THE IMPACT OF TAX EQUITY ON INCOME TAX COLLECTION DURING ECONOMIC DECLINE

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Abstract

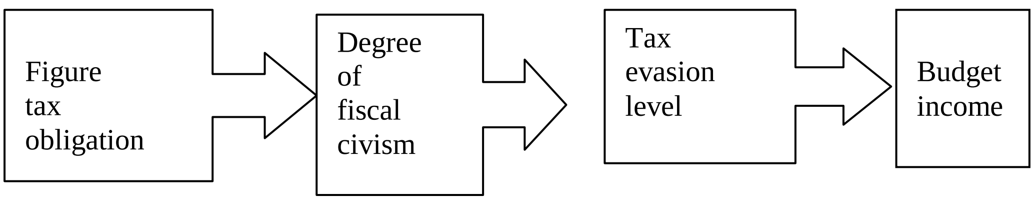
Generally, during financial crisis benefits liable to taxation represented by revenues which have been generated, consumed or saved that create fiscal prelevation are variably reduced. An element that can have an influence is tax payers' conformation degree, which is lower in these times and the natural trend of tax evasion is higher for objective reasons, we might state. The speed of reduction of taxable income during financial crisis is amplified when tax payers feel the tax duty as inequitable. In this paper I shall analyze the effects of the most recent two measures within tax policy in Romania, as far as taxing company profit is concerned, alongside with ensuring equity.

Key words: fiscal policy, tax equity, fiscal civism, voluntary conformation, contributive capacity, tax evasion.

JEL Classification: G01, H21, H25

1. General aspects of tax equity

There is a direct relation between the way tax obligation is determined and the degree of fiscal civism. Fiscal civism or voluntary conformation to pay tax obligations directly influence tax evasion and public financial resources within public budget.



One of the main requirements that must be taken into consideration by institutions that make decisions in taxes is to ensure equity when figuring tax obligation for tax payers, as a precondition for the premises to raise tax income.

Tax equity, as a specialized term, is synonymous to social justice as far as taxes are concerned. Creating an equitable fiscal system is necessary due to philosophical reasons and pragmatic reasons of efficiency and fiscal effectiveness. An inequitable fiscal system generates some sort of resistance from tax payers, which can amplify tax evasion.

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The implications of the way taxes are figured and of the equity degree ensured have on the effectiveness of duties can be noticed better in times of economic fall, when finding public financial resources is more difficult than in times of rising economy when the basis of taxation is also high.

The principle of tax equity, as Adam Smith initially stated, lies within the fact that subjects of a state must pay their taxes according to their income.

Tax equity, as basic principle of tax policy, was progressively implemented. Ensuring tax equity refers to meeting the following several conditions at the same time:

- Making all people who generate certain income or own specific wealth submit to taxes under the stipulations of the law;
- Passing laws on tax exemption when dealing with minimum income, so that minimum living standards can be met;
- Establishing fiscal duties for each tax payer according to their payment possibilities, taking into consideration their income (wealth) that can be liable to taxation;
- Establishing the same fiscal duty for all tax payers with specific payment possibilities;

The way taxes are established, namely the criteria of setting the basis of taxation and the duty at a certain level of the basis of taxation is highly significant when it comes to ensuring tax equity.

2. Analysis of the evolution of tax income in romania from 2007 to 2009

When dealing with economic fall, the basis of taxation is lower, and therefore the possibilities of public authority to collect financial resources necessary to cover public expenses are fewer.

On the other hand, economically and socially speaking, the role of state intervention can be expected to become higher, as a requirement from members of the society (individuals and legal entities). To meet the extra demand of public financial resources which ensure a higher degree of state intervention in supporting economic activities and legal entities affected by crisis, public institutions must reconsider their tax policy measures to ensure high tax income.

Under these circumstances, it becomes crucial to ensure equity in establishing the fiscal role of tax payers.

Tax measures taken in Romania after the beginning of the current crisis prove that tax equity has not been taken into consideration by decision-making institutions, although it ia one of the most important principles within tax system.

The consequences of this fact became obvious when budget revenues got lower because of fiscal charges.

Changing the level of the main budget indicators from 2007 to 2009 highlights the reduced possibilities when trying to cover public expenses and probably the emergence of the first proof of crisis in Romanian public finances.

Table 1: Budget indicators in Romania, 2007-2009

	2007		2008		2009	
	mill.RON	% in GDP	mill.RON	% in GDP	mill.RON	% in GDP
Fiscal income BGC	76.365,8	19,5%	94.044,4	18,3%	88.324,3	17,5%
Overall revenues BGC	127.108,2	32,5%	164.466,8	32%	156.624,9	31%
Total expenditure BGC	136.556,5	34,9%	189.121,7	36,9%	193.025,4	38,2%
Deficit	-9.448,4	2,4%	-24.654,9	4,8%	-36.400,6	7,2%
Fiscal income flexibility as related to GDP	-		0,73		3,74	

Source: www.mfinante.ro and author's own calculations

The flexibility of tax income in relation with the gross domestic product measures the reaction of tax income to changing GDP.

As one can notice from the data that have been shown, in 2008, compared with the previous year, the flexibility of tax income in consolidated budget was sub-unitary. This shows that there is a trend of lowering tax income in GDP, and slow growth to the raise of GDP.

In 2009, because of the economic fall, the flexibility of tax income as related to the gross domestic product was 3.74, which indicates that the speed to cut down tax income is higher than the speed to reduce the gross domestic product. If the gross domestic product decreased by 1.63% in 2009, the tax income in consolidated budget decreased by 6.08%.

One of the main reasons for this evolution is the constantly high level of tax evasion, which seems logical under conditions of financial crisis.

During 2007 –2009, the tax pressure accepted by tax payers and provided as the relation between tax income and gross domestic product. The evolution of accepted tax pressure resulted in the increase of tax income during 2007-2008 considering the real economic growth, whereas during 2008-2009 when the gross domestic product had a negative evolution, we dealt with the decrease in real tax income.

Table 2: The evolution of accepted tax rates and the real level of tax income based on fiscal charges during 2007 – 2009

	2007	2008	2009
Accepted tax liability	19,5%	18,3%	17,5%
GDP – constant prices 2006 (mill. RON)	372.758,49	454.540,77	423.404,81

Income tax collected – constant price 2006 (mill.RON)	72.840,32	83.180,97	73.979,65

Source: Personal calculations based on statistic data from www.mfinante.ro and www.insse.ro

If in 2008 unlike 2007 in spite of tax liability being lowered by 1.2 p.p., considering the real growth by 22% in the tax income within consolidated budget, the real tax revenues within general budget grew by 14.2% in 2009. In 2008, when the real gross domestic product was lowered by 6.9%, the reduction of official tax rate by 0.8 p.p. the overall tax income decreased by 11.06%.

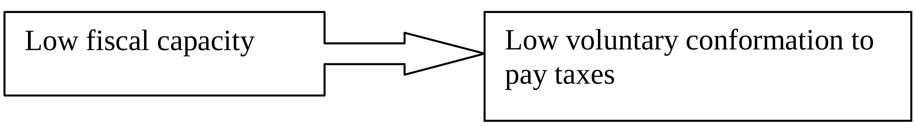
The data support the statement that during economic fall it is inefficient to provide tax payers with a superior duty.

Integrating tax policy in the decision-making process of economic agents generates a change in their initial state and behavior that arises objectively as a result of their concern for finding ways of organizing and carrying out activities that generate the lowest taxes possible, as expenses within economic activity, under the context of meeting the objective of maximizing their benefits. According to the theory created by the American economist Arthur Laffer, an extremely high level of charges destroys the basis that the tax system operates on, as it discourages the tax payers to carry out activities that generate taxable income or even makes them hide these revenues. Under the current economic and financial context in Romania, Laffer theory becomes important. Thus, under financial crisis the effects of higher taxes will get stronger on the tax income decline.

The only measures within tax policy that can be taken during financial crisis refer to using economic instruments as means to stimulate the recovery of economic activity. In such times, the reduction of tax level can bring higher income in the public budget.

As I have previously mentioned, voluntary conformation to paying taxes is reduced, as tax payers try to survive by any means and making tax liability more difficult will highlight tax evasion level.

This statement is directly related to the requirement of tax policy that tax liability must be established according to the fiscal capacity of tax payers, especially when the capacity to pay taxes is reduced.



3. Profits tax in romania under the context of the current financial crisis

Ensuring tax equity in Romania under the context of financial crisis is analyzed by referring to the measures regarding changes in tax liability and profits tax payers after May 1st 2009, namely economic agents that operate in various fields of economy.

3.1. Minimum profits tax

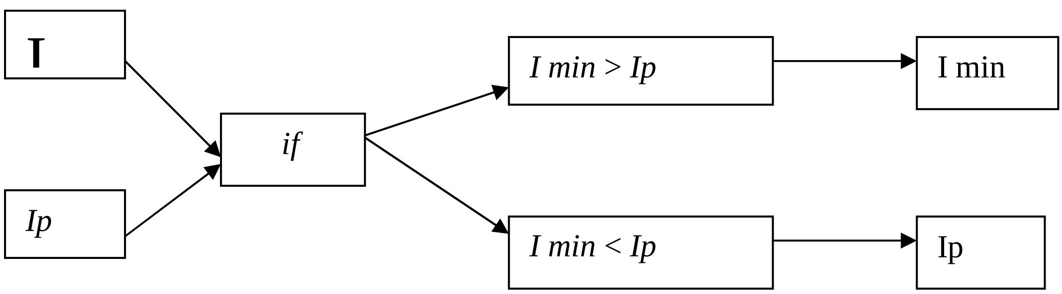
Economic agents have been forced into paying minimum profit tax by the Emergency Ordinance no 34/2009, starting from the second quarter of 2009.

The minimum tax was set as a fixed sum according to the income portion. Annual revenues that define minimum taxes are those earned the previous year when taxes were due to be paid.

By means of minimum tax, tax payers are forced to pay the highest sum of the tax calculated according to data in bookkeeping and the minimum tax established according to previous year income.

To establish profits tax, we show the following decision tree, where:

- *I min* is the minimum profits tax as a fixed sum according to previous year's revenues
- *Ip* is profits tax as a proportional coefficient of 16% of taxable income for the year liable to taxation.



In the following stages we shall analyze the effects of minimum tax on tax equity for bearers of tax liability and tax payers.

The main requirement of tax equity refers to establishing tax liability according to the financial possibilities of the bearers of taxes.

From this perspective, the mínimum tax induces the following effects:

• *it determines a certain regresiveness of tax payment, specific to indirect taxes*

As a fixed sum according to income level, all tax payers with revenues within the limits of a portion, that are liable to pay the minimum tax, will have to pay the same fixed sum. This way, the weight of taxes in the revenues decreases within a portion from tax payers with income on the lower part of a portion to those with high income at the superior layer of a portion, which results in: $\frac{\operatorname{Im} in}{V\min} > \frac{\operatorname{Im} in}{V\max}$.

To explain this statement, tax pressure on payers will be analyzed according to the tax grid established by the Emergency Ordinance 34/2009, to establish minimum tax. This is the following:

Total annual income (lei)	Official minimum tax (lei)
0-52000	2200
52001-215000	4300
215001- 430000	6500
430001 – 4300000	8600
4300001 – 21500000	11000
21500001 – 129000000	22000
Over 129000001	43000

Relying upon this grid, tax pressure for payers with income on the lower/higher part of a tax grid will be established, as it follows:

- For anual income of 52001 lei, the tax liability of tax payers will be 4300 lei. In this case, the tax pressure is 8.27%, while
- For anual income of 215000 lei, the tax liability of payers is 4300 lei. In this case, the tax pressure is only 2%.

From this perspective, one can state that that the minimum tax brings about inequity as far as tax payers are concerned, as it does not meet the requirement of establishing tax pressure according to contribution possibilities, establishing an inverse proportional relation between income and taxes to be paid.

• *it determines the raise of tax liability for tax payers with income that is higher in the respective year than the previous year*

Tax liability as profits tax refers to taking a part of the profit of tax-paying legal entities. After this stage, the part that remains with the economic agent is used to further finance activity or is given to shareholders. Maximizing profit is the essence of any activity developed by economic agents. The tax policy reduces the benefit that they can enjoy as a consequence of their effort.

To carry out activity that generates profit, economic agents make certain expenses that must be taken into account by the tax system when profits taxi s established.

Connecting tax liability exclusively to revenues is against the principles and basic rules in tax system, considering that these revenues are earned in other times than the one that is liable to taxation.

From this perspective, the tax liability of a tax payer can be increased if the revenues for the previous year V_0 are higher than those for the time when they are liable to pay the tax V_1, or reduced in the opposite case.

This way,

° $V_0 > V_1$ $\Rightarrow$ increased tax liability

° $V_0 < V_1$ $\Rightarrow$ reduced tax liability

As far as Romania is concerned, under the context of the negative trend of tax basis (the gross domestic product in nominal and real terms) during 2008-2009, the tax liability is increased as it relies upon superior tax level.

This way, all tax payers with income below the part with revenues of the previous year will be faced with an increased tax liability.

Let's consider a tax payer with revenues of 100000 lei in the previous year, where the minimum tax is 4300 lei. If during the year he is liable to pay taxes (under the circumstances of minimum taxes) the revenues are 50000 lei, the tax pressure will get to 8.6%, while 4.4% would have been the case when income in the time that taxes are due to be paid.

If we take into consideration all that has been stated so far, the minimum tax does not rely upon payers'or tax bearers' contribution capacity, or on the income earned in the time when the tax is due to be paid.

• it determines the increase in the tax liability of payers whose expenses are over a certain rate of the total income;

To establish the minimum limit of the weight of expenses in the total income beyond any increase brings about an increase in tax liability, we shall start from the inequality *I min > I p*, where profits taxation is the tax that payers are supposed to provide on account of the taxable profit as the difference between income and expenses. To simplify, we will not take into account tax adjustment, and all revenues will become taxable income and all expenses will be deductible, which makes taxable profit the same as bookkeeping profit.

This way,

*Minimum tax > profits tax = taxable profit * 16% = (Total revenues - Total expenses) * 16%*

If the total expenses are a specific percentage *g* of total income, the inequality shown previously will become:

Minimum tax > Total revenues * (1 – g) * 16%

From this relation we conclude that when g > 1 – p,

where p = $\frac{Tax\_\min tax}{16\% * Totalrevenues}$,

the mínimum tax liable within public budget is higher tan that calculated on account of taxable profit.

In other words, tax payers whose expenses weigh more than (1- tax weight minimum in 16%* Total revenues) will be liable to pay more than what they would have been liable to pay by establishing the tax as a proportional rate of 16%.

Consequently, a tax payer with total anual income of 60000 lei for those with total expenses of 44400 lei, has to pay an annual profits tax calculated as proportional rate of 16%, namely 2496 lei. Considering that annual income of payers in the previous year was 52001 lei - 215000 lei, the minimum tax is 4300 lei. Therefore, tax pressure of the respective payer is increased by 11,5 p.p, from 16% to 27, 5%.

3.2. Quarterly anticipated payment as annual profits tax

According to current regulations, profits taxation is an annual tax with quarterly anticipated payment.

The general rule that has worked until this tax year, 2010, refers to the fact that anticipated payment is established considering quarterly taxable profit from the beginning of the tax year.

Starting from January 1st 2010, quarterly anticipated payment is established considering the profit of the previous year, along with the inflation index estimated when establishing the initial budget for the year they are due to be paid.

After the tax year the profits tax is calculated again considering the profit from the year the tax should be paid for, and the tax differences that are paid higher that the tax liability are given back to tax payers.

Such a change in the way anticipated payment is generated, where P_0 (taxable profit from previous year) is higher than P_1 (profit from the time the tax is due to be paid), involves an increase in PA_0 (anticipated payment calculated considering previous year's profit), whereas the taxes liable established by means of quarterly profit in the respective tax year (PA_1), $PA_0 = (P_0 / 4) > PA_1 = (P_1 / 4)$, Tax payers are this way forced to credit she state budget for a while with the difference (PA_0 - PA_1), without asking for their approval.

Considering that tax payers have to pay increases for delays when they are unable to pay off their duties according to tax policy, as anticipated payment, the state should give tax payers interest for using monetary funds that belong to tax payers, which is not stated under the current legislation.

The state is the user of funds that belong to tax payers and it does not have to pay anything for that. It is in a privileged position, as tax payers do not get the same treatment when they have debts.

4. Conclusions

Maintaining equity in establishing tax burden for payers is one of the main requirements to ensure the effectiveness of taxes.

Under financial crisis, when the tax basis is lowered and voluntary conformation is low as a natural consequence of saving money for personal needs, a significant part of income, any raise in tax liability and failing to meet tax equity requirements leads to cutting down the sums that can be acquired within public budget because of tax prelevation.

The last two tax measures with respect to the income tax in Romania breach both the principle of tax equity and the rule according to which the tax burden must not be increased in periods of economic decline.

To sum up, the introduction of the minimum tax as a responsibility of income tax payers entails the following effects:

- It does not contribute to the establishment of a correct relation between the contributive capacity and the tax burden of tax payers determining, on income installments, an inverse proportional relation between the leve of the income obtained and the growth of the tax due;
- It does not consider the real contribution power, setting the tax due depending on the incomes obtained by the tax payer in a period other than the one for which tax is due nu;
- For certain tax payers, it determines the increase of the tax pressure over the level of 16%

On the other hand, the introduction of the anticipated payment system based on the profit obtained in the year preceding the year for which tax is due also introduces a certain degree of inequity with respect to the tax treatment of tax payers as to the privileged position of the public authorities.

The effects of such measures will be visible in the growth of the tax evasion and implicitly in the reduction of tax income collection.

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