ECONOMY

FISCAL POLICY ISSUES: A LOOK AHEAD

By Daniel Daianu

Tax policy is of major concern in all transition economies; the balance of budgets and the need to provide an adequate amount of public goods, in a period of budget retrenchment, dominate public policy. Is there an optimal level and structure of taxation in transition economies, which should take cognizance of their specifics? Can economically advanced countries provide an indication in this respect? Is there a need for tax reform, and which directions should it take? In Romania, taxation efficiency (tax collection) has become a major policy concern, in view of insufficient tax revenues and the need to keep a low budget deficit. Indeed, the EU accession demands a low budget deficit. In this context, the Romanian Government recently announced its intention to undertake an overhaul of tax policy. This brief analysis explores a few fiscal policy issues in transition economies, with particular focus on Romania.

1. Taxation efficiency in transition economies

There are major differences in the effectiveness and efficiency of taxation amongst transition countries. One can easily observe that, on average, taxation is more efficient in Central and Eastern Europe than in the CIS area. But there are differences within these groups of countries as well. Thus, Central European governments have been more effective at collecting taxes than the majority of their counterparts in South East Europe; and this performance has been due, quite likely, to stronger public administration and institutions, in general. Romania fares in between in this respect (Fig. 1), albeit its objective of joining the European Union and the claims on public expenditure by very sensitive sectors (such as health care and education) demand considerably higher tax efficiency. An improvement in tax efficiency would allow budget revenues to jump from around 32% of GDP in 2002 (this year's budget target) to more than 34.5% in 2005 (according to official projections).

2. Basic constraints for taxation in transition economies

The legacy of a **"premature welfare state"** was a metaphor used by Janos Kornai, years ago, to portray an over-supply of public goods in the communist economies. The bottom line is that many citizens are used to be provided with these goods, in a period of deep retrenchment of public budgets. This is a terrible constraint for policy, whilst the pursuit of balanced budgets (or easy to finance deficits) is a major policy goal. This constraint is becoming even more severe under the pressure of globalization, when governments resort to *competitive taxation schemes* – which is reminiscent of the old competitive devaluations race. Such a competition can bring about a vicious circle for both individual economies and the international economic system as a whole, to the extent that social exclusion gets out of hand.

A "catch-22" syndrome reinforces the issue highlighted above. The production of private goods is "crowded in" by basic public goods (Robert Barro); but the very expenditure assigned to the supply of public goods may overtax private firms, which are forced out of business and, thereby, trigger the collapse of other companies for which switching costs are too high. Thence emerges a target for fiscal policy: optimal taxation. But, in practical terms, this is a fairly complicated task. The experience in many transition countries shows that, frequently, the temptation was to raise taxes (as *quick-fixes*) in order to cut budget deficits, for the sake of macroeconomic stabilization, instead of trying to rationalize (prioritize) expenditure, or of improving tax collection. This temptation quite often prevailed in Romania as well.

A major constraint for public policy is the **fragility of institutions**, which is reflected by a poor capacity to collect taxes, to enforce laws and regulations. This constraint varies quite widely, but it is indisputable that most transition economies are plagued by institutional fragility.

There is substantial **hidden private taxation** in transition economies; bribes and protection taxes raise the cost of doing business. Firms may be willing to pay these “taxes” to a state, which can enforce laws, or enforce them better. But how can this “transformation” take place, and the deadlock be unraveled. Hidden private taxes combine with the temptation to evade taxes and operate in the underground economy. This is a particularly important challenge for public policy in Romania, where law enforcement is relatively weak.

Last, but not least, is the issue of **access to capital markets**. Transition countries differ widely as to the ability to raise money on foreign capital markets, and this ability can be related to how governments use fiscal policy to cover budget needs, and ensure macroeconomic stability, in general.

3. “Best practices” and “catching-up” supportive tax systems

Which structure and level of tax revenues should be a target for tax reform in Romania? Other countries’ experience can be illuminating in this respect.

3.1. Diversity of circumstances

The OECD countries (the developed countries) show, in general, a higher level of tax revenues, as compared to developing countries. But the OECD area, itself, presents variety, with glaring differences between the Anglo-Saxon world and the continental countries (the European Union). There are substantial differences amongst the EU countries as well; several Mediterranean states (Spain, Portugal, Greece) collect less, whilst their informal sectors are, notoriously, significantly larger (Fig. 1). There can be several explanations for this variety. One is rooted in the different patterns of welfare states in various sub-areas of OECD. Another explanation can be the very quest for tax reform in many OECD countries, which complicates, in a way, the search for “best practices”. The EU, as a whole, is contemplating tax reform, which should enhance its competitiveness in the global economy. However, this is made difficult by the fact that the national components of the EU maintain essential prerogatives in the realm of fiscal legislation.

Therefore, examples do exist and they have relevance; but one needs to be careful, since there is substantial variety even amongst the countries that, supposedly, provide good practices. In order to see how complicated is to figure out proper tax levels, it is worthwhile looking at the VAT. In the OECD area, this tax brings, on average, about 7% of GDP. Except in Romania and Macedonia (where the tax intake is about 6% of GDP), this tax brings, in Central, Eastern and South East Europe, considerably higher revenues. Actually, the numbers for Croatia and Slovenia are quite stunning: 13% and 15%, respectively, of GDP. Is VAT an example of massive over-taxation in transition economies? The actual rates are not exceptionally high, which would indicate that there is no over-taxation. In any case, the VAT could bring significantly higher budget revenues in Romania as well.

When it comes to improving administrative skills for tax collection, things appear more clear-cut. But even this issue may be easier to deal with in theory than in practice. As the Argentinian experience amply illustrates – with its largely failed attempt to overhaul (reform) the tax system in recent years, despite heavy guidance from the IFIs – this reform is far from being easy. This, and other botched experiences, should provide warning signals to Romanian policy-makers who intend to undertake a thorough reform of tax administration and pin much hope on this endeavor. Croatia, instead, provides an example of an effective tax administration and policy reform, which deserves a closer look from Romanian policy-makers.

3.2. Which best practices?

It is common knowledge that rich countries used a different level and structure of taxes when they were at an inferior level of economic development. How does this fact bear on the suggestion – which some make – to use their current taxation systems as signposts for tax reform in transition countries? Several questions can be raised in this respect:

> a) which *best practices* does one have in mind? Are taxation systems in the industrial countries the model(s) to follow, as an iron rule? Can an economy leapfrog development stages by just trying to imitate (import) institutions?
>
> b) do *best practices* mean uniform rates?

c) does it make sense to also look at the experience of economies, be they very few, which scored remarkable economic progress during the last decades (the successful catching-up stories[4])?

d) to what extent globalization and the rules and regulations of the international economic system (WTO, etc) allow to an economy room for using fiscal devices to foster growth? The case of Ireland is conspicuous in Western Europe; equally, amongst transition countries, the Visegrad group attracted most of the FDI by using fiscal incentives. One can even broaden the discussion and also look at Asian economies. The developmental challenge may be less relevant for the accession countries (albeit, they, themselves, have to close major gaps vis-à-vis the West), but it is certainly becoming of paramount importance for many countries in the CIS area and in most of Southeast Europe.

The conventional wisdom (and the advice provided by the IFIs) stresses the need for non-distortionary taxes, for fiscal neutrality. But how can least distortionary effects of taxes be judged in a world in which there are numerous externalities, asymmetries, adverse external shocks, multiple equilibria, etc? How can one deal most effectively with the multitude of second-best options? And what are the policy implications, in general, and for taxation, in particular?

3.3. The international ***tax regime***

At the same time, can one talk about the efficiency of national taxation systems without addressing the functioning of the international economic system – the *international tax regime*? An analogy can be used in this respect: can one talk about the opening of the capital account without examining the working of international capital markets? Similarly, one can question the effectiveness of the fight against tax evasion (avoidance) when individuals and firms can use tax-havens. The fight against tax evasion (avoidance) in transition economies should be seen in the context of combating money laundering, and against the backdrop of the struggle against international terrorism.

Notwithstanding the caveats made above, it is likely that the EU accession countries will have, in general, a smoother path in upgrading their administrative

[4] One needs to acknowledge, however, that historical and cultural circumstances matter a lot.

skills and tax collection capabilities. This is also related to the degree of cultural and institutional empathy with their western partners, and should be a valid assumption for Romania as well, who needs to capitalize on the technical assistance that it receives from EU member countries.

4. The EU factor

There are several layers for judging the EU's influence on taxation in transition economies, and in the accession countries in particular. One layer is the *Acquis Communautaire*, which shapes institutional reforms in the accession countries. Whether we like it or not, whether we deem it appropriate (fiscally wise) or not, the fact is that the EU accession countries are compelled to adjust their legislations to EU norms. Having said that, one should acknowledge that there is significant room for policy maneuver, since tax rates are not uniform across the EU area. But there are instances – as in the case of excises – when the pressure to move into one direction, and at a certain speed, is considerable.

Another layer is represented by EU's financial assistance to less developed regions and, in this context, to the accession countries. Structural and cohesion funds could supplement the accession countries' budgets considerably – to the tune of 4% of each country's GDP[5]. This revenue supplement could fill in large budget holes and mitigate tax reform pains. On the other hand, the financial benefit of structural and cohesion funds needs to be seen in conjunction with the impact that nominal convergence requirements (the Masstricht criteria) have on budget revenues; lower economic growth rates will, *ceteris paribus*, bring in fewer budget revenues. In addition, as Mitra and Stern rightly observe, the commitments made under the 2000-2004 Pre-Accession Economic Programs (which demand, on average, an improved budget balance by around 0.5% of GDP, while cutting taxes by about 2% of GDP and undertaking additional expenditure of the order of 3.5% of GDP) pose a "formidable fiscal challenge", which would "require a thorough reappraisal of the role of the state in the economy". *Mutatis mutandis*, the debate on the nature of the welfare state in the industrial countries[6] is also illustrated by the dilemmas that policy-makers face in the accession countries.

[5] According to a decision adopted by a EU ministerial meeting in Berlin, in 1999.

[6] This debate is of a longer vintage than the one fuelled by Anthony Giddens' "Third Way" (1998)

Romania may not be under the same pressure as the frontrunner accession countries, but the challenge is amplified in view of its lower taxation efficiency. However, one can argue that the lower tax yields in Romania provide substantial room for increase, which would orient policy reform towards improving tax efficiency.

5. Final remarks: improving tax efficiency in Romania

Romania needs to improve taxation efficiency (the collection of taxes) in order to raise budget revenues. Arguably, tax revenues could increase substantially through better tax collection, assuming no fundamental change in the structure of taxation. But for this to happen, a thorough overhaul of tax administration (tax collection) is needed.

The plans to create a unified tax administration department and a large taxpayer directorate are to be encouraged and supported.

The reform of tax administration should aim at improved levels of voluntary compliance through the delivery of modern and reliable taxpayer assistance services, well-targeted audit and other control activities, and timely follow up on unpaid debts. This reform involves a betterment of the skills, professionalism and integrity of tax collection officials.

The tax system needs to be simplified, in order to ease administration and reduce compliance costs. In this context, a streamlining of the VAT policy, which would imply the termination of an array of exemptions, does make sense; this streamlining would also directly help raising budget revenues. The reduction of VAT exemptions should be accompanied by the removal of delays in VAT refunds.

The simplification of the tax system, however, should not turn into policy fundamentalism. One should keep in mind that the EU member countries, themselves, use the logic of non-distortionary taxation in a flexible way.

Romania needs a tax regime that should be friendly to investment, from wherever it comes. This regime should not be captured by vested interests – but this does not necessarily mean not to provide incentives to FDIs when they engage in greenfield operations, which create jobs, bring in new technologies and have trickle-down effects (which benefit the entire economy). Such incentives do not harm budget revenues when they involve genuinely new investment; actually, such investments may even raise budget revenues by increasing aggregate economic activity. It is fair to say, however, that when the existence of such incentives prompts existing firms to ask for similar benefits, total budget revenues may be damaged. Arguably, a friendly business environment attracts FDI even without special incentives, but there is a time constraint here: a proper business environment cannot be created instantaneously, whereas, sometimes, fiscal incentives can provide a competitive edge to governments which badly need investment from outside.

The issue of social security contribution (the payroll tax) is of paramount concern in Romania, where the payroll tax amounts to over 57% of the wage fund (in all likelihood, the highest rate in Central and Eastern Europe). The reduction of the payroll tax would be a means to diminish labor disincentives. It is, therefore, good news that the Government announced its intention to reduce this tax in the near future. The initial loss of budget revenues could be offset by a rise in the overall efficiency of taxation.

The Ministry of Finance and the Government should closely watch the implementation of the recently adopted Ordinance, which introduces “rigorous” criteria for the rescheduling of tax arrears and the cancellation of penalties. There is a risk that the new regulation may increase the size of arrears, rather than reduce it.

Low taxation and simplified regulations, combating red tape are essential for the development of SMEs. But only good ideas and entrepreneurial spirit may not be enough when there is need for bank finance and banks demand hardly available collateral. Consequently, one has to be more nuanced when looking at the circumstances in transition economies. Arguably, the BIS’ (Bank for International Settlements) new regulations on banks’ provisioning for loans will hit severely small and medium sized firms, unless banks find creative ways for financing. If such firms are so badly hit in a country like Germany (where *Mittelstand Betriebe* rely extensively on bank credit), one can imagine the impact of the new regulations in transition economies, where capital markets function poorly and self-financing is often not an option. One way to mitigate the difficulties of SMEs in obtaining finance is to set up specialized financial institutions to cater to their needs; it is a positive sign that the EBRD is among the sponsors of a SMEs focused bank to be set up in Romania soon.

Finally, the speed at which some excises are raised, as part of the EU accession process, may be too high, given Romania's current income per capita – this speed favors tax evasion and the underground economy. The EU should probably be more lenient in this regard.

References

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- *Giddens, Anthony, "The Third Way: The Renewal of Social Democracy", Cambridge, Polity Press, 1998*

- *Mitra, Pradeeb and Nick Stern, "Tax Reform in Transition", World Bank, 2002, manuscript*

Fig. 1. Tax revenues as a ratio of GDP, 1999-2000 (average)

Eastern Europe & the CIS		**Western World**	
Albania	18	Austria	48.2
Croatia	39.3	Danmark	49.2
Czech Republic	37.2	Germany	38
Slovakia	34	Portugal	33.3
Hungary	36.1	Australia	29
CIS	24.8	Ireland	32.7
Bulgaria	30.5	USA	27.6
Romania	30.5	Belgium	45
Poland	32.6	France	42.2
Slovenia	40.3	Italy	42.8
Russia	33.8	Spain	33.5
		Canada	37.3
		New Zeeland	32.5

Source: Pradeeb Mitra and Nick Stern, 'Tax Reform in Transition", World Bank, manuscript, 2002

FIRST QUARTER 2002: SOME WORRYING SIGNS

Overall foreign trade stagnated, and it even decreased in the "technology-intensive" group. Industrial output grew at a slower pace than last year, real productivity in the manufacturing industry remained low, whilst real wages spurred in the utilities sector.

The trade deficit decreased slightly, industrial output grew by 5.7%, the ROL appreciated against the Euro in real terms, and inflation reached its lowest monthly rate over the last ten years. All these disparate facts risk creating an overoptimistic picture of Romania's economic realities. What lies behind may be less impressive and requires more prudent judgment.

Romania's foreign trade almost stagnated in the first quarter of the current year. Exports grew by just 0.8%, and imports decreased by 0.9% as compared to 2001. One year ago, the trend was completely different, with both exports and imports skyrocketing (by 19%, and 36% respectively).

For many, this may have been a shock, since exports were perceived as one of the engines of growth in recent years. For the readers of our Annual Early Warning Report[7], this is merely a confirmation. Based on the interpretation of the concentration index, coverage ratio and revealed comparative advantages, we warned that Romania's foreign trade in general, and its trade with the EU in particular, seem to have reached a stalemate. We also highlighted, in the Annual Report, that while in absolute terms trade volume increased, in relative terms trade performance stagnated over the last four years. Trade volumes tend now to stabilize, probably also influenced, with a time lag, by the stagnating foreign demand in the context of the economic slowdown in Western Europe.

Fig. 2. Foreign trade evolution

	1st quarter 2002 compared to 1st quarter 2001	**1st quarter 2001 compared to 1st quarter 2000**
Total exports	+0.8%	+19.6%
Exports to EU	+3.4%	+27.7%
Textiles and clothing	+6.8%	+21.3%
Machines and equipment	-6.8%	+61.7%
Metals and articles thereof	-4.9%	+1.7%
Total imports	-0.9%	+36.8%
Imports from EU	+3.0%	+32.9%
Textiles and clothing	+6.0%	+22.5%
Machines and equipment	-10.4%	+42.3%
Metals and articles thereof	-2.7%	+46.3%

Source: adapted from INSSE

[7] Liviu Voinea, No Harry Potter in Romania's Foreign Trade, Annual Early Warning Report, UNDP/Romanian Academic Society, Bucahrest, 2002.

CEFTA continues to represent a problem for Romania's foreign trade, with exports to this area decreasing by 21.6%, while imports slightly increased by 1.9%. This sharply different evolution validates another remark made in the Annual Report, namely that CEFTA is not an integrated area, and the import concentration index is much below the export concentration index (exports are not import-related).

Equally, trade in metallurgical products decreased, confirming yet another warning issued in the Annual Report, namely that in the context of the accelerated increase in energy prices, metallurgy trade in the SEE area is likely to decline.

A second reason for the stagnation of foreign trade might lie with the real appreciation of the Romanian currency (in real terms, ROL gained 1% to Euro in the first quarter). This, however, is less obvious, as imports were not stimulated; on the contrary, they significantly decreased in import-dependant industries such as machines and equipment.

A third explanation relates to the lower rates of output growth in the main export-oriented sectors, as compared to the same period of the last year.

Fig. 3. Industrial production indices, adjusted according to working days,

corresponding month of previous year = 100	March 2002	March 2001
Industry	102.7	110.6
Manufacturing	103.9	114.0
Textiles and clothing	104.0	114.0
Footwear	96.0	121.8
Wood industry	79.6	95.0
Machines and equipment, mechanical	99.5	114.7
Machines and equipment, electrical	103.2	110.5

Source: adapted from INSSE; Note: at the end of March 2002, stocks represented 38.8% of resources in the manufacturing industry, and 64.5% in the machines and equipment group.

Apparently, the problem in the manufacturing sector is, as stated before[8], the lack of a development horizon. Amongst candidate countries, Romania is the one that

[8] Idem 7.

produces most in OTP (outward processing traffic) arrangements, and has failed up to now to pass consistently to the next stage of OEM (original equipment manufacturing)[9]. Low integration in the international networks of production and distribution (see Fig. 4) prevents Romanian manufacturing industry from increasing its value-added.

Fig. 4. Production chain characteristics in the Romanian economy

Indicator	Value	Ranking in the world (out of 75 countries)
Extent of product and process collaboration (product and process development are conducted: 1-within companies or with foreign suppliers; 7-in collaboration with local suppliers, customers and research institutions)	2.9	73
Value chain presence (exporting companies: 1-are involved primarily in production; 7-conduct also product development, distribution and marketing)	2.7	72

Source: Global Competitiveness Report, 2001-2002

Fig. 5. Productivity, wages and prices, March 2002 compared to March 2001

	Manufacturing	Electric and thermal energy, gas and water
Nominal work productivity (production value / number of employees)	22.4%	26.2%
Nominal average wage	13.6%	39.8%
PPI (production prices index)	20.2%	43%
CPI (consumer prices index)	22.6%	

Source: authors' calculations, based on INSSE data

When computing figures for the end of the first quarter, 2002 compared to 2001, two worrying results appear:

- the manufacturing industry records virtually no real productivity gains. The good news is that nominal wage increases in this sector are, however, covered by nominal productivity.

[9] Denis Eylem Yoruk, Patterns of Industrial Upgrading in the Clothing Industry in Poland and Romania, working paper 19/2001, Center for the Study of Economic and Social Change in Europe, School of Slavonic and East European Studies.

- large real wage increases, unjustified by productivity levels, appear in the utilities sector. Once again, this demonstrates the extent of structural problems, and threatens the process of disinflation.

Together with the stagnation of foreign trade, these developments (which should, however, be treated cautiously, as they only apply to the first quarter of 2002) constitute warnings on the potential slowdown of economic performance this year. One cannot cheat the economy for too long; and restructuring still has a long way to go (the recent Petrom case, of original interpretation of what laying-off means, in the context of World Bank's PSAL II and of IMF's Stand-by Agreement, is proof of that).