

TO WHAT EXTENT IS THE LOCAL TAX INCREASE APPROPRIATE?

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Abstract: : Fiscality represents a major decision factor for investment as it represents an important cost of every business transaction regardless of its type, size or geographical location. In this respect, we find that a legislative initiative could be a solution worthy of being taken into consideration, an initiative that would allow each locality - regardless of its rank - to provide its citizens with standards in accordance with their efforts. Tax federalization may allow higher efficiency in spending public resources that are never abundant enough, and also greater political accountability. Moreover, tax federalization could also be beneficial for increasing Romania's degree of democracy, as the decisions directly concerning the citizen are brought much closer to him/her so that he/she can control them more easily, by vote or by a proper spending of taxes he/she pays. The paper analyses the usual arguments discussed about fiscal federalization through normative and positive (public choice) approaches.

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Key words: **fiscality; local tax; tax increase; tax federalization; public choice**

1. INTRODUCTION

In Romania, fiscality has been one of the domains that has undergone the most significant transformations in recent years and, unfortunately, those transformations took place either too slow or too fast, the financial environment remaining thus within the tax payer's conscience as an instability factor for the development of the Romanian economical system.

In most of the cases, the business environment is aware of the legislative progress, like the harmonization with the European regulatory framework or the flat tax introduction. However, poor administrative capacity remains the weak link of the Romanian tax system. Thus, unfortunately, the remarkable progress of the tax law that started in 2004 by merging the tax provisions into a single code has sometimes been overshadowed by the inability of the state to meet the basic principles assumed. The efficiency and the certainty of imposition, the stability and the predictability of the tax system are essential principles for a viable economy.

2. WHAT DOES THE BUSINESS ENVIRONMENT WANT FROM THE LOCAL TAX?

Fiscality represents a major decision factor for investment as it represents an important cost of every business transaction regardless of its type, size or geographical location. A 2005 study of the World's Bank points out the 14 main worries of the business community when taking investment related decisions. Among them, the tax level comes in third, and the tax regulation and administration comes in seventh.

This triggers the need of a simple tax system, a transparent and stable one that could allow commercial societies (companies) and investors to plan long term strategies, and that could ensure the coherent management of the everyday business. This condition is particularly acute in difficult times, when financial constraints affect the conduct of business. In such times, the government should intervene to raise the tax burden and help businesses out of crisis.

A recent study of the prestigious financial consulting firm Deloitte entitled "Romanian fiscality – The radiography of an incomplete reform"¹ revealed as the first demand of the Romanian business environment, the financial measures taken to remedy the current situation, and not really the financial stimulation measures. This highlights the need for authorities to pursue a medium and long term financial strategy and to focus their efforts to reduce the frequency of legislative changes. Thus, almost 34% of those who participated in this study argue that the premise for a financial environment proper for business development is the stability of law. This way, businesses can establish and pursue a coherent strategy and a sustainable budget. Also, 22% of those who participated in this survey expressed their desire for the introduction of clear procedures in the tax administration.

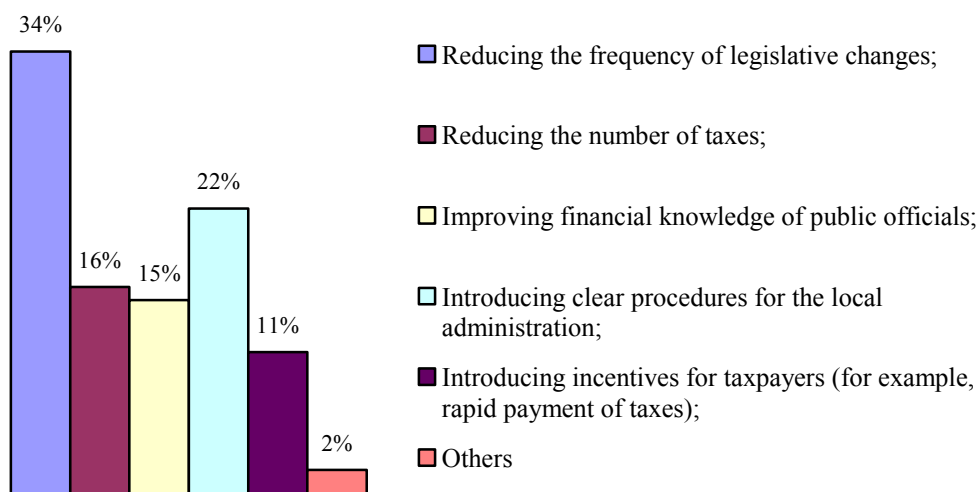


Figure no. 1 Expectations of the business environment concerning the Romanian tax system

¹The study was published in 2009, http://www.deloitte.com/assets/Dcom-Romania/Local%20Assets/Documents/RO/Tax%20and%20Legal/ro_TaxSurvey_102309.pdf, accessed on the 20.03.2010

3. DOES THE CRISIS NEED A TAX INCREASE?

A very complex problem of any governance is determining the optimal tax rate level that could bring to the state (be it central administration, local or regional authority) higher tax revenues. Therefore, the optimal is viewed in terms of who decides on the tax rate, the objective function to be maximized being tax revenues.

The legend has it that somewhere in the 1974's Washington Arthur Laffer went down in history by drawing a graph on a napkin, at a dinner with Donald Rumsfeld and Dick Cheney. Thus was born the theory that bears his name (Laffer's curve) stating that the tax decrease can bring more revenue to the budget because it stimulates the economy.

Arthur Laffer believes that the basic concept of his theory is that changing the tax rate can have two effects on tax revenue: the arithmetic effect and the economic one. The arithmetic effect is quite simple: if the tax rate decreases, tax revenue also decreases. The economic effect results from reducing the tax rate and thus stimulates the economic activity leading to an increased tax base.

In fact, the arithmetic and the economic effect are interdependent. In other words, Arthur Laffer noticed that there is a maximum threshold for the tax burden that when exceeded, it generates a reduction in the tax return and this is because a higher tax burden will discourage taxpayers (natural or legal person) to invest, to save, to produce and to work.

Long before Laffer, Jean Baptiste Say used to say "an exaction destroys the basis to which it applies". The idea that "a higher tax kills the tax" was strongly believed by other economists, too. For example, in 1952, Laferviere and Waline argued that "the increased tax causes a decrease of the taxable material, either by restricting non-necessary consumption, or by concealment or evasion"².

All those leading thinkers within the optimal tax domain with all their arguments apparently failed to persuade the Romanian Government. Furthermore, for 2010, the peak year of the crisis (as some optimists believe), while most of the EU states, but also others, compete in minimizing the tax burden, in Romania, local taxes increase by Government Decision³.

Changing tax levels is explained by the Executive as a natural and necessary measure (in a year of deep crisis!?) as they have remained unchanged for the last three years, since 2006, a period of time during which inflation rose by 20.49%. At the same time, the substantiation of the regulation shows that by indexing the inflation of local taxes and revenues, an increase of the local budgets by about 796 million lei is expected (really!?).

Moreover, the same substantiation, under "socio-economical impact", when it comes to the impact on the business environment, states that it is "not applicable", as the tax increase for cars would have no effect on any carrier in particular, and

² I. Botea, „Evaziunea fiscală și căile de combatere a acesteia”, PhD Thesis, Academy of Economic Studies, Bucharest, 2002, pp. 42.

³ In the Official Journal. no. 633 of 24 September 2009, the Gov. Decision no. 956/2009 was published in relation to the levels of the local tax values, local taxes and other taxes included here, as well as the fines applied starting with the financial year 2010. Starting with the 1st of January 2010, this regulation has cancelled the provisions of the Gov. Decision no. 1.514/2006 concerning the levels of the local tax values, local taxes and other taxes included here, as well as the fines applied starting with the financial year 2007. Also, the values of the non-judicial stamp taxes for the Law no 117/1999 with its subsequent amendments have been modified.

businesses in general, as the tax increase for buildings would not affect at all the companies, etc.

But this is an example of a total misunderstanding of our current macroeconomic context, and shows us that the strategy of the government is actually based on a narrow and short-term vision. It's easier to raise taxes than to streamline and reduce public expenditure that, just between us, represents a great unknown factor from which, from time to time, election campaigns and personal wealth are financed.

In our view, the only positive aspect of this given context is the increase of fines, providing that we do not lose sight of the purpose of these sanctions, namely a corrective / preventive one and not a significant budgetary source.

The previously mentioned Deloitte study points out that of all the taxes and levies imposed by the state, both at central and territorial levels, the local taxes are those causing the most controversy, at first sight. The perception is equally divided between an optimal (35%) and complicated (32%) assessment of the tax system. Thus, 46% of the participants at this survey believe that the local tax system is non-transparent and that it is, perhaps, the most difficult in terms of interpretation, the local and central authorities being most times in dissonance.

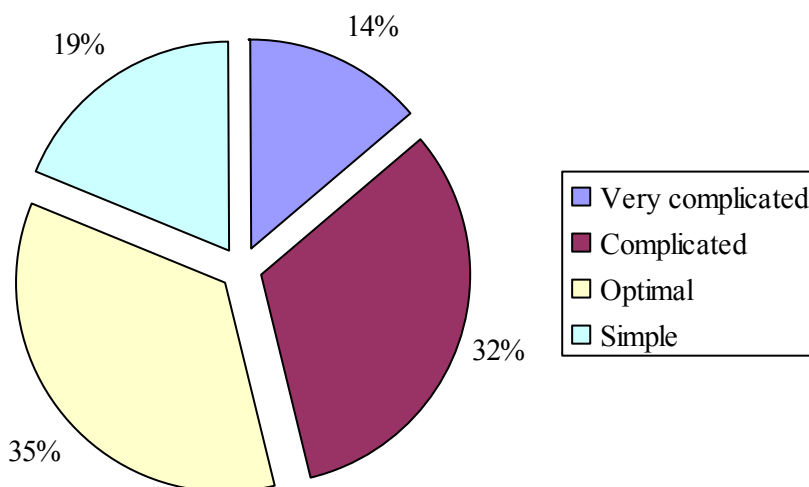


Figure no. 2 Characteristics of the local taxation system in Romania

4. WHO SHOULD DECIDE ON LOCAL TAXES?

A developing community is a community that depends more and more on its own decisions and resources that it manages, and less and less on outside help.

If decisions and management are not taken within the community, it will become dependent. Dependent on those institutions and bodies that the community itself controls, more or less directly.

The institutions that are not directly controlled by the citizen are less transparent, and thus less effective. In this context, the following type of phrases is often used with great ease: "government's money ...", "the county's money ..." or "the town hall's money ...". An important issue has been forgotten. The money belongs to the citizen, he/she is the one to finance the budgets of the administrative institutions, he/she is the one to generate the community's resources. Unfortunately, at the time, a small amount of this money remains within the community from where it left.

Therefore, we embrace the view according to which the local community is the one who needs to manage its own resources, values and mechanisms.

The relationship between the state and the administrative – territorial units should be based on loyalty, cooperation and solidarity. Central government must not prejudice or limit the autonomy of localities, and localities, in their turn, are not allowed to diminish the state's authority or the county's incumbent objectives. Exercising local autonomy should not affect the territorial integrity and the state's sovereignty. Therefore, we believe that *a fiscal federalization only on a fiscal line is imperative*. The latest example to sustain this is given by the Italian Government that, in 2008, adopted the bill for fiscal federalism, allowing local bodies to keep a larger share of the taxes it collects.

In this respect, we find that a legislative initiative could be a solution worthy of being taken into consideration, an initiative that would allow each locality - regardless of its rank - to provide its citizens with standards in accordance with their efforts.

Today, given the current system, we are all paying for the economic development in different parts of the country, especially for the development of the county seats and several other strategic locations (often randomly chosen according to the mayor's political views).

The insufficient budgets of the local authorities from many small and medium-sized cities, and from most of the communes, cannot ensure basic-necessity services for all the communities. I think we can all agree that any local community should have access to a *minimum package of services*, which could include:

1. Ensuring wage rights for the town halls' employees and for those in the subordinate services;
2. Educational institutions with proper facilities, where activities could be developed in decent conditions;
3. Ensuring citizen safety, including, at least, nocturnal lighting, and security and protection services (community police);
4. Social assistance services for people in difficult situations;
5. Medical services having a mandatory minimum structure;
6. Environment protection, stopping degradation, and its restoration;
7. A functional infrastructure.

Although the law currently provides a mechanism for distributing particular sums to support local budgets, these are insufficient and cannot ensure the strictly emergency needs of the communities.

5. CONCLUSIONS

Tax federalization (decentralization) may allow higher efficiency in spending public resources that are never abundant enough, and also greater political accountability. Part of the fees and taxes, instead of being collected centrally and then assigned according to some more or less transparent principles, could be collected and used locally. Attracting projects, their relevance to the community and following them locally would be much better if local authorities were directly responsible. In addition to this, local authorities would find it easier to attract much larger loans than those attracted to date.

Moreover, tax federalization (decentralization) could also be beneficial for increasing Romania's degree of democracy, as the decisions directly concerning the citizen are brought much closer to him/her so that he/she can control them more easily,

by vote or by a proper spending of taxes he/she pays. "Public Bureaucracy" should operate for the benefit of the citizen and not against it. Everyone could benefit from these solutions, as we have tried to show. What is lacking here is a genuine political will.

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