9. WEAK REDISTRIBUTION DAMPENS ECONOMIC GROWTH AND CAUSES STRONG SOCIAL TENSIONS

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Abstract

The paper aims to assess the intensity and efficiency of using the redistribution function of public finance in Romania as compared to other countries in Europe. The analysis underscores that the major redistribution levers, i.e. tax revenues, social transfers and subsidies, as well as public expenditures in healthcare and education sectors are undersized as compared to the Romanian citizens' needs. By assuming the setting-up and functioning of the minimal state, with limited tasks in the economy and society, Romania is characterised by one of the highest levels of the citizens' income inequality, and this grim economic and social landscape proves the weak efficiency of the redistribution function. Hence, by taking an unbiased approach, the fiscal system needs to undergo a substantial revision by including into the taxation base all the resources in the society, without affecting the corporate sector, and placing the emphasis on the progressive taxation of personal income and wealth.

Keywords: redistribution function of public finance, tax revenues, social transfers, social and economic inequality, progressive taxation of personal income and wealth

JEL Classification: H20, H30, D31, E64, E10

1. Functions of public finance

Since the 1930s, in the aftermath of the Great Depression, the macroeconomic approach to public sector objectives, more precisely the state's role in the economy, has grown in importance, as its traditional functions (in defence, public order, legal system, etc.) have been complemented by the economic function, or the fiscal function.

The rationale behind more intensely activating the lever of public finance is based on the objective need for the government to improve the efficiency of companies' and households' individual economic decisions taken amid the free market functioning. In this vein, the government employs public revenues and expenditures as its tools. The government's fiscal

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function was developed as a result of market failures, which prevents from ensuring perfect competition among economic agents during its functioning, an essential market feature in order to achieve an optimum equilibrium (efficient, stable and fair – also known as Pareto optimality). In the absence of perfect competition, market failures mainly result in: inefficient resource allocation; deviations of macroeconomic indicators from sustainable levels (with a negative impact on the achievement of the public finance function relative to macroeconomic stability); information asymmetry at firms' level; non-observance of the fairness principle in the distribution of wealth and income in the society, etc.

From a theoretical and practical perspective, the functions of public finance materialise in the following actions (Musgrave, 1959): stabilisation, allocation and redistribution.

The stabilisation function focuses on reducing the magnitude of fluctuations in the business cycle phases and the effects of these fluctuations on the economy, with the government aiming to maintain both a high resource utilisation rate and a stable value of money. A free economy, in the absence of any intervention by public authorities, posts fluctuations in prices and employment, and the government should ensure these deviations from the equilibrium level remain within low bounds. Musgrave (1959) shows that the success of the free market system is conditional on the government's capability to take measures so as to ensure a high level of employment in times when an economic downturn looms and price stability when, at aggregate level, demand tends to exceed supply. In the context of the stabilisation function, the taxation system is seen as an effective tool for fending off inflation and transfers are a useful lever to prevent deflation. The manner in which fiscal policy has fulfilled, in the past, its stabilisation function, has a significant bearing on how it can achieve this task now and, in the future, (Isărescu, 2010).

The allocation function aims to maximise the efficiency of the distribution of public expenditures so as to ensure maximum benefits for citizens amid a certain level of tax revenues and public wealth. Musgrave (1959) is of the opinion that, given the imperfect resource distribution by the market, the government is required to intervene mainly in the following instances: (i) when hindrances emerge to firms' entering certain sectors or when high production costs are manifest in various industries; (ii) when the resources needed to produce strategic goods and services for households exceed the financial strength of private entrepreneurs (*e.g.* railroad construction); and (iii) when the negative externalities of some activities of economic agents are elevated *(e.g*. substantial environmental pollution). In light of the allocation function, the tax-setting system is essentially for procuring the resources necessary to ensure public goods and services. When adopting decisions on taxation (as the government authorities opt for progressive, proportionate or regressive tax rates), it is necessary to take into account both households' demands and the current income distribution.

The redistribution function seeks to reduce inequality in the distribution of income and wealth in society by shifting part of the available resources from some categories of citizens to other groups. The natural location of income and wealth in a market economy is contingent upon factors such as individuals' native endowment, education opportunities, social mobility, market structure, etc., as these variables lead in fact to a certain degree of inequality among citizens. The role of the redistribution function is to secure an institutional correction mechanism for the unbalanced distribution of income and wealth society-wide, with as little negative effects on the efficient functioning of the economy as possible. Taxes and social transfers play an important part in the functioning of this mechanism.

Other authors reckon that the functions of public finances aim, along with the three described above, to ensure sound economic growth (Amadeo, 2020) and make an analysis of resource utilisation via the control function (Văcărel *et al.,* 2007).

The allocation function whereby the state ensures the provision of public goods and services to its citizens can be regarded as the classic attribute of public finance. In time, however, an increasing number of countries have come to attach greater importance to the social role of fiscal policy*, i.e.* the redistribution function, leading to new shifts in the dynamics of income and wealth distribution at a national level (Musgrave, 1959). In fact, Boushey (2019) points out that, over the past few years, besides the focus on economic growth and productivity, economic thinking pays a greater deal of attention to addressing the thorny issue of the increasingly unequal distribution of income and wealth among citizens. This calls for implementing effective economic policies aimed at identifying avenues to ensure that the economy works for the benefit of most of the population, not only a small number of citizens.

2. The redistribution function of public finance

In regard to this function, the government acts in light of the set of values related to social consciousness, community spirit, solidarity, etc. and is based on the degree of acceptance of these principles by the society. There are two manners in which fiscal policy can influence income distribution (DGIZ, 2011): (i) the authorities, conditional on the collected revenues, besides healthcare, education, etc., can extend the range of free-of-charge public services to population, thus helping improve the primary distribution of income (prior to being subject to taxation or transfers) and (ii) taxation and social transfers regimes are meant for the secondary distribution, *i.e.* to activate income redistribution.

Baumol and Blinder (2010) show that we cannot expect a market economy to ensure that income is distributed according to the fairness and righteousness principles. A similar conclusion is drawn by Grauwe (2017), who points out that the market economy is indifferent to income and wealth distribution among households, and that an off-market institutional system, namely the government, should ensure that public dissatisfaction is avoided by improving market economy functioning via using public finance for the income and wealth redistribution society-wide. Hyman (2010) shows that: (i) shifts in income distribution that curb the incidence of poverty can bring collective benefits; (ii) many citizens supportive of the government’s action in terms of redistribution do so because they believe that they and other inhabitants of the country will benefit from a stable social environment; and (iii) households support policies warranting a minimum income, which they regard as a safety net in case adverse economic events occur, etc. Saez and Zucman (2019) consider that the sole pursuit of one’s own interest destroys the rules of confidence and cooperation among citizens that lay at the basis of any prosperous society. Lazea (2020) and Deneen (2018) emphasise that when selfishness is presented as the natural state of a human being any excess is justifiable, and crises such as that of 2008-2009 become the natural follow-up to a philosophy centred solely on one’s own interest.

Baumol and Blinder (2010) highlight two lessons that are seen as fundamental to the objective nature of redistribution, as follows: (i) this should be achieved through the most effective policies so as to lead to a greater deal of equality among citizens, with minimal loss of production, and (ii) it is clear that the optimal choice in a society can be neither a complete *laissez-faire* nor complete equality. Specifically, the authors consider that the optimal level

of equality in a country is most likely higher than that stemming from the unhindered functioning of the free market, yet lower than complete equality. It is therefore necessary for the government to ensure income and wealth redistribution, to a certain extent, that is democratically accepted by the society.

As for fairness, a country's fiscal regime is required to ensure it along two lines, *i.e.* horizontally (taxpayers with the same income and wealth are to pay the same amount of taxes) and vertically (citizens with higher income and wealth are due to pay a higher level of tax rates and, hence, a higher amount of taxes). Starting from these fundamental taxation principles, redistribution should be analysed in close correlation with the criterion of financial solvency at an individual level, which stipulates that every taxpayer must pay taxes (fiscal burden) in direct correlation with his/her ability to pay (contributive power).

Recent studies (Ostry *et al*., 2014) underscore the importance of effective action for the redistribution function of public finance, pointing out that the low inequality of income resulting from active redistribution policies is associated with higher, more sustainable economic growth. In fact, literature has shown that an increase in the income of poor and middle classes by 1 percentage point leads to an advance in the GDP by 0.38 percentage points, while the increase in income of the rich by 1 percentage point causes the GDP to fall by 0.08 percentage points. These facts show that, in practice, there is no trickle-down (welfare moves from top to bottom), but rather a trickle-up is, demonstrably, manifest (welfare shifts from bottom to top, see Dabla-Norris *et al*., 2015).

3. Progressive taxation and redistribution

The tax system is one of the most important institutions of democracy. This idea is clearly highlighted by Schumpeter (1918), who wrote, "the spirit of a people, its cultural level, its social structure, the deeds its policy may prepare – all this and more is written in its fiscal history". Against this backdrop, with a view to reducing the negative externalities of globalisation, which benefitted mostly high-income earners, any democratic society is required to discuss the optimal size of the state and the appropriate degree of tax progressivity (Saez and Zucman, 2019). Thus, in regard to using taxation as a redistribution tool, this comes in the form of progressive taxation of personal income in the most advanced economies. The progressivity principle is based on the need to observe fairness vertically. In fact, progressive taxation is supported in most industrialised countries by the vast majority of citizens, since they believe that such a fiscal regime adequately links the level of taxes to individuals' ability to pay (Hyman, 2010). Specifically, by setting a higher tax burden (as a percentage of income) for higher-income earners, a progressive taxation system shifts part of the tax contribution from the poor to the better-off, with a strong redistributive effect (Essama-Nssah, 2008). As Baumol and Blinder (2010) emphasise, at least partially, "poor citizens are so poor because the rich are so rich". Grauwe (2017) shows that capital owners, who amassed an increasing proportion of global well-being in recent decades, are, in fact, the greatest opponents to capitalism; this is because they pose a real threat to the survival of that economic system, owing to the discontent and tensions that the impaired functioning of capitalism causes among the citizens through the excessively high income and wealth accumulated by big owners. The rationale for the implementation of progressive taxation (as well as various anti-poverty programmes) relies precisely on the liberal principle that the free market determines the distribution of earnings before tax, and thereafter the government, via the redistribution function, which implies the application of the system of taxes and transfers, intervenes to reduce inequality (Baumol and Blinder, 2010).

A clear-cut advantage of progressive taxation is the adequate manner of adjusting higher earnings (Buchanan and Musgrave, 1999), which is particularly relevant as the income and wealth distribution in the society has become increasingly polarised. Conversely, as Musgrave notes, the single tax rate system, despite its seemingly simple and attractive nature, can become a lever whereby wealthy citizens are protected. The author adds that, as the poor need larger resources, applying the single tax rate calls for increasing transfers to these social categories, putting a strain on the budget.

According to Piketty (2019), the magnitude of private property build-up and the ensuing power should be adjusted via a strong progressive tax and a good endowment with capital altogether. The author takes the case of Russia and considers that in the former communist countries applying the single tax rate there has been a very high opacity surrounding income and property quantification and distribution, mushrooming off-shores and assets placed in tax havens, as well as dysfunctions caused by the abandonment of any propensity for redistribution. He shows that no country other than those using the single tax rate has gone so far with the annihilation of the idea of progressive taxation. Piketty (2019) points out that the absence of political will to apply progressive taxes goes hand in hand with a very poorly transparent tax administration and with highly rudimentary and limited tax data available, fuelling increased inequality and tax evasion.

Against this background, it is worth noticing that progressive taxation, together with transfer payments, as the main redistribution tools, also helps strengthen the stabilisation function of public finance, with the use of these tax levers ensuring that the magnitude of swings in business cycle phases is cushioned and being one of the automatic stabilisers (Boyes and Melvin, 2011). During an economic downturn, for instance, when a household's income declines, it falls into a lower taxation bracket and the reduction of tax rates below progressive taxation allows the household to spend more of its income, mitigating the impact of lower earnings on consumption expenditure individually and economy-wide. Similarly, the transfers, when they depend on the level of personal income as an eligibility criterion, act as automatic stabilisers. Hence, in a recession, as households' incomes decrease, more citizens become recipients of transfers, with this budget instrument injecting additional resources into the economy, which significantly underpin consumption and, in turn, domestic demand.

Similar conclusions were drawn by Voinea and Mihăescu (2009), who show that, in Romania, the single tax rate has caused income inequality to increase and what needs to be done is to shift to progressive taxation.

4. Quantifying the action of the redistribution function

With a view to carrying out this function, the government has two main categories of tools, as mentioned above, consisting of: (i) taxes and duties included in tax revenues and (ii) transfers and subsidies included in public spending.

A. The first indicator used for quantifying the redistribution function is the volume and breakdown of taxes and fees applicable in the economy. First, redistribution is achieved through the taxation system that ensures both the procurement of the resources needed by the government to provide public goods and services and the reconfiguration of citizens' purchasing power (Hyman, 2010).

Direct taxes, chiefly those applied to individual income and wealth, have the capability to reduce inequality and, thus, are an appropriate tool for redistribution (Urbánek, 2019; Essama-Nssah, 2008). Conversely, indirect taxes have a negative effect on redistribution and accentuate inequality (Prasad, 2008; Decoster *et al*., 2010), given that citizens on low incomes spend a higher proportion of them on goods and services than wealthy social groups, so that the share of indirect taxation in the expenditures of the poor is much wider (narrowing gradually, as income increases) as compared to high-income earners. In countries where tax systems rely mainly on VAT or other indirect taxes, the positive impact of redistribution through direct taxes and transfers is reversed by indirect taxation, especially in the case of families with children and the elderly (this is also the case of Romania, according to Inchauste and Militaru, 2018).

B. Second, redistribution is made by the government through social transfers and subsidies, which have a strong positive effect in carrying out this function of public finance. According to the European System of Accounts (ESA2010), social transfers comprise both: (i) cash transfers, including pensions, benefits for unforeseen events such as unemployment, sickness, disability, social housing, allowances for persons having no income, children, etc., and (ii) transfers in kind, *i.e.* public goods and services granted to citizens by the government, free of charge or at subsidised prices, such as public health services, education, etc. A similar nature has the tax exemptions set by law, as well as the deductions applicable under the progressive tax on personal income, which are, in fact, receipts that the government relinquishes and makes them available to natural or legal entities in a form similar to transfers. Thus, for reasons of fairness, with favourable economic effects in the advanced economies, under the progressive taxation, various tax deductions are granted to individuals for: children/other dependants; participation in private pension and healthcare schemes; purchase of dwellings; stimulation of charities, etc. (Hyman, 2010).

Adding to the amount of transfers is that of subsidies, *i.e.* the current payments made by the government to domestic producers with the aim of favourably influencing the level of production or prices of public services benefitting consumers (*e.g.* public transportation, heat distributed to households through centralised systems, vouchers for visiting cultural institutions, etc.).

C. In turn, public spending in the area of education and healthcare, which adds value to citizens relative to the primary income distribution, has a favourable impact on the medium- and long-term income distribution in the society. Access to these public services improves the quantity and quality of human capital, which supports both economic growth and, by increasing equal opportunities among citizens, the reduction of social disparities. It should be pointed out that, relative to transfers in kind for healthcare, education, etc., reflecting the specific cost of each service provided to citizens, the total public expenditures on health protection, education, etc. comprise the total budget allocations for these areas (including those for the functioning of specific institutions, *i.e*. staff costs, various running costs as well as adequate capital expenditure), reflecting the relevance that the society attaches to these public services.

D. Generally, in the literature, the summarised assessment of the redistribution function is performed through indicators reflecting the degree of inequality. Thus, the intensity of redistribution is quantified by: (i) the Lorenz curve associated with pre-tax and post-tax income; transfers included. This curve depicts the categories of citizens ranked by income and their share in total earnings in the society. The information provided by the Lorenz curve

is summarised by the Gini index[3] measuring income inequality (Causa and Hermansen, 2018; Rost, 2018). (ii) analysis of distribution of pre-tax and post-tax income, including transfers, by type of taxpayers (*e.g.* by income deciles, according to Essama-Nssah, 2008).

It is worth mentioning that in the societies where the shadow economy and tax evasion are wide-ranging, the government has significantly fewer instruments it can use to perform the redistribution function of public finance. Moreover, it should be pointed out that in the developing countries, the efficiency of using personal income tax levers in carrying out the redistribution function is limited by the large scale of the informal economy. Therefore, those countries' tax revenues are based more extensively on indirect taxes and duties, which, as showed above, are regressive in nature (Prasad, 2008).

5. Redistribution function in Romania. Comparative analysis with other European countries

The overall importance attached by the government to the public sector, which provides public goods and services, is assessed via budget revenues and expenditures as a percentage of GDP (Eurostat, 2019). In Romania, total revenues made up 32.3% of GDP in 2018 and expenditures accounted for 35.2% of GDP. By comparison, the public sector in the European Union is of significantly higher importance, as reflected by the much larger share in GDP of both tax revenues (45.1%, up by 12.8 percentage points against Romania) and public spending (45.8% of GDP, up by 10.6 percentage points).

We find that, while undertaking the setting-up and functioning of a minimal state, with reduced tasks within the economy and society, Romania is characterised by a redistribution function of public finance that is significantly lower in both scale and efficiency than in the advanced economies that have a sound and effective system of public institutions focused on fulfilling citizens' needs.

Below, we present the key indicators for quantifying the redistribution function.

A) Tax revenues, including social contributions, hold a very low share of GDP in Romania as compared to other countries in Europe. They accounted for only 27.1% of GDP in 2018, down by 13 percentage points as compared to the EU average of 40.1% of GDP. Romania has a lower share of tax revenues in GDP also than advanced economies such as France 48.2% (-21.1 percentage points), Belgium 46.4% (-19.3 percentage points), Denmark 45.2% (-18.1 percentage points), as well as former centrally-planned countries in the region: Croatia 38.5% (-11.4 percentage points), Slovenia 37.7% (-10.6 percentage points), Hungary 37.4% (-10.3 percentage points), Czechia 36% (-8.9 percentage points), Poland 35.9% (-8.8 percentage points), etc.

Moreover, the breakdown shows that in Romania the share of indirect taxes in tax revenues is above the EU-wide average. Thus, receipts from such taxes make up 39.1% of total (5.7 percentage points above the EU average of 33.4%). As far as the realisation of the redistribution function is concerned, this situation is of a negative kind, since indirect taxes, as showed above, counteract the positive effects of tax fairness arising from the application of direct taxes, helping decrease inequality, as indirect taxation is virtually regressive.

[3] *Ratio of (i) the area between the Lorenz curve for a given income distribution and the 45-degree line (signalling income equality) to (ii) the total area below the 45-degree line.*

Furthermore, the breakdown of direct taxes (net of social contributions) differs significantly in Romania from that of its peers in the EU. Thus, the share of receipts from the taxation of personal income accounts, under the single rate regime, is only 49% of total direct tax revenues, down by 23 percentage points against 72% in the EU (where progressive taxation prevails). It is, thus, significantly lower than in Denmark 86% (-37 percentage points), Italy 82% (-33 percentage points), Sweden and Latvia 81% (-32 percentage points), Hungary 78% (-29 percentage points), Germany 73% (-24 percentage points), France 72% (-23 percentage points), Slovenia and Poland 68% (-19 percentage points), the Netherlands 64% (-15 percentage points).

Hence, given the poor budget revenues, the ability to finance public goods and services is substantially lower in Romania than in other European countries. It follows that Romania, in order to ensure a sound basis for providing these social benefits at an appropriate quantitative and qualitative level, should make an in-depth review of the tax system, without affecting the corporate sector, and focus on progressive taxation of the individuals' income and wealth, which is badly needed following the major structural shifts in households' income and wealth distribution over the past 30 years. We believe that by taxing the total income and implementing progressive taxation the income tax base will grow substantially, thereby boosting tax revenues, which allows for the simultaneous application of an effective system of tax deductions relative to each individual, consistent with the practice validated in the Western countries. Such a measure should not affect household or corporate income on the whole, but by increasing the tax base as a result of centralisation of information on income and wealth at an individual level and by introducing higher taxation of wealthy citizens, additional budgetary resources are obtained. They will allow a quantitative and qualitative increase in public goods and services provided to the population and ensure a fair relationship between citizens in terms of bearing the tax burden relative to the contributive power, having a positive influence on both the budget and economic growth. Special mention deserves the fact that the European Commission (2020) showed that Romania counted among the EU Member States with the lowest level of progressive taxation of labour income in 2018.

Worth pointing out is that, given the low tax revenues in Romania, wage and pension expenditure, a category of objective allowances required for the normal operation of the society, made up to 72% of these revenues in 2018, *i.e.* the highest level in the EU (+19 percentage points versus the EU average of 53%). This is significantly above the values recorded in advanced economies such as the Netherlands 38% (+34 percentage points in Romania), Luxembourg 45% (+27 percentage points), Germany 46% (+27 percentage points), Ireland 47% (+25 percentage points) and above those seen across the region: Hungary 48% (+24 percentage points), Czechia 49% (+23 percentage points), Slovakia 52% (+20 percentage points), etc. In the authors' opinion, this unfavourable situation in Romania owes not to the fact that public-sector wages or pensions are excessively high, but to the extremely low amount of tax revenues, while in the other aforementioned countries, thanks to the balanced and comprehensive taxation system and to the tax administration offices performing efficient tax collection, the fiscal situation is tension-free and sustainable.

The improvement in Romania's tax system should be carried out given that the population's demand for public goods and services does not depend on the government's fiscal capacity. Citizens need a reasonable level of these benefits, regardless of the authorities' ability to set and collect taxes efficiently, as countries with poor fiscal capacity face major difficulties in meeting these social demands at appropriate parameters. Moreover, the examination of the

potential to provide public goods and services to citizens, quantified by the level of public expenditure per capita, shows that Romania ranks second to last (ahead of Bulgaria) in the EU by the volume of budget allocations (in purchasing power standards – PPS[4]) per capita. Thus, in 2018, Romanians benefited from such expenditure in amount of merely 7,100 PPS/capita (half the EU average of 14,200 PPS/capita), well below the levels in: Slovenia 11,700 (+39% as compared to Romania), Czechia 11,400 (+38%), Hungary 10,200 (+30%), Estonia 9,900 (+28%), Slovakia 9,500 (+25%), etc.

B) Social transfers are, in turn, an important fiscal lever of the government in carrying out the redistribution function, and are also undersized in Romania as compared to other EU Member States. Thus, in our country, they account for only 11.7 % of GDP, 8.7 percentage points below the EU average of 20.4%, with Romania ranking third from last in Europe. This type of expenditure takes 25.5% of GDP in France (+13.8 percentage points as compared to Romania), 24.6% of GDP in Belgium (+12.9 percentage points), 24.1% of GDP in Germany (+12.4 percentage points), whereas in former centrally-planned countries the level of transfers is also much higher than in Romania: 18.2% of GDP in Slovakia (+6.5 percentage points), 17.6% of GDP in Slovenia (+5.9 percentage points), 16.7% of GDP in Poland (+5 percentage points), 15.6% of GDP in Croatia (+3.9 percentage points), etc.

By taking pensions out of total transfers (reflecting entitlements granted on a contribution basis), accounting for 8.6% of GDP in 2018, social transfers in Romania amount to only 3.1% of GDP, which places Romania last in Europe, more than 3 times lower than the EU average of 10.8% of GDP (+7.7 percentage points). By comparison, this indicator runs at a much higher levels both in the advanced economies: Belgium 15.7% (+12.6 percentage points), Germany 14.8% (+11.7 percentage points), the Netherlands 14.3% (+12.2 percentage points) and other countries in the region: Slovakia 10.8% (+7.7 percentage points), Czechia 8% (+4.9 p.p.), Slovenia and Poland 7.8% (+4.7 percentage points), Lithuania 7.7% (+4.6 percentage points), etc.

Not only hold social transfers a small amount in Romania vis-à-vis the European countries, but, in the absence of their adequate targeting due to scarce information on citizens' incomes, by applying the single tax rate, these transfers have little efficiency in protecting the population from the risk of poverty. Thus, in 2018, the positive impact of social transfers on reducing the rate of citizens at risk of poverty in Romania recorded the lowest level in the EU, *i.e.* 16% (representing the percentage reduction in the risk of poverty as a result of transfers), which is less than half of the EU average of 33%. Therefore, if 28% of Romanians were at risk of poverty before applying the redistribution function through transfers, after receiving this type of social protection, roughly 84% of these citizens remain in the same situation (poverty rate decreased meagrely, from 28% to 23.5%). By comparison, in the EU as a whole, before receiving transfers 25.6% of the citizens faced the risk of poverty, but only 67% of them remain at risk after receiving them (the poverty rate falls from 25.6% to 16.8%). Against this background, Romania reports the highest risk of poverty (23.5%) across the EU, the country being followed by the Baltic States and Bulgaria in this ranking of insufficient and inefficient social protection.

Moreover, the analysis by income deciles of the cumulative impact of taxes and transfers shows that, in Romania, redistribution is barely efficient: the net difference between the

[4] *PPS (purchasing power standard) is a unit of measurement that eliminates price differences between different countries generated by the exchange rate fluctuations (Eurostat, Glossary. Statistics Explained).*

volume of transfers received by a given group of citizens and the taxes paid by that social category is, inadequately, on the increase for the population in the first 3 deciles of income distribution (the poorest 30% of citizens), as follows: citizens with the lowest 10% income receive fewer net transfers from the government (26% of their total income in 2018) than those in the second and third deciles of income (28% and 29%, respectively). By comparison, the slope of net transfers in the OECD countries tends downwards, as they are, naturally, an important income source for the needy, as follows: the poorest 10% of citizens receive 30% of their disposable income as net transfers, with the next two deciles receiving less in this form, 20% and 10% of disposable income, respectively (Causa and Hermansen, 2018).

Against this background, the gap between the earnings of the richest 20% of citizens and those of the poorest 20% declines in Romania following the application of taxes and transfers by only 38% (from 11.7 to 7.2 in 2018), below the EU average of 47% and lower than in other countries in the region such as: Hungary (-51%), Slovenia (-48%) and Croatia (-42%) or in the EU's advanced economies such as Ireland (-78%), Finland (-64%), Denmark (-63%), Belgium (-61%), etc. In this context, the ratio of the richest 20% of citizens to the poorest 20% remains in Romania at the second highest level in the EU (after Bulgaria), namely 7.2, as compared to the EU average of 5.2. As regards this indicator, Romania's level is nearly twice as high that recorded in advanced economies such as Finland (3.7), Belgium (3.8), Austria (4), or Slovakia (3), Czechia (3.3) and Slovenia (3.4).

The weak performance of the redistribution policy through taxation and social transfers is attributed in Romania to the fact that the current fiscal system generates a strong economic and social distortion as (i) groups of lowest-income citizens do not receive adequate government support in the form of social transfers and, at the same time, (ii) individuals earning the highest income do not pay enough taxes and duties as compared to their financial capacity. The low share of tax revenues in GDP, as well as the reduced benefits of social transfers received by the households with the most fragile financial standing are also the effects of the elevated share of the informal sector in Romania's GDP. In 2019, this indicator ran at a much higher level than in other EU Member States: 26.9% of GDP against the EU average of only 17.3%[5] (Schneider, 2019).

It should be underscored that, similarly to social transfers, the volume of subsidies is also undersized in Romania as compared to other EU Member States: merely 0.4% of GDP in 2018, 3.5 times lower than the EU average of 1.4% (-1 percentage point) and substantially lower than in: Belgium 3.7% of GDP (-3.3 percentage points), France 2.6% of GDP (-2.2 percentage points), Germany 0.9% of GDP (-0.5 percentage points), or Bulgaria and Czechia 2.2% of GDP (-1.8 percentage points), Hungary 1.7% of GDP (-1.3 percentage points), etc.

C) High inequality among Romanian citizens is also caused by insufficient funds channelled by the government into the two key budgetary sectors with a social nature, *i.e.* healthcare and education. This can contribute, over time, to the redistribution of purchasing power among citizens by raising the quantity and quality of human capital (Jittungsakul, 2014), thereby reducing inequity and increasing equality of opportunity.

The volume of these fiscal expenditures in Romania is markedly lower than that of all the EU Member States. Thus, a mere 4.7% of GDP is allocated to healthcare in Romania, as compared to the EU average of 7.1% (-2.4 percentage points), which ranks the country

[5] *Data for 2017.*

second-to-last in the EU, whereas budgetary funds for education account for only 3.2% of GDP (-1.5 percentage points against the EU average of 4.7% of GDP), with Romania ranking last in the EU.

D) As a result of calculating the Gini coefficient of inequality for citizens' incomes, both pre- and post-taxation and having allocated social transfers, it is confirmed that the redistribution function of public finances is barely efficient in Romania. Thus, the Gini coefficient related to the population's income, after taking into account the impact of taxation and transfers, decreases in Romania by only 32% from its level prior to applying these fiscal instruments (from 51.8 points to 35.1 points in 2017), *i.e.* one of the lowest adjustment levels EU-wide. For instance, the difference between the Gini indicator before and after taxation of personal income and the application of transfers is significantly higher both in advanced economies such as Finland (48%), Belgium (46%), Ireland (45%), France (44%), Austria (43%), Germany (42%), etc. and in former centrally-planned countries such as Slovenia (where the Gini coefficient drops to 45%), Czechia (43%), Hungary (40%), Poland (38%), etc. Against this background of poor efficiency of Romania's taxation and transfers, the Gini coefficient for the country's net income is at one of its highest readings. Thus, with 35.1 points in 2017, Romania ranks fifth at a European level in terms of inequality, after Bulgaria (39.5), Lithuania (37.4), the United Kingdom (35.7) and Latvia (35.5). It must be mentioned that these social disparities are prevailing, as shown by the figures above, in countries that applied or apply the single rate tax system, namely Bulgaria, Lithuania (until 2019), Latvia (until 2018) and Romania. On the other hand, *i.e.* the lowest level of income inequality (especially following an adequate correction by the government via progressive taxation and transfers), there are Slovenia (Gini coefficient of only 24.3 points), Czechia (24.9), Belgium (26.3), Finland (26.6), Austria and Poland (27.5), Sweden (28.2), Germany and Hungary (28.9), etc.

In view of the above-mentioned, one may conclude that the small share of tax revenues and their inadequate structure (especially the ratio of direct to indirect taxes in favour of the latter), low and inefficient social transfers, together with a meagre amount of subsidies confirm Romania's placing in the group of less developed countries, where strong inequalities and a high risk of poverty are manifest, owing to the poorly-functioning redistribution function. This has been referred to as a "Robin Hood paradox", in which redistribution is least present where and when it seems most needed (Lindert, 2004).

6. Concluding remarks

The more intensive resort to the public finance lever at present in Romania is driven by the objective need for the state to improve the efficiency of economic decisions made by companies and households amid the free market functioning. In retrospect, the authors found, based on economic and social developments in Romania, that the use of the three functions of public finance shows the following:

a) the stabilisation function from 2004 (when Romania had already gained NATO membership and talks on EU accession had ended, so the country had two political and strategical anchors that entailed in the years that followed massive foreign capital inflows, foreign direct investment included) to 2019 was out of step with the business cycle most of the time: i. for 7 years (44% of the 16 year-period) it had a procyclical feature, as the positive fiscal impulse was applied at a time of above-potential economic growth (positive gap); ii. in other 5 years (31%) pro-cyclicality was manifest, as the adjustment (negative fiscal impulse) worked amid below-potential economic growth

(negative gap); iii. only in 4 years (2010, 2012, 2016 and 2018), *i.e.* 25% of the entire period, fiscal policy had a countercyclical nature.

The fact that over 75% of the 12 years under review fiscal policy was pro-cyclical, thereby unduly increasing the burden on monetary policy and making it more difficult to achieve the inflation target, testifies to the obsolescence of Romania's current tax system, which prevents policy-makers from meeting the electorate's demands otherwise than by encroaching on the fundamental economic principles specific to the stabilisation function of public finance.

b) as for the allocation function, its high inefficiency is manifest amid the ongoing pressure in the society for ensuring a reasonable level of public-sector wages and pensions. Moreover, the government grapples with covering the state institutions' running expenditures by substantially cutting on the resources intended for efficient public investment projects, also due to non-prioritisation.

c) the redistribution function is poorly activated given: i. the single tax rate; ii. an inequitable ratio of direct to indirect taxes; iii. the social transfers that are low by volume and inefficiently allocated; iv. the marked decapitalisation of firms, financial indiscipline and illegalities in the society; v. employment precariousness (Guga, 2016), as a result of the legislation enacted in the period 2009-2010, which weakened employees' bargaining power relative to the primary distribution of newly-created value, etc.

Against the backdrop of an improper fiscal system, effective January 2005, the functions of public finance in Romania operate entirely out of phase with the society's demands, which dampens economic growth, the efficient use of funds, the quality and quantity of public goods and services earmarked for the citizens, and social cohesion and equilibrium. Given that Romania undertook the setting-up and functioning of a minimal state, with reduced tasks within the economy and society, the country is characterised by a redistribution function of public finance that is significantly lower in both scale and efficiency than in the advanced economies that have a sound and effective system of public institutions focused on fulfilling citizens' needs.

Beginning from the conclusion drawn by Piketty (2019), according to which "Inequality is neither economic nor technological; it is ideological and political", the authors think that, in light of the current economic and social conditions in Romania and the findings of this paper, in order to ensure the necessary framework for the country's sustainable development, what we need is not less, but more redistribution. Against this backdrop, it is worth emphasising that redistribution has not only an important economic and financial content, but also a strong cultural, educational and political feature. While the whims of history caused, over the centuries, tax avoidance to the Dominating Powers in Romania's historical provinces or during dictatorships to stand out as a key factor of shielding and preserving personal wealth (Nicoară, 2006), once democracy and the warranting of individual freedom and private property were in place, citizens had to realise their obligations to adjust to the requirements of the new political regime in terms of tax compliance. As the experience of advanced economies shows, the ideological debate in the fiscal area does not concern the option between the single tax rate and the progressive tax rate on individuals' income and wealth, but the parties, depending on the political doctrine. They let voters choose between the type of income tax that imposes lower taxes on low-income earners, levying, in compensation, for the economic and social balance, higher taxes on the wealthy (leftist vision) and the right-wing approach to lower-end taxation of the individuals on high income and wealth levels, stating that they will create new jobs and activate the trickle-down process, with a positive impact on earnings and the standard of living for medium- and low-income earners.

Hence, in Romania it is necessary to establish, through a consistent sociological study, the degree of individualism that characterises the Romanian society. If this level is high, which is not shown by the analyses conducted so far, it is incumbent on citizens to assume, besides low taxes, a small volume of public goods and services. Conversely, if the study reveals that Romanians have as priority values the community spirit and solidarity, the government is compelled to amend the legislation in order to adequately correlate the tax burden with the individual's contributive power and ensure, at the same time, a much broader range of public goods and services in terms of quantity and quality.

The currently tense situation of public finance reflects the strong distributional conflict in Romania (Piketty, 2019) as regards: (i) the options for achieving a sustainable budget balance and (ii) the improvement of the distribution of newly-created value, which, while not identifying adequate solutions for dialogue and negotiations between social groups, also via much heavier resort to the redistribution function of public finance, leads to the suboptimal alternative of achieving economic equilibrium through high inflation rates and local currency depreciation, implying the steady reduction in the country's foreign exchange reserve if the authorities preserve an artificial exchange rate relative to economic facts.

At the same time, it can be asserted that, similarly to other areas, the fiscal sector in Romania also exhibits an impossible trinity consisting of: (i) a rise in the citizens' purchasing power, together with the development of physical and human infrastructure; (ii) maintenance of the consolidated general government deficit within the 3%-of-GDP threshold, while respecting the structural deficit threshold; (iii) non-utilisation of fiscal policy as a lever for redistribution based on economically stimulative and socially fair criteria, amid weak distribution of newly-created value in the society. For the economic and social policies to run efficiently, one of the above-mentioned objectives should, in the authors' opinion, be relinquished, as Romania needs to intensely activate the redistribution function of public finance that is substantially underutilised.

The impaired functioning of Romania's economy calls for the invisible hand of the market to be thoroughly balanced by the government's visible hand in a bid to correct all imbalances and abuses deriving from the free market functioning.

With a view to ensuring a solid basis for the provision of public goods and services to citizens in adequate quantitative and qualitative terms, Romania should substantially revise its current taxation system, not affecting the corporate sector, with a focus on progressive taxation of global income and property of individuals. This is an objectively necessary step, given the major structural shifts in households' income and wealth distribution over the past 30 years. The amendments to the economic and financial legislation require a change in the attractiveness factors of investors in general, foreign investors in particular, towards Romania, shifting away from the philosophy of offering cheap workforce amid fiscal dumping to the approach of raising attractiveness with adequate physical infrastructure, together with a more skilled labour force in proper health conditions, by prioritising tax allowances for education and healthcare.

At the same time, the Romanian authorities' choice for adequate macroeconomic policies and fast-track structural reforms is the best option, because loose policies lead to frequent resort to the "safety valve" of the exchange rate; currency depreciation helps adjust, in order to secure the equilibria, the excess demand caused by inadequate policies, entailing, however, moral hazard among decision-makers. It should be stressed that, while the fiscal excesses and the lack of structural reforms generally benefit small groups of interests, the adjustment cost by depreciating the domestic currency to correct the external deficit and by

raising the interest rate so as to stifle inflation are borne chiefly by the vast majority of low-income earners, which fuels polarisation and causes strong social tensions.

Using the single tax rate, for example, in Bulgaria and Estonia, was possible because these countries had run or still run a strong anchor of financial stability, namely a tool for achieving economic policy discipline, *i.e.* the currency board (in Estonia, until joining the euro area in 2011 membership of this select club was an even stronger disciplinary factor; in Bulgaria, until nowadays, when the country is to enter the Exchange Rate Mechanism – ERM II, the antechamber to the euro, playing the same part of ensuring rigorous and fair economic policies). On the other hand, Hungary can afford to apply the single tax rate thanks to a more efficient post-communist transition, as the country enjoys balanced budgetary and foreign exchange positions, along with the functioning of a quasi-rigid system for designing and implementing economic policies.

Yet, in Romania, a much larger country than the aforesaid ones, with a significantly greater need for public goods and services, applying the single tax rate under a managed float regime is not backed by a solid tool for disciplining economic policies. As mentioned above, those who pay for the policies' slippages are the low- and medium-income earners, since the local currency depreciation and, ultimately, higher inflation rates erode their purchasing power. Thus, given the implementation of unfair, pro-cyclical economic policies (both from 2005 to 2008 and from 2016 to 2019), based mainly on the single tax rate, the one-third decapitalisation of the corporate sector as compared to the legal level, a loose trade and tax legislation, etc., Romania is the only country in the EU, together with Malta, which, in the aftermath of the 2008 crisis, has twice been subject to the excessive deficit procedure (2009 and 2020), which distances the country from the moment of euro adoption, failing to bring it closer, as it should.

A society based on private property, without sufficiently strong fiscal and social security measures, risks an inequality drift, which may prove lethal in the long term (Piketty, 2019). Piketty writes that financial opacity, which allows the mushrooming of tax havens as well, concerns all countries, especially the least developed ones. The absence of taxation of personal income and the fraudulent privatisation of state ownership gave rise to oligarchs and kleptocrats in the former communist countries, a fact found to a greater or a lesser extent in all these countries, Romania included. The author, therefore, points out that currently there is a general form of post-communist disillusionment as regards the great social and economic inequalities and the weak redistribution; this is because, in these countries, the transition to a market economy brought about frustration and misunderstandings, which, subsequent to the EU accession, have deepened, making Eastern Europe a genuine laboratory of post-communist disillusionment.

In a nutshell, we consider that, in Romania, the progress made in terms of raising transparency of public expenditure should be backed by a substantial improvement in the transparency of personal income and wealth. Balancing both sides of transparency at the level of the government budget ensures a society-wide improvement in the symmetry between individual freedoms and responsibilities, which is currently detrimental to accountability in Romania. Aside from the economic and social benefits of using the tools for progressive taxation of personal income and wealth, we think they will have a major positive impact on the appeasement of the social climate by increasing confidence among citizens – a consistent bond for cohesion and social peace.

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