DIFFERENTIATED TAXATION - A REQUIREMENT OF FISCAL EQUITY

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1. Introduction

In most countries, the reduction of fiscal disparities between social classes is a recognized goal of fiscal policy. Fiscal transfers, in order to balance the incomes of the population, are, in many countries, an important tool for solidarity between the rich and the poor. However, the fiscal theory on income equality is elusive. Bernard Dafflon, Professor of Public Finances at the University of Fribourg, believes that there is no program that can be considered as the basis of this theory; it is mainly derived from the theory about the subsidies offered by the State as support *(grants-in-aid)*.[1] As such, we have developed several ways to evaluate a person's ability to contribute, but the distinctions between public expenditures, social costs and the need for equalization is still unclear. This is not surprising. Equalization is primarily a matter of redistributive justice between people and considers responses to the following questions: how much should rich people contribute to balance incomes and how much can the poor claim as a result of redistribution.

The estimation process of contributive capacity and the amount to be paid or received is based on the concept of solidarity, a concept knowing a variety of opinions, because balancing policy requires value judgments that cannot be restricted to a single theory. And, since equalization formulas are included in several economic systems, the generalization of a constricted fiscal policy is difficult.

In the view of the authors Constantin Tulai and Simona Şerbu[2], the size of taxes must take into account the contributive ability of each payer, the tax finding its basis in the theory of sacrifice. This theory presents taxes as sacrifices which payers have to make for the state to function and the payments depend on the amount of the income earned or property owned, but also on the social considerations (number of dependents, marital status, age etc.)

Generally, it is considered that wealth is a reward for hard work. According to this view, redistribution of income determines not only the disappearance of work and savings incentives, but is almost immoral, because it deprives people from deserved rewards. We believe that those who emphasize economic efficiency tend to be less concerned about non-economic values as social justice, environment, cultural diversity, universal access to health care and consumer protection.

2. Differentiated taxation

Progressive tax involves applying a taxation scale which allows the increase of the due amount value as tax, according to the importance of the tax base. The system involves two methods:

[1] Bernard Dafflon - Solidarity and the design of equalization: setting out the issues, eJournal of Tax Research (2012) vol. 10, no. 1, pp. 138-164, online at http://www.unifr.ch/finpub/assets/files/RecherchesPublications/Articles/paper8_v10n1_Dafflon.pdf

[2] Constantin Tulai, Simona Şerbu – Fiscalitate comparată şi armonizări fiscale, Casa Cărții de Ştiință Publishing House, Cluj-Napoca, 2005, pp. 26

income installments or global progressive rates. Whereas the global imposing quotas method is grossly unfair, because it violates the principle according to which the same taxes should be paid at the same level of income, from the same source; we shall use in our analysis only the progressive taxation on income installments. Progressive tax mechanism is a basic principle of taxation systems in developed countries, applying to the income tax, solidarity tax, wealth and inheritance tax. This taxation has the advantage that it represents a solution for periods with budgetary problems, whereas it enhances taxes that can be collected and reduces social grievances. Progressive taxation leads to lower inequality, involving an equalization of social benefits. In this respect, as the gap between incomes increases, people from middle-classes have a poor lifestyle: they are less healthy, are little involved in society and community, have poor nutrition and education or are prone to domestic violence.

Differentiated taxation appears as a viable solution to stabilize the economy and get the right balance and according to the Keynesian theory, once incomes rise, people tend not to eat so much, therefore the propensity to consumption ceases to grow or stagnates. Through progressive taxation, the state collects revenue surplus and redistributes it through public expenditures, therefore helping to increase economy.

Furthermore, people with higher incomes can pay higher taxes. In this sense, a person who finds it hard to live decent will find it harder to pay some taxes, without having to suffer, while persons who earn more can pay higher taxes. Here we give an example of a differentiated VAT system, with lower rates for commodities and higher ones for luxury products. Therefore, people with lower incomes receive support in the purchase of consumer products for a decent living. At the same time progressive taxation allows greater support for people with lower incomes because it reduces the income tax burden and these incomes are not as affected.

We also believe that markets fail to produce effective results while only reducing inequalities may cost less than expected. We must also grasp the enormous costs involved in ignoring these problems: social consequences, including alienation, violence and conflict. Joseph Stiglitz says *” globalization has been used to impose "the liberal Anglo-American model" over other alternatives - and even if the American model has worked very well in terms of GDP, it gave good results in terms of many other dimensions, such as duration (and, according to some, quality) of life, poverty eradication or even the maintenance of middle-class welfare.”*[3]

As another argument of the thesis of equity income, we shall use the results of Ha-Joong Chang’s analysis[4] who states that after the Second World War, in most developed countries, although there has been a rapid increase in progressive taxation and social expenditures, during the years 1950 - 1973 the highest rates of growth have been achieved, income per capita increased by 2-5% in the U.S., Great Britain and Western Europe or even by 8% in Japan. Compared with this period, before the war, the growth was only by 1-1.5% per year. After this period, fiscal policies of income redistribution have seen involution, for the benefit of economic liberalization policies.

In the 1980s, tax reforms were implemented in all Europe, pursuing the same objectives that were based on the general idea that market forces can be better guided by a tax efficient policy, than by government intervention. As such several steps have been taken to generate the shift from tax

[3] Joseph Stiglitz – Mecanismele globalizării, Polirom Publishing House, Iaşi, 2008, pp. 24
[4] Ha-Joon Chang – 23 de lucruri care nu ți se spun despre capitalism, Polirom Publishing House, Iași, 2011, pp. 151-156

interventionism to tax neutrality and to allow the reduction of distortions caused by taxes. In general, reducing the tax burden was monitored by changes in income tax, owed by individuals, but fiscal measures taken have varied from country to country, both in structure and in magnitude.

Taking into account all the fiscal measures relating to tax rates, the taxation base and reliefs to taxpayers, we find that the tax reforms, in some countries, have led to a reduction in the personal income tax in GDP, while in other countries, have led to its growth. In many countries, the power was held almost always by governments that have supported the income peak redistribution. There were tax reductions for people with high incomes because high income tax rates were lowered. Although, on average, the countries' fiscal change was not large, however, in the population income structure, a trend of increased tax burden was observed on low and middle income groups and a reduction in groups of people with high incomes, according to an analysis by Iulian Văcărel.[5]

Differentiated imposing system also has many critics. Since 1826, Martin Michel Charles Gaudiw[6] criticized this system, considering that it had drawbacks and dangers, because he believed in the normal distribution of incomes and therefore, if the rich, less numerous, are subject to progressive taxation, in order to relieve the poorer classes, but more numerous, from the tax burden, then the authorities should provide more money in public budgets, amounts which would only affect, to a very large extent, the interests of the rich class. Drawbacks of this kind are much more serious if the system would apply to capital taxation, as its owners are provided with appropriate means of circumvention. Thus, differential taxation involves a complex administrative system which encourages inevitable bureaucracy.

Also, high progressive taxes may encourage the emigration phenomenon because of the misalignment to international market requirements. Thus, the phenomenon of outsourcing certain services arises, in order to avoid the payment of some taxes and all the bureaucratic process involved by this system.

David A. Hartman[7] shows that progressive taxation does not lead, in fact, to the reduction of inequalities, because the share of low incomes, in the total income, has not decreased. But such an observation does not exclude the possibility of government intervention on this issue, although there are cases where governments are less efficient than necessary, although there are examples of remarkable successes. This is because among the key choices faced by all societies there are also the ones relating to the role of government. Economic success requires a balance between the government and the market that must consider the services that should be offered by the government, public pension programs, encouraging specific sectors through subsidies, regulations to protect employees, consumers and the environment.

3. Undifferentiated taxation. The Case of Romania

Although the principle of redistribution is very old in tax history, taxation by using a single tax rate is

[5] Iulian Văcărel - Politici economice şi financiare de ieri şi de azi, Economică Publishing House, Bucureşti, 1996, pp. 230

[6] Martin Michel Charles Gaudiw – Souvenirs, opinions et écrits du Duc de Gaëte, Baudouin Frères Éditeurs, Paris, 1826, pag. 281, on line at http://books.google.ro/books?id=NpAFAAAAQAAJ&pg=RA2-PA281&redir_esc=y#v=onepage&q&f=false

[7] David A. Hartman - Does Progressive Taxation Redistribute Income?, Institute for Policy Innovation: Policy Report no. 162, February 2002, on line at http://www.ipi.org/ipi%5CIPIPublications.nsf/PublicationLookupFullTextPDF/7412EB9AFBB4D28786256B4D00738EBE/$File/PR162-Hartman-Redistribution.pdf?OpenElement

relatively recent. The principle of using such rate belongs to American economists Robert Hall and Alvin Rabushka[8], who, in the early 1980s, developed the idea of Milton Friedman, based on the finding that in the U.S. tax system, more than half of business incomes were not reported. This reality made that the use of a single rate to be in fact an act of justice, managing to make those who evaded the existing tax system to also pay taxes. Tax evasion is a reality worldwide and the two economists wanted to replace the progressive tax system, which suffered from leaks and deductions, with a single uniform rate for all incomes, applied only once. However, their approach implied also a certain progression for the poor, if it was accompanied by an exemption for incomes below a certain level. This involved the use of two rates: 0, for incomes up to a certain threshold, and another rate, their proposal being 19% for all other incomes.

Analyzing this view we can conclude that if the poorest people are excluded, and the most wealthy are advantaged, then the tax burden moves on the middle class, which, generally, is the most economically active. This system was designed to stimulate the economy based on the supply theory, which proposed lower taxes for investment and production. However, in countries where this system was introduced, new investments were also included in the tax base and its purpose was not achieved, thus, not leading to significant increases in economy.

Imposing with a single tax rate has become increasingly used in Eastern Europe, the first state to introduce it being Estonia, in 1994, followed by the other two Baltic States, Latvia and Lithuania. Russia adopted the system in 2001, Serbia in 2003, Slovakia and Ukraine in 2004 and Romania and Georgia in 2005. In 2008, the system was introduced in Albania, Bulgaria (which has a very low rate, 10%) and in the Czech Republic. Some countries still maintained different taxes on income and profit, the system resuming in most cases only on the income tax. In most countries, the introduction of this system was associated with the increase of personal deductions.

If we refer to Romania's case, it experienced a variety of tax systems. Between 2000 and 2004 differentiated taxation was used, with 5 installments of income tax, corresponding to the rates: 18%, 23%, 28%, 34% and 40%. Low incomes were exempted from tax. Since 2005, all personal incomes and profits were taxed at a rate of 16%. Later, in 2010, a plan of economic recovery appeared, based on the introduction of progressive taxation but failed to be imposed in parliamentary debates.

The main measure implemented in 2005 was to introduce a single rate of 16% both for profit tax and income tax. In parallel an alignment process was initiated towards this share of tax rates for other sources of earnings, as was the case of dividends, interests or capital gains. Constantin Ionete considered the new fiscal policy as being wrong. Although it was justified by the danger of reducing budget revenues, he considered significant the scope of changing the tax system. He noted „*The single rate will not be limited to those two taxes, but will also apply to other direct taxes. [...]The mode of fiscal relaxation, limited to direct taxes provides the consolidation of the gravity center of the tax burden on indirect taxation.*”[9]

Radu Buziernescu also highlights other weaknesses of this system:[10] the non-compliance with the tax principles of equity and social justice of taxes, which

[8] Robert Hall, Alvin Rabushka - The Flat Tax, second edition, Hoover Institution Press publication; no. 423, Stanford University Stanford, California, 2007, pp. VII-IX

[9] Constantin Ionete – Evoluții economice în aşteptarea aderării la Uniunea Europeană, Revista Finanțe – Provocările viitorului, Editura Universitaria, Craiova, Anul V, Nr.5/2006, pp. 11-14

[10] Radu Buziernescu – Fiscalitate, Universitaria Publishing House, Craiova, 2009, pp. 36

imply differentiated taxation, according to the ability to pay, putting the rich and the poor in the same group, increases social division, stimulates inflation by increasing the incomes of one part of the population and finally leads to the need of budgetary balance by increasing taxes on activities with high tax evasion degree, such as incomes from rents, thus stimulating illegal renting.

Since 2008, the issue of high deficits led to a reduced scope for the support of adequate financial fiscal stimulus, as Cristian Socol and Radu Soviani consider.[11] The external financing that fueled economic growth during 2006-2008 became more expensive and less, leading to a decrease in crediting towards the real economy, because together with the reduction of financial resources available, capital outflows occurred globally.

Ioan Talpoş and Alexandru Avram, defining opportunistic cycles in the economy, which are promoted by the government in an effort to maintain the power and who adopt various measures of fiscal policy in order to maximize their chances of being reelected, conclude that in 2008 the Liberal government outlined a government program based on increases in pensions and salaries as well as on the increase of budget deficit to 5.4% of GDP, versus 2.5% as registered in the previous year. The newly formed government in 2009 enacted opportunistic policies managing to lead budget deficit to 7.3% of GDP, which in 2010 led to measures of wage reduction by 25% and an increase of VAT by 5 percentage points.[12]

These problems determined Romania to legalize in March 2009 an agreement with international lenders for a loan of 20 billion euros, accompanied by the ambitious promise to reorganize the budget policy. In March 2011, the program was resumed. A new financing program for a period of two years, amounting 4.9 billion euros, was contracted for contingency. This new program aimed at consolidating the results obtained in terms of macroeconomic stabilization and focus on the objective of stimulating economic growth. The program must ensure the continuation of fiscal consolidation, tax reform and the improvement of public finance management, being oriented towards three main objectives: elimination of excessive budget deficit in 2012, improving growth potential and the decrease of the future likelihood of new excessive imbalances in the Romanian economy.

However, this program did not include any possibility of a differentiated tax system to ensure the necessary budgetary funds. No action has been taken to restructure the taxation system, but instead it was intended to restructure public enterprises in two strategic areas: transport and energy.

4. Conclusions

Global market integration has led to greater mobility of tax base, which has led, therefore, to reconsidering the sensitive issue of relative levels of taxation in different countries. Personal income tax progressivity, which is the main theme of this article, is important in at least two aspects. The first issue concerns the distribution of a fair tax burden, in terms of ability to pay and relating to the effect of increasing income inequality through taxes. The second issue concerns the need to avoid serious economic distortions that could lead to inefficiency. The concept of marginal tax rate should be considered and also the possible means to determine the effects of economic stimulus, which may conflict.

We believe that another important aspect is the political decision. The methods of assessment should not be political. Each political party chooses

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[11] Cristian Socol, Radu Soviani – Experiențe ale ajustărilor fiscale largi în UE. Cazul României, Economie teoretică şi aplicată, Volumul XVII (2010), No. 12(553), pp. 21-28

[12] Ioan Talpoş, Alexandru Avram - Considerații cu privire la mixul de politici fiscale anticriză în România, Economie teoretică şi aplicată, Volumul XVIII (2011), No. 1(554), pp. 3-22

one or the other assessment method, based on their political agenda, but given that, in a time of crisis, there are good arguments that support reduction and overcoming its effects can be much faster and easier by adopting a particular method of taxation, such as progressive taxation, and its application must be made, whatever may be the political party program governing the country.

It is true that while the European Union was affected by an economic downturn in late 2011, Romania recorded a European record by economic growth in the third quarter of 2011 of 4.4%, compared to the third quarter of 2010 and overall having an increase of 2.5% in 2011 compared to the initial forecast of 1.5%, but these results may be unsustainable if there are no internal sources of financing, to reduce currency risk and external interest rate debt. We believe that a fiscal policy based on taxation progressivity may be a solution for this.

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