

# PLEADING FOR A NEW TAX STRATEGY

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**Abstract.** *Especially in recent years we witness, not only in Europe, but even worldwide, the worsening of monetary, fiscal and budgetary processes. It's equally true that in the world doesn't exist a perfect system of public governance, and the current tax system is unfair, fragmented and, above all, ineffective.*

*The economic imbalances worsening, the prolonged crisis and the slow economic recovery entitle us to rethink the relationship between state's power to tax and the taxpayer's ability and willingness to pay taxes. Given the significant asymmetry of this report, the more active involvement of citizens in the constitution of the state budget resources, and setting limits on government spending and budget deficit would be likely to provide a sustainable insight not only to public finances, but even to the economy as a whole.*

*Such ideas are increasingly intense promoted by economists and businessmen from many countries, going as far to the introduction in the Constitution of provisions regarding GDP destinations, the introduction or increase of some taxes or the public debt levels. Setting the maximum deficit and debt limits government's power and makes it more responsible in the public resources management. The introduction of these rules in the Basic Law also prevents governments' arbitrary in economic circumstances and changes caused by short-term interests.*

**Keywords:** *economic transmission mechanisms, conditional probabilities, flexible behaviours.*

## 1. Introduction

The United States of America, a country that has long tolerated an unnaturally high public debt, is now reaching the maximum leverage, which caused it to increase the legal ceiling, in the same old compromises line, in order to avoid the entry into payment incapacity. Not at all surprising, this debt has increased by 72% within only five years, reaching

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a 92% share of GDP, almost equal to that of Portugal. Federal Reserve President<sup>1</sup> from Dallas – Richard Fisher, appreciates that the United States are on the road to insolvency, remains just the answer to when it will occur. And Timothy Geithner, US Treasury Chief, declared that "Our Deficits are too high. They will not be solved by economic growth and, if left unresolved, will affect the pace of development in the future. "And he speaks of the need for a more sustainable budget that would allow the US "to do the essential things".

The situation in the US is a concern for the world community as a whole, in anticipation to some of the FED decisions with implications beyond the boundaries of the country. Other countries, like Greece, Portugal and Ireland are also close to bankruptcy situations, while Spain and Italy also seem to expect it. Budget deficits and public debts have reached huge sizes here, unthinkable a few years ago. Ireland recorded a record budget deficit for the entire euro area, 32.4% of the share in GDP. In the case of Greece the budget deficit was 10.5% in 2010 (13.6% in 2009), and the Government debt of 143% relative to GDP, with growth prospects. The loans, regardless of their source, provide a breath of oxygen but growing indebtedness to unprecedented levels. And images with tens of thousands people marching in the streets of the capital of Greece and other cities, expressing their disapproval with the austerity measures, which have become a fact of daily life, tend to extend dangerously.

The European Union, the European Central Bank and the International Monetary Fund agreed to support these countries and, in the case of Greece, even supplementing aid. Alternative financing costs in the financial markets would be far too large and would increase even further the already excessive debt. The question arising is how effective are these credits and if in fact they only postpone a horrifying denouement, even if they are offered in exchange for the commitment to implement austerity and public finances reform programmes.

The consequences of such situations cannot be only short term. Many analysts believe that the world will sink into a long-term deficit crisis, difficult, if not impossible to manage. Regardless of the actions, more or less concerted of the governments and international financial institutions, which recover what they claim to have learned from previous events and innovates measures in bail-out programs, to require changes in attitudes and corporate behaviour, especially public behaviour. The initiation of

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<sup>1</sup> One of the 12 institutions belonging to the EDF.

these programs is the new cornerstone of the crisis treatment. And it doesn't seem to be enough. What needs to become more important is the change in corporate, but especially in public attitudes and behavior. Thus, one can hope that other recessions to find the governments more prepared to react.

## **2. Romania's tax system**

With an open economy, it was impossible for Romania to avoid being affected by what happens abroad. But also it created premises for which generated the same and other imbalances, which overlapped the internal crisis over the imported elements. Since the crisis began in 2008, Romania has doubled its debt to a level of 40% of GDP. If we admit what some standards say about the debt tolerance to the level of 60% of GDP, than the rate at which the debt has increased in recent years should inspire fear. And not only fear but also rethinking of the fiscal strategy. On the other hand, the same three-year period was marked by the adoption of decisions, at least at first sight contrary to the course of economic processes and phenomena, such as introducing a minimum tax<sup>2</sup> charge of bankruptcy or closure of a large number of small and medium companies or increasing the added value tax – recently recognized as an economic and ethical error. The last measure took into account to obtain additional income to the budget, as confirmed in the short term, but the paid price was higher prices and the consumption fall.

The economic imbalances worsening, the prolonged crisis and the slow economic recovery entitle us to rethink the relationship between state's power to tax and the taxpayer's ability and willingness to pay taxes. Given the significant asymmetry of this report, the more active involvement of citizens in the constitution of the state budget resources, and setting limits on government spending and budget deficit would be likely to provide a sustainable insight not only to public finances, but even to the economy as a whole.

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<sup>2</sup> The minimum tax was introduced in spring of 2009. The Government intended to replace the minimum tax with a flat tax, restricted only to those areas where tax evasion cannot be fought, but the measure was postponed.

increase of some taxes or the public debt levels. Setting the maximum deficit and debt limits government's power and makes it more responsible in the public resources management. The introduction of these rules in the Basic Law also prevents governments' arbitrary in economic circumstances and changes caused by short-term interests.

Currently, in Romania citizens' legislative initiative on tax matters is not possible. Article 74, paragraph 2 of the Constitution states that: "There may not be subject to citizens' legislative initiative the matters concerning taxation, international affairs, amnesty or clemency". In terms of new initiatives such provision would be eliminated and enabled the community consultation on tax issues by the referendum institution.

A working group associated to the H. Rusu Foundation suggests the following phrasing regarding voters' consultation on fiscal issues: "The public administration authorities, central and local, must obtain voters approval in advance, by general or local referendum, for any tax or fee general or local, for the tax rate change, for the extension an expiring tax or fee, and for any other change in fiscal policy which can generate a revenue increase. For the existing general and local taxes at the date of the Constitution's approval, except those that cannot be repealed because they are included in the treaties concluded by Romania with the European Union, should be approved by general or local referendum to be held within maximum of one year from the approval date of the Constitution. General and local taxes that will not be approved by referendum will be repealed in maximum two years from the date of the referendum"<sup>3</sup>.

The exercise of the consultation democratic right would be associated with awareness, education and empowerment of the community. The government's power restriction and empowering the citizens in this direction would change, among others, citizens' optics of perpetual government's guilt for the failure of welfare, derived from too much tax. In addition, increase the chances of a fair sharing of the tax burden, based on clear rules and standards shared by the population.

All this and others are truths that have found their first and perhaps the best form in the writings of Adam Smith, economist and philosopher, one of the fathers of economics and classical liberalism:

*"The tax which each person is obligated to pay must be well-defined and not arbitrary. The period of payment, the method of payment, the*

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<sup>3</sup> <http://www.fundatiahoriarusu.ro/wp-content/uploads/Fundatia-Horia-Rusu-Carta-Responsabilitatii-Fiscale.pdf>

*payment amount must be clear and obvious, both for taxpayers and any other person. [...] The uncertainty in taxation encourages insolence and favours corruption for a category of people who are so, naturally, unpopular, even when they are neither insolent nor corrupt. Each individual's safety on what to pay is, in terms of taxation, of so much importance that a high degree of injustice, – as you can see, I think, from the experience of all nations, – is a much smaller evil than a lower level of uncertainty.*

*Any tax should be designed so as to remove and dispose of the pockets of people as little as possible, over as long as the public can bring the state treasury. A tax may either remove of the population's pocket or to remain out of the pockets of the population much more than it brings into the public treasury, in the following four cases: first, its perception may require a large number of officials, whose salaries may absorb most of all taxes and whose gratification may be an added tax to the population.*

*Second, the tax payers can hamper the economic activity and may discourage them from their occupations in certain business sectors that can ensure the existence and occupation for a large part of the population. [...]*

*Thirdly, through fines and other penalties which those unfortunate taxpayers bear, trying unsuccessfully to evade the payment, those can often be ruined and thus to end the benefit that the society could get of using these taxpayers' capital. A reckless tax calls for fraud and the fraud penalties are increased in proportion to the tax evasion tendency. The law, contrary to all basic principles of justice, first creates the temptation and then punish those who obey it. [...]*

*Fourth, the fact that exposes people to the frequent visits and odious research of the tax officials, tax can expose them to completely unnecessary hampering, to insult and oppression; [...] In one or another of these four cases the taxes are often more damaging for the people than profitable for the sovereign”<sup>4</sup>.*

Fiscal developments in recent years in Romania seem to meet all of a counterproductive tax system features presented by Adam Smith. Romania is a champion in Europe for the number of taxes and charges. The World Bank has identified in Romania nearly 100 taxes that local companies pay, which represents more than in any European Union country. Many taxes

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<sup>4</sup> A. Smith, 1992, *Wealth of Nations. Research on the their nature and causes*, Universitas Publishing, Chisinau, 1992, Book IV, pp. 243-244.

regard the labour force and have monthly character. In addition to these requirements, the companies have to pay other 100 fees, the so-called parafiscal charges. As a result, some companies pay about 200 taxes in Romania. The Ministry of Finance estimated that, overall, businesses and individuals taxpayers pay 420 taxes and charges. The present situation is an extreme one if we consider that in Sweden, for example, companies pay only two fees. With more tax liability for taxpayers stands Poland where are perceived about 40 taxes<sup>5</sup>.

Much of taxes in Romania generate much higher costs than the revenues to the budget. In strictly economic perspective such taxes should be abolished.

Beyond the reduction in employment and investment motivation, the payment of a large number of taxes causes a high number of hours for tax compliance. From the perspective of the payer, regardless of its quality – natural or legal person – it is a waste of resources leading to either default or delay; either to avoid the payments to the budget. Time wasted in Romania is around 200 hours, which places our country at the top of a ranking on this issue.

The initiative of approving by referendum of the introduction or modification of taxes has been promoted in countries with stable democracy, as the U.S., Switzerland and Finland. In the U.S. there are provisions in a number of states to limit public spending and tax revenues. In Finland an increase in taxes for a period exceeding one year requires a vote in Parliament of two-thirds of its members.

The call for the referendum institution as an instrument of direct democracy in the introduction of certain taxes and charges make possible correlation between “the price” paid by taxpayers for the authorities to provide public goods and services and the benefits derived from their consumption. Such a solution is in the spirit of the vision of Knut Wicksell<sup>6</sup>, known as an important predecessor of the public choice school. He claims that the collective action is based on the aggregation of some individual characteristics, as preferences. The individuals are guided by self-interest and rational maximizers of utility, while in political decision are involved reasons regarding voters, politicians and government officials. Wicksell rejects the anthropomorphism and promotes the individualism.

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<sup>5</sup> For example, when buying a car are paid registration tax and town hall tax, first registration fee, the fee for the Police numbers, tax for provisional numbers from the dealer, coupon fee and if the car is from domestic production, is paid the card’s classification fee to RAR.

<sup>6</sup> Swedish economist (1851-1926).

The state cannot be considered a rational human being who can take decisions on behalf of individuals. Only they are able to support and promote their interests.

Comparing the two types of democracy, direct and representative, it is clear that the size of expenditure, income and public debt is significantly lower in the first case than in the second<sup>7</sup>. In other words, the relationship of Wicksell is present more in direct than in representative democracies. If there is consensus regarding the favourable effect on the economy following a lower level of public debt, when we talk about the expenditures and revenues there is disagreements. A lower level of expenditure is justified by lower income earned on budget, on behalf of lower charges. And if the economic agents give a lower proportion of their income, they are able than to support a range of costs for services which were traditionally financed from the budget. And they can do it better than the state. And the latter requires fewer resources to finance their own programs. If we admit that the level of income and consumption taxation could fall and the public resources would be managed more effectively, then two defining variables can occur in the size of public expenditure, namely the anticipated dynamics in prices and the population dynamics. An interesting calculation formula for revenue and public expenditure was promoted in the U.S. and the legislation in question is known as TABOR. We briefly present this approach and some of the consequences of its application.

The Taxpayer Bill of Rights (TABOR) aimed to limit the power of government in the fiscal area and to correlate the revenue collection for the budget with the inflation and population dynamics. More specifically, it was about their increase in a size equal to the sum of inflation rate and population growth rate. The supporters of the initiative came from among the conservatives and libertarians.

The most famous example of TABOR legislation is the one applied in Colorado since 1993. In this state the voters have amended Article X of the Constitution restricting the central and local revenues. Only the electorate vote allowed both the tax increases and budget revenues spending beyond the dynamics resulting from inflation and population growth. The revenue beyond this limit could be returned to taxpayers or kept but only after a referendum.

Following the adoption of TABOR, a series of proposals to increase taxes at the state level in the 1990's were rejected by referendum. In

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<sup>7</sup> Lars P. Feld, Gebhard Kirchgässner, *The Role of Direct Democracy in the European Union*, CESIFO Working Paper No. 1083, February 2003, p. 14.

contrast, other proposals to increase local taxes were approved. Between 1997 and 2001, the state of Colorado reimbursed \$ 3.2 billion to the taxpayers, money that could otherwise fund (pre) academic education, public health, public transport, safety and other public services. Other important effects produced in the next 10 years were the slowdown of both tax revenue and government expenditure compared to the previous pace of the legislation application, a better correlation between the size of government sector and the demand for public services and the savings rate increasing in personal income with favourable impact on investment and employment.

Subsequently, the spending of public resources was relaxed, at least for education, with the cost of lower funding for other public services. Other restrictions of TABOR were later removed after a new referendum, and the framing in revenues associated to the compliance of the correlation with the prices and population dynamics was still observed.

The Colorado experiment was considered as a confirmation of the positive effects derived from tax cuts. Proponents claim that the introduction of this system explained the achievement of a higher level of economic growth registered by the state Colorado than the U.S. In addition, the system ensured the financial independence, being considered as very democratic and transparent.

An interesting fact about promoting TABOR legislation was that it wasn't stipulated any relation to the productivity dynamics and, therefore, the additional revenue derived from increased productivity in terms of a constant population were not taxed and didn't bring any additional income to the budget.

Looking at things from a mathematical and economic point of view, the respect of this formula leads to the reduction in public expenditure in real terms per capita. This decrease can be accepted taking into account the intention of lowering the public spending while increasing the possibility of funding from individuals of previous costs to the State, in the context of the taxation level decreasing.

### **3. Conclusions**

We believe that keeping the public spending in real terms (the strict correlation of nominal spending with inflation) and then increase it with the population index might be a useful formula. In this way the public expenditure per individual remain constant, which may be admitted at least at the start. This does not preclude that when the population decreases to



reduce the public expenditure. As a result, the population variation must be reflected in the absolute level of the public spending and not in the real one.

However, a public spending formula that takes into account the variables mentioned above is preferable to establishing and targeting a fixed percentage who ignores the economic and demographic context and can cause of the worst adverse effects, especially when both inflation and population dynamics are significant. Other advantages of using a formula dependent not only to the variation of economic sizes consist of avoiding the manifestation of political discretionary power, along with the responsibility of the political class. Recognizing that the forecasts regarding economic growth and population evolution are made with enough accuracy, the anticipated and grounded calculation of state's expenditure is another important advantage. Thus the tax system acquires more safety and transparency, virtues often ignored.

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