

## **PUBLIC POLICY AND TAXATION**

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**ABSTRACT:** *The state administration process and hence also the economy coordination effort requires the promotion of robust, consistent and transparent public policy, which must be accepted by all stakeholders of economic development. Public policy is a set of measures taken by the authorities legally constituted as public power. Under normal conditions these policy aims at improving living conditions of citizens by developing grounded strategies which are applied by measures implemented to stimulate economic development in all its complexity by harmonizing the efforts of the institutional and non-institutional bodies responsible for ensuring the overall public interest. In Romania, public policies, especially fiscal ones on which we dwell, not reached in many cases the expected effects primarily because of their superficial grounding, lack of transparency, unpredictability, poor communication and secondly as an effect of ineffective management of public financial resources.*

**KEY WORDS:** *economy coordination, public interest, state involvement, degree of compliance, streamline the budget process.*

**JEL CLASSIFICATIONS:** *H20, H21.*

### **1. INTERRELATION PUBLIC POLICY, PUBLIC POWER AND TAXATION**

Relevant literature develops concepts for public sector regarding public power, public order, public security, public interest, public services etc. and gives them different meanings, the purpose and the nuance being fingerprinted by the political factor with reference to the intensity of public policies promoted and implemented in a given time interval.

Among the concepts outlined, the public policy has a variety of definitions, which start from simplistic approach - which governments choose to do or not (Dye, 1992, p.4) - to general approaches - a course of action for a specific purpose, followed by an actor or group of actors in addressing a problem (Anderson, 1994, p.5) or to approaches that account for the development of a decision-making process, meaning

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that - a public policy is a network of interrelated decisions on the choice of objectives, means and resources allocated to achieve their specific situations (Miroiu, 2001, p. 9).

A key aspect to consider in policy making is that it is designed primarily as an analytical process (problem solving) and at the state level is always a political process. In turn, the economic doctrine developed this approach and accepted that, "politics and policies are not independent factors, but elements of the social process" (Schumpeter, 2011, p.76.) and government action should be seen as an external factor for the business world.

Although the approach is typical for the 1950s, it remains timeless, maybe just to demonstrate the persistence of some concepts.

During the process of developing the public policy, of major importance is the relationship of the public power with the general public interest in the sense given by Professor A. Iorgovan who defines public power as "all credentials (special rights, exorbitant) that public authority is endowed, in order to represent and defend the public (general) interest, which must prevail over individual interests (Iorgovan, 1996, p. 90), and, in agreement with the view expressed above, the public interest results from "those activities that are necessary to meet a social need, judged as by the political power" (Iorgovan, 1996, p. 92).

The conclusion that emerges is that meeting a social need is the very rationale of the public administration's existence, and its recognition as public interest necessarily involves government regulatory actions which incumbent legislative obligations, actions and in the same time liability for the government task.

From the given perspective, public power is a specific attribute of public authorities in the sphere of the three power of a state (legislative, executive and judicial) that demonstrate their effectiveness only if and when they respond to interest of the general public.

A specific for the public administration is that public authorities adopt unilaterally enforceable administrative acts that run directly, and authorities reserve their right to resort to coercive force through various instruments including which fiscal (taxes) have a major role.

In the state law cited we witness also a reverse phenomenon whereby citizens have legal protection against possible abuses of government and in doing so have various remedies against government as such administrative court, ombudsman, etc., institutions that must be understood as part of the public authority with aim to address the public interest and not exterior elements.

The technical means of implementing public policies are general regulations of the Romanian Constitution, organic laws and other normative acts (decisions, decisions, regulations, orders, etc.) by which social and economic environment is stimulated or discouraged. Referring to the quality and the way how these regulations are complied with and implemented in Romania, there are opinions that say that "The lack of well-developed regulations and low involvement of state and community are the main reasons for which Romania can be categorized as a "refuge of criminals" (White, <http://www.zf.ro>).

The issues presented are found also in the vast field of taxation namely how the tax policies promoted and implemented do not always prove their efficiency.

*In the quoted area, the development, encouragement and implementation of public policies is particularly complex* and disagreements, contradictions and even conflicts are generated by the difference between the legitimate interests of the state to collect financial resources for covering political interest, which is at odds with general public interest, namely, the real social needs. Any of the cases economic development is influenced.

An example that can be given is the opaque allocation of public funds that encourage migration of central and local politicians to other parties, unpredictable changes in tax laws by expanding the tax base on special construction or the discretionary establishment of the fuel over-excite for different payers. Other examples are those related to obtaining benefits for different categories such as exemption from paying arrears or their conversion in state shares in state companies, even though they hold monopoly in key areas of the economy.

The risk of this approach is an increased doubt in political leaders and a conflicted position of different social categories.

In the current Romanian government fiscal policies must be inextricably linked to the construction of a new economic model imposed by the rules of the free market and the fact that natural and productive resources are limited, social needs are continuous and endless and that the state structure is often challenged due to inefficiency of public policy.

The admitted reality that the market does not work perfectly provides the first function to the public policy, namely *to correct its imperfections*, and public action aims to intervene to eliminate malfunctions and, more difficult, to reduce social inequalities that have accentuated lately as a result of inequitable distribution of the welfare.

## **2. THE ECONOMIC RELATIONSHIP BETWEEN PUBLIC POLICY, BUDGETARY COLLECTION, TAXATION AND TAX EVASION**

Efficiency or inefficiency in taxation policy is demonstrated by the level of taxation that impacts the collection level of the budget revenues and the tax evasion directly. Economic theory and practice demonstrates that high taxes lead to low collection and high evasion.

It is revealing in justifying the claim that important tax changes (Moldovan, 2014) in 2013 materialized in increasing fiscal impact in 2014, although these measures were aimed at obtaining additional income from general government, the result was not successful.

In the first half of the year, the collection budget was only 15.2% of GDP versus 15.5% of GDP in the same period of 2013 or versus the first half of 2011 when this indicator was 16% (<http://www.zf.ro>, 29.07.2014). These results rank Romania as the European state with the lowest share of budgetary revenues to GDP. In the European Union the average income to GDP is 45.7% (Consiliul fiscal, [www.zf.ro](http://www.zf.ro), 29.07.2014) and for the whole year 2013 the total revenues of the consolidated budget

of Romania was 31.8% of GDP. The year 2013, in terms of budgetary collection, was one of the worst years in a decade (<http://www.zf.ro>, 29.07.2014).

In the expressed purpose is relevant also the analysis of the Fiscal Council (<http://www.capital.ro>, 20.09.2014) regarding the evolution of the compliance payment during 2003-2013, as shown in the chart below:



**Figure 1. The degree of tax compliance (%)**

It is observable in the chart that the payment compliance has continuously felled after 2006 until 2010 with a stabilization starting with 2012.

This year, the revival is expected from the collection of about RON 1.4bn due to broadening the tax base of the special constructions, at a level that is triple to the initial estimations, and due to the establishment of the fuel over-excise.

Regarding these measures is important to highlight how poorly the fiscal policies are grounded and applied. The estimation of the Public Finance Ministry for the collection from special constructions was of RON 488mn but amounts declared by the payers were three times higher (RON 1.45 billion) and at the first payment due RON 710.4mn were collected. The fuel excise duty was three months postponed and modified by the implementing rules pursuant to the discretionary decision to refund a portion of it to large carriers. In the second quarter, fuel excise collections were, after the fuel duty, lower with RON 387mn versus the first quarter.

Both fiscal measures were justifiable criticized since they increased the tax level and the fiscal uncertainty, create discomfort to the payers and did not encourage the economic development (e.g. taxation of the special constructions in agriculture). In the analysis of the budget collection level, we can see a number of inaccuracies from:

- The reduced VAT collection level: although retail sales increased by 08.2% in the first months of the year versus the same period of the last year and VAT collection increased by only 1.9%
- The reduced tax income level: collections increased by only 0.6% in the first 6 months versus the same period last year while the social contribution collections increased by 5.6%, the medium wages increased by 4.8% and average employee number by 0.8%

The reasons for these poor results are considered as due to:

- excessive taxation
- lack of performance of the fiscal collection
- low liquidity level of the payers
- low economic activity resulting from low domestic demand
- the general approach to the economic development
- decreasing bank financing

A part of these causes are identified by the business, which following an internal survey in March and April 2014<sup>1</sup> identifies as the main difficulties that impact the performance: excessive taxation, inflation and decrease of the domestic demand.

It is to be highlighted that, in Romania, the taxation is considered as high although stays below the European level and that is because it creates discomfort by its unpredictable nature and from this perspective leads to high evasion.

It is relevant the situation produced from the increase by 250% in July 1<sup>st</sup>, 2010 of the excise to the intermediary alcoholic beverages with the purpose of harmonization with EU level which resulted in the decrease by 97%<sup>2</sup> of the taxed alcoholic production, the rest resulting in counterfeit production. The Fiscal Council finds that despite the increase of the excise to the alcoholic products starting 2007, the tax collections had increased by a very small amount in the same period and were converted in evasion.

An issue remains the taxation of the labour force in Romania; the total contribution due by both the employer and employee is 4% higher versus CEE average and ranks as fourth (<http://www.zf.ro>, 07.07.2014). By the level of the contribution to the pensions system, Romania ranks first with 31.3% (20.8% charged to the employer and 10.5% to the employee).

The reduced economic activity resulted from the low domestic demand is proved by the number of companies that are closing the business as presented by the Trade Office (<http://www.capital.ro>, 08 august 2014). The data shows that during the first five months of this year, the number of companies that went insolvent is still high (11,030), although it dropped by 13.5% versus the same period last year, the number of companies closed diminished by 26% to 7,531 and the number of companies with suspended activity dropped by 29.5% to 7,546. In this context it needs to be said the big number of insolvent, closed or suspended companies is clearly linked to evasion and the control of the fictitious import/export activities, made for VAT recovery or avoidance of the arrears payment, remains an area where the tax inspection can be easily increased.

The relative positive results are due to the enactment of the new insolvency law that makes more difficult to declare insolvency as protection against creditors, state obligations or loans repayments.

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<sup>1</sup> Of 1,569 respondents entrepreneurs, identifies challenges affecting SMEs: 58.06% excessive taxation, inflation (55.45%) and lower domestic demand (55.39%), in 2013 the order was: decreased domestic demand (70.8%), excessive taxation (54.25%) and inflation (50.27%). [http / www.capital.ro](http://www.capital.ro), May 13, 2014 <http://www.capital.ro>, 13 mai 2014.

<sup>2</sup> according to representatives of the National Vine and Wine Employers <http://www.capital.ro/> September 23, 2014

With regards to the approach on economic development, it can be said that this is rather discouraged. It is relevant that in 2014, the construction market decreased as a result of the drop in public investments and the financing of public expenditure in electoral interest (<http://www.zf.ro>, 22.09.2014). The economic development is negatively impacted and so is the EU funds absorption level which has become chronic for the public administration.

The decreasing bank financing is proved by the reduced financial intermediation level of the Romanian banking system. In 2007 Romania's financial intermediation level, as bank assets to GDP, was of 60%, in 2009 of 67% and in 2013 of only 57% (<http://www.zf.ro>, 06.07.2014), although the banking system has enough liquidity and solvency. Loan demand is reduced as a result of the reduced degree of the companies to invest.

Fiscal public policies influence the level of fiscal evasion, estimated between 16-28%. According to the analysis of the Fiscal Council (<http://www.zf.ro>, 29.07.2014), this was 16.2% of GDP in 2013 (EUR 22.7bn), decreasing from the 16.7% 2012. The highest evasion is registered at VAT with 12.2% of GDP (close to EUR 17bn) and social insurance (2.4% of GDP). An EU study, Moneyval, estimates the underground economy at 30% of GDP in 2011, decreasing from 28.4% (<http://www.capital.ro>, 08.08.2014). The estimated losses for the public budget due to underground economy are estimated at EUR 40bn.

### **3. FISCAL POLICIES FOR ECONOMIC DEVELOPMENT**

Streamlining the budgetary process through increased collection in order to support economic development, requires adequate public policies to increase consumption and resume economic activities.

Within this framework worth mentioning following fiscal measures that may contribute to the recovery of economic activity, but a number of risks remain:

- Reducing Social Security Contributions (Law no. 123/2014) with five points, starting with October 2014 wages carry the risk to lead at excessive budget deficit or taxes increase in 2015. Budgetary income earned after the reduction will decrease by 3-4 billion lei annually. Compensation measures to keep the budget deficit in next year's proposed target of 1.4% of GDP, will focus on tax hikes, reducing expenses etc. The effects can be offset by additional budgetary revenues resulting from the reform of revenue collection and economic multiplier effects from increased investments and creation new jobs, conditioned by the maintenance of the Social Security Contributions and other taxes at the same level,
- New state support scheme, which allocates 100 million Euros / year by 2020, to co-finance investments with major impact in the economy to stimulate confidence to the business environment.
- Ministry of Economy's strategy to increase competitiveness by identifying and supporting the development of 10 priority sectors by 2020.

- Tax exemption for profit reinvested in new technological equipment purchased after July 1, 2014 and operated until December 31, 2016 inclusive<sup>3</sup>, in order to stimulate investment in new technologies. Note that the exemption has been previously given in 2009-2010 without particular effects because of its restrictive features.
- Cancellation 92 taxes with low budgetary impact<sup>4</sup>, which will reduce bureaucracy.

The fees to be waived include: the rate for a simple electronic passport, or other documents required to cross borders (22 lei), setting company guidance assistance rate (19.8 lei per hour), some charges levied by the National Trade Register, tariff to access documentation concerning anticompetitive practices investigations charged by the Competition Council etc.

These measures should be accompanied by streamlining fiscal control and strong measures to combat tax evasion such as the regulation of electronic payments, which provides greater control over payments recorded directly in the company accounts leading to higher transparency, as implemented in Austria, UK, Netherlands etc. An increase electronic payment by 10% per year for four consecutive years would result in a reduction of the shadow economy by up to 5%, say representatives of Visa Europe (<http://www.capital.ro>, 07.07.2014).

National strategy, launched by Visa Europe, to promote and encourage electronic payments in the public sector, aims an increase from 33% to 40% of GDP in the four-year horizon. In developed countries such as Austria, UK and the Netherlands per capita annual averages to about 300 electronic transactions, while Romania and Bulgaria average only 16 electronic transactions annually.

Approach for economic development, given the macroeconomic stability observed in Romania, offers a positive view also on the labour market amid slight decrease in unemployment, but unfortunately, also due to the decrease in the number of inhabitants as a result of migration. In this respect it is relevant that, according to the National Institute of Statistics, the employment rate of the population aged 15 to 64 reached 61.2% in the second quarter of 2014, up 1.7 percentage points from the first quarter previously calculated and unemployment standards International Labour Office shows that in the second quarter fell to 6.7% (compared with 7.2% in the first quarter), but remains high, the number of unemployed people being 624,000. According to the target set in context of Europe 2020, Romania has to reach an employment rate of the population aged between 20 and 64 years of 70% in the next six years, and now the percentage is 66%.

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<sup>3</sup> See Government Emergency Ordinance no. 19/2014 to modify and complete Law no. 571/2003 published in "Monitorul Oficial", Part I, No. 308 from April 25, 2014

<sup>4</sup> The impact of the 92 taxes will be 900.000 lei, out of which approximately 850.000 lei in the total consolidated budget and the rest to independent institutions, see <http://www.capital.ro> accessed in 01.07.2014

#### 4. CONCLUSIONS

The process of economic recovery to achieve economic development is very complex and seems conceivable only in regional and European context. Moreover, zero GDP growth recorded in the euro zone in the second quarter of this year confirms the scenario of a slow economic recovery.

Romania is favoured as macro-economically stable and the five EU convergence criteria are met. From this perspective, public policy in general, fiscal policy in particular will have to answer in the near future to challenges concerning economic recovery through a new economic model that should follow:

- financing public investment at the expense of electoral charges, following the strictly regulated fiscal principles for allocating public funds, but interpreted strictly subjective for political interest;
- stimulate consumption as a result of the increasing number of jobs and strategy for improving living standards as a result of sustainable economic development;
- improve access to Cohesion Funds which were drawn only 37.2% ( only 7.1 billion Euros spent out of 12 billion Euros to be spent by the end of 2015 remaining the cheapest financing source in the economy);
- firmly approach infrastructure improvement by setting medium and long term priorities;
- improving the education system according to the labour market, the health system and
- increase fiscal predictability to provide confidence to the business environment;
- effective fiscal control.

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