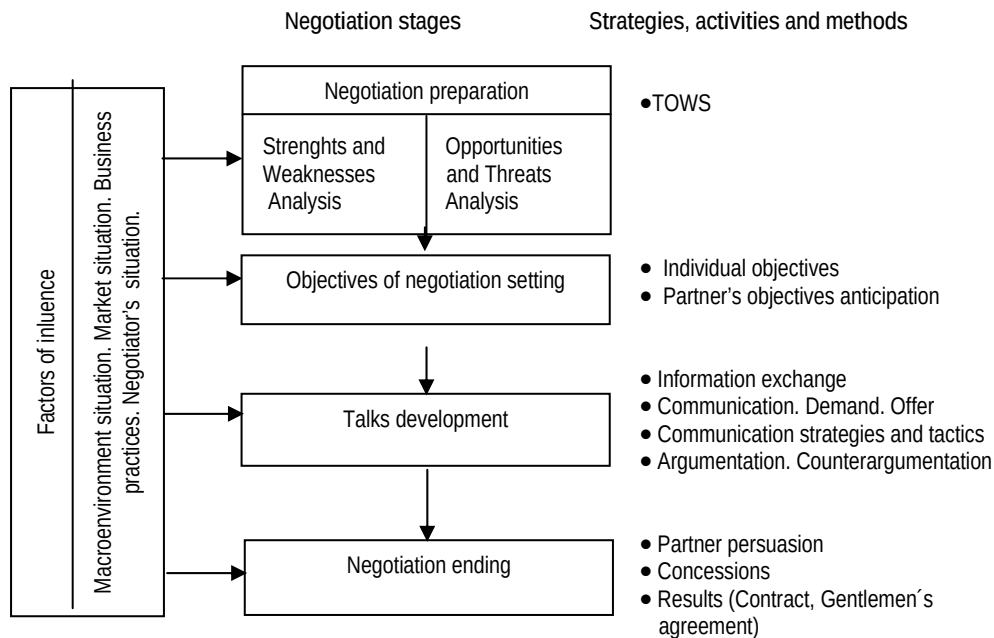
The cultural patterns of the negotiations have frequently more or less important differences. Every time when differences between the cultural patterns of the negotiators are present, the business issues have to be treated accordingly (Figure 1).



Source: author's design and execution.

Figure 1. *The culture as influence factor of communication pattern in international business*

The partners in any commercial negotiation have in mind to gradually harmonize their positions in order to achieve a mutually acceptable contractual agreement. The factors that could influence every stage of the negotiation have to be operatively and successfully identified, understand and used, in order to reach the agreement. Figure 2 shows out the stages, content and influence factors of the negotiation process.



Source: author's design and execution.

Figure 2. *The negotiation process in international business*

Negotiation preparation is the stage of analysis and evaluation. The general context of the talks development is now under analysis. The evaluation could be made using a characteristic research of the PEEST model of environment, the export market situation analysis and the firm's situation. Could be successfully utilized during the negotiation if they are in TOWS matrix that could suggest strategies (Gilligan, Wilson, 2005, Danciu, 2004). The opportunities and the trends have to be carefully used in order to achieve the objective of the negotiation. The strengths of every negotiator could be used in order to capitalize the identified opportunities or to reduce the existing threats. The weaknesses could be over passed if the opportunities are intelligently capitalized and the threats are moderated.

In order to increase the negotiation chances of success, the elaboration of a *negotiation plan* that could explain and support the efforts is needed. The plan should include a synthesis having as main elements a list of negotiation issues, the comparative evaluation of both partners agenda and the evaluation, classification and hierarchy of convergent and divergent themes of the negotiation (Popa, 2001).

Objectives of negotiation setting should be based on the focus principle. Each objective have to be precisely and in detail formulated and putted down having as content the issues the negotiator intends to solve; it should fulfill the SMART requirements of a good objective. The negotiation has to have characteristic, simple, measurable, adequate, relevant and tangible objectives. The price, volume of export, quality of commodity, conditions of delivery, financing and payment, potential risks and so on has to be taken into account as specific objectives if the object of the negotiation is an export.

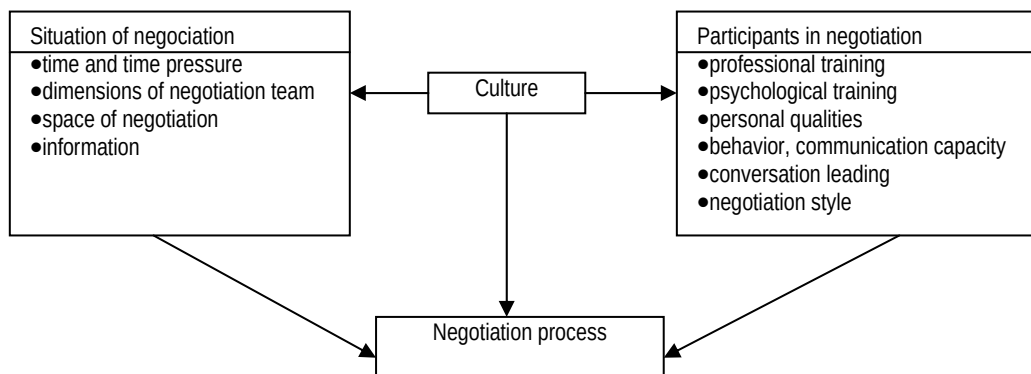
Talks development is the stage of a proper negotiation. Each part intends to act in such a manner so that the own objective could be achieved, without neglecting the partner's objective. In order to be successful, the negotiators involve themselves in verbal a nonverbal communication. They use commercial letters, demand and offer as methods of information exchange. When the partners have a face/to/face meeting, they resort to the strategies and tactics, arguments and counterarguments in order to persuade the opponent.

The success of the talks largely depends on the training and personal qualities of the negotiator. The professional and psychological background and the personality of each partners is important because it decides the methods of attack and defense, supports the flexibility and could secure the advantages needed for the achievement of the negotiation objective. The cultural profile of each negotiation isn't less important, for it could have an impact over all communication components and over particularly the methods used for the transmission, reception and understanding of information.

Negotiation ending is possible when the partners obtain a tangible, agreed result. The result of the international commercial negotiation is the contract as a rule. The Asian negotiators hold sometime enough one's word, particularly when they trust the person.

3. The international negotiation process under the influence of different cultural patterns

The environment to that each partner belongs could mark every aspect and stage of the negotiation. The impact of the culture could be found either, in the case of business contacts, the establishment of friendly or representation relations, business talks with the technical and commercial characteristic, at export and import or in the case of direct sale. The culture could play a role in every stage beginning with the negotiation preparation, influencing the vision and approach of the situation but also the strategic approach and the entire negotiation process, the rivalry and cooperation included (Figure 3).



Source: author's design and execution.

Figure 3. *The influence of the culture on negotiation*

Many cultural variables are influencing the expectations, actions and response of the member of a culture. A particular attitude, behaviour and negotiation style should be observed throughout the entire negotiation. The clothing, bearing, expression, gesture, punctuality and many others are transmitting signals about the attitude and behaviour. The way the talks are leading depends on the importance given both to the issue and the partner, negotiation style, the easiness to express one self. All these factors depending on the cultural partner are mirrored in the negotiation details. The language of

negotiation is important because it allows or not a certain balance between the partners. The language of one partner could be chosen depending on the ratio of forces, but in most of the cases a modern language is used. A significant language dimension that could be changeable depending on the culture pattern is the implicit or explicit characteristic. In the low context cultures the things that are communicated should have a clear and precise meaning. The speaker is supposing to be responsible for the effective communication in an explicit manner. The speaker and the listener are sharing the responsibility of effective communication in the high context culture as China and Japan, where the language is more implicit.

As a powerful mean of communication, the nonverbal language is more important in the high context cultures. The individuals are more sensitive to various nonverbal messages in high context cultures, while in the low context cultures as Anglo-Saxon cultures many nonverbal messages are not noticed. The significance of nonverbal language has an importance in negotiation because it could influence the conversation and result during the talks. In the Table 1 are included the most important factors of the nonverbal language and their way of expression in various countries from different cultural models.

Table 1

National differences in negotiation due to cultural factors

Factors	Country	Way of expression
Attitude against time	Germany	The country of time awareness. The time is a valuable commodity and an important unit of measure for the human activities. The lack of punctuality is a sign of poor organization and of bad manners.
	Spain	The country of time waste. The time has little value and is excessively available; the interest in punctuality is missing. The lack of punctuality is a sign of prestige in business.
Mimicry	Germany	The absence of mimicry of mind. The most important form of mimicry means lack of attention, lack of interest, lack of presence is the smile accompanied by occasional movements of the head.
	United Kingdom	The correct behaviour needs emotion hiding and a serious expression of the face. The smile is judged as a sign of weakness and lack of self-control.
Expression of eyes. Sight	West Europe United Kingdom	The elusive sight or the avoidance of partner's sight is a sign of lack of respect, lack of politeness, lack of friendship and attention.
	Japan	Looking down in front of the superior is a sign of respect.
	Countries of Mediterranean Sea Zone	Zone of intense sight. The sight is a mean of control of influence against others and of taking distance against strangers.
	Central East and North Europe Countries	This is a zone where sight has little importance. The persistent sight is taboo. Staring at the conversation partner more than ten seconds could bring him to lack his self-control and begin to fear.

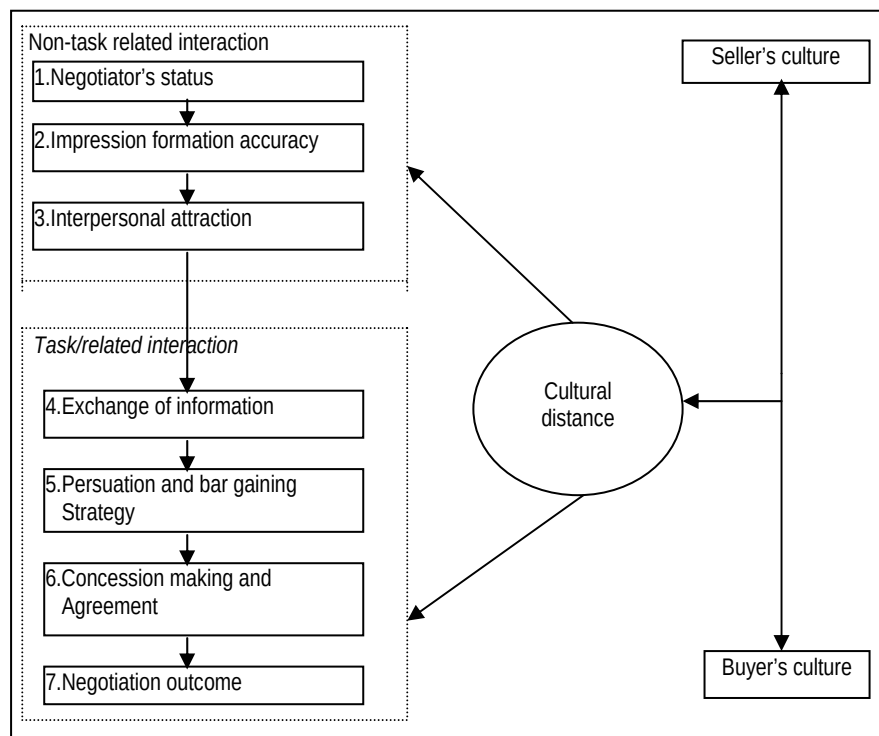
Body language Gesture	Italy, Greece, France, Spain, Portugal	The body is a mean of expression and communication. The gesture is the manifestation of melodramatic behaviour. People are using gladly his hands and arms in order to underline the ideas. They salute at the beginning and end of talks by shaking hands.
	Germany, United Kingdom, Nederland, Belgium	Giving his word is more important than gesture could bring tensioned atmosphere and cause and adverse response to the partner.
Language	France	The French is the favourite language in negotiation; even the majority of French-people speak English and German. The text should be written in French too.
	Italy	The business letters should be writing in Italian. The talk's language could be English.
	Spain	The Spanish language is used only if foreign partner faultlessly masters it.
	United Kingdom	English is the preferred language in during negotiation. Few English people speaks a foreign language well enough for business negotiation.
Hierarchy and Status	United Kingdom	The status depends on origin, social class and status of family and accent.
	France	The status depends on the level of education, the social status of the family and wellness.
First contact	France	Relationships are very important. The French people wish having much information about partners, before the beginning of talks. The conversation about French art, history and literature could support the relations' establishment. The formal clothing that is stylish and elegantly wearing is the standard.
	United Kingdom	Certificates and recommendations are very necessary. Men and women should wear cloths and shoes having a formal and conservative style. The negotiation partner has time and place to make proposals and counter proposal.

Sources: S. Hollensen, 2008, p. 146; Keegan, Schlegelmilch, Stöttinger, 2002, pp.123-125; R. Hünerberg, 1994, pp. 274-275; Mühlbacher, Leihs, Dahringer, 2006, p. 191.

Cultural differences prevalent in the international sales negotiation that could influence the verbal and nonverbal language can have a tremendous impact upon the process itself and its outcome. These cultural differences are the “cultural distance” between seller and buyer. Figure 4 show the modified cross-cultural negotiation process that emphasizes the interactions is the first category. They could appear rather in the negotiation preparation stage. The motives could be found within the emotional component of the negotiation process. The emotional elements which can't be measures as impression formation accuracy, interpersonal attraction and even the negotiator status can increase the flexibility or rigidity during talks, even if the parts are professionally very well trained and have enough and valid information. The task related interactions are the other category and they are more important (Hollensen, 2008, pp. 416-419).

Negotiator's status is defined by interpersonal rank, age, gender, education, the position of individual in the company and the market relative position of the company.

The high-context cultures as those of Asia and Middle East are status-oriented. As a result, the words used by the negotiators in high-context cultures are not as important as the negotiator's status. The status distinction of negotiators between high and low-context culture are sources of potential problems. A seller from a high-context culture negotiation with a buyer from a low-context culture is likely to attach importance to the status of the buyer. The seller expects the buyer to reciprocate this respect, but this will rarely take place. The trust and respect are essential in many high-context cultures as the Japanese, Chinese, Mexican and most of the Latin America. The Japanese people could request more meeting before the talks about negotiation issues begin (Le Baron, 2003).



Source: author's adaptation according Hollensen, 2008, p. 417.

Figure 4. *The influence of cultural distance on negotiation process*

Interpersonal attraction accuracy is the stage of initial contact between negotiators. Meeting someone for the first time, individuals have immediate feelings that precede rationalized thought process. These feelings lead to the formation of instant opinions. As the perceptions of the individuals from dissimilar cultures differ, the likelihood of a negotiator forming accurate impression based on an inaccurate impression formation may also have negative effects on subsequent stages of negotiation.

Interpersonal attraction takes place when the negotiators are face-to-face. Interpersonal attraction can have either positive or negative influence on the negotiation. Individuals who are attracted are likely to make concessions in the bargaining process except those who are not separating the business relationships from personal relationships because each cultural pattern.

Exchange of information becomes more important for a clear understanding of negotiator's needs and expectations as a point of departure for an effective communication flow between the partners. Communication in cross-cultural negotiations through verbal means is complex and difficult with the extra complexity of several languages and local dialects in the world. The exchange of information becomes efficient if the meaning of information exchanged is fully understood. The meaning of information must be exactly understood by both partners. The cross-cultural sales negotiations are subject to non-verbal problems such as body language and the negotiators should accurately understand its differences and similarities.

Persuasion and bargaining strategy is the phase of the negotiation process, which refers to a negotiator's attempt to modify the performance expectations of the other part through the use of various persuasive strategies and tactics in order to get concessions. The various styles and instruments of persuasions across cultures can be found in two basic strategies used in the negotiation process. *The representational strategies* use communication based on identification of problems, a search for solutions and the selection of the most appropriate course of action. The partners can exchange information, share points of view and easily select the most appropriate solution. *The instrumental strategies* have as main goal affecting the other party's behavior and attitudes. They may use persuasive promises, commitments, rewards and punishments in order to influence the buyer's position. This kind of strategies is more manipulator and can cause tensions and incertitude. The strategy of persuasion each negotiator can use depends on his culture. The people in high-cultures are more willing to use strategies and tactics being apparently based on an inconsistent behavior. One says about Arab people that if they are not a long time bargaining are not content and about Japanese people that are afraid not losing their "honor". The negotiators do not take offence dominating and

manipulating the other part, even if they belong to low context cultures. The French negotiators have a competitive negotiation style and confrontation oriented, when German negotiators reprove no significant aspects of the partner's behavior. The north-American negotiators talks on equal position with other part and the best can win (see Table 1).

Concession making and agreement are upon the influence of cultural factors too. Negotiators from different cultures have different approaches to concession making. Negotiators from low/context cultures are likely to use logic, while individuals from high-context cultures are more likely to use personalized arguments.

Negotiation outcome can take different forms. The final agreement of a negotiation process may take the form of a gentleman's agreement, which is common in high-context cultures, are more formal contracts, which are more prevalent in low-culture countries.

4. Negotiation style as a result of cultural influences

As the previous analysis shows there are cultural differences within all constituent parts of the international negotiation. The negotiation style is one invariable constituent of the negotiation process. It is influenced by cultural similarities and differences, since the individuals having a certain negotiation style come from a particular cultural pattern. Shell (2006) has identified five-negotiation style as follows:

- *Adaptation.* The negotiators who are able to adapt are sensitive to emotional mood, body language and verbal signals of the counterparts.
- *Avoidance.* The negotiators who avoid are willing to discuss only if they get warranties. They are inclined to postpone and avoiding the issues which could be subject to confrontation.
- *Cooperation* is the style of negotiators who like to discuss cases entailing various solutions trough creative methods.
- *Competition.* This is the negotiation style of people who think having the opportunity to obtain something. The competitive negotiators have powerful instincts and strategic vision. Such individuals may ignore the importance of relationships and this may create obstacle if the counterpart has a cultural pattern inside which the relationships are important.
- *Compromise* is a style used by the negotiators who wish to conclude the agreement by doing what is proper and equal for each part. These negotiators are very useful particularly when the time for concluding the agreement is limited. They can accelerate the process of concluding

an agreement even when is not necessarily and can too soon make concessions.

Within a culture there is a reference framework concerning the meaning of verbal and non-verbal arguments through out the negotiation process. The international negotiation has not such a common framework and this may create confusions and inexact interpretations, even wrong reactions. Therefore, the international business negotiations have to be very carefully prepared and planned. They should at the same time take into account and include the cultural differences influencing the negotiation behavior.

In order to contribute to the enhancement of the general framework of the negotiation theory, we propose a possible structure of the negotiation process, cultural differences and similarities included. This structure includes the following elements:

- *The sense of the negotiation goal;*
- *The nature of the negotiation objective;*
- *The characteristics of the talks;*
- *The formality within negotiation;*
- *The role of the parts within negotiation;*
- *The propensity to compromise;*
- *The conflict management;*
- *The emotion and emotional expression;*
- *The personal thrust.*

The sense of the negotiation goal varies depending on the cultural background of the participants. The negotiators originated in high-context cultures, such as those of Japan, China or South Korea, are insistent, status oriented and respect the relationships they have.

As a result, the time has a small importance for such negotiators comparing with the importance given by the partners from West countries. The Japanese people like better a negotiation style called *haragei* according to what all the aspects of a subject are in detail and repeatedly discuss in order to get a holistic image of the negotiated issue (Mühlbacher, Dahringer, 2006, p. 193). The Chinese people act very similar as they give great importance to the detailed questions and take advantage of time shortage of the negotiation partner at the same time. The North American and generally west people are short time oriented and like better to come rapidly to the point, because they are aiming to negotiate systematically and efficiently. This propensity for efficiency is many times considered by the negotiators belonging to other cultures as a punishment and makes the west people to negotiate inside a small margin. By contrast, negotiators from Brazil, China and Arab countries begin the negotiation from an exaggerated position (great market potential, high

prices) in order to have repeatedly negotiation rounds about the same subject until they come to the real dimensions (Hollensen, 2008).

The nature of the negotiation objective is in connection with the relationship between the negotiator and his firm or himself. The negotiators from US, Japan, Europe feel they have to reach the goal of the firm. The negotiators from India are inclined to pursue their own objectives such as power, prestige and personal satisfaction.

The characteristics of talks and argumentation are to be found between two significant extremes. The negotiators who belong to complex, high-context cultures have the ability to adjust to the negotiation style of the partner. The Japanese and Chinese people are more flexible in this respect. The negotiators who belong to low-context cultures fail to be flexible enough because these cultures are more egocentric. The French people are considered arrogant and self-important. They are also very proud of their logical way of thinking and are pleased to question other people logic. The negotiation rounds are relatively little organized, and the time period in which the issues are discussed is longer than in Anglo-Saxon space (Hünerberg, 1994, p. 276). The French like negotiation style can be considered as competitive and confronting oriented (Graham Mintu-Wimsatt, 1994). The British people like better to start the negotiation by leaving place for future concessions. As in German cultures, they take the final decision in shorter time.

The formality within negotiation can be analyzed on two co-ordinates, which are the formality of relationships and formality of outcome. The formality of relationships varies between formal and informal. The US negotiators are more informal and leveling in human relationships. The negotiation partners are sooner called on their first names, the titles having no importance. The Asian and European negotiators are very formal calling the other part with first name they think that the individual try to “soften” them, in order to make unjustified concessions. The communication between partners depends on the social status of everyone in Japan, while in Arab culture strict rules are to be observed. Many times, the formality could be a mode of hiding the feelings, which could negatively influence the negotiation.

The outcome formality refers to the precise way the partners express the negotiated agreement. Within low context cultures, the high formality is to be found in written, signed and sealed documents. The German, Britain, North American and European people think that the agreements and conventions need a written conformation having many information and signatures. The outcome of international commercial negotiation is the contract agreed on according to national and international rules. Within the high context cultures the given word is very important and it could be enough for concluding an agreement.

The gentlemen's agreements are often viewed as serious and trustful as a written contract, even they became formal contracts.

The role of the parts within negotiation is aiming at the equilibrium of forces. The North-American negotiators give the seller and the buyer equal rights and the best can win. The French people are making sure they have all under control, while the Japanese and Chinese negotiators use various tricks in order to handle the situation in their favor (Mühlbacher, Dahringer, 2006).

The propensity to compromise depends on its importance within different cultures. Within US it is viewed as a signal of democratic attitude, goodwill and fair/play. Within many Latin America's countries the concessions made to the business partner are highly respected because they are considered as a sign of honor, integrity and sometimes greatness. Within East Europe's countries and particularly in the case of Russia the concessions are perceived as weakness. Who complies with somebody's request lose control of self-determination and self-esteem in Russia ([en wikipedia.org/wiki/Negotiations](http://en.wikipedia.org/wiki/Negotiations)).

The conflict management has a wide range of approaches, cultural differences included. French, German, North American negotiators don't avoid the direct confrontation in the cases when the interests of parts are diverging. The transparent attitude, probity and integrity are highly appreciate by North Americans negotiators who use the without turning style of communication. Within high context cultures such as Japanese and Chinese the negotiator is under the pressure of "losing face". Therefore, the potential conflict of interests is negotiated with modesty and respect rather using an indirect language. All dissimilar approaches are indirectly solved in the Middle-East. The negotiation team never tackles a disputed subject. Both parts agree a trusted go between wrangler and he negotiates until a solution is agreed upon.

An influence on the various aspects of the negotiation could have the *emotion*. The culture may influence the social percepts, which in turn could affect the way the emotion is shown. The negotiators organizing in Southeast Asian cultures prefer to be cold and respectful. The Chinese negotiators even agree relatively long periods of silence and thinking during negotiation, a situation hardly accepted by the west-developed countries negotiators, particularly by those originated in low context cultures, which plan every pause. The people originating in Latin America and Mediterranean countries are more expansive and show his emotions during negotiation. Many Brazilian individuals talk all at the same time and touch the partner, while the Arab people raises the voice.

The state of mind of those who are part in negotiation influences various stages of the negotiation process such as the strategies to be used, strategies already used, the way the presence and intentions of the other part are

perceived, which for an agreement, and even the final outcome of the negotiation.

The emotion has a great potential to play a positive and a negative part within negotiation. The negative emotions may cause a strong and even irrational behavior and may contribute to conflict escalation and stop the negotiation, but it could be an instrument of getting conclusion too. The furious and angry negotiations may propose to themselves to rather use competitive, confrontation based strategies and to less cooperate (Forgas, 1998).

The fury affects talks by lowering the thrust level, negatively influencing the parts judgment, reducing the focusing capability, and even starting retaliation in some cases. The angry negotiators pay less attention to the other part, could reject advantageous offers. Such a behavior affects the outcome of negotiation by not taking care of the objectives and gaining less. The negative emotions may sometimes be advantageous too. The justified fury may show the commitment sincerity and needs of an individual.

The positive emotions begin to work still before the negotiation process starts. People who are in high spirits are more confident and inclined to use cooperation strategies. The negotiators being high-spirited appreciate more the interaction between partners; use less aggressive and more cooperative tactics during the talks. All these increase the probability of reaching the negotiation objectives, enhancing the chances of integrative outcomes and observing the agreements. These favorable effects are the result of better decisional processes such as those based on flexible thinking, creative problems solving, respect the partner, which of taking risks and increased confidence (Fulmer, Van Kleef, 2004). The positive influences could be found even within the post-negotiation stage as a favorable commitment in needed actions for the agreement achievement.

The personal thrust depends on the negotiators characteristics of the culture, which could gradually affect the negotiation. Within countries such as Brazil, Malaysia and Thailand that have a high collectivism, the personal relationships are important for the business negotiation. The personal thrust is a requirement for successful business negotiation in China or Mexico, where the legal system is viewed having very little effectiveness and being to little socially acceptable. Therefore, good relationships are viewed as something that lasts. Within individualist countries such as US, Great Britain or Nederland, the personal thrust has a great importance for initiating business negotiation, and is presumed creating and extending during negotiation. Even in Germany the emotions and friendship take a back seat.

5. Conclusions

The international theory and practice establish the negotiation as a multidimensional concept having the communication the central point.

This characteristic give the negotiation a complex substance and do it depending on numerous and different factors. The culture is one of these factors for the success of negotiation. The influence of cultural factors increases the complexity of the negotiation and adds a new dimension to the substance of international negotiations.

The culture has various and multiple influences on the negotiation as a whole and particularly on business talks. The cultural influences have as a distinct characteristic the distance between cultural models and this gives many forms. All these cultural influences in the form of verbal and nonverbal language are to be found in the negotiating styles. The five negotiation styles based on adjusting, avoiding, cooperation and compromise are the result of negotiators models of behavior originating in different cultures. The distinct negotiation behavior and styles influence the whole negotiation process. In order to achieve their objectives, the negotiation parts rarely have the same approach about the talk issues and use different strategies and tactics. Therefore, in order to obtain and improve the aimed outcome of the international business negotiation sustained efforts, which could eliminate the diverging, issues of the cultural distance are to be made. The particular efforts have to be made at the individual level and by the firms, which are interested in the international negotiation success. At the individual level, cultural knowledge and sensitivity, adjusting capability, flexibility and personality are key efforts. The essential part of the international business negotiator profile and personality has to be the international adjustment capability and cultural conscience. People who negotiate have to have a high cultural sensitivity, easiness in communication, and great adjusting capability.

In their turn, the firms have to have cultural knowledge and particularly to insist for cultural training of the negotiation staff, in order to complete their professional profile. Among the possibilities, methods and instruments for human intercultural resources training are to be found the research of cultural differences for cultural distance identification between business partners, use of negotiation games based on talks simulations, and foreign languages.

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Model for the Analysis of the Company Performance¹

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Abstract. *The analysis of the performance of a firm (company) has a determinant role in setting the strategy to follow and this is more necessary during the period of economic-financial crisis. In the following items, I have performed the analysis, based on the balance sheet data, for SC DELTA SRL, using a system of indicators that have relevance, and the interpretation of which allows to draw certain conclusions, depending on which the future development can be forecasted. I have tried to use a number of indicators, viewed as a system, which would define, in the end, a model for company performance analysis. The research focused on using the system of indicators on the data from the balance sheet of SC DELTA SRL.*

Keywords: patrimony; assets; liabilities; capital; indebtedness rate; balance sheet; working capital; rotation speed; profitability.

JEL Code: M41.

REL Codes: 14I, 14K.

1. Analysis of the patrimonial elements

Based on the data from the balance sheet at December 31st, 2009 I have performed the analysis of the balance sheet assets and liabilities following, on the first place, the determination of some rates that characterize the relationships existing between various patrimonial elements.

That way, the structure of assets in the patrimony if the analyzed society can be synthesized as follows:

Table 1

Structure of the assets for SC DELTA SRL

Name of the item	Value (lei)	Weight (%)
Fixed assets	51,998.6	17.89
Circulating assets	238,496.4	82.11
Expenses in advance	0	0
Total assets	290,495	100

The relationship existing at the level of the analyzed economical entity between the levels of the various categories of assets is represented in the following chart:

Structure of company assets

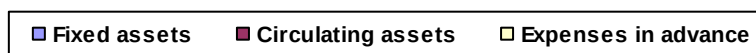
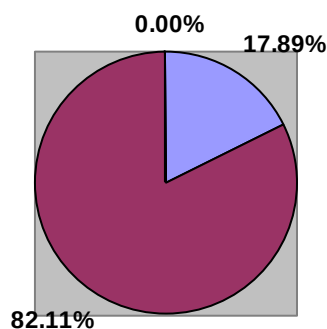


Figure 1. Structure of assets for SC DELTA SRL

Also, based on the previously presented patrimonial elements, I have determined the specific rates for each component of the company's assets, as it can be subsequently seen.

a) Fixed assets rate

The fixed assets rate reflects the weight of the patrimonial elements that have a permanent character in the patrimony and measures the immobilization degree of the capital items.

$$\text{Fixed assets rate} = \frac{\text{Fixed assets}}{\text{Total assets}} \times 100, \text{ resulting a value of } 17.89\%.$$

From the calculation, it can be observed that the fixed assets hold a relatively reduced weight (17.89%) in the total assets of the company.

The detail of the fixed assets rate will be realized based on intangible, tangible and financial fixed assets, as it follows:

$$\text{Intangible assets rate} = \frac{\text{Intangible assets}}{\text{Total assets}} \times 100$$

By inserting the available data in the calculation formula, it results that the intangible assets rate is 1.41%.

The fixed assets rate for economical agents that act in developing countries is extremely low (under 25% of total assets), but in the case of the analyzed company, its value is 1.41% (almost non-existing).

$\text{Tangible assets rate} = \frac{\text{Tangible assets}}{\text{Total assets}} \times 100$. The calculated value for the tangible assets rate is 14.81%.

$\text{Financial fixed assets rate} = \frac{\text{Financial fixed assets}}{\text{Total assets}} \times 100$, calculated based on data from the balance sheet, has a value of 14.81%.

The following table synthesizes the resultant data regarding the structure, in absolute and relative values, of the fixed asset's.

Table 2

Structure of the fixed assets for SC DELTA SRL

Name of the item	Value (mil. lei)	Weight in total assets (%)
Intangible assets	4,081.0	1.41
Tangible assets	43,028.8	14.81
Financial fixed assets	4,887.9	1.68

The calculated data are represented in the following chart, for greater significance:

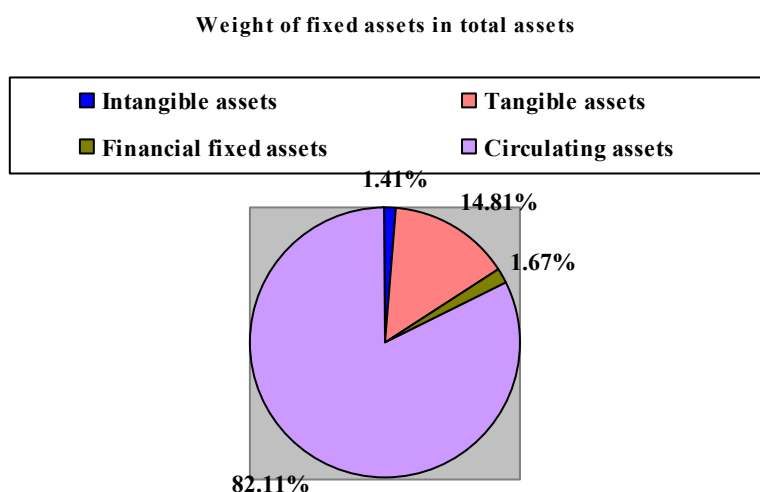


Figure 2. *Weight of fixed assets in total assets*

b) Circulating assets rate

This rate has a great significance in the activity of a firm. Thereby, I will apply it at the data from the balance sheet of the analyzed company and I will achieve the following indicators.

Circulating assets rate, given by the following relationship:

$$\text{Circulating assets rate} = \frac{\text{Circulating assets}}{\text{Total assets}} \times 100, \text{ which from calculations will}$$

have the value of 82.11%.

The analyzed company has an extremely high weight of the circulating assets in the total assets (over 80%).

In the case of the circulating assets rate too I will perform its breakdown on the main component items, in order to obtain relative structural measures. I take into consideration the rate (weight) for inventories, commercial receivable accounts, and cash for the analyzed company. The respective rates are calculated based on the formula presented below, the results being synthesized in Table 3.

$$\text{Inventories rate} = \frac{\text{Inventories}}{\text{Total assets}} \times 100$$

The value of the inventories rate is 35,32%.

$$\text{The commercial account receivables rate} = \frac{\text{Customers and assimilated accounts}}{\text{Total assets}} \times 100$$

The calculated value for the commercial account receivables rate is 25.71%.

$$\text{Cash rate} = \frac{\text{Cash and cash equivalents} + \text{Placements value}}{\text{Total assets}} \times 100$$

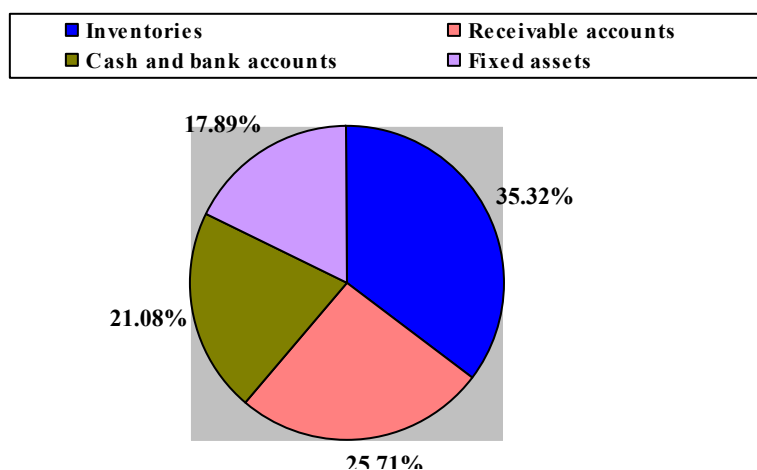
Following calculations, the cash rate is 21.08%.

Table 3

Structure of circulating assets for SC DELTA SRL

Name of the item	Value (lei)	Weight in total assets (%)
Inventories	102,594	43.02
Receivable accounts	74,695.6	31.32
Short-term investments	0	0
Cash and bank accounts	61,206.8	25.66
Total	238,496.4	100.00

For greater significance, the weight of circulating assets in the total assets of the company is presented in the following chart:

Weight of circulating assets in total assets**Figure 3.** *Weight of circulating assets in total assets*

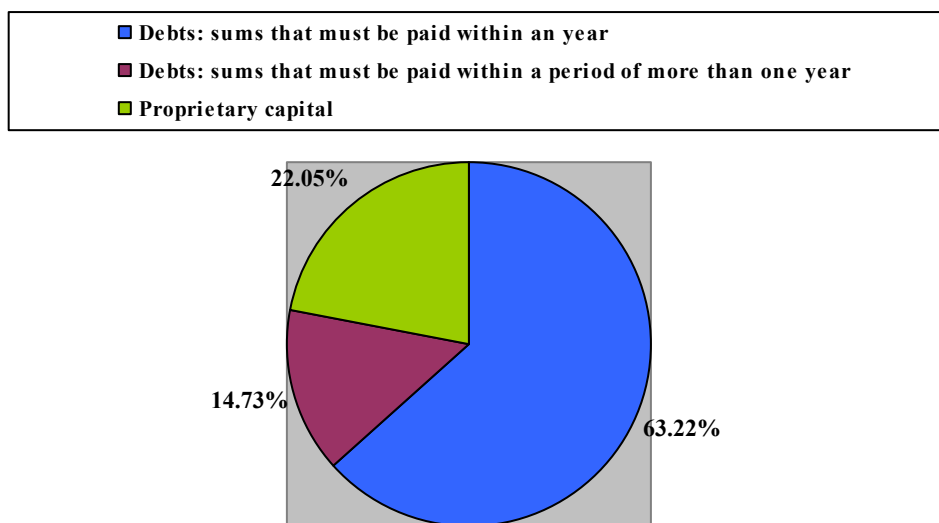
In a similar manner, by using data from the balance sheet, I have calculated the relevant indicators regarding the liabilities.

Thus, the liabilities of the company, presented in the balance sheet for 2009, can be synthesized in the following table and chart. These ones (the table and the chart) are built based on the absolute and relative data included in the company's balance sheet.

Table 4

Structure of liabilities for SC DELTA SRL

Name of the item	Value (mil. lei)	Weight (%)
Debts: sums that must be paid within an year	183,669.1	63.22
Debts: sums that must be paid within a period of more than one year	42,777.9	14.73
Proprietary capital	64,048	22.05
Total liabilities	290,495	100

Structure of company's liabilities**Figure 4.** *Structure of liabilities for SC DELTA SRL*

Following the analysis, based on calculated data (indicators), it can be observed the fact that debts due within one year hold a significant weight (63.22%) in the total liabilities.

For a better characterization of the structure of liabilities for the company, it is recommended the determination of other rates.

2. Analysis of the financial structure of capitals for SC DELTA SRL

a) *Financial stability rate*

Reflects the weight of financing sources that remain at the disposition of the company for a period of more than one year in the total coverage sources for economical means. For that, the financial stability rate was calculated, using the relationship:

$$\begin{aligned}\text{Financial stability rate} &= \frac{\text{Permanent capital}}{\text{Total liabilities}} \times 100 = \\ &= \frac{\text{Own capital} + \text{Debts on medium and long-term}}{\text{Total liabilities}} \times 100\end{aligned}$$

By using the balance sheet data as input, I have obtained the financial stability rate's value of 36.77%.

b) *Indebtedness rates*

Presents the weight of debts with a term of chargeability of less than one year in the total liabilities of the company or that of total attracted financing sources, in the total liabilities. By using the calculation relationships on the data of the company's balance sheet, we shall obtain:

$$\text{Short-term debts rate} = \frac{\text{Short-term debts}}{\text{Total liabilities}} \times 100$$

The calculated value of the short-term debts rate is 63.22%.

From previous calculations, it can be observed that short-term debts hold an extremely large share in the total liabilities of the company. Such situation can be considered extremely unfavorable for the company, this being subjected to the risk of occurrence of further difficulties following the concentration of due dates for various debts in a short time interval (less than one year).

- *Global autonomy ratio* presents the weight of proprietary sources in the total of means used for the financing of the activity of an economical agent. In practice, it is recommended that the weight of proprietary financing sources is minimum 33% of the total financing sources used by the enterprise. This indicator is calculated based on the following formula:

$$\text{Global autonomy ratio} = \frac{\text{Own capital}}{\text{Total liabilities}} \times 100$$

The value of the global autonomy ratio is 22.05%.

The value of this indicator (22.05%) is smaller than the recommended value (33%), that rises a first question mark about the future evolution of the analyzed economical agent. This situation is due to the under-sizing of the own capitals of the society, compared with the total value of liabilities, this making appeal mostly to external financing sources for the economic activity, situation leading to the occurrence of supplementary costs, not justified.

- *Total debts rate* reflects the weight of attracted financing sources in the total liabilities of the company, being calculated from the relationship below:

$$\text{Total debts rate} = \frac{\text{Total debts}}{\text{Total liabilities}} \times 100$$

The calculated value for the total debt rate is 77.95%.

The total debt rate records a value that is greater than the recommended optimum level, 67%, an elevated share of the external financing sources attracting the occurrence of significant supplementary costs. The company management has considered that the level of these costs can be supported on the account of optimal use of tangible assets acquired.

- *The general solvability rate* quantifies the risk of payment incapacity for debts the analyzed economical agent is exposed to. The minimum value of the global solvability is considered 1.4 (in the case in which the minimum weight of the own capital in total financing sources is 30%). In case the global solvability ratio is lower than 1, the company faces insolvency.

At the analyzed company, General solvability rate = $\frac{\text{Total assets}}{\text{Total debts}}$ is 1.58.

- *Financial autonomy rate* expresses the weight of proprietary resources in the long-term financial resources attracted by the commercial entity. By applying the calculation formulas, the result is:

$$\text{Financial autonomy ratio} = \frac{\text{Proprietary capital}}{\text{Permanent capital}} \text{ is } 0.6.$$

$$\text{Financial inventories ratio} = \frac{\text{Permanent working capital}}{\text{Inventories}} \text{ is } 0.53.$$

3. Analysis based on the financial balance sheet

Based on the data included in the balance sheet at December 31st, 2009, taking into account the liquidity of assets and the chargeability of liability items, for the analyzed society, the financial (patrimonial) balance can be built.

Using the information presented in the financial balance sheet, based on the considered model, I have identified the main indicators for the analysis of

the patrimonial situation: the working capital, the necessary working capital, the net treasury and the net situation.

a) The working capital

The working capital represents a safety margin of the enterprise, imposed by the differences existing between the money to be collected and the ones to be paid, and also by the gap that can occur between the term of turning assets into money and the average duration of debts becoming clearable.

With the help of information presented in the superior part of the patrimonial balance sheet, the working capital can be determined as follows:

$$\begin{array}{lclclcl} \text{Permanent} & & & & & & \\ \text{working capital} & = & \text{Permanent} & - & \text{Fixed} & & \text{Relationship that becomes} \\ & & \text{capital} & & \text{assets} & & \\ \\ \text{Permanent} & \text{working} & = & \text{Proprietary} & + & \text{Long-term} & \text{financial} & - & \text{Fixed assets} \\ \text{capital} & & & \text{capital} & & \text{debts} & & & \end{array}$$

The permanent working capital is + 54,827.3 mil. lei

The positive value of the working capital reflects a state of long-term equilibrium for the analyzed economical entity, it has the capacity to support the gap between the term needed to transform assets into cash and the average duration for the chargeability of debts.

To analyze the real patrimonial situation of the society, I have calculated the proprietary working capital, by using the relationship below:

$$\text{Proprietary working capital} = \text{Proprietary capital} - \text{Fixed assets}$$

The proprietary working capital thereby calculated has a value of + 12,049.4 mil. lei

The existence of a positive proprietary working capital demonstrates the fact that the analyzed economical entity is in a state of long-term financial equilibrium, realized on the foundations of proprietary capital.

The value of the working capital can be calculated also with the help of the elements in the second half of the patrimonial balance sheet, respectively based on the balance sheet items with a higher liquidity (circulating assets) and of the ones with lesser chargeability (short-term debts), respectively.

$$\text{Working capital} = \text{Circulating assets} - \text{Short term debts}$$

The calculated working capital records the value of + 54,827.3 mil. lei

The working capital records a positive value, meaning that the society is in a state of short-term equilibrium, having available assets with high liquidity

whose value is superior to the sum necessary to pay all the debts with chargeability within a year.

b) The necessary working capital

This indicator reflects the value of short-term assets, regardless the nature of the inventories and receivable accounts that are not financed from short-term attracted sources. I will use the following calculation formulas:

$$\begin{aligned} \text{Necessary working capital} &= \text{Short-term assets} - \text{Short-term liabilities} \\ \text{(NFR)} & \\ \text{that becomes} & \\ \text{NFR} &= \text{Inventories} + \text{Receivable accounts} - \text{Operational debts} \end{aligned}$$

The value of the necessary working capital is – 6,379.5 lei

The necessary working capital records a negative value, meaning that the short-term assets are totally covered by high-chargeable financing sources, and that, furthermore, partially finance the permanent assets (current debts are exclusively operational debts). Such situation is appreciated to be favorable to the company being the direct consequence of the application of a correlation strategy between the periods necessary to transform circulating assets in cash with the terms for paying the debts.

c) The net treasury

The net treasury allows the reflection of the correlation between the working capital and the necessary working capital, by identifying the financial situation of the analyzed economical agent, both on long-term and short-term.

In the case of the analyzed society, the net treasury can be determined with the use of the relationship:

$$\text{Net treasury} = \text{Working capital} - \text{Necessary working capital}$$

The net treasury records a positive value (61,206.8 mil. lei) and indicates a status of financial equilibrium at the level of the company. This value of the net treasury is the direct consequence of a financial surplus occurred during the year 2009 and, implicitly, of a profitable activity of the company during the period subjected to financial analysis.

The net situation of the company is important because it reflects its solvability at a given moment and for this the following relationship is used:

$$\text{Net situation} = \text{Total assets} - \text{Total debts} = \text{Proprietary capital}$$

A positive value of the net situation reveals the fact that the analyzed economical entity is sound (the calculated value is 64,048 mil. lei).

d) Indicators regarding the liquidity and rotation speed

The financial analysis, performed based in the information included in the balance sheet at the end of 2009, can be extended also by calculating a set of *specific indicators*, regarding the liquidity and rotation speed of the capital through the turnover. In the following topics, by using the calculation relationship, I have obtained the mentioned indicators.

- *The current liquidity* measures the capacity of the economical entity to pay the long-term debts by using short-term assets from the balance sheet. By using the relationship

$$\text{Current liquidity} = \frac{\text{Current assets}}{\text{Current debts}}, \text{ we obtain a value of 1.29.}$$

The value recorded by the current liquidity represents an alarm signal regarding the capacity of the company to honor its due short-term debts (the optimal value is 1.5-2). In that situation, the company must borrow funds or sell a part of the fixed assets to pay its debts.

- *The immediate liquidity* measures the capacity of the company to pay its short-term debts by using the most liquid assets of the patrimony.

By using the balance sheet data in the relationship

$$\text{Immediate liquidity} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current debts}}, \text{ we obtain the value of the}$$

indicator equal to 0.73.

For this indicator too the sub-unit value (compared with the optimum value 1) represents an unfavorable aspect for the company, respectively the high-liquidity assets are not enough to cover the short-term debts, no matter the real value of the inventories.

- *The on sight liquidity* is calculated with the relationship:

$$\text{On sight liquidity} = \frac{\text{Treasury assets}}{\text{Current debts}}$$

Based on the balance data, the resultant value is 0.33.

This indicator shows that the treasury assets represent only 33% of the total current debts. It has to be taken into account that this liquidity must be more severely controlled, to avoid the creation of difficulties for the company in the relationships with the creditors (those the company owns its current debts).

- *The rotation speed of the debts-customers* allows the valuation of the performances of the economical entities in which regards their relationships with the beneficiaries, having a special importance in the case of credit-selling companies (commercial credit). The duration of a rotation of the debts-customers is calculated as a report between the average balance of the customer

account and the turnover dedicated to the patrimonial item “debtors-customers”, report multiplied by 365 (the calendar days of the year).

By using the data in the relationship
 Rotation speed of the debts - customers = $\frac{\text{Customers balance} \times 365}{\text{Turnover}}$, we obtain a measure equal to 138 days.

- *The rotation speed of the fixed assets* through the turnover evaluates the efficaciousness of the management of the economical entity in which regards the usage of these patrimonial elements in obtaining income. The following relationship is used: $\text{Rotation speed of the fixed assets} = \frac{\text{Turnover}}{\text{Fixed assets}}$.

The available dataset leads to an indicator equal to 3.79 (times).

The recommended value for this indicator must be above 1, so it is ascertained a favorable situation for the company, taking into account the recorded value of 3.79.

- *The rotation speed of the total assets* is an indicator that reflects the efficiency of use for the assets from the patrimony of a company and is given by the relationship:

$$\text{Rotation speed of the total assets} = \frac{\text{Turnover}}{\text{Total assets}}$$

From calculation, I have obtained the value of 0.68 that reflects an average rotation of the total assets.

e) *Analysis of the company's profitability*

- *The return on equity (ROE)* of the proprietary capital emphasizes the return of the placements made by the company's shareholders through the acquisition of company's shares. The profit, an important financing source for the development of the activity, represents a component of the enterprises' capital, remunerating, in the first place, the participation of shareholders, through dividends. It is calculated with the relationship

$$\text{Return on equity} = \frac{\text{Profit after taxation}}{\text{Proprietary capital}} \times 100.$$

From calculation, a value of 5.53% results.

The value of this indicator must be above 5%, so it can be stated that the company's activity was effective from the point of view of shareholders' equity capitalization.

- *The profitability rate of the advanced capital* is determined as a report between the current profit of the fiscal year and the advanced capital (fixed and circulating), by using the relationship.

$$\text{Profitability rate of the advanced capital} = \frac{\text{Current result}}{\text{Fixed assets} + \text{Circulating assets}} \times 100,$$

based on which I have achieved a value of 1.43%.

Based on the measure recorded by this indicator in 2009, it can be observed a less-than-sufficient capitalization of the advanced capital within the analyzed period.

- *Commercial margin rate*, given by the relationship

$$\text{Commercial margin rate} = \frac{\text{Gross profit}}{\text{Turnover}} \times 100, \text{ leads to a value of 2.11.}$$

Taking into account the fact that the value recorded by the company is greater than the value recommended for this indicator (>1.8), it can be stated that its activity in 2009 was profitable.

- *Economic profitability*

The economic rate of return is calculated based on EBIT (EBIT = Earnings Before Interests and Taxation), by using the formula:

EBIT = Total income – Total expenses (not including interest-related expenses and the profit taxation)

$$\text{Economic rate of return} = \frac{\text{EBIT} - \text{Profit taxation}}{\text{Economic assets}} \times 100 = \frac{\text{EBIT} - \text{Profit taxation}}{\text{Fixed assets} + \text{Net current assets}} \times 100$$

Also, the following calculation formula can be used:

$$\text{Economic rate of return} = \frac{\text{Net Profit} + \text{Interest}}{\text{Proprietary capital} + \text{Financial debts}} \times 100$$

In 2009, the calculated value of the indicator was 2.78%, reflecting a positive evolution.

In the topics presented above, I have pursued the synthesis of a model of financial analysis for the company's performance (I have exemplified the theoretical aspects by applying them to the concrete study of a company), based on a system of correlated indicators. It results that such analysis model is easily to be applied, the data from the balance sheet and its annexes being sufficient.

Also, I appreciate that the analysis can be deepened or resumed to a smaller pool of indicators, depending on the objective pursued in the management of the company.

Note

⁽¹⁾ SC DELTA SRL is conventionally assigned, from confidentiality reasons, the data being obtained from a real company.

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