The Role of Fiscal Policy as an Instrument to Achieve Economic and Social Balance

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Key words: *Globalization , integration, fiscality,* taxation policy*, Romania*
Abstract: The State, irrespective of its institutional nature and contents throughout history, has been the most important answer or, better said, the best-structured solution of society members to the issues of their world's complexity.

Processes such as globalization and integration, individuals' increasing reliance upon technology, limited vital resources in order to ensure normal life, social polarization growth, poverty augmentation, migrating flows, occurrence of diseases that can rapidly spread at world level – all the above increase the complexity of our world and make the State's economic involvement compulsory. In this respect, an important role is held by the fiscal system, originally created to meet strictly financial goals of the State but subsequently enriched by various economic and social objectives due to the development of human society.

Fiscality can be viewed as a prerequisite to compensate gaps and for a genuine European policy of economic growth.

The impact of fiscality upon society members in every economy is significant, with tax payers' acceptance or refusal having a major effect upon the State's intervention by typical means in the entire activity of a society.

The paper suggests a comparative analysis of fiscality in Romania and other European Union member states with a view to emphasize that the difference between Romania's and other countries' fiscality is not significant enough to be seen as serious. Romania suffers from the lack of ″self-image″ and the factors generating it are also to be found in the present paper.

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The word "fiscal" originates in the Latin "fiscus" which in the Roman Empire meant "basket" or "container" used to collect the Prince's incomes meant to cover his expenses.

A large number of authors have contributed in explaining the concept:

▪ Nicolae Hoanță thinks that fiscality represents "a set of concepts, principles, methods, processes regarding several elements (taxable material, quotas, fiscal subscription) that have relationships occurring as a result of the design, enactment, set-up and charge of taxes and they are administered according to the fiscal legislation with the purpose to accomplish the system's objectives"[1].

▪ Carmen Cordureanu in the paper called "The Fiscal System in the Science of Finance" thinks that fiscality is the "set of taxes set up by the state that brings the latter a major amount of budgetary incomes, each tax specifically contributing and regulating the economy".[2]

▪ A juridical view of the notion is given by D. Drosu Şaguna – "the set of taxes and fees regulated by normative acts".[3]

▪ In the paper called « Fiscality in Romania – Regulation, Doctrine, Jurisprudence »[4] another juridical opinion on fiscality is to be found: "a system of enacted principles, rules and norms regarding the recording and management of tax payers, the set-up, emphasis and removal of fiscal duties, the control and adjustment of complaints, the fiscal assistance for tax payers in order to know and correctly apply the fiscal legislation".

▪ Other authors start from defining taxes – ways to take some of the incomes and/or money of individuals or businesses at the state's disposal with the purpose to defray public expenses – and they regard fiscality as a "connection between the state and individuals and businesses".[5]

Analyzing the above definitions, one can think that the fiscal system's major element is the tax, but the fiscal system also includes other independent elements: fiscal legislation (regulating and setting up taxes and fees considered the basis of the state's incomes and justifying the state's right of receiving its debentures from tax payers); the fiscal device (comprising the set of technical procedures and methods to pursue and charge taxes and fees); fiscal modalities with their typical structures (meant to help in applying the fiscal legislation to the interest of public authorities).

The main features that should characterize the fiscal system are : charging universality, unity and equity.[6]

The fiscal system's *universality* supposes the charge of all people that have incomes from the same sources or have the same type of money, and also the involvement of the entire calculation basis.

Charging unity means that fiscal duties should be set up according to unitary criteria for all the owners of the same taxable objects

Fiscal equity means that taxes and fees shoul be set up according to the principle of social justice without any ethnical, religious or political discrimination. The objective is accomplished by progressive charging rates on incomes, excluding those incomes earned by certain categories of tax payers etc.

All those lead to a fact: fiscality can be treated as a compulsory charge by the public administration with the purpose to finance its functioning. At economy level, the charge is meant to meet the expenses related to goods/public services supplying: this is the main objective of fiscal activity. Yet, fiscality can also be seen as a relevant factor that influences social and economic processes.

Thus, one can think that the essence of fiscality and taxes can be analyzed not only from the perspective of fiscality functions and principles, but also of the role and place taxes have in the economy as well as of their impact upon social, economic processes.

Formally, fiscality is to individual tax payers the payment of direct and indirect taxes to the state budget, local budgets and contributions in special funds. To companies, fiscality means the turnover share destined to the state under the form of direct and indirect taxes. Yet fiscality means much more as a factor influencing economic processes. Analyzing it as such it can be a burden not only because of numerous taxes but also because of fiscality and inflation's impact upon the real incomes of individuals and businesses. On the other hand, adequate fiscality can lead to encouraging certain activities needed at social level by means of a more attractive fiscal regime and to discouraging the activities that harm the social climate or health, education and social protection of those unfavoured people by means of tax relief.

That is why a well-based fiscal policy that takes account of the concrete conditions of social and economic life, the demands of current and future times can prove beneficial to progress. In exchange, a fiscal policy that ignores all that can stop development, and lead to regress and social pressure.

The functioning mechanism of the national economy comprises a series of financial competences that make up the financial mechanism. It has a complex structure made up of: financial system, financial devices, institutional framework and juridical framework. The fiscal policy comprises the concrete methods and means to procure economic resources and commercial relations. The fiscal field policy must set up the

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[1] Hoanță Nicolae- "Economy and Public Finances", Polirom, Iaşi, 2002, p. 169
[2] Cordureanu Carmen – "The Fiscal System in the Science of Finances", Codecs, Bucureşti, 1998, p. 21
[3] Şaguna Dan Drosu - "Financial and Fiscal Law", All Beck, Bucureşti, 2003, p. 345
[4] Florescu Dumitru, Coman, Bălaşa – "Fiscality in Romania-Regulation, Doctrine, Jurisprudence", All Beck, 2005
[5] Țâțu Lucian, Şerbănescu C., Ştefan D., Vasilescu D., Nica A. – "Fiscality from Law to Practice"
[6] Vintilă Georgeta – "Fiscality. Fiscal Methods and Techniques", Economică, Bucureşti, 2004, p. 13

amount and origin of budgetary and extrabudgetary resources that can make up the state's financial funds, the charging methods in use, as well as the economic objectives that fiscal instruments should accomplish.

Fiscal policy steps play an integral role in a country's economic programmes both on short and long term. Fiscal policy gets a more comprehensive connotation in economic growth-oriented adjustment programmes. Fiscal policy steps should not only contribute in the growth of domestic economies needed for financing the investment related to economic growth objectives, but also special attention should be given to the ways fiscal policy influences resource allocation and growth.

The need to organize public finances results from the fact that they represent a growth factor for the state. Ever since the Middle Ages political powers have been in charge of public finance organization. The Roman Empire had a powerful fiscal system that was administratively unified and well adapted to the diversity and huge size of its territory.

Public finance organization also allows the taking over of the society's new needs. The importance of the state's role in the society is thus emphasized by the development of public expenses; they have never ceased to grow, as public actions are covering more and more sectors.

Public finances also mean a source for getting wealthier. Since the 17th century a connection between the fiscal system and economy has been put in practice; governors have realized that tax structure may influence the decisions of players operating in an economy. Later on, in the 20th century, the tax became a social justice factor.

Finally, public finance organization is a quality index of the connection between politics and social field. No matter if it refers to the devices to agree upon taxes, the transparence degree of public accounts or public expenses' control should meet democratic requirements.

Debates upon fiscality approach its functions – representing the state's role in achieving economic and social balance – and the principles its functioning relies on.

The fiscal system's functions are set up according to the goals in whose accomplishment all fiscal institutions and regulations should contribute.

Emphasizing the fiscal system's functions should start from knowing the state's role in the economy. The need of the state's intervention in the economy was made public even back in 1776 by Adam Smith in his masterpiece called "An Inquiry into the Nature and Causes of the Wealth of Nations". Smith did not hide his negative opinion about sovereigns and princes whom he considered conceited, shallow, unproductive, yet they had a role in the economy, although quite a modest one:

- ✓ To protect the society against any inside or outside violence;
- ✓ To protect all society members against lack of justice or oppression caused by their peers;
- ✓ To provide the necessary beneficial infrastructures and public institutions for the society which individual entrepreneurs could not afford from their own funds.

In A. Smith's opinion, *national defence* does not authorize the great empires' military "adventures"; to him, all modern wars had commercial causes and effects.

Justice practice and financing are a more important responsibility from his point of view. Justice is closely connected to the struggles aimed at reaching property rights and economic relations. Property defence is not often just in itself; but a country where justice management is relatively impartial protects everybody's property including that of people with no incomes.

Public goods provision is the government's third significant function. Smith asserts a sovereign's last duty "to achieve and maintain public works and institutions which, although being able to bring great benefits to the society, could never make up for the expenses of an individual and that means an individual/group of individuals should not have and maintain expenses"[7].

As far as public incomes are concerned, Smith recommends as main source the payment of income-related taxes without arbitrary elements, in a comfortable and cheap way to individuals. He agrees with the idea that luxury products should be taxed higher than others thus encouraging the economy in order to increase national revenues.

Adam Smith's principles set up more than two centuries ago are still valid today. But due to the increase in economic and social life complexity a phenomenon has occurred, generically called "market failure". There are instances when free markets do not lead to efficient resource allocation which makes the state's involvement necessary in order to adjust imbalances. Market failure can be sensed in three main directions:[8]

- ✓ Market failure in the supply of goods and services needed by the society;
- ✓ Market failure in revenue distribution;
- ✓ Market failure in reaching the balance of labour force market.

The idea of the state's involvement in the economy's adjustment is not recent. The British economist John Maynard Keynes (1883- 1946) stated that state's intervention is important provided it has an important

[7] Moşteanu Tatiana şi colectiv- "Public Sector Economy", second edition, Universitară, Bucureşti, 2005, p.10, taken from Adam Smith – "Nations' Wealth", Universitas, Chişinău, 1992
[8] Idem, p. 18

role in a country's economic activities. The state should theoretically represent a country's general concern and economic policy in order to keep the balance between consumption and investment with a view to encouraging economic growth.

Practically, the main purposes of the state's intervention in the economy are:

- ✓ Economic growth characterized by the increase in domestic gross product, price stability and inflation control;
- ✓ Good balance of foreign payments represented by the control over the foreign account deficit;
- ✓ Public finance balance characterized by the control over budgetary deficit and the reduction of public debts.

In order to get involved in the economy, the state uses various policy types which it applies according to real needs:

A. Random policy – which allows the regularization of the economy's global development on short term by the impact upon prices, labour force, economic activities' fluctuation especially in temporary crises.

B. Structural policy – which aims at the concrete ways to get involved in the economy on long term applying, as its name suggests, upon economic structures and relations with various economic players.

C. Budgetary policy – which often allows the achievement of certain random policy objectives such as removing the effects caused by the reduction in private demand by the increase in public demand. It largely depends on the budget voted for the respective year in order to identify the charging ways of public money resources and their priority use.

D. State's intervention policy in the labour force market – which aims at reducing unemployment by creating new jobs. From this perspective, the state frequently encourages enterprises to employ labour force, acting in two directions: either upon labour force supply and demand improving the level of professional training or cutting down labour cost by means of social assistance programmes, or by forcing the market players to reduce labour time.

The fiscal sector has several **major functions**[9]:

a) allocation function:

b) revenue distribution function;

c) stabilization function.

The allocation function refers to the state's involvement in the market mechanism in order to determine a public service's type and quality and to the revenues' growth opportunities in order to cover the expenses needed for its rendering. Of course, when the market ensures an efficient use of resources, the state's involvement is minor and means several actions meant to encourage market competition and free access. On the contrary, when there is no efficient competition and there is a monopoly or externality, public involvement is necessary to regulate economic activities. That is done either by direct public production or by supporting private firms in adopting the decisions related to the type, quantity and quality of production. In this respect, there is a distinction between **direct state production** where the entire production of goods is ensured by the public sector and **indirect state production** where goods are manufactured by private companies based on public decisions. For example, military equipment is generally provided by the public sector by orders with private companies.

Revenue distribution refers to the state's market involvement by adjusting the revenues and wealth acquired from economic transactions. Although the economic analysis does not provide clues about that distribution's correctness, the principles of wealth social equity and just regulation underlie fiscal policies and public expenses. Revenue distribution is practically ensured by the system of progressive taxes which means charging higher taxes on higher revenues. Thus, the public sector charges funds that can be used to grant meal tickets to those having low incomes or to supply cheaper living places.

Stabilization is a function of the public sector that aims at creating the legal framework to ensure and protect public and private economic transactions. Objectives such as the increase in employment, price stability and economic growth lie at the core of macroeconomic policies.

Employment is a process that can be seen as closely related to unemployment and the policies meant to decrease the latter. Price stabilization is the requirement of a solid and prosperous market economy and can be provided by inflation control and steps taken to reduce inflation. Economic growth is a complex process that occurs as a result of economy enhancement and is synthetically reflected by the increase in total and per capita production expressed in the increase of national gross product per capita.

The state's involvement in the economy by exerting the functions of allocation, distribution and stabilization were supposed to aim at the permanent correlation of public decisions and actions. That happens because sometimes there are contradictions among public objectives. Progressive taxation can lead to the decrease of labour incentives and lack of efficiency, thus the **distribution** function being in conflict with **allocation**. **Stabilization** as an essential function of the public sector can turn into inadequate

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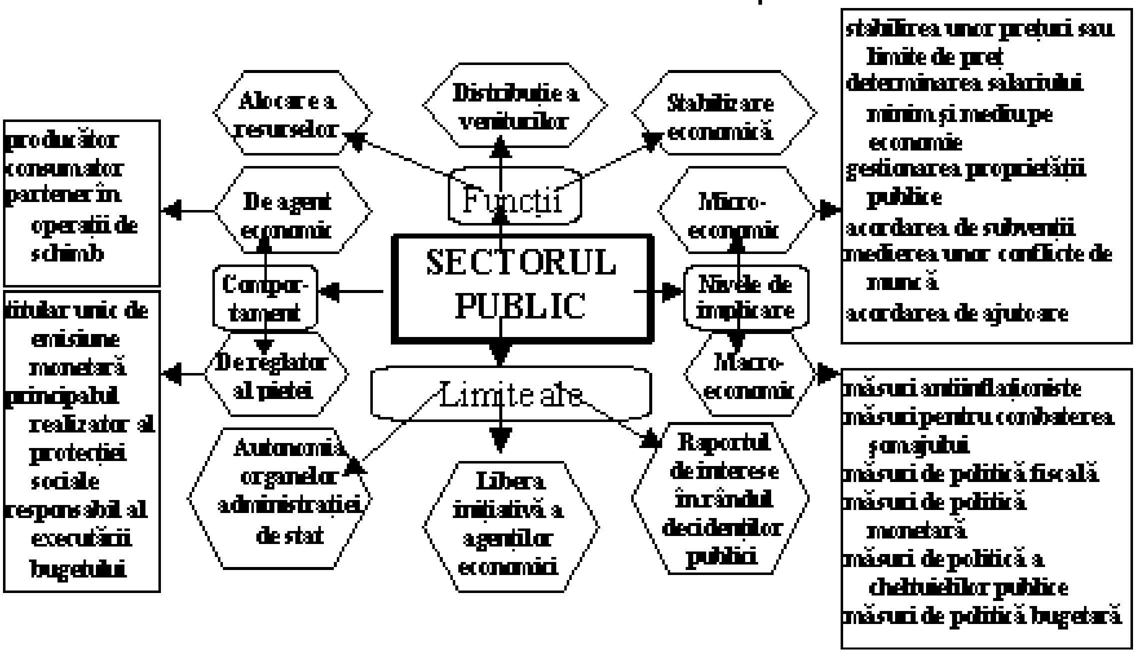
[9] Apgar, W., Brown, H., *Microeconomics and Public Policy*, Scott, Foresman and Company, Illinois, p. 292.

legislation regulations as it is well known that laws can be misinterpreted especially if methodological application norms occur later than their coming into force. Thus, stabilization can lead to discouraging some economic agents or even to an infringement of the distribution principle if certain social categories are favoured. In other words, the state's involvement in the economy does not automatically ensure economic efficiency and social equity. Removing certain imbalances by public decisions is done if other flaws are maintained. But that does not mean that the public sector's role in economic life shoud be neglected.

The public sector's role and its economy involvement features are shown by the main elements in graph 3.

The public sector's involvement in the economy

Graph 1:



Source: made by the authors based on the information in the text

The theory of fiscal optimism as a coherent scientific approach is new, but some of its elements have been analyzed for a long time. Even back in the 18th century, Adam Smith stated that a tax can be rated as "good" if it obeyed four rules:[10]

- ✓ Economy- assuming the fact that taxes do not require a costly charging procedure and do not discourage good business;
- ✓ Facility – all taxes should be collected by a convenient procedure to tax payers;
- ✓ Certainty – payment terms, payment methods and debts of tax payers as taxes should be certain, not random ;
- ✓ Equity – all taxes should be perceived as "correct".

What Adam Smith meant by certainty was to set up taxes in a directly proportional ratio to revenues.

Starting from the essence of Adam Smith's statements, the British professor Stephen C. R. Munday, (Director Of Sixth Form, Saffron Walden County High School), stated that all the talks on ideal fiscality admit the fact that there are three requirements that should always be taken into account:

1. The need for correctness irrespective of how it is defined;
2. The need to minimize the administrative costs caused by fiscality;
3. The need to minimize the side effects of taxes.[11]

The issue of fiscal optimization is not easy because its requirements contradict one another which makes it hard to set them up and to find a sole "objective function of requirements". The principle of fiscal equity is thus in opposition with the principle of effectiveness. Similarly, enhancing tax correctness (directly proportional to revenues) can generate the emergence of a strong side effect.

Taking account of taxes' permanent lack of popularity all throughout the economy, the issue to identify the best way to set up taxes that are accepted by tax payers is legitimate and extremely important. Its legitimacy can be emphasized both from the perspective of fiscal authority that wants the best tax, at least

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[10] Florescu Dumitru, Coman, Bălaşa – "Fiscality in Romania-Regulation, Doctrine, Jurisprudence", All Beck, 2005, p. 77

[11] Stephen C.R. Munday- "Avantgarde Ideas in Economy", Codecs, Bucureşti, 1999, p. 183

to prove the fiscal system's administration ability, and from that of tax payers who are pleased by an average rather than extreme level.

In this respect, Diamond and Mirrelees[12] in "The Theorem of Production Efficiency" created in 1971, studying what one calls today "the theory of best fiscality" or "the theory of fiscal optimization", suggested the search not only for political fiscal optimization, but also for economically legitimate fiscality, thus engaging the best use of resources. In a comparative analysis of two systems: **production efficiency** – the manufacturing prices of inputs and outputs should be equal among countries, which requires the use of residence principle for direct taxes and destination principle for indirect taxes – and **consumer efficiency** – consumer prices should be equal among countries, which means the use of income sources for direct taxes and origin for indirect taxes – the theoretical issue arising here is which of the two efficiency categories should be privileged. According to Diamond and Mirrlees (1971), the priority should be the following : even if taxes are going to change consumers' choices, it is recommended that input choice should not be altered by manufacturers because, due to the effect it has upon the final price, an input fee will end up by changing consumers' choices anyway just as a consumption fee.

Diamond and Mirrelees' theory was set up in the context of a closed economy. Identifying fiscal optimization in open economies also brings about difficulties; every government tries to find an advantage by fighting against others, resorting to one of the following ways: the reduction of taxation level or the supply of higher amount of public services.

"Modern Governments need lots of money" (Steinmo, 1993).[13] This statement made in 1993 can be easily applied nowadays as well. Since fiscality is the only source of public financial resources, a tax introduction or change is an issue that should be given much importance because of the consequences it may have at various levels: economic, financial, social, political.

In order to meet certain quality and performance requirements, modern fiscal systems should be organized and function on the basis of unanimously accepted principles. Among them, the principles above: equity and efficiency.

The principle of fiscal equity is required both from philosophical reasons, meaning ensuring social justice concerning taxes, and from practical reasons, because it is known that an uneven fiscal system causes tax payers' disagreement under the form of tax evasion (the infringement of fiscal duties). The classic principle of fiscal equity set up by Adam Smith has been adjusted to modern economy and it currently refers to meeting certain conditions:[14]

- An untaxable minimum amount that can be ensured only for direct taxes;
- Taxation should be universal, meaning that everybody having taxable objects, income or money must pay taxes;
- Fiscal duties should be set up according to the paying ability of every tax payer.

Taking account of the above, more and more economists consider that a modern fiscal system should pursue both horizontal equity such as the identical fiscal treatment of those that are equal from the perspective of their paying ability and vertical equity, respectively a different fiscal treatment of those that are at different paying levels, followed by an "income redistribution among society members in order to diminish or remove inequalities generated by market mechanism"[15].

Whereas horizontal equity is generally well understood and appeciated, vertical equity brings about controversies related to the possible ways to accomplish revenue distribution which is seen as arbitrary by some.

In Romania, fiscal equity is regulated by the Constitution: "the legal taxation system should ensure the just set-up of fiscal duties".[16]

The argument of economic calculation used by the fiscal policy reveals its arbitrary feature. Why did the government suggest the transition from progressive income taxation to the unique rate of 16%? Why 16%? The natural question refers to the way taxation quotas are set up; to the possibility to emphasize the best tax which helps the economy run well and "flourish". Yet, in practice, the reason of any fiscal system is not and cannot be objective. It is not about ensuring the economy's good running or reducing tax collection costs, as fiscal authorities often show. The rules of this democratic game encourage leaders to maximize the advantages resulted from public expenses' growth even sacrificing economic development. That is why governments spend the maximum resources they can charge by constantly creating deficits and public

[12] Negrescu Dragoş (coordinator)- "Trends of Fiscal Compliance in the European Union. Romania's Challenges", Project SPOS 2007 – Strategy Studies and Policies, The European Institute of Romania, Bucure,ti, 2007, p. 21

[13] Alfano Rosaria- "Tax Competition in EU Scenario: an Empirical Application", German Working Papers in Law and Economics, volume 2001, p. 2

[14] Vilaia Dan, Popa Ionela, Pietraru Alina- "Public Finances-Theoretical Syntheses, Practical Applications, Questions and Quizzes", Independența Economică, 2005, p. 36

[15] Moşteanu Tatiana – "Fiscal Structure and Balanced Taxation","Tribuna Economică" REview, no. 49/ 4 December 2002

[16] Romania's Constitution, Chapter III – Fundamental Duties, art.56 – Financial Contributions

debts. More often, the fiscal regime is subject to discretionary budgetary needs and political interests in a world where most specialists speak of "fiscal optimization" as an ilusion. It is not the economic calculation that determines protection level and taxation rate, but political interests and the potential electing effect of various arrangements. Consequently, taxation is not an intrinsec issue of market economy, but of the state political system.

During the debates upon the fiscal regime, specialists have abandoned precisely the essential element: the general fiscal burden. The real issue does not concern the progressive or proportional taxation modality, but taxation general level. This is an issue that primordially relates to ethics and efficiency in addition.

The principle of efficiency involves charging taxes at low costs and earning very high revenues. Revenues' maximization should be regarded from two perspectives: from the perspective of taxation agreed upon by the population and from the perspective of the level taxes charged by the state budget. One should take account of the fact that in the context of easy taxation there is a higher charging degree (tax payers' voluntary agreement is high), which makes the state's revenues even higher in some instances, as compared to the revenues earned by difficult taxation, where fiscality degree is much lower and generally leads to the increase of costs for tax collection (the number of people that try to infringe fiscal duties grows and there is a need for an increase in fiscal procedures and control actions).

The efficiency of tax charging depends on several factors among which some are especially important, specifically in our country:

- ✓ Legislation stability, issuing normative acts and their application rules that should be easy to understand. Adam Smith said that "a slight degree of uncertainty is much more serious than a major act of injustice";
- ✓ Professional training, intellectual and moral ability of the staff working within various organizational structures of fiscal authorities ;
- ✓ Applying an even fiscal treatment to all tax payers;
- ✓ The reduction of non-productive and non-economic governmental expenses;
- ✓ A stronger analysis of granting fiscal facilities in order to reach the goals suggested by them and not only to reduce budgetary needs;
- ✓ Discouraging tax evasion and underground economy;
- ✓ A quicker compliance of fiscal legislation within the European Union.

The major fiscality differences in the European Union show that the governments of the member states choose the modality they please according to their economies' status and economic strategies. Thus, competition arises, as each one wants to attract as many market revenues as possible; in this respect, obeying fiscal equity involves legislation compliance by means of the European Union Directions.

As a result of the 16% rate consequences, with the purpose to identify the relationship between it and the government's practical ability to set up the best level, it can be seen that at least from the perspective of fiscal authority – the rate is meant to bring about high tax revenues – the goal has been reached.

Table 1: The development of fiscal revenues in Romania during 2000-2008*

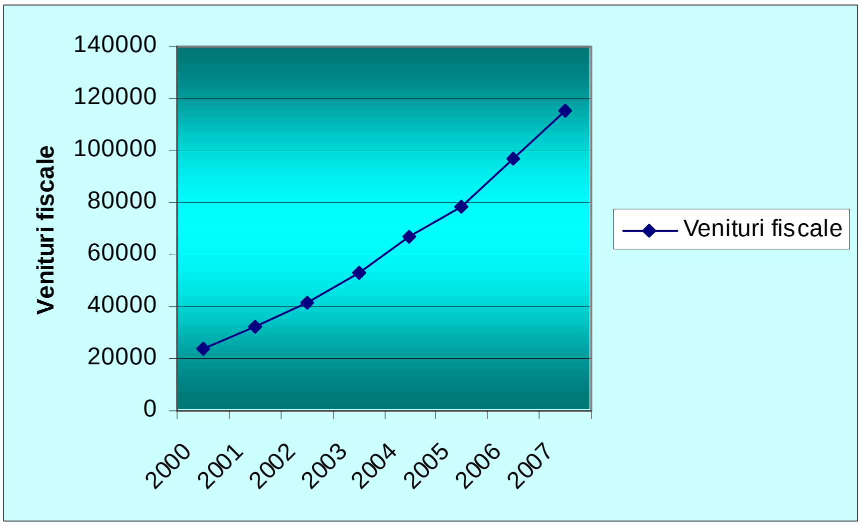
Years	Fiscal revenues (million lei, current prices)
2000	**23504,8**
2001	**32669,9**
2002	**41816,6**
2003	**53248,2**
2004	**66678,3**
2005	**78281,4**
2006	**96773,9**
2007	**115208,8**
2008	**23274,4**

Source: made by the authors based on www.mefromania.ro

* - the data in 2008 include the fiscal revenues achieved during January-February.

It can be seen that even if on the 1st of January 2005 the unique 16% rate started being applied for most individuals' and businesses' incomes instead of the progressive taxation (the rates between 18% and 40%) along with the 25% rate for businesses' incomes, fiscal revenues grew from 66,678.3 mil. lei in 2004 to 78,281.4 mil. lei in 2005.

Graph 1: The development of fiscal revenues in Romania during 2000-2007



Source: made by the authors based on the data in table 1.

It is obvious that higher fiscal revenues are also the result of additional steps – the increase of certain taxes, the coming into force of Law 241/ 2005 on the prevention of tax evasion etc; one should keep in mind that the values are shown in current prices without taking account of the influence of prices' growth upon the presented index. We have only attempted to show the overall trend of fiscal revenues in Romania in the context of major taxation changes. Optimization from the government's perspective with a view to maximize tax revenues has been accomplished. A more comprehensive analysis should also be made by means of specific indices: fiscality rate, fiscal pressure.

In an interview in the Romanian newspaper called "Capital", Arthur Laffer, the author of the famous curve that bears his name, said about the unique rate in Romania:"It is going to settle many corruption issues because if it is applied on a large scale, it will remove the trend to infringe the law. Yet, a fiscal amnesty programme is necessary, which is very difficult. How could one settle all the crimes of the previous fiscal regime when one replaces a corrupted system by an easy one? One should start from the bottom, which is very hard". And regarding the issue of fiscal optimization, he stated: "It is important to collect taxes in the least harmful way and spend them in the most beneficial way. The most important lesson is not to pay people that do not work and not to tax others just because they do"[17]

As a conclusion, fiscality, although never to become popular, is very necessary ; the issue is how to design a fiscal system to diminish social losses and accomplish equity goals that are socially accepted at a given time.

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[17] Arthur Laffer: "Fiscal Amnesty is a Necessary Step", Capital newspaper, 18 May 2005

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